

Russian Federation: Financial System Stability Assessment

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Russian Federation

Financial System Stability Assessment

Prepared by the Monetary and Capital Markets Department

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August 18, 2011

This report summarizes the findings of the Stability Module under the Financial Sector Assessment Program (FSAP) for Russia. Pursuant to the September 20, 2010 Board decision (SM/10/235, Suppl. 3), this stability assessment is part of Russia's obligations under Article IV. The mission visited Moscow during March 30–April 12, 2011, and comprised Dimitri Demekas (head), Marc Dobler, Fabiana Melo, Hiroko Oura, Vassili Prokopenko, Robert Rennhack, Rodolfo Wehrhahn (all MCM), Dawn Chew (LEG), David Hofman (EUR), and Andrea Corcoran and José Tuyá (consultants). The team was assisted by Odd Per Brekk, Senior Resident Representative in Moscow. John Pollner (World Bank) participated in some of the meetings.

- A decisive and broad-based policy response enabled the Russian authorities to maintain financial stability in the face of a major global shock and despite a sharp contraction in domestic output. Financial soundness indicators began to recover last year and crisis-related support measures were discontinued. Stress tests suggest that banks are resilient to a variety of sizeable shocks, although reported data may overestimate loan quality while the level of provisions, though rising, is still low.
- The crisis has set back progress toward a more competitive banking system, as concentration has risen and moral hazard increased. The system continues to suffer from weak governance, including sometimes non-transparent ownership structures and deficiencies in reporting.
- Despite progress achieved in recent years, the regulatory and supervisory framework still has gaps and weaknesses. Compliance with the Basel Core Principles has improved only marginally since the assessment in 2007. The recent unification of the supervision of nonbank financial institutions is an opportunity for strengthened oversight.
- The authorities have solid experience with bank resolution and an effective deposit insurance scheme. A more structured corrective action regime and a unified administration regime for all banks, with broad powers for the administrator, would help strengthen the system further.

The main author of this report is Vassili Prokopenko, with contributions from the team members.

FSAP assessments are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAP assessments do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

Contents	Page
Glossary	4
Executive Summary	5
I. Experience with the Recent Crisis and Current Risk Assessment	8
II. Strengths and Vulnerabilities: Institutions and Markets.....	10
A. Banks	10
B. Non-Banking Sectors.....	24
III. Strengths and Vulnerabilities: The Policy Framework	24
A. Regulation and Supervision.....	24
B. Macroprudential Policy	29
C. Crisis Management and Resolution	30
 Appendices	
I. 2008 FSAP Main Recommendations: Status of Implementation	35
II. Russia: Risk Assessment Matrix	36
III. Russia: Structure of the Financial System.....	38
IV. Summary of Stress Testing Framework.....	41
V. Summary of Factual Update of Compliance with Code on MPT	43
VI. Basel Core Principles—Summary Assessment.....	45
VII. IOSCO Core Principles—Summary Assessment	54
 Tables	
1. Russia: Key FSAP Recommendations	7
2. Russia: Financial Soundness and Balance Sheet Indicators of the Banking System	15
3. Russia: Financial Soundness Indicators of Banks by Groups, end-2010	16
4. Russia: Summary of Stress Test Results	19
5. Summary of Bottom-Up Stress Test Results.....	22
6. Russia: Financial System Structure, 2007–10	40
7. Summary of Compliance with the Basel Core Principles	51
8. Recommended Action Plan to Improve Compliance of the Basel Core	52
9. Russia: Summary Implementation of the IOSCO Principles	60
10. Recommended Action Plan to Improve Implementation of the IOSCO Principles	69
 Figures	
1. Russia: Comparative Indicators of Banking System Soundness.....	17
2. Russia: Share of Restructured Loans to Large Loans ¹	18
3. Mandatory and Actual Provisions, End-2010	18
4. Russia: Summary of Stress Test Results	20
5. Summary of Bottom-Up Stress Test Results.....	23

Boxes

1. The Recent Financial Crisis and the Monetary and Financial Policy Response	9
2. The failures of Mezhprombank and Bank of Moscow	11
3. The Exercise of Supervisory Discretion.....	25

GLOSSARY

AM	Law on Additional Measures to Strengthen the Stability of the Banking System through December 31, 2011
BCP	Basel Core Principles
BL	Banking Law
CAR	Capital adequacy ratio
CBR	Central Bank of Russia
CCP	Central Counterparty
DI	Deposit insurance
DIA	Deposit Insurance Agency
DTI	Debt to income ratio
ELA	Emergency liquidity assistance
IAIS	International Association of Insurance Supervisors
ICAAP	Internal capital adequacy assessment process
IFRS	International financial reporting standards
IL	Insurance law
IOSCO	International Organization of Securities Commissions
FSFM	Federal Service for Financial Markets
FSAP	Financial Sector Assessment Program
FSIS	Federal Service of Insurance Supervision
LTI	Loan to income ratio
LTV	Loan to value ratio
MICEX	Moscow Interbank Currency Exchange
MoU	Memorandum of understanding
MTPL	Motor third-party liability
MoF	Ministry of Finance
NPL	Non-performing loan
OBA	Open bank assistance
P&A	Purchase and assumption
RRP	Recovery and resolution plan
RTGS	Real time gross settlement system
RTS	Russian Trading System
SIFIs	Systemically important financial institutions
SRO	Self-regulatory organization

EXECUTIVE SUMMARY

The Russian authorities maintained financial stability at home in the face of a major global shock. The economy is now recovering, the performance of financial institutions has begun to improve, and the emergency anti-crisis measures have been unwound. The success in maintaining financial stability in the face of this major systemic threat reflected the decisive and broad-based policy response by the government, the CBR, and the DIA, which cooperated extensively during the crisis.

However, the financial system is still fragile. Economic activity is projected to grow at a modest pace in the coming years and, given the structure of the Russian economy, the financial system will continue to be exposed to significant risks from fluctuations in international commodity prices and capital flows. In addition, the reported data overestimate loan quality and the level of provisions for nonperforming loans, though rising, is still too low. For this reason, although financial soundness indicators are strong and stress tests suggest that the sector can withstand sizeable macroeconomic and financial shocks without extra help by the government or the CBR, increased vigilance is required.

The crisis, combined with certain long-standing governance weaknesses, has set back progress toward a strong, competitive financial system for the future. Post-crisis consolidation has reduced competition by strengthening mainly large, state-owned banks. Moral hazard has increased as a result of the emergency measures to maintain stability, which inevitably benefited systemically important institutions. In addition, the system continues to suffer from weak governance, including sometimes non-transparent ownership structures, deficiencies in financial reporting, and endemic perceptions of corruption in the Russian economy. These weaknesses were highlighted by the recent failure of the Bank of Moscow. The success of the authorities' medium-term strategy for the development of the banking system requires tackling these challenges.

Despite progress in recent years, the regulatory and supervisory framework for banking has gaps and weaknesses. Key among these is the lack of authority for the CBR to supervise bank holding companies and broadly-defined related parties; issue binding guidance on risk management by banks; use professional judgment in applying laws and regulations to individual banks; and share without restrictions information with other supervisors. Most of these shortcomings would be addressed by pending legislation at the State Duma; but until this is implemented, Russia will continue to score poorly in compliance with accepted international standards on banking supervision.

The supervision of non-bank financial institutions was recently overhauled. The recent move of insurance supervision to the FSFM can generate significant benefits. Although the decision to unify insurance and securities supervision appears to have been taken without adequate preparation, creating a temporary vacuum in oversight in the insurance sector, the new framework seems broadly appropriate. The authorities need to ensure that it is

implemented in a way that provides the FSFM with the adequate powers and resources and ensures its independence and accountability.

Recent steps to strengthen macroprudential policy oversight are welcome. The establishment of an inter-agency working group under the Presidential Council and the creation of a special department at the CBR in charge of macroprudential analysis are important elements in developing mechanisms for systemic risk monitoring and management. Given the dominant position of banking in the domestic financial sector, the CBR will inevitably have the lion's share of the responsibility for assessing systemic risk and developing tools to mitigate it. At the same time, close cooperation and information-exchange between all supervisory agencies, the government, and the DIA is crucial. In this context, the DIA should be a member of the inter-agency working group.

The CBR achieved substantial progress in enhancing transparency of monetary policy, but the effectiveness of monetary operations can be improved in certain areas. The CBR complies now with all criteria under the Code of Monetary and Financial Policy Transparency. However, more can be done to provide clearer signals of the direction of monetary policy. To improve the effectiveness of monetary policy and the management of liquidity in the banking system, the functioning of the interbank market should be improved by requiring repo transactions to take place using central counterparty clearing and setting limits in the concentration of collateral. The CBR's emergency liquidity assistance proved effective during the crisis, but the framework could be strengthened further by requiring the government to guarantee any CBR refinancing backed by non-marketable assets.

Some elements of the crisis prevention and resolution framework also need strengthening. The framework for deposit insurance is well-structured and effective, as attested by the experience during the crisis. The framework for bank resolution, on the other hand, needs to be unified into a single regime for all banks, with broad authority for the administrator to assume all powers of decision-making bodies of the bank; override the preemptive rights of existing shareholders; write down capital; restructure debt; undertake purchase & assumption; and arrange mergers. "Open bank assistance" tools, however, such as loans to investors, recapitalization using public funds, or nationalization should be reserved only for situations of systemic crisis and be deployed after a decision by the government. There should also be prompt and early communication of information between the CBR and the DIA on problem banks.

The key recommendations of the mission are prioritized in Table 1, and the status of implementation of the recommendations of the previous FSAP is shown in Appendix I.

Table 1. Russia: Key FSAP Recommendations

Recommendations	Paragraph reference
Short term (implementation within 12 months)	
Empower the CBR to use professional judgment in interpreting laws and regulations, issuing enforceable risk management guidance, and applying it to individual banks.	21
Approve pending amendments to expand CBR supervisory authority over bank holding companies and related parties, and eliminate restrictions on information-sharing with other domestic and foreign supervisors.	21, 22
Allow the CBR to sanction individual directors and key managers, raise capital requirements on individual institutions, and impose restrictions on transactions between affiliates.	21
Ensure the unified securities and insurance supervisor (FSFM) has the power to issue secondary regulation to interpret the law, as well as industry-wide binding norms.	26
Empower the FSFM to require insurers to have in place internal controls and risk management systems commensurate with for the complexity of their business.	28
Apply fit and proper requirements to directors and key management of insurers on an ongoing basis.	28
Make home-host notifications and cross-border cooperation in insurance mandatory for the FSFM.	28
Adopt pending legislation that empowers the FSFM to appoint a provisional administrator, freeze assets, and wind down distressed securities firms.	32
Medium term (implementation in one to three years)	
Pursue efforts to ensure an effective macroprudential policy oversight	34
Require government guarantee for all CBR loans that are unsecured or not backed by marketable collateral or guarantees.	40
Require repo transactions to take place using central counterparty clearing.	40
Set limits on concentration of collateral in the repo market.	40
Adopt a prompt remedial action framework for banks.	41
Introduce a unified administration regime for all banks (systemic or otherwise) with broad powers for the administrator, including P&A.	43
Open-bank assistance such as loans, capital injections, nationalization by the DIA should be restricted to systemic situations.	43

I. EXPERIENCE WITH THE RECENT CRISIS AND CURRENT RISK ASSESSMENT

1. **The Russian economy suffered from a severe crisis in late 2008 to early 2009.**

Following a decade of unprecedented boom, real GDP contracted sharply by 7¾ percent in 2009, reflecting plummeting world oil prices and a sudden surge in global risk aversion. The magnitude of recession was one of the deepest in the world, highlighting the dependence of the Russian economy on the performance of its energy sector and its exposure to volatile capital flows.

2. **The authorities responded with a massive discretionary policy stimulus.** Fiscal policy was substantially relaxed, with the increase in the non-oil budget deficit by 9 percentage points of GDP in 2009 (one of the largest stimuli among the G-20). Monetary and prudential policies were also significantly relaxed in the face of increased capital outflows and growing problems with credit servicing (Box 1). The provision of large scale liquidity assistance and the use of reserves to delay ruble depreciation were the cornerstones of the authorities' crisis response. In addition, the deposit insurance framework was strengthened, and some banks were recapitalized using public funds.

3. **These policy measures helped restore macroeconomic growth and ensured systemic financial stability.** The Russian economy began to recover from mid-2009. Real GDP increased by 4 percent in 2010, and is expected to reach 4.8 percent in 2011 and 4.5 percent in 2012. Higher-than-projected oil prices could result in an even more favorable growth outcome in the short-term, although longer-term prospects remain clouded by abiding structural problems in the Russian economy. Although many small- and medium-sized banks were taken into receivership or restructured, the banking system as a whole was able to weather the crisis relatively well. The turbulence in financial markets was also quickly abated as the sharp increase in interest rates was reversed, and the volatility on the foreign currency market was reduced.

4. **The crisis-related support to banks has since been gradually withdrawn.**

Improved liquidity conditions enabled banks to use excess funds to repay uncollateralized CBR refinancing ahead of schedule, and such refinancing was terminated by end-2010. Sberbank made an early repayment of Rub 200 billion (out of Rub 500 billion) in subordinated credits it had received during the crisis. The lax loan classification rules were terminated for new loans in mid-2010. And the CBR guarantees on interbank lending were unwound by end-2010.

Box 1. The Recent Financial Crisis and the Monetary and Financial Policy Response

The initial policy response to the crisis focused on maintaining the stability of the ruble while providing large-scale liquidity support to financial institutions. The CBR used its sizable reserves to support a gradual and predictable depreciation, allowing the private sector to hedge its foreign exchange exposures and preventing large-scale deposit runs by easing concerns of disorderly ruble depreciation (akin to the one that took place during the 1998 crisis). The CBR also provided emergency liquidity assistance by offering guarantees for interbank lending to qualifying banks; widening the range of acceptable collateral on repurchase and Lombard operations; and extending loans that were unsecured or backed by non-marketable collateral and guarantees. In addition, the government auctioned excess budgetary funds to banks. The sizable liquidity provision—which at its peak, amounted to two-thirds of base money—facilitated a rebalancing of bank obligations away from foreign exchange liabilities.

After this initial phase, and in the face of surging reserve losses, the authorities subsequently allowed a faster depreciation of the ruble. In addition, the CBR started to curtail its liquidity support, allowing interest rates to rise significantly—at their peak, overnight interbank rates reached 28 percent. Pressure on the exchange rate eased almost immediately and reserves stabilized. In the context of a more stable ruble and recovering oil prices, monetary policy was then gradually eased during April 2009-June 2010. The reserve requirement was lowered, and policy interest rates were cut from 13 percent in April 2009 to 7.25 percent in June 2010.

Meanwhile, to strengthen the banking system, the authorities provided capital injections and enhanced deposit insurance. The Russian government shored up capital in several government-owned banks, with capital injections of Rub 505 billion (1.3 percent of GDP). Additional capital was provided to state and private banks from either Vnesheconombank (state development agency) or the CBR in the form of subordinated loans, totaling Rub 904 billion (2.2 percent of GDP). To bolster confidence in the banking system, the deposit insurance limit was raised and the deposit insurance agency was given additional resources and powers to deal with bank failures.

The CBR also used regulatory forbearance, temporarily easing loan classification and provisioning requirements. Under the relaxed loan classification requirements, a corporate (retail) loan was considered overdue only if had been delinquent for 30 days (60 days), up from 5 days (30 days) under the old rules. Provisioning requirements were also relaxed for overdue loans to borrowers whose financial condition was considered as adequate by banks. In addition, restructured loans were allowed to remain in their original classification category. These steps are estimated to have saved banks Rub 300 billion in provisions (7 percent of capital) by mid-2009.

5. **Nevertheless, risks to financial stability remain significant, at least in the near term, as indicated in the staff's Risk Assessment Matrix (Appendix II).**¹ These risks arise in part from the very volatile economic environment in which the Russian financial system operates. The swing in GDP growth from about 5 percent in 2008 to nearly -8 percent in 2009 far exceeded that observed in other major emerging markets, not to mention advanced economies. Of particular concern are risks related to the balance of payments: although oil prices have gone up substantially in the past 10 years, they remain highly volatile. The

¹ Macroeconomic developments and risks are covered in more details in the accompanying staff report for the 2011 Article IV consultation.

Russian banking system is also vulnerable to shocks to capital flows, both directly in terms of access to cross-border interbank funding (although these flows are concentrated among foreign-owned banks vis-à-vis their group entities and the reliance on such funding was reduced in the aftermath of the crisis, see below); and indirectly through increased exchange rate volatility and financial market volatility.

6. **In addition, the crisis and its aftermath brought in sharp relief certain fundamental weaknesses in the Russian financial sector that could also have implications for financial stability.** CBR exceptional refinancing or government support measures was directed mainly to the large systemically, important financial institutions. The crisis also illustrated the vulnerabilities stemming from the insufficient diversification of Russian banks and their reliance on short-term funding. The crisis has also underscored weak corporate governance in many banks and key flaws in the supervisory framework. The recent failures of Mezhprombank and the Bank of Moscow are illustrative in this regard (Box 2).

7. **Risks from cross-border exposures are limited.** Foreign banks account for only 17 percent of the Russian banking system in terms of assets (Appendix III). Russian banks are also not very active abroad, with a noticeable presence only in a few CIS countries, though some large state-owned banks are now discussing the possibility of sharply increasing their penetration in Eastern Europe. As noted above, the external liabilities of Russian banks were substantially reduced in 2009, while the external assets continued to increase. But Russia is a marginal source of funds even within the CIS, though the reported figures might understate the extent of flows going through international financial centers.² Securities investment of Russian banks are mostly in domestic assets (government and corporate), and exposures to distressed European sovereign securities are negligible.

II. STRENGTHS AND VULNERABILITIES: INSTITUTIONS AND MARKETS

A. Banks

8. **Russian banks have fairly plain balance sheet structure (Table 2).** The majority of assets are loans (mostly to industries), followed by plain-vanilla securities (mostly in domestic government and corporate bonds) and interbank lending (of which 60 percent are vis-à-vis non-resident banks). Banks are mainly funded by deposits of non-financial corporations and individuals and from other banks (including non-resident banks). Overall, Russian banks' reliance on external borrowings declined to 13 percents of their book at end-2010 from 20 percent in 2007, and they are mostly long-term. About a half of these borrowings are from non-resident banks, and foreign-owned banks tend to rely more on this funding source. Capital market funding through debentures are very limited.

² See IMF Country Report No 08/308 (<http://www.imf.org/external/pubs/ft/scr/2008/cr08308.pdf>).

Performance

9. **After the severe shock during the crisis, the performance of banks started to recover.** Partly as a result of bank recapitalization (based both on public funding and private capital markets), the aggregate capital adequacy ratio stood at 18.1 percent in December 2010, well above the prudential minimum of 10 percent and higher than in many comparator countries (Table 2, and Figure 1). Bank profitability rebounded in 2010, largely reflecting a reduction in provisioning for loan losses and release of existing provisions, which occurred despite the termination of a temporary relaxation of loan classification rules during the crisis. After climbing to almost 10 percent in 2009, the nonperforming loan ratio fell to 8.2 percent by end-2010. Funding conditions also improved, as household and corporate deposits grew strongly, allowing CBR to discontinue its emergency liquidity support. Bank assets and credits are now growing again, although at a much slower rate than before the crisis.

Box 2. The failures of Mezhprombank and Bank of Moscow

Mezhprombank (MPB) was a relatively large pocket bank. With assets of RUB 175 billion (US\$6 billion), it was among the top 30 Russian banks. The bank did not collect household deposits (it had no license to do so), and its business was concentrated on servicing companies affiliated to it, which centered around two large shipyards. Since early 2009, MPB had been under severe liquidity pressures due to the fall in profits of its clients as the recession hit Russia, and possibly also reflecting fraud or mismanagement. However, the bank continued to enjoy good ratings from several international rating agencies, which enabled it to issue Eurobonds (€200 million was issued in early 2010, in addition to €200 million issued in 2007), as well as get large uncollateralized emergency funding from the CBR (RUB 32 billion). In July 2010, it defaulted on its maturing Eurobonds issued in 2007. In October 2010, the CBR withdrew its license. According to the Russian media, the reported capital of MPB was inflated by a factor of almost two through the use of multiple affiliated special purpose vehicles that were not subject to consolidation.

The Bank of Moscow (BoM) was Russia's fifth-largest bank in early 2011. The BoM was partly owned by the city of Moscow and closely associated with former mayor Luzhkov. Problems began to surface after Mr. Luzhkov's ouster, when the state-owned Vneshtorgbank (VTB) was directed to acquire a controlling stake in BoM. A review of the BoM's credit portfolio by the authorities in June 2011 uncovered problem loans of about one-third of BoM's total assets. The BoM had been able to disguise the true quality of these bad loans by the use of special purpose vehicles often located in offshore jurisdictions, many of which were apparently affiliated with the former managers of the BoM. On July 1, 2011, the Russian authorities announced a one percent of GDP rescue package for the BoM. Under the authorities' rescue plan, the BoM received Rub 100 billion (US\$3.6 billion) in new capital from VTB, as well as a Rub 295 billion (US\$10.6 billion) 10-year loan from the DIA at a below market rate, which is ultimately financed by the CBR.

10. **Performance varies significantly across different bank groups (Table 3).**

- *State-owned banks.* The 20 state-owned banks, with 46 percent of the system's assets, are well capitalized, but the quality of their loans is, on average, weaker than that of

other banks. These banks have relatively cheap and stable household deposits and can quickly access CBR refinancing, which allows them to hold less excess liquidity.

- *Foreign-owned banks.* Foreign banks (108 banks, 19 percent of the system's assets) are also well capitalized but do not typically have a branch network and rely substantially on external funding (particularly from their parent banks). Household loans represent the largest share of their credit portfolios.
- *Large private banks.* These banks have relatively low capitalization and profitability, but also a relatively low share of nonperforming loans.
- *Small private banks.* The aggregate capital and liquidity ratios of around 700 smaller banks are well above the system's average, reflecting the difficulties in accessing interbank market and the absence of big foreign parents. These banks face higher concentration risks on both asset and liability sides and report weaker profitability.

11. The reported data, however, probably overstate the capital strength of the system as a whole, potentially masking pockets of significant vulnerability.

- The true magnitude of non-performing assets is probably higher than reported, due to (i) overvaluation of the foreclosed assets on bank balance sheets, (ii) transfer of distressed assets to affiliated off-balance sheet entities that are not subject to consolidated supervision, and (iii) doubtful quality of restructured loans, which account for around one third of all large loans (Figure 2).³
- There are doubts about the adequacy of loan loss provisions. The provisioning ratios are on the lower end of the required ranges specified in the regulations for all loan classification categories (Figure 3).
- There are also concerns about the collateral valuation. While bank lending to the private sector is typically secured, the quality of collateral varies widely. The costs of seizing the collateral, as well as the ability to sell it in distressed conditions does not seem to be reflected accurately in its valuation.

Stress testing

Methodology and assumptions

12. The stress testing exercise was based on the existing top-down CBR approaches, and also included a separate bottom-up exercise. The top-down single factor tests and macro scenario tests used bank-by-bank supervisory data as of end-2010 and covered all 1,012 operating banks. The bottom-up exercise covered 15 large banks, covering 56 percent of the system assets. The CBR's Supervision Department coordinated the bottom-up tests using the same macroeconomic assumptions as were used in the top-down exercises. The

³ The share of restructured loans among smaller loans is reportedly significantly lower but there data were not available.

macro scenario had a one year horizon. The resilience of the system was assessed in terms of the minimum regulatory capital adequacy ratio (CAR) of 10 percent, though other metrics were also shown as reference (Tier I capital ratio, liquidity ratio, and potential capital injection needs). The exercises covered a wide range of risks, including credit, market, and liquidity risks. Appendix IV provides details of the methodology and assumptions.

13. For macro stress tests, the FSAP team relied on the macro-financial linkage model recently developed under the initiative of the CBR. Key components of the model are the estimation of the NPL ratios for the household and corporate sectors vis-à-vis macroeconomic variables. The analysis of sensitivity of the NPL ratio to one standard deviation shock of each macro factors indicates that oil price is the most important source of risk to Russian corporations. The indirect effect of ruble depreciation through credit quality is estimated to be favorable for the corporate sector (other factors being constant), reflecting strong foreign currency earnings by the largest Russian companies, which are typically resource-oriented. While the effect on the quality of household loans from a depreciation of the ruble would be negative, the overall impact on bank credit portfolio is estimated to be negligible since most banks have larger exposures to the corporate sector.

14. The assumptions and stress scenarios were agreed between the CBR and the FSAP team.

- The single-factor shocks were calibrated to be broadly in line with the 2009 experience and included increases in the NPL ratio by about 5 and 8 percentage points, the default of top five borrowers, a liquidity shock (withdrawal of liabilities followed by fire sales of liquid assets), market risks (exchange rate, equity valuation, and interest rate), and interbank contagion risks.
- The macro scenarios included (i) a baseline scenario assuming annual GDP growth in 2011–12 of around 4 percent—slightly below the WEO forecast, (ii) a pessimistic scenario, and (iii) a severe scenario. The shocks in the pessimistic and severe scenarios (a drop in GDP growth by respectively 4½ and 8 percentage points relative to baseline) were equivalent to 1 and 1.7 standard deviations of GDP growth using data for 2000–2010.⁴ The swing assumed in the severe scenario is meant to represent a highly unlikely-but-plausible economic shock.

15. In addition, efforts were made to quantify the overestimation of capital discussed above. Staff has tried to assess the quantitative impact of some of the structural

⁴ The magnitude of such macro shocks was comparable to that tested in recent FSAP exercises in major advanced and emerging economies. The shock is quite substantial even compared to Russia's extremely volatile history. Excluding the contraction period (1990–96) when the transition process started, the 8 percentage points swing only seconds to the swing between 2008 and 2009 (from 5.2 percent to -7.8 percent), exceeding the swing at the time of the 1998 Russian crisis (from 1.4 percent to -5.3 percent). The standard deviation for the 2000–2010 periods is 4.7 (WEO database). If the 1998 crisis is included, the estimate will rise marginally to 5.1. These volatility estimates are comparable to those for countries that experienced severe crisis during the same period (e.g., Indonesia and Hungary).

and supervisory weaknesses referred to in paragraph 10. Specifically, (i) to adjust for the impact of regulatory forbearance introduced during the crisis (Box 1), the estimated impact of these measures at end-2010 is added to provisions; and (ii) to adjust for the low level of provisions, provisions in each loan category are raised to the midpoint of the regulatory range and poor quality collateral is assumed to have no value. These adjustments were somewhat ad hoc (owing to data limitations) and arguably extreme; they also did not cover every factor identified in paragraph 10 (e.g., credit quality issues with restructured loans, which is very hard to estimate). But they still provide a useful gauge of the underlying strength of bank portfolio and capital.

Results

16. **The results of stress tests suggest that the Russian banking system is, on the whole, resilient to a variety of shocks** (Tables 4 and 5, Figures 4 and 5).

- Under the worst-case macroeconomic scenario, gross losses to the banking sector would be about one third of capital. The majority of losses would be due to credit quality deterioration, followed by losses from security valuation. However, around one third of these losses (11 percent of capital) would be offset by retaining conservatively estimated bank profits. The system-wide CAR would remain above 14 percent, with only a small group of banks—79 banks representing 8 percent of the system—ending up with a CAR below the 10 percent minimum.
- The series of single factor tests indicate that credit risk is the most important source of risks. In particular, the concentration risk is significant, especially for smaller banks where the share of top 5 borrowers is about 20 percent or more (Table 3). Valuation losses on securities (mostly domestic), especially bonds, could be notable, reflecting the recent increase in securities investment. Direct foreign exchange valuation risk is negligible, given the small open foreign exchange position.
- Acute systemic liquidity shocks may have immediate effects on banks (unlike credit losses, which tend to materialize over a longer timeframe), especially large private and foreign banks (Figure 4).

17. **However, the structural and supervisory weaknesses discussed above imply that the system may be more fragile and vulnerable to shocks that the stress tests results suggest.** Indeed, the quantitative impact of staff adjustments to the baseline to take these factors into account exceeds that of the most severe stress scenarios: staff estimated that adjusting for these factors could wipe out as much as one-third of total bank capital under the most extreme assumptions (Table 4). As mentioned above, however, in the absence of hard data, the magnitude of these adjustments is driven to some extent by subjective assumptions.

Table 2. Russia: Financial Soundness and Balance Sheet Indicators of the Banking System, 2006–10

	2006	2007	2008	2009	2010
Financial Soundness Indicators (in percent)					
Capital adequacy					
Capital to risk-weighted assets	14.9	15.5	16.8	20.9	18.1
Tier 1 capital to risk-weighted assets	10.6	11.6	10.6	13.2	11.1
Capital to total assets	9.7	10.3	10.9	12.7	10.8
Credit risk					
NPLs to total loans ¹	2.4	2.5	3.8	9.6	8.2
Loan loss provisions to total loans ¹	4.1	3.6	4.5	9.1	8.5
Large credit risks to capital ^{1/}	240.6	211.9	191.7	147.1	184.6
Distribution of loans provided by credit institutions					
Agriculture, hunting and forestry	3.6	3.8	4.2	4.9	5.1
Mining	3.9	3.1	3.3	3.9	3.6
Manufacturing	14.6	13.5	14.4	15.7	16.0
Production and distribution of energy, gas and water	2.0	1.7	1.9	2.4	2.6
Construction	4.9	6.0	6.1	6.2	5.9
Wholesale and retail trade	19.6	18.0	17.4	18.4	17.1
Transport and communication	3.7	3.7	4.3	3.4	3.8
Other economic activities	21.3	23.3	23.3	21.9	23.7
Individuals	23.9	24.8	25.1	23.0	23.7
of which mortgage loans	3.0	5.1	6.6	6.5	6.6
Geographical distribution of interbank loans and deposits					
Russian Federation	35.9	40.0	27.1	29.5	...
United Kingdom	21.5	23.3	29.1	21.7	...
USA	7.7	4.1	7.1	4.1	...
Germany	7.9	6.8	7.5	4.7	...
Liquidity					
Highly liquid assets to total assets			14.5	13.3	13.5
Liquid assets to total assets	26.8	24.8	25.9	28.0	26.8
Liquid assets to short-term liabilities	76.8	72.9	92.1	102.4	94.3
Ratio of client's funds to total loans	101.7	94.8	84.6	99.9	109.5
Return on assets					
Net interest income/assets	1.5	0.7	1.7
Net securities income			0.0	1.3	1.1
Net income, excl. provisions			3.1	4.3	2.4
Net provisions			-1.6	-3.6	-0.7
Net interest margin for customer loans	5.6	12.2	6.7
Return on equity	26.3	22.7	13.3	4.9	12.5

Sources: Central Bank of the Russian Federation and IMF staff calculation

^{1/} Large borrowers are those with loans exceeding 5 percent of regulatory capital.

Table 3. Russia: Financial Soundness Indicators of Banks by Groups, end-2010

	All	State-owned	Foreign-owned	Large private	Small-Medium, Moscow	Small-Medium, regional
Market structure						
Number of banks	1012	20	108	128	317	368
Share in the sector by assets	100	46	19	30	3	3
Financial Soundness Indicators (in percent)						
Capital adequacy						
Capital to risk-weighted assets	18.1	18.6	19.7	15.7	25.2	21.3
Tier 1 capital to risk-weighted assets	11.1	10.2	14.6	9.9	21.1	16.6
Capital to total assets	10.8	11.5	11.2	9.3	12.8	12.6
Credit risk						
NPLs to total loans	8.2	8.7	9.2	7.1	6.8	8.4
Loan loss provisions to total loans	8.5	8.7	8.2	8.3	9.6	8.7
Large credit risks to capital 1/	184.6	110.6	156.1	302.2	255.0	229.6
Share of loans to largest 5 borrowers/total loans	10.1	8.5	9.2	11.5	24.8	19.9
Share of loans to largest 10 borrowers/total loans	15.3	12.3	13.9	18.4	37.8	30.1
Share of loans to largest 20 borrowers/total loans	21.1	16.4	19.2	26.3	49.6	39.8
Distribution of loans provided by credit institutions						
Agriculture, hunting and forestry	5.1	8.8	1.2	2.0	1.5	3.6
Mining	3.6	4.4	2.2	3.7	0.7	0.6
Manufacturing	16.0	18.0	16.6	13.8	6.8	9.5
Production and distribution of energy, gas and water	2.6	2.7	1.7	3.3	0.6	0.8
Construction	5.9	5.7	4.1	6.7	8.4	8.7
Wholesale and retail trade	17.1	16.4	15.8	16.4	37.8	27.8
Transport and communication	3.8	4.1	3.4	3.9	1.9	2.7
Other economic activities	23.7	17.5	21.1	29.9	25.1	19.0
Individuals	23.7	22.3	33.8	20.3	17.3	27.2
Geographical distribution of interbank loans and deposits (asset side)						
Russian Federation	...	37.3	34.8	45.9	84.5	97.8
United Kingdom	...	29.8	20.2	13.0	0.4	0.0
USA	...	2.6	2.5	2.7	1.3	0.3
Germany	...	1.8	13.7	6.0	2.4	0.2
Austria	...	0.7	6.8	5.7	2.7	0.8
France	...	2.9	3.5	6.3	0.1	0.0
Italy	...	0.2	0.0	0.0	0.0	0.0
Cyprus	...	11.9	0.0	0.0	0.0	0.3
Netherlands	...	0.4	7.8	1.7	0.3	0.0
Other	...	12.4	10.9	18.7	8.4	0.5
Liquidity						
Highly liquid assets to total assets	13.5	12.0	15.3	13.3	23.3	20.4
Liquid assets to total assets	26.8	21.0	30.9	30.6	40.7	35.2
Interbank loan assets to total assets, excl. CBR	8.7	8.6	12.1	7.6	4.6	5.5
Of which						
Vis-à-vis non-residents	5.2	5.4	7.9	4.1	0.7	0.1
Deposits from individuals to total assets	29.3	36.9	18.6	24.1	23.8	40.3
Funds from organizations to total assets	30.6	25.1	30.3	38.1	39.7	33.1
Interbank loan liabilities to total assets	11.1	9.4	21.2	9.1	4.6	1.5
Of which						
Vis-à-vis non-residents	6.2	4.3	16.1	4.2	0.5	0.1
Ratio of highly liquid assets to demand liabilities	64.8	73.6	80.7	51.4	64.7	65.5
Liquid assets to short-term liabilities	94.3	99.2	96.9	88.8	95.5	97.1
Ratio of client's funds to total loans	109.5	105.5	90.4	119.8	146.4	143.2
Market risk (to aggregate capital)						
consisting of:	48.6	43.6	41.7	59.7	56.2	43.2
Interest rate risk	36.7	33.1	34.6	43.1	40.1	35.2
Securities risk	8.6	7.4	3.9	13.1	12.7	5.6
FX risk	3.2	3.1	3.2	3.4	3.4	2.5
Return on asset	1.9	2.4	2.1	1.1	1.5	1.0
Return on equity	12.5	15.2	14.3	8.6	7.4	5.7

Sources: Central Bank of the Russian Federation and IMF staff calculation.

1/ Large borrowers are those with loans exceeding 5 percent of regulatory capital.

Figure 1. Russia: Comparative Indicators of Banking System Soundness

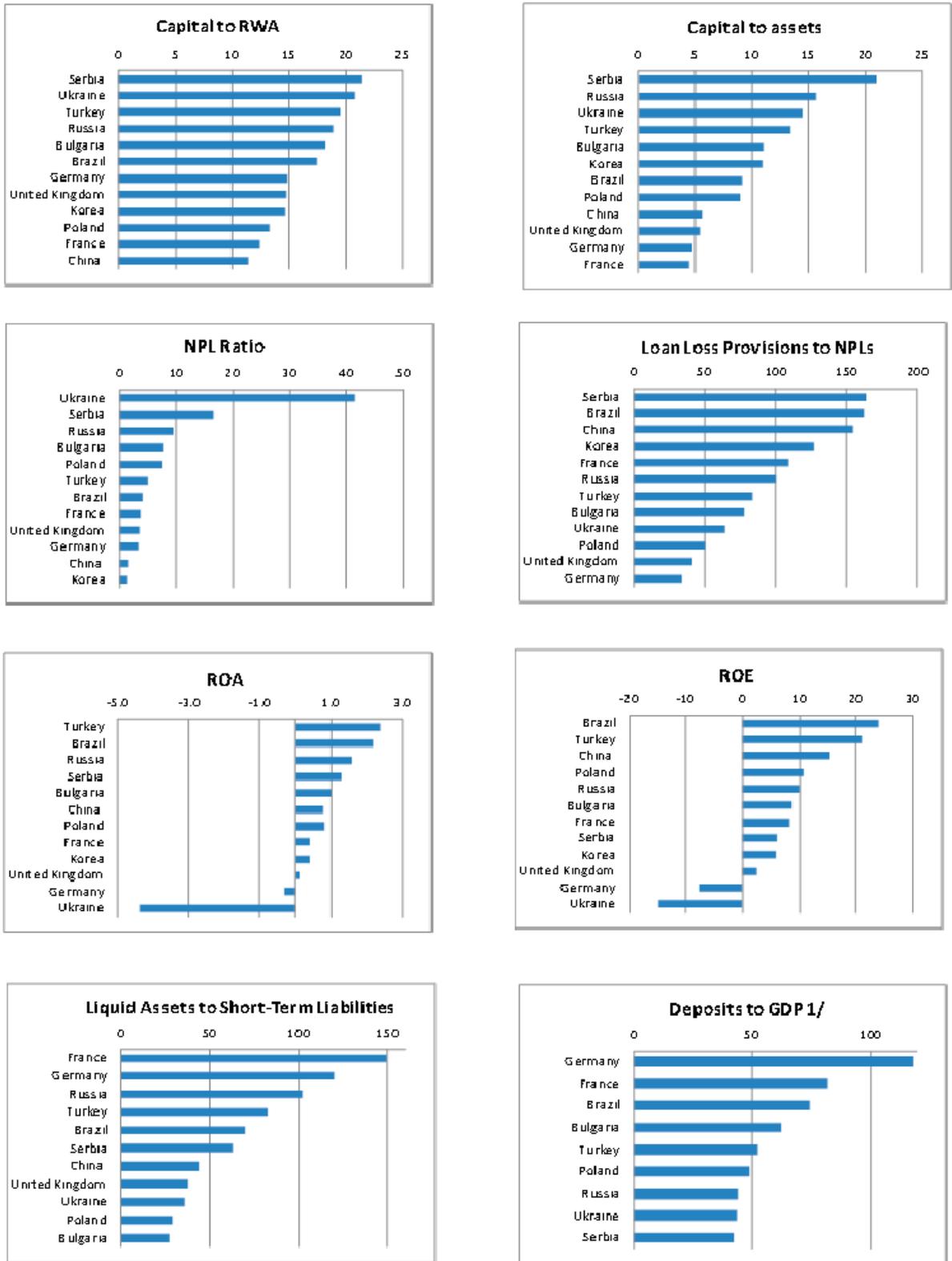


Figure 2. Russia: Share of Restructured Loans to Large Loans¹

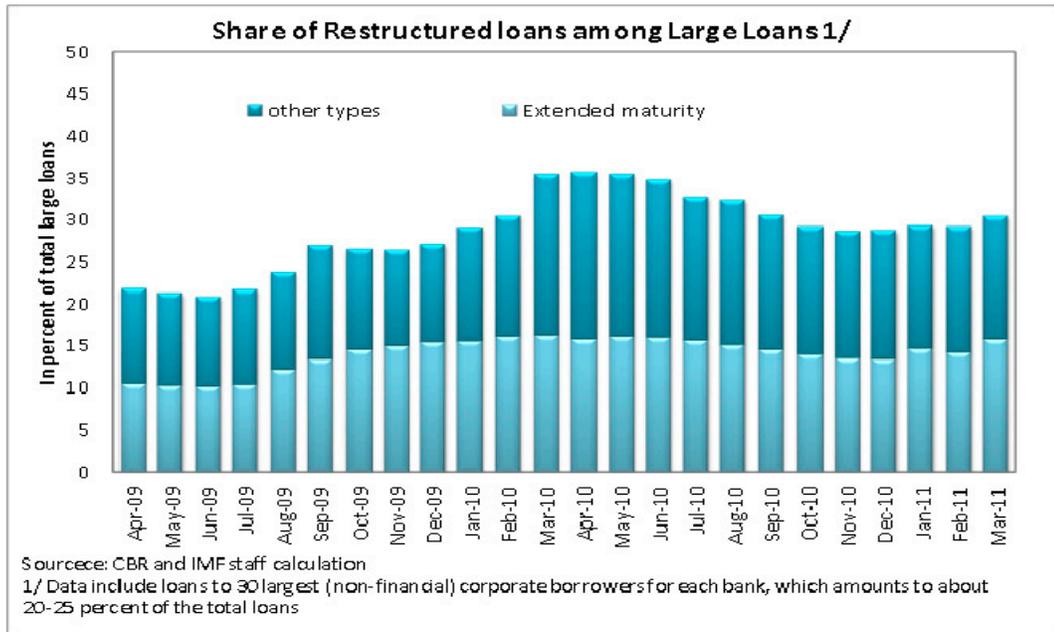


Figure 3. Mandatory and Actual Provisions, End-2010¹

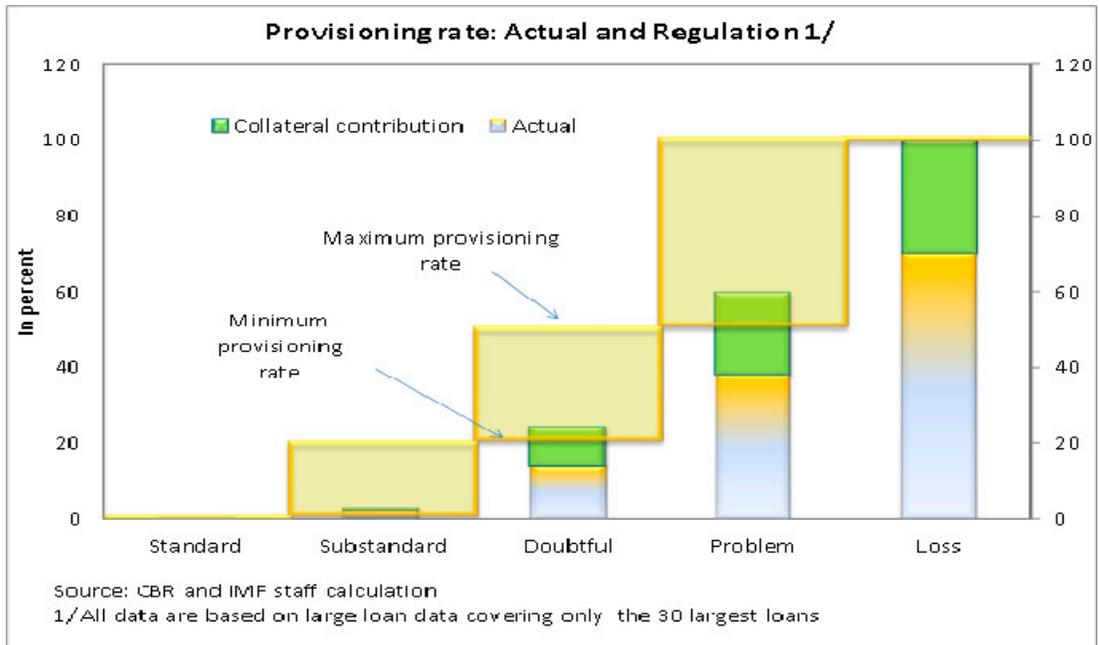


Table 4. Russia: Summary of Stress Test Results

	All	State- owned	Foreign- owned	Large private	Small- Medium, Moscow	Small- Medium, regional
End-2010, actual	(In percent)					
Regulatory capital ratio (CAR)	18.1	18.6	19.5	15.5	26.8	22.2
Tier 1 capital ratio	11.4	10.2	14.4	9.9	22.8	17.2
Adjustments	(Losses under stress in percent of initial capital)					
Forbearance (FB)1/	2	1	2	3	2	3
Provisioning +forbearance 1/2/	35	34	43	34	24	35
Single factor stress tests, based on unadjusted data as of end-2010	(Losses under stress in percent of initial capital, unless otherwise mentioned)					
<u>Credit risk</u>						
Increase in NPL ratio						
<i>A: 1.65 stdev shock on historical average NPL ratio</i>						
Of which: Corporate	24	25	20	26	18	28
Of which: Household	20	23	11	20	14	22
<i>B: 1.65 stdev shock on latest actual NPL ratio</i>	4	2	9	6	4	6
Default of top 5 borrowers 3/	38	39	40	37	27	38
<u>Liquidity risk 4/</u>	49	49	32	57	51	59
<u>Market risk (direct impact only)</u>	14	9	18	22	6	11
Of which: Ruble depreciation (20%)	13	9	10	22	9	6
Of which: Equity valuation (-30%)	0	0	1	0	0	0
Of which: Bond valuation 5/	4	2	2	10	4	2
<u>Interbank contagion effects 6/</u>	8	7	8	11	6	4
	13	15	10	8	13	27
Memo items						
<i>Combined test (including credit (increase in NPL ratio (shock type A)), liquidity, and market risks listed above)</i>						
Total losses	51	42	49	69	34	45
Regulatory capital ratio % (CAR)	8.9	10.7	10	4.8	17.9	12.1
Capital shortfall % GDP	1.8	0.3	0.4	1.1	0.0	0.1
Macro stress tests, based on unadjusted data as of end 2010	(Key post-shock indicators)					
Severe scenario 7/						
Regulatory capital ratio % (CAR)	14.1	14.9	15.3	10.2	22.2	16.7
Tier 1 capital ratio %	7.1	6.4	8.9	6.1	13.3	10.7
Net losses, % capital	-22	-20	-22	-35	-17	-25
Of which: Profits before provisions, % capital	11	11	10	11	9	7
Of which: Total losses, % capital	-34	-32	-33	-48	-27	-33
Capital shortfall % GDP	0.3	0.1	0.0	0.1	0.0	0.0

Sources: Central Bank of the Russian Federation and IMF staff calculation.

1/ Impact of losses from temporary forbearance measures introduced during the crisis time.

2/ Raise provisioning rates of each loan category to the middle value of the regulatory acceptable ranges, including high quality collaterals only.

3/ Assuming 100% losses upon default. Loans to top 5 borrowers are about 50% of capital. Compared to other shocks, this scenario should have extremely lower probability to occur.

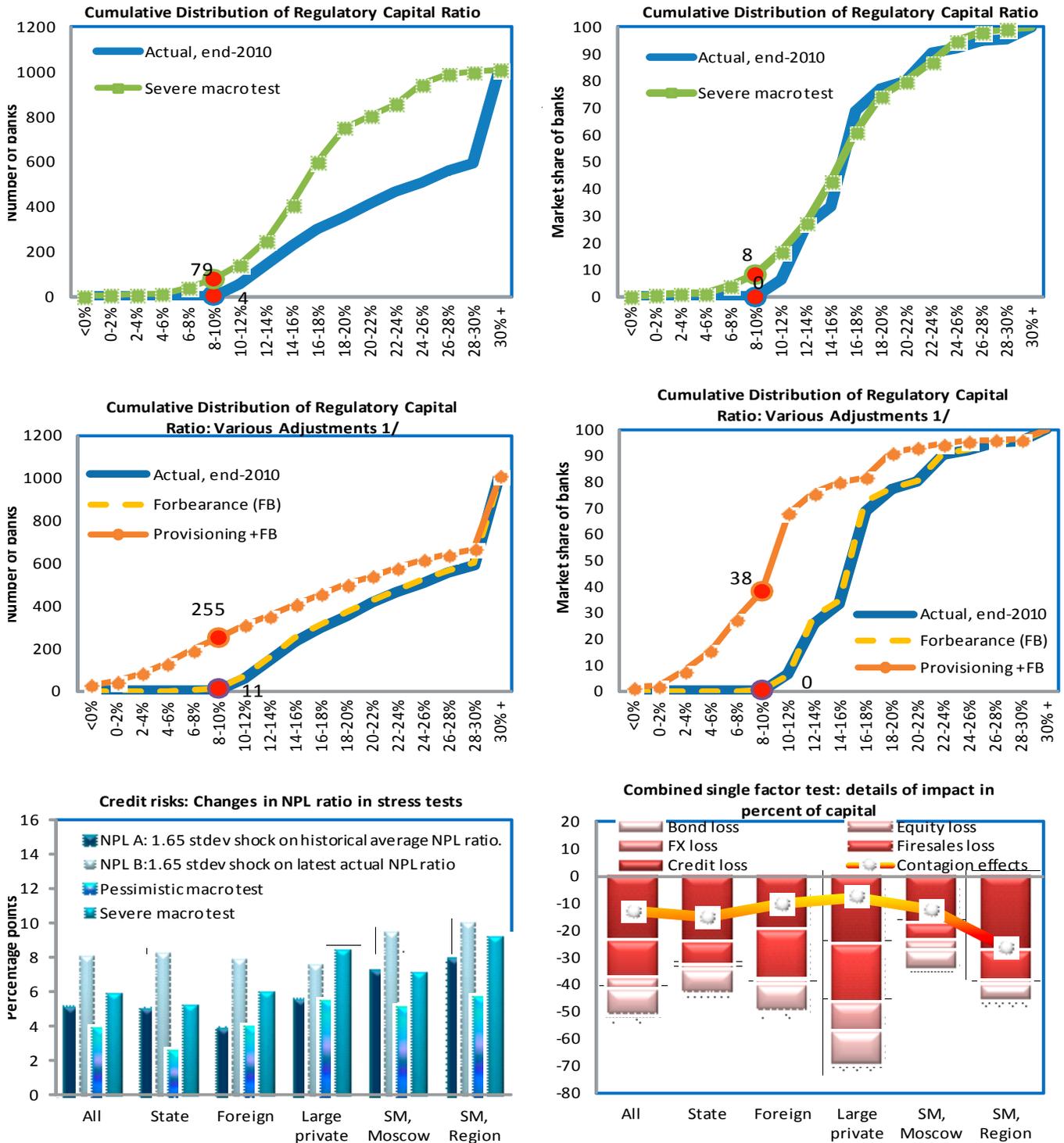
4/Losses from asset firesales upon liability withdrawals (30% of interbank liabilities from non-resident banks; 20% of individual deposits and corporate settlement accounts; 10% of corporate deposits). 5, 20, and 60 percent haircuts with highly liquid, liquid, and low-liquid assets. No access to domestic interbank market, including the CBR.

5/ Pararell shift up of bond yield curves, 300 (900) bps for government (corporate) bonds.

6/ In addition to the combined test of credit (A: historical distribution), liquidity and market shocks. In the contagion stage, a bank "defaults" 100% on its interbank borrowings when its losses from interbank contagion effects reach 75% of its stressed capital.

7/ Assuming, a 8 p.p. drop in GDP growth rate (i.e. 1.68 standard deviation using 2000-2010 data) from baseline.

Figure 4. Russia: Summary of Stress Test Results

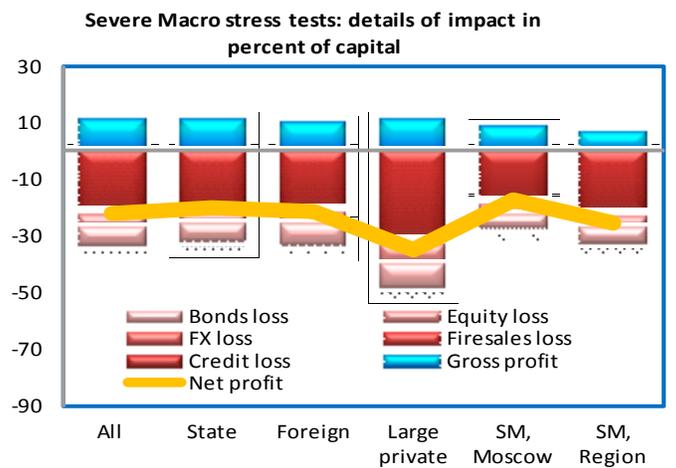
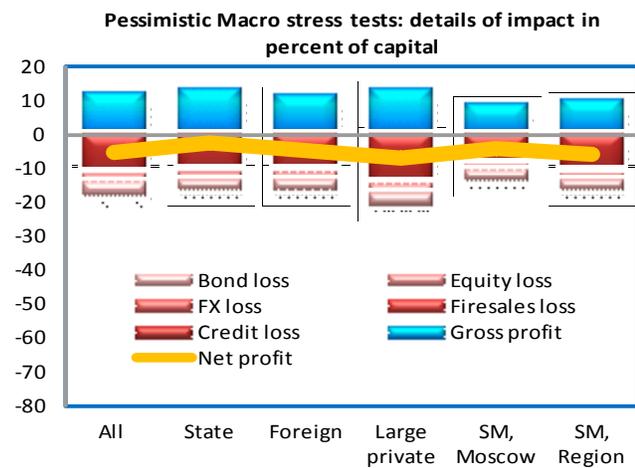
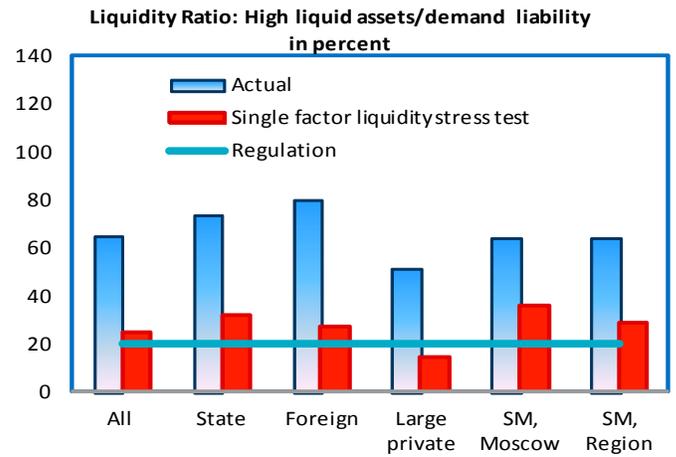
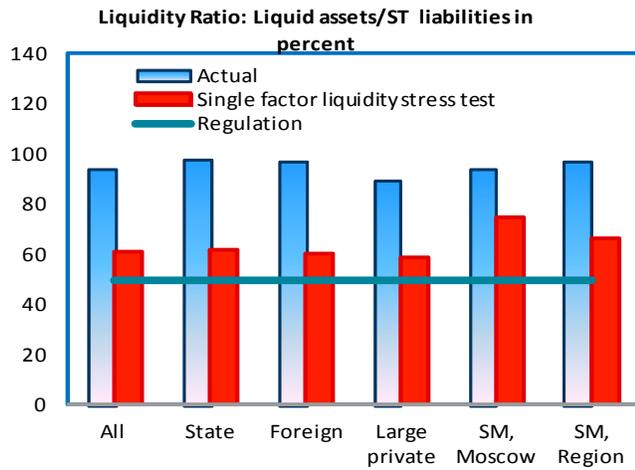
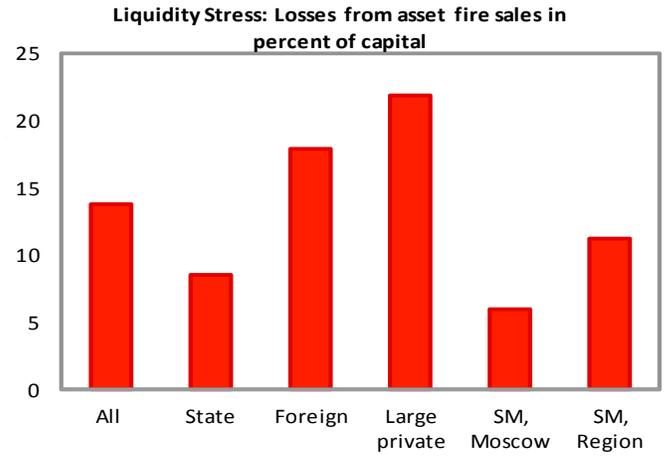
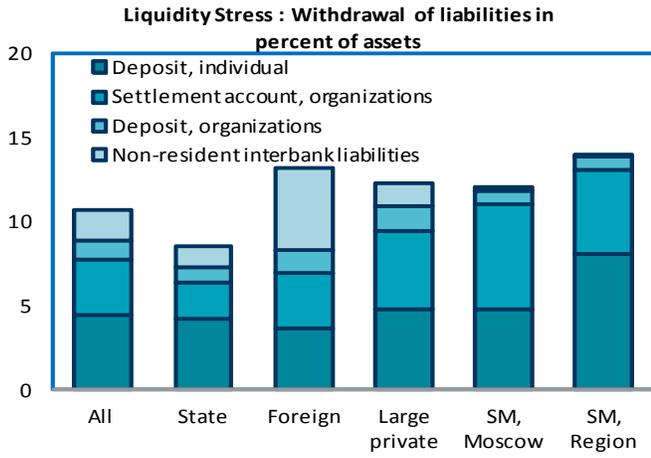


Source: CBR and IMF staff calculation.

1/Forbearance: Impact of losses from temporary forbearance measures introduced during the crisis time.

Provisioning: Raise provisioning rates of each loan category to the middle value of the regulatory acceptable ranges, including high quality collaterals only.

Figure 4. Russia: Summary of Stress Test Results (contd.)



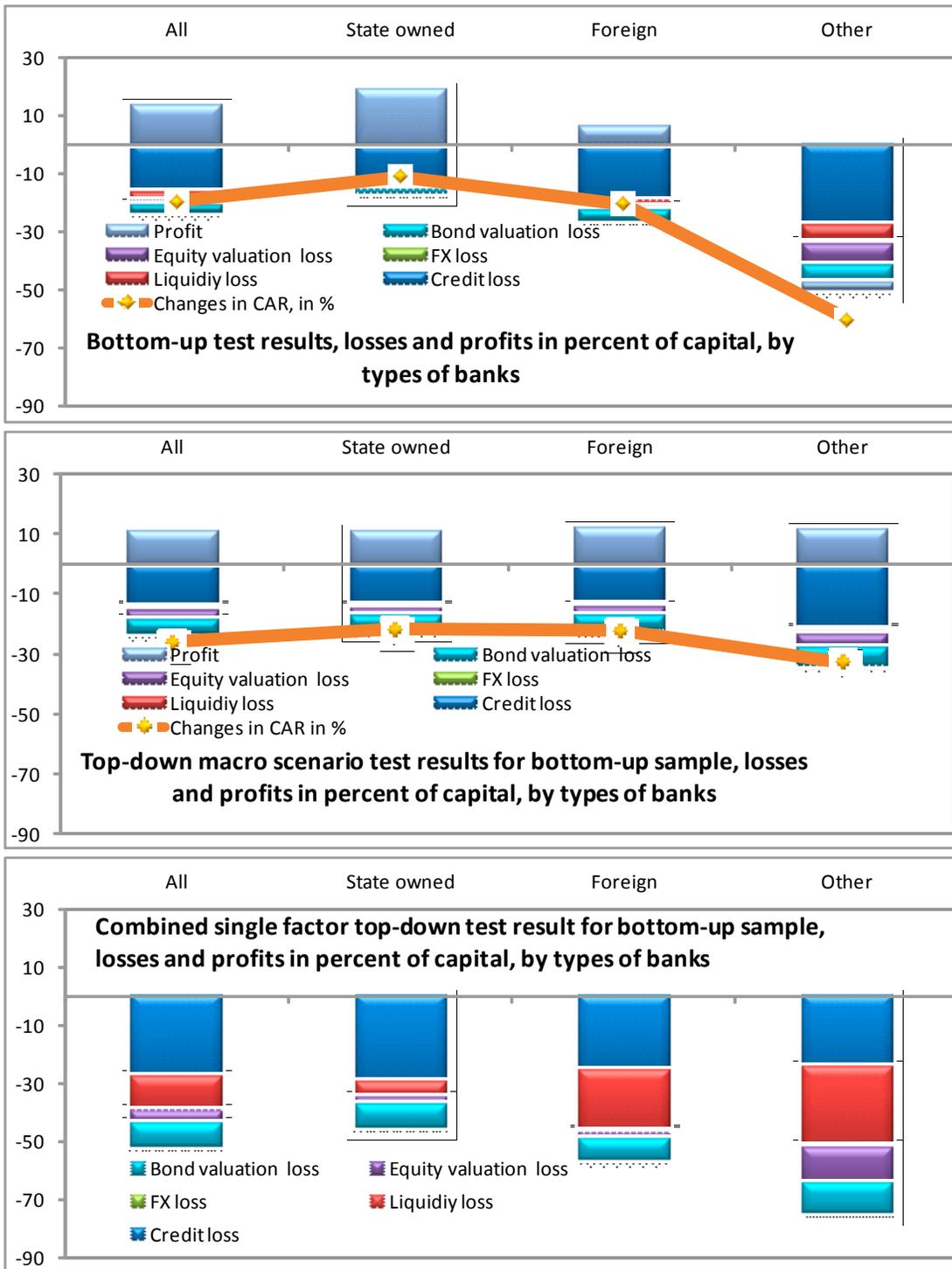
Source: CBR and IMF staff calculation

Table 5. Summary of Bottom-Up Stress Test Results

	All	State owned	Foreign	Other
Sample				
Number of banks	15	2	8	5
Share in total banking sector by assets	56.7	35.9	10.3	10.5
Test Methodology				
Approach A: Number of banks using internal macro model	6	1	4	1
Approach B: Number of banks using combined sensitivity	9	1	4	4
Actual data as of end 2010, for bottom-up sample				
CAR	17.6	19.1	16.1	14.1
Core capital ratio	9.8	10.0	11.4	7.8
NPL ratio	9.3	9.7	10.9	6.1
Bottom-up results, severe scenario				
CAR	14.1	17.0	12.8	5.6
Total losses, % capital	23.2	16.5	26.2	47.8
Profit, % capital	13.6	19.2	6.1	-2.1
Changes in NPL ratio, in percentage points	3.0	2.4	4.9	3.4
CBR's combined single factor test results, for bottom-up sample				
CAR	8.5	10.6	7.0	3.6
Total losses, % capital	51.5	44.8	56.3	74.6
Changes in NPL ratio, in percentage points	5.5	6.1	3.7	5.1
CBR's macro stress test, for bottom-up sample				
CAR	13.0	15.0	12.5	9.5
Total losses, % capital	23.1	21.9	21.6	27.9
Profit, % capital	11.2	10.9	11.9	11.5
Changes in NPL ratio, in percentage points	3.6	3.4	4.1	4.2

Source: CBR

Figure 5. Summary of Bottom-Up Stress Test Results



Source:

18. **These results notwithstanding, there are important mitigating factors contributing to the stability of the system and limiting the costs of rescue.** Even if capital injections are required to restore capital adequacy, the estimated economic cost of recapitalization is small and manageable, given the relatively small size of the Russian banking sector relative to GDP, low government debt, and high reserves.

B. Non-Banking Sectors

19. **The performance of nonbank financial institutions is mixed.** Investment funds and private pension funds registered solid profits in 2010, reflecting a booming stock market. As to insurance companies, both non-life and life sectors continue to suffer from lower demand due to the crisis, high claim payout, and low return on investment. The pre-crisis returns on assets of around 5 percent that supported negative combined ratios are no longer available in the current environment. The number of bankruptcies of insurance companies is increasing and clients are experiencing difficulties in claiming benefits, suggesting financial distress. Even though distress in the insurance sector is unlikely to threaten systemic stability, it might have adverse social repercussions. The new minimum capital requirement, which will enter in force in 2012, will put additional pressure on insurance companies.⁵

20. **The combination of thin markets and weaknesses in market infrastructure require increased vigilance over the securities market.** The low development of the capital market in Russia, notably the dearth of long-term securities and lack of a long-term institutional investor base, contributes to significant market volatility. The fact that corporate securities are commonly used as repo collateral translates this volatility into funding risk for banks. The absence of a central depository for securities also opens the possibility that some of these securities may be pledged as collateral more than once, amplifying this risk.

III. STRENGTHS AND VULNERABILITIES: THE POLICY FRAMEWORK

A. Regulation and Supervision

Banks

21. **Despite some progress in recent years, the regulatory and supervisory framework for banks has numerous gaps and weaknesses.** Although CBR strives to improve its supervisory process, it lacks enforcement powers to ensure implementation of those recommendations. In particular, the CBR lacks authority (i) to prevent abuses arising from exposures to related parties; (ii) to take enforcement action against banks' directors and managers; and (iii) to require additional capital in individual banks to be maintained

⁵ Around half of the existing companies would need to increase capital in order to comply with the new requirement.

against specific risks.⁶ The legislation continues to limit the scope of consolidated supervision. The legal framework does not provide the CBR sufficient flexibility to exercise supervisory judgment (Box 3). There is also insufficient legal protection of the CBR and other supervisory agencies. Accordingly, progress in addressing shortcomings identified by the 2007 Basel Core Principles (BCP) assessment has been slow.⁷

Box 3. The Exercise of Supervisory Discretion (“professional judgment”)

The financial sector supervision in Russia is currently hampered by the lack of legal capacity for supervisory agency to use discretion, or “professional judgment” in the preventive and corrective activities. This issue affects to some extent all supervisory agencies. The CBR’s lack of flexibility to use supervisory judgment in implementing existing legislation, for example, identification of connected parties and ability to implement international best practices without legislative changes, is a serious impediment to effective supervision. In the case of insurance, the problem is aggravated by the lack of power of the supervisory agency (prior to its absorption by the FSFM) to issue and sometimes even interpret regulations, which is a critical impediment to timely action.

International standards, such as the BCP, embed supervisory judgment in several Principles. The most well-known is capital adequacy, where supervisory discretion is needed to judge if the capital is adequate to the risk profile of individual banks. More broadly, when an assessment of “adequacy,” “sufficiency,” “consistency,” and “effectiveness” is warranted, it is always expected to be based on the supervisory authority’s discretion. The ultimate decision on whether a bank’s behavior is unsafe or unsound cannot be based on compliance alone. The legal framework for financial supervision in Russia today falls well short of these principles.

Naturally, supervisory discretion is only possible when applied in tandem with a robust internal organization and accountability. This includes well-defined decision-making processes and clear accountability mechanisms. The desirability of supervisors being able to make judgments and take actions needs to be balanced with a good governance framework. This can be achieved by establishing reviews of key decisions or raising them to committee structures. In practice, the operational level at which supervisory judgment may be exercised should be restricted depending on the experience levels of staff, possible impact of decision and layers of institutional review. While the ability to question a bank’s classification and provisioning of a loan may be delegated to a territorial office, issues on sanctions or capital adequacy may be limited to CBR headquarters.

22. **Cross-border supervisory cooperation has improved, but its effectiveness is impeded by restrictions on information sharing.** The CBR has entered into numerous bilateral MoUs or letters of cooperation with foreign bank supervisors to achieve cooperation and information sharing. Even in the absence of these formal agreements, the CBR cooperates with foreign supervisors by addressing ad-hoc requests for information and engages in bilateral meetings with bank supervisors of the home-host countries. However, the

⁶ CBR currently can impose higher CAR to individual banks only as sanction for violations of federal laws and for a period no longer than six months.

⁷ The FSAP team conducted a targeted BCP assessment, which covered the following areas: major acquisitions, capital adequacy, risk management process, credit risks and provisions, exposure to related parties, abuse of financial services, remedial actions, and consolidated supervision. For details, see Appendix.

CBR powers to provide information subject to banking secrecy, in particular the information related to the operations of the credit institutions, their clients and correspondents, are restricted by the laws, even if a foreign supervisory body guarantees the safety (confidentiality) of such information.⁸

23. Many of these shortcomings are expected to be addressed in the near term.

Legislative amendments are pending before the Duma that would enhance the CBR's ability to conduct consolidated supervision and will expand CBR powers to define related parties. The amendments will also eliminate restrictions on the types of information that the CBR may exchange with other supervisors. In addition, the legal framework for bank regulation and supervision should be strengthened further in the context of implementing the government's Development Strategy for the Banking Sector through 2015, which was adopted in April 2011.

Nonbank financial institutions

Supervisory architecture

24. The supervisory framework for the nonbank financial sector was overhauled in 2011. In accordance with the Presidential decree of March 2011, the insurance supervisor (FSIS) was absorbed by the securities market supervisor (FSFM). While this plan had been under discussion for a while, the decision to merge was taken without adequate preparation, creating a temporary gap in the supervision of the insurance sector.⁹ By June 2011, the basic legal and operational framework of the new, expanded FSFM had been introduced, although the actual merger will take longer.

25. The creation of a unified supervisory agency for the nonbanking sector can generate benefits. These include a comprehensive view of the financial market, harmonization of the supervisory approach, and economies of scale, in particular for the performance of centralized activities like licensing and enforcement. The unification may also strengthen human resources policy for the supervisory personnel, making the new agency more attractive by offering a more varied and challenging career for its staff.

26. The new legal and operational framework for the FSFM appears broadly appropriate, but needs to be tested in practice. In addition to insurance and capital markets, the FSFM's remit is expanded to cover all nonbank financial entities. The FSFM is given the status of an independent government agency, like the Federal Antimonopoly Service, reporting to the Prime Minister. Its budget is approved by the Duma and is not part of any Ministry. The Chairman and Deputy Chairman of the FSFM are appointed by the Prime Minister (though their terms are not fixed and the law does not specify grounds for

⁸ Articles 51 of the Central Bank Law and 26 of the Law of Banks and Banking Activities.

⁹ As a result of the uncertainties and disruption created by the merger, which coincided with the FSAP mission, a detailed assessment of compliance with the IAIS principles was not possible.

dismissal). The FSFM has absolute supervisory and enforcement authority, but its regulatory function is shared with the MoF. Specifically:

- Submitting to the Duma laws affecting the non-bank financial sector, including minimum capital requirements, is the responsibility of the Ministry of Finance (like the central bank, the FSFM does not have the authority to propose legislation to the Duma directly).
- Other regulations (e.g., on disclosure standards, licensing requirements, professional activities, etc.) are issued by the FSFM after consultation with the Ministry of Finance.
- Implementing regulations, reporting requirements, licenses, audits, inspections, remedial letters, penalties, etc. are the sole responsibility of the FSFM.

Although this basic framework appears to guarantee adequate authority and operational independence for the FSFM (with the possible exception of the terms of appointment of its Chairman), a lot will depend on how it is implemented. In the near term, at any rate, the preoccupation with the ongoing merger may raise questions about the speed with which the needed improvements to the insurance and securities markets supervision (see below) may be made.

Insurance companies

27. **The authorities have implemented important recommendations of the last FSAP in the areas of insurance regulation and supervision.** Recently adopted legislation clarified and reduced the time for the completion for declaring bankruptcy of insurers and non state pension funds, and granted the supervisory agency the powers to appoint a temporary administration should this be required to protect the policyholders as a pre-bankruptcy step. Minimum capital requirements have been increased four-fold and are now at the EU level. The government adopted a medium-term insurance business development strategy that envisages removal of regulatory impediments, encourages competition, and contributes to a favorable business environment for the insurance activity.

28. **However, there are significant shortcomings in insurance supervision.** Although a formal assessment of compliance with IAIS principles was not, as noted above, possible, due to the disruption caused by the merger, the supervisory framework seems to depart from international standards in a number of areas. Licensing does not require insurers to have the necessary operational infrastructure, in the form of internal controls and risk management functions. Information on related party obligations and broader governance rules and responsibilities is not sought at present. The range of individuals to which fit and proper requirements apply is limited.¹⁰ Also, the supervisory agency does not have the power to disqualify key managers, including auditors and actuaries, who do not comply with the fit and proper requirements. While cooperation and information-sharing appears to function

¹⁰ The fit and proper requirements do not cover directors, key managers (like the chief financial officer), auditors, and controlling shareholders.

well, the home-host notifications and other relevant cross-border cooperation activities are not mandatory for the supervisory agency. Group-wide supervision is not incorporated in the regulation and presents a major risk to the objectives of supervision, given the importance of group activity. Preventive and corrective actions are missing from the current supervisor powers. Derivatives are used in the market and are becoming more sophisticated, but the current regulation does not address them.

29. **The supporting infrastructure remains weak.** The numbers of accountants and auditors that meet minimal professional requirements is small. Qualified lawyers and judges are in short supply due to a large number of disputes currently being brought to court, especially in the area of motor insurance. The actuarial profession has recently made progress, and the incorporation of the Russian Guild of Actuaries as a full member of the International Actuarial Association at the end of 2008 is a recognition of achieving international standards and qualification for their fellow members. However, with only 154 members, the supply of actuaries remains inadequate.

Capital markets

30. **Compliance with the IOSCO principles has improved compared to the previous assessment** (for details, see Appendix). This reflects a major expansion of FSFM's powers in recent years. In particular, the FSFM was given increased authority to cooperate with foreign counterparts and investigate misconduct in the market; the authority to obtain more comprehensive disclosure on controlling and controlled persons; the capacity to obtain and provide the market with more informative material event disclosure, which in turn can trigger more intensive and targeted monitoring or help shareholders better evaluate investments; and additional powers to administer monetary sanctions and compel information from unlicensed third parties. Additionally, resources were found to fund new surveillance tools for FSFM staff, such as a real time monitoring system, to provide alerts as to non-standard or suspicious transactions.

31. **The implementation of the procedures to execute the new powers and authorities may require further regulatory actions.** It is therefore premature to confirm the efficacy of the newly-granted powers or to assess their operation in practice. Some experience with their actual application to specific circumstances will be necessary to determine whether they will achieve the intended benefits.

32. **Further substantial legislation which should bring additional improvement is in train.** Such legislation includes the laws on exchanges and organized trading, prudential supervision, joint stock companies, and amendments to the Federal Law on investment funds. The pending legislation on prudential supervision, when adopted, should provide FSFM with increased authority to freeze assets, take other prompt corrective action through the appointment of a temporary administrator or receiver, or assist in winding down of a regulated business so as to prevent asset stripping and protect customers.

B. Macroprudential Policy

Institutional setup

33. **Commendable steps have been taken recently to strengthen macroprudential monitoring and inter-agency coordination.** In December 2010, an Inter-Agency working group under the Presidential Council (Working Group to Monitor Financial Market Conditions) was created, with the mandate to identify mechanisms to monitor the state of the financial market and systemically important financial institutions and propose the legal amendments needed for the establishment of these mechanisms.¹¹ In addition, in March 2011, the CBR established a Financial Stability Directorate, which is expected to carry out monitoring of emerging risks not only in the banking sector but also arising from emerging trends and products in other sectors.

34. **Efforts are now required to make the systemic risk monitoring framework effective.** The new working group participants should not only meet regularly to identify the institutions to be monitored and emerging risks, but agree on a road map where each agency has a clear understanding of its roles and responsibilities if pressures emerge. The working group should make sure all legal and operational hurdles for information exchange among participants are cleared. It would also be advisable to include representatives from the DIA in this working group, particularly as it is to be given permanent powers to resolve banks.¹²

Macroprudential policy tools

35. **The CBR should play a leading role in developing macroprudential policy tools.** Given the systemic importance of the banking sector in Russia and the synergies that can be achieved in conducting monetary policy and supervision, the CBR should be the leading agency in designing and applying macroprudential policy instruments. In this regard, the fact that the Director of the newly created Financial Stability Directorate has a seat on both the Supervision Committee and the Monetary Policy Committee is encouraging.

36. **The CBR has already used some instruments of the macroprudential toolkit.** It used differentiated reserve requirements for obligations denominated in foreign currency and for obligations to non-residents, and sought to implement an interest rate policy aimed at “mitigating the risk of a sudden capital outflow.”¹³ It lowered provisioning standards during the crisis to act against the cycle and stimulate credit in the downturn, and introduced

¹¹ The working group is headed by the Deputy Minister of Finance and its members include representatives from MoF, Ministry of Economic Development, CBR, FSFM, Federal Antimonopoly Service, Federal Service for Financial Monitoring, and other agencies.

¹² Although there are representatives in this working group who are also members of the Board of the DIA, this does not mean that these individuals will represent the interests of the DIA, given they are invited to attend the working group in their capacity as representing different agencies (MoF or CBR) and there may be a difference of opinion/ interests between these agencies and the DIA.

¹³ At the height of crisis in 2008 rates were raised to curb outflows, while cuts in 2009 and 2010 aimed at slowing the appreciation of the currency.

a balance-sheet open foreign-exchange position with regard to foreign assets. It has also proposed legislation outside its mandate with a view to promoting financial stability, for example, an amendment to the Tax Code to make foreign currency denominated borrowings less attractive to financial and non-financial companies. In addition, the results of CBR's stress tests are used not only to check resilience of the individual banks and orient supervision, but also to monitor systemic stability.¹⁴

C. Crisis Management and Resolution

37. **The Russian authorities cooperated effectively in responding to the crisis despite the absence of formalized arrangements.** Russian legislation does not assign explicit responsibility for overall financial stability and systemic risk monitoring, but the lion's share of responsibility resides with the CBR, due to the dominance of the banking sector in the system. In fact, the CBR is legally responsible for maintaining the stability of the Russian banking system and protecting the interests of depositors and creditors. During the crisis, the MoF and the CBR played an important and appropriate role in coordinating crisis management, with regular meetings held with the other agencies.

Systemic liquidity

38. **By early 2011, the liquidity position of credit institutions returned broadly to pre-crisis levels.** The interbank money market overnight interest rate declined to 2.8 percent per annum, well below its peak of 28 percent in late January 2009. The segmentation of the interbank market also appears to have eased since the peak of the crisis in early 2009, although the operations remain concentrated on 15 banks. In March 2010, credit institution deposits in the CBR amounted to 7 percent of broad money, which was somewhat less than the pre-crisis level, but these deposits have been well in excess of those needed to comply with the required reserve ratio.

39. **The CBR's emergency liquidity assistance (ELA) played a crucial role in containing the effects of the liquidity crisis.** The CBR significantly eased the conditions for access to its liquidity, including expanding existing monetary instruments, introducing new liquidity instruments, and helping to contain counterparty risk in the interbank market. With clear disclosure of the changes to its policies, the CBR was able to guide expectations, enhancing the effectiveness of the ELA.¹⁵ However, the CBR exposed its balance sheet to

¹⁴ The frequency of CBR's stress tests was intensified during the crisis from twice a year, to quarterly, and monthly in late 2008. While only commercial banks are covered, staff in the newly created Financial Stability Directorate plan to extend top-down stress tests to nonbank institutions which may present a systemic risk.

¹⁵ More generally, there have been substantial improvements to the transparency of monetary policy in Russia over the past seven to eight years. On the basis of a factual update of the previous assessment in 2001, the CBR now appears to comply with all criteria related to monetary policy under the Code of Monetary and Financial Policy Transparency (Appendix V). While it has complied with these criteria, the CBR could continue to make further gains in transparency to help provide clearer signals of the direction of monetary policy.

additional risk by extending loans that were unsecured or backed by non-marketable collateral or guarantees. The stock of liabilities of credit institutions peaked at Rub 4.2 trillion (about 10 percent of GDP) in January 2009, but these liabilities returned to pre-crisis levels by early 2011.

40. Going forward, the functioning of the interbank money market and the CBR's ELA should be strengthened.

- *The use of RTGS should be expanded.* Only one-fifth of the total volume of payments made through the CBR's payment system passed through the RTGS in 2010. Further development of the CBR's payment system is set forth in the "Conceptual Framework for the Development of the Bank of Russia Payment System for the Period up to 2015," which was approved by the Board of Directors of the CBR in July 2010.
- *Counterparty risk in repurchase operations should be addressed.* Given the short supply of government securities, the repo market relies heavily on corporate securities for collateral. However, steps to mitigate counterparty and other risks should be taken by: (i) extending the operations of the National Clearing Center to all operations of the repurchase market; (ii) setting minimum regulatory haircuts on securities used as collateral in repurchase transactions; (iii) setting concentration limits on collateral securities to limit exposure of single institutions as well as the market to a single issuer; and (iv) issuing CBR guidelines for banks that engage in repos.
- *ELA should be enhanced in several areas.* The ELA could be strengthened by requiring the government to guarantee any loan that is unsecured or backed by non-marketable assets or guarantees. The CBR should also continue to strengthen its management of collateral. The CBR may also wish to consider the potential benefits of a more explicit explanation of its ELA policy—which could be implemented over time as market confidence continues to strengthen—especially to make the allocation of ELA among financial institutions more transparent.

Bank intervention tools

41. There is a range of early intervention tools set out in different pieces of legislation, but a more structured and consolidated corrective action regime is needed. The authorities should adopt a transparent regime for supervisory action (Prompt Remedial Action framework), with a clearly delineated set of mandatory and discretionary measures as a bank's regulatory situation deteriorates. This regime should include a stepped scale of mandatory and discretionary penalties/restrictions as a bank falls below certain quantitative thresholds relating to capital and liquidity or qualitative triggers such as not complying with laws, regulations or directives, engaging in an unsafe or unsound practice or when the interests of depositors are otherwise threatened. This would enable a consistent approach in the treatment of different banks and contribute towards public confidence.

Bank resolution

42. **A temporary law dealing with bank resolution adopted in October 2008 will expire at end-2011.** This law introduced wide-ranging powers that are deployable at an early stage if the failing bank presents a systemic risk and there exists evidence of the bank's unstable financial position or there is a threat to the legitimate interests of bank depositors and creditors. The DIA was empowered to take control of a bank, inject equity into, or purchase assets from, a bank, write down bank capital, undertake P&A transactions, and provide open bank assistance (OBA), including in the form of financial assistance to third parties needed to restore normal operations of an acquired bank (assisted mergers and acquisitions). Between October 2008 and April 2011, the DIA and the CBR used these temporary powers to successfully resolve 18 banks.

43. **On the basis of this crisis experience the authorities plan to make the temporary law permanent, whereas we would recommend designing a new, permanent bank resolution regime.** Although the current framework functioned well during the crisis, it risks exacerbating moral hazard, as it enshrines a limited set of resolution tools with late triggers for non-systemic banks and a wide range of tools with early triggers for systemic banks. Based on international best practice, staff would recommend the following for the new, permanent regime:

- The CBR should be able to appoint the DIA as an official administrator at a sufficiently early stage for *all* banks, not just systemic ones, when one or more quantitative or qualitative triggers are met, e.g., capital falls below a fixed percentage of required CAR; if there is a threat to financial stability; and if the bank is or is likely to become insolvent, is engaging in unsafe/unsound practice, or poses a threat to interests of depositors/creditors.
- The existing provisions in the Insolvency Law for Credit Institutions, BL, and the proposed permanent legislation should be merged into a single piece of legislation empowering the DIA as official administrator with a range of powers including: (i) taking over all powers of all decision-making bodies of the bank—management, board, shareholders—including the power to override the preemptive rights of existing shareholders in a recapitalization; (ii) writing down capital or converting subordinated debt into capital; (iii) P&A, including use of a bridge bank; (iv) merger; and (v) bank debt restructuring.
- The decision on which official administration power to deploy, or whether instead to liquidate the bank and pay out insured deposits, should be taken on a least-cost basis. To mitigate moral hazard, OBA tools such as loans to purchasers and investors, capital injections, or nationalization should be restricted to only those cases that pose a grave systemic threat, with a clear process that entails a decision taken at a high level by the government. Furthermore, in such circumstances, the DIA can only contribute up to what it would have had to pay out if the bank were liquidated, with the remainder of the funds having to be provided by the government.

- As needed to fulfill the official administrator powers, the DIA should be given more advanced notice before a license is revoked by the CBR, as well as the powers to conduct an audit of problem banks jointly with the CBR. A watch-list of problem banks should be created, and the DIA should be notified by the CBR of any banks that are placed on the list or that are reviewed for placement on the list subject to pre-agreed criteria.¹⁶

Orderly liquidation

44. **The current liquidation framework is appropriate.** There is a specific bankruptcy regime for banks that, while subject to the court process, closely involves the CBR at each stage of the liquidation process. The CBR is able to file the bankruptcy petition, appoints the temporary administrator, controls the appointment of the liquidator, audits the activities of the liquidator, requires the submission to the CBR of reports, performs accreditation of liquidators and approves the interim liquidation balance sheets and the liquidation balance sheets. Consideration should be given to introducing mechanisms for the mutual recognition of decisions made in other jurisdiction in the context of liquidation or reorganization proceedings, subject to conditions such as non-discriminatory treatment of foreign creditors and reciprocity.¹⁷

Deposit Insurance

45. **The legal framework for the deposit insurance scheme is well-structured and functions well, as attested by the experience during the crisis.** The purpose of the DI scheme is clear and participation is mandatory for all banks that accept household deposits. The DIA has made pay-outs to insured depositors in more than fifty cases during the crisis. In practice, the DIA is able to pay the depositors promptly (within 7 to 14 days after bank closure, upon receipt of depositor's claims). The coverage is 100 percent of total deposits per depositor with a bank, net of liabilities, up to a maximum of Rub 700,000, which works out to about 99 percent of household deposits by number, and about 70 percent by amount. The DIA, through subrogation, is given a high priority right over the assets of the failed bank as part of the pool of first priority creditors. Depositor preference is provided for under the DI law and the bank insolvency law. There is also the possibility of using the DI fund to assist in bank resolution, such as a P&A transaction. This is subject to important safeguards to ensure that it is least-cost when compared to the amount that would have been paid by the DIA in case of liquidation of the bank. In this context, the recent abolition of co-insurance was appropriate.

46. **The DI scheme is funded ex ante—through an initial contribution from the government and quarterly premiums paid by the member banks.** As of January 1, 2011,

¹⁶ This could be partly based on the CAMELS classification groups of the CBR.

¹⁷ See Basel Committee on Banking Supervision, Report and Recommendations of the Cross-Border Bank Resolution Group, March 2010

the fund had Rub 122.7 billion, which was equivalent to 4.4 percent of total covered deposits excluding Sberbank, or 1.8 percent including Sberbank. Adequate provisions are also in place for funding from the federal budget if there is a shortfall.

47. **A few features of the DI Law warrant reconsideration.** In addition to the enhanced information sharing with the CBR on problem banks discussed above, the authorities should reconsider the use of a ban on accepting household deposits in the event of non-compliance of a bank with particular ratios established by the CBR, for example bank profits. This may cause difficulties, for example at banks which make small losses for a period longer than six months but which otherwise would not fail and which do not represent a risk to depositor interests, and this may have unintended consequences on financial stability. While there is a moratorium on this provision currently in force, it expires in July 2011. It is noted that there is a draft law before the Duma to consider making the moratorium permanent. If the moratorium is not made permanent, it would be desirable to revise the Directive to allow more discretion to the CBR or the DIA to assess the underlying reasons for the non-compliance with the various financial ratios and take action commensurate with the risk to depositor interests.

APPENDIX I. 2008 FSAP MAIN RECOMMENDATIONS: STATUS OF IMPLEMENTATION

Recommendations	Status
Immediate stability priorities	
Begin tightening loan-loss provisioning standards to foster appropriate levels of bank capitalization.	Pending
Review banks' liquidity estimates and develop contingency plans that conform to CBR recommendations under preparation.	Ongoing
Continue to develop the lender-of-last-resort function by broadening the range of nonmarketable assets eligible as collateral, along with appropriate supervisory oversight and prudential safeguards to avoid excessive access to emergency liquidity.	Implemented
Further strengthen risk-based supervision and build off-site capacity through developing the CBR's financial stability analysis function by introducing stress tests based on macroeconomic scenarios.	Implemented
Medium-term structural priorities	
Strengthen transparency and disclosure; improve data quality and availability for the financial sector including through IFRS implementation, better corporate governance and disclosure of securities transactions.	Ongoing
Introduce cash management by the Ministry of Finance, in coordination with the CBR, in order to smooth the volatility of the overnight interest rate resulting from monthly tax collections.	Partially implemented
Establish the legal concept of "beneficial owner" to address weaknesses in bank licensing, large exposures, consolidated supervision, and overall market transparency.	Ongoing
Provide for development of consolidated supervision of banking groups based on appropriate methodologies.	Ongoing
Strengthen the remedial action and bank resolution frameworks by introducing prompt corrective actions and giving the CBR powers for early intervention, including the sale of failing banks.	Ongoing
Strengthen prudential oversight of the securities markets by implementing pending legal and regulatory reforms and strengthening the capacities of the FSFM.	Ongoing
Increase enforcement authority against insider trading/market manipulation.	Implemented
Improve market transparency through the mandatory listing of active stocks, separate disclosure of repurchase transactions, and continuing to improve reporting of over the counter (OTC) transactions.	Partially implemented
Implement regular oversight of SROs.	Implemented
Create a central clearing and settlement system, and rationalize and automate custodian arrangements.	Ongoing
Upgrade the insurance law to include fit and proper criteria.	Pending
Strengthen FSIS regulatory authority and capacity, including by allowing it to issue technical directives and emergency actions.	Partially implemented
Bring minimum capital of insurance companies to EU standards.	Implemented

APPENDIX II. RUSSIA: RISK ASSESSMENT MATRIX

Nature/Source of Main Risks	Likelihood of Severe Realization of Risk in the Next One to Three Years	Expected Impact on Financial Stability if Risk is Realized
A sizeable decline in oil prices	<p style="text-align: center;"><i>Medium</i></p> <ul style="list-style-type: none"> • Severe global economic and financial distress could depress commodity prices, including oil. • With still weak macroeconomic and financial conditions in advanced economies, the uncertainties for global economy remain elevated. 	<p style="text-align: center;"><i>High</i></p> <ul style="list-style-type: none"> • Declines in oil prices impact a large part of the economy beyond the energy sector, affecting GDP growth, external balance, exchange rate, and asset prices. • A generalized deterioration of asset quality and valuation losses would cause credit losses. Some banks with concentrated exposures to the energy and other commodity sectors, in particular, could be affected disproportionately. • Direct risks from exchange rate and equity prices seem manageable. The impact from exchange rate depreciation could be small as well: only a fraction of FX loans (1/3 of total loans) are granted to borrowers without FX income. The NPL ratio for corporate sector loans is estimated to decline when Ruble depreciates as they tend to have strong FX revenue related to natural resources.
A sharp increase in capital outflows reflecting higher risk aversion in global financial markets (e.g. triggered by distress in Euro area debt markets)	<p style="text-align: center;"><i>High</i></p> <ul style="list-style-type: none"> • Severe global financial distress events would increase global risk aversion and shift capital flows away from EMs, including Russia. • Although unlikely, major negative political events in Russia could also damage investor confidence and reduce capital inflows to Russia. 	<p style="text-align: center;"><i>Medium</i></p> <ul style="list-style-type: none"> • Exchange rate and financial markets face higher volatility partly owing to shallow markets, with higher interest rates and spreads and with weaker ruble and asset prices. • In addition to valuation losses that affect solvency, a systemic liquidity shortage could emerge mainly due to high volatility of household deposits in Russia because of negative historical experiences. Eligible collateral for central bank liquidity operations and customer deposits are concentrated in a few large banks, leaving many smaller banks with significant funding risks. • Banks face higher funding costs even when they can sustain access to funding.
Global macroeconomic and financial shock (e.g., double-dip)	<p style="text-align: center;"><i>Medium</i></p> <ul style="list-style-type: none"> • Despite the global recovery, risks and uncertainties remain high. Relatively small macro and/or 	<p style="text-align: center;"><i>High</i></p> <ul style="list-style-type: none"> • Russian economy could be hit hard, as in 2008, with weaker growth, external balance,

Nature/Source of Main Risks	Likelihood of Severe Realization of Risk in the Next One to Three Years	Expected Impact on Financial Stability if Risk is Realized
recession)	financial shocks (could develop into a global double-dip recession reflecting adverse macro-financial feedback loops.	exchange rate, and asset prices. • Banks incur losses from weak credit qualities and asset prices. Concerns on solvency could lead to deposit withdrawals from smaller (private) banks and to higher costs of funding. Uneven distribution of stable deposit and repo-eligible assets could also exacerbate segmented liquidity shortage.
A major decline in real estate prices	<i>Medium</i> • Large Russian cities have experienced very rapid growth in real estate prices in the past.	<i>Low/medium</i> • The share of residential and commercial real estate loans in bank balance sheet is low, but loans to the construction sector and links through collateral valuation of properties could be significant. • Some systemically important banks may experience concentrated effects as they have high share of loans in the metropolitan construction sector.
A large bank failure rooted governance and other structural issues, and unanticipated due to data gaps and poor reporting	<i>Medium/High</i> • Weaknesses in the regulatory and supervisory framework (consolidated supervision, related party lending, accounting, asset classification and provisioning) entail risks of not detecting major accumulation of undetected vulnerabilities, including concentration of exposures beyond regulatory limits. • Banks have weak corporate governance and inadequate risk management practice. • Out of over 1000 banks, failures of minor banks have been fairly common in Russia	<i>Low/Medium</i> • Closure of systemically important banks is rather unlikely. Large state-owned banks are well capitalized and tend to have stable and low cost funding base. Large private banks are likely to be rescued. • However, in the event of a major bank failure, a system-wide run on deposits, as well as wholesale funding, could happen. In a worst case scenario, the relative health of public finances could allow the government to intervene without jeopardizing fiscal sustainability. • Bank failures are usual events in Russia. The cases of Mezhprombank and Bank of Moscow illustrate that even a closure of a relatively large bank is not likely to have systemic impact.

APPENDIX III. RUSSIA: STRUCTURE OF THE FINANCIAL SYSTEM

46. **The Russian financial system is relatively small compared to advanced economies and dominated by commercial banks.** As of end-2010, total assets of financial institutions were equal to Rub 36 trillion, or around 80 percent of GDP (Table 6). Banks accounted for over 90 percent of the total assets.
47. **Despite ongoing gradual consolidation, the number of banks in Russia is large, but the system is dominated by a few state-owned banks.** As of end-2010, there were 1,012 banks operating in Russia, a decline by 46 from January 1, 2010, and about 250 lower than five years earlier. This trend continued during the crisis, supported by official policies (the CBR's minimum capital requirement for banks was raised to Rub 90 million in January 2010, and further increases to Rub 180 million in 2012 and Rub 300 million in 2015, are in store). But the recent consolidations have favored a few large state-owned banks. Although the share of state-owned banks in total deposits had been falling through most of the decade until 2007, the financial crisis turned this trend around as depositors fled for safety. At the end of 2010, the share of the state banks in total was 52 percent, up almost 3 percentage points from 2007.
48. **The degree of interconnectedness of the Russian banking system with the rest of the world is relatively limited.** Foreign banks account for only 17 percent of the Russian banking system in terms of assets. Russian banks are also not very active abroad, with a noticeable presence only in a few CIS countries. And even in those countries, Russia is a marginal source of funds, though the reported figures might understate the extent of flows going through international financial centers.¹⁸
49. **The dominance of the state-owned banks weighs heavily on the competitive environment.** Since the state banks are widely viewed as safer—as they benefit from implicit guarantees on their liabilities—private banks must pay a premium over state banks to attract deposits. The state banks also benefited from superior access to emergency liquidity support during the crisis. As a result of the increasingly strong position of the state banks in core banking segments, some private banks are trending towards niche markets and, possibly, greater risk-taking, while some foreign banks are leaving the market.
48. **The government is moving to partially privatize state banks.** As part of the government's strategy for the development of the banking system through 2015, the authorities intend to divest part of state holdings in banks, while keeping the majority in the three largest. A 10 percent stake in VTB was already sold in 2011, and there are plans to divest another 25 percent in this bank. Also, in March 2011, the CBR got a clearance from the National Banking Council for the sale of a 7.58 percent stake in Sberbank (which is owned by the CBR) in 2011. Separately, the government is moving to reduce the number of state officials on the boards of state-owned companies, including banks. While these

¹⁸ See IMF Country Report No 08/308 (<http://www.imf.org/external/pubs/ft/scr/2008/cr08308.pdf>).

measures represent progress, it is unclear that they will imply significant changes for the structure of the banking market as long as the key banks remain viewed as benefiting from an implicit government guarantee.

49. **The nonbank financial institutions represent a small fraction of the financial system.** Insurance companies, private pension funds, and investment funds each account for less than 3 percent of the total financial system assets.¹⁹ Factors constraining the expansion of these institutions include lack of a broad investor base, relatively underdeveloped pension companies, and lack of comprehensive disclosure by issuers. A consolidation has taken place in the last few years, with the number of nonbank financial institutions gradually decreasing.

50. **Insurance penetration remains very low.** It amounts to around 1 percent of GDP, when the state compulsory health insurance is not considered, or only one-third of the average penetration of the OECD countries in 2009.²⁰ As in many countries the motor insurance is the dominant business, accounting for around 50 percent of the industry. Property is the second line of business, with 25 percent of the total premium. Life business traditionally creating large reserves is practically non-existent, with less than 2 percent of the whole insurance business, compared to the world average of around 50 percent.

51. **Russia has a mid-sized securities market.** Market capitalization of MICEX—the largest exchange—is about 60 percent of GDP; however, equity penetration is reportedly low. MICEX Group and RTS, the two Russian exchanges, are now expected to conclude a binding merger agreement by May. MICEX is among the top 20 exchanges according to the World Federation of Exchanges. RTS's largest market is Futures and Options RTS, on which equity repos are traded through a CCP. More than 50 percent of securities markets participants by volume and value are banks, who often use equities for collateral given the lack of long-term bonds. The top ten market participants account for almost 50 percent of trading.

¹⁹ There are also nonbank credit institutions in Russia, which are allowed to perform a limited set of banking operations in accordance with the license issued by the CBR. These institutions account for a very small fraction of the financial system (less than 0.5 percent of the total assets, Table 6) and are not discussed in this report.

²⁰ The mandatory health insurance has limited financial sector implications and falls outside the scope of the FSAP. This insurance represented around 60 percent of all insurance premium in 2009, with the premium paid by local government budgets.

Table 6. Russia: Financial System Structure, 2007–10

	2007			2008			2009			2010		
	Assets (Rub bn)	Percent of Total	Number	Assets (Rub bn)	Percent of Total	Number	Assets (Rub bn)	Percent of Total	Number	Assets (Rub bn)	Percent of Total	Number
Credit institutions	20,125	91.5	1,135	28,022	93.1	1,108	29,430	93.7	1,058	33,805	93.8	1,012
Banks	20,030	91.1	1,092	27,831	92.5	1,058	29,324	93.3	1,007	33,673	93.4	955
o/w State-owned banks 1/	7,327	33.3	22	10,499	34.9	14	11,528	36.7	12	13,871	38.5	21
o/w Other local banks	9,029	41.0	993	12,385	41.2	951	12,622	40.2	907	13,717	38.1	844
o/w Foreign banks 2/	3,674	16.7	77	4,947	16.4	93	5,175	16.5	88	6,084	16.9	90
Nonbank credit institutions	95	0.4	43	192	0.6	50	106	0.3	51	132	0.4	57
Nonbank financial institutions	1,871 [█]	8.5	2,121	2,075 [█]	6.9	2,042	1,987 [█]	6.3	1,664	2,241	6.2	na
Insurance companies 3/	748	3.4	857	847	2.8	786	874	2.8	702	960	2.7	na
Unit investment funds (PIF) 4/	520	2.4	1,024	649	2.2	1,047	370	1.2	796	420	1.2	796
Private pension funds 4/	603	2.7	240	579	1.9	209	743	2.4	166	862	2.4	158
Total	21,996 [█]	100.0	3,256	30,097 [█]	100.0	3,150	31,417 [█]	100.0	2,722	36,046	100.0	na
<i>Memorandum item</i>												
Total assets in percent of GDP	66.2			72.9			81.0			81.0		

Source: Central Bank of Russia; Federal Service for Financial Markets; Expert RA

1/ Majority government-owned.

2/ Majority foreign-owned.

3/ Data for 2010 are for June.

4/ Data for 2010 are for September.

APPENDIX IV. SUMMARY OF STRESS TESTING FRAMEWORK

		Top-down Tests		Bottom-up Test
		Single-factor	Macro Scenario	
1	Who performed the tests	CBR	CBR and Prognoz 1/	Individual banks
2	Institutions covered	All (1012)		15 (56 percent of the system)
3	Assessment date and type of data	December 2010, supervisory bank-by-bank data		December 2010, banks' internal data
4	Risk horizon	Instantaneous	One year	
5	Metrics (hurdle rates)	Regulatory minimum CAR (10 percent)		
6	Positions and risk factors included	<ul style="list-style-type: none"> • Credit risk (household and corporate loans). • Concentration risk • Market risks (FX, equity and interest rate) from trading + AFS accounts. • Liquidity risk • Combined shock of credit, market and liquidity risks. • Interbank contagion risk. • Adjustment for regulatory issues. 	<ul style="list-style-type: none"> • Credit risk (household and corporate loans). • Market risks (FX, equity and interest rate) from trading + AFS accounts. • Liquidity risk • Profit generated within risk horizon. 	
7	Severity of shocks	<ul style="list-style-type: none"> • Credit risk: (A) 1.65 st. dev. shock on historical average; (B) 1.65 st. dev. shock on actual. • Concentration risk: default by top five borrowers. • Market risks: FX—20 percent depreciation; equity—30 percent decline; interest rate—+300 (900) bps for government (corporate) bonds. • Liquidity risk: Outflows; household deposit—20 percent; corporate settlement accounts—20 percent; corporate deposits—10 percent; cross-border interbank deposit—30 percent. Haircut: high liquid asset—5 percent; liquid asset— 	<ul style="list-style-type: none"> • Baseline: GDP growth rate 4 percent—slightly below WEO forecast (as of early 2011). Oil price US\$70/barrel. Equity price no change. Ruble depreciation 10 percent. • Pessimistic: GDP growth rate -1 percent (1 st. dev. shock using 2000–2010 history). Oil price US\$50/barrel. Equity price -50 percent. Ruble depreciation 20 percent. • Severe: GDP growth rate -4 percent (1.7 st. dev. shock using 2000–2010 history). Oil price US\$43/barrel. Equity price -67 percent. Ruble depreciation - 	<ul style="list-style-type: none"> • For banks using internal macro-financial model: same macro assumptions (severe scenario) as top-down macro scenario tests. • For banks using combined single-factor test approach: same assumptions as with the top-down combined single-factor test.

		Top-down Tests		Bottom-up Test
		Single-factor	Macro Scenario	
		<p>20 percent; low-liquid assets—60 percent. No access to domestic interbank market.</p> <ul style="list-style-type: none"> • Combined shock: credit risk (A), market and liquidity risks. • Contagion: Initial shock is the above combined shock. 	26 percent.	
8	Methodology	<ul style="list-style-type: none"> • CBR's regular test • Constant RWA, no profit, 100% provisions for new NPLs. • Liquidity risk is measured by its solvency impact due to losses from fire sales of liquid assets, no cash inflows. • Contagion: a bank "defaults" on all of its interbank liabilities when total losses amount to 75% of capital. 	<ul style="list-style-type: none"> • Operational since early 2011 • RWA grows with asset, 100 percent provisions for new NPLs. • Profit is modeled with constant interest margin from performing loans (but income will be lost from non-performing loans, reducing profits). • Liquidity risk measured by solvency. CBR's haircut is applied for securities available for CBR's repo operation. Cash inflow from loan repayment and access to interbank market (at punitive rate). 	<ul style="list-style-type: none"> • Approach A: use banks own internal macro-financial model and behavioral assumptions. • Approach B: follow CBR's single-factor test (combined shock).

1/ Prognoz is an external consulting company based in Perm. It has been working with the CBR to develop various macroeconomic and stress testing models.

APPENDIX V. SUMMARY OF FACTUAL UPDATE OF COMPLIANCE WITH CODE ON MONETARY POLICY TRANSPARENCY

In recent years, the CBR has taken numerous steps to enhance its transparency by addressing shortcomings noted by the assessment of observance with the IMF's Code on Monetary Policy Transparency in 2003. The 2003 assessment asked for clarification of several aspects of disclosure policy, and action has been taken in each of these aspects. These include:

The institutional relationship between the CBR and the MoF in debt service transactions and for disclosure of conditions for paying interest on the MoF deposits in CBR

- By law, the CBR serves as fiscal agent for the government, and manages the resources of the reserve fund and the national welfare fund in accordance with an established legal framework that is publicly available. The financial balances of the government in the CBR are published monthly on the CBR website, and other financial information, such as yields on international reserves and balances in the two sovereign wealth funds are presented in the annual report.

Procedures for the CBR's participation in the secondary market

- Open-market transactions are defined by law as the purchase or sale of treasury bills, government bonds, or securities, and the purchase or sale of other securities by decision of the CBR Board of Directors. The CBR may not buy primary issues of government securities. The annual report explains the procedures for participation in the secondary market. Information on the size of the CBR's portfolio of government securities is published in various ways, including the balance sheet of the CBR and the annual report.

The CBR's participation in financial institutions and all other organizations it controls

- The CBR is not entitled to participate in credit institutions unless stipulated by law. The CBR may participate in the capital and activities of international organizations that promote monetary and banking co-operation, including between central banks of foreign states. Information on this participation is disclosed in the Annual Report.

Division of responsibilities between government and CBR on secondary market

- The CBR is the agent for the government's domestic bond placements. The rules governing these transactions as well as the associated statistics are posted on the CBR website.

Reasons for changes in monetary policy

- The instruments of monetary policy are presented on the website of the CBR. Explanations of changes in monetary policy appear in many ways, including publication of minutes of meetings of the Board of Directors, the quarterly inflation report, the annual report, and speeches by the members of the Board of Directors. A consultative council on monetary and regulatory policy allows for a more open dialogue with the private sector.

APPENDIX VI. BASEL CORE PRINCIPLES—SUMMARY ASSESSMENT

A. Introduction and Methodology

52. **A targeted assessment of the Basel Core Principles for Effective Banking Supervision (BCP) was conducted as part of the FSAP in April 2011.** The assessment was performed by Jose Tuya, an external consultant, and was based on the 2006 BCP Methodology. The principles reviewed (5, 6, 7, 8, 9, 11, 12, 18, 23, and 24) covered the following risk areas: major acquisitions, capital adequacy, risk management process, credit risks and provisions, exposure to related parties, abuse of financial services, remedial actions and consolidated supervision. The assessment was based on information available as of June 2011.

B. Institutional and Market Structure—Overview

53. **The CBR Law and the Law on Banks and Banking Activities (BL) assign responsibility for the licensing and supervision of banks to the CBR.** The law empowers the CBR to grant banking licenses, approve permissible activities, issue regulations, supervise and enforce compliance with laws and regulations.

54. **As part of the Development Strategy for the Banking Sector through 2015, the CBR is in the process of overhauling the supervisory, legal and operational landscape to enable the implementation of supervision by risk; including an enhancement in the scope of consolidated supervision.** A published strategic plan to strengthen capital requirements and strengthen banking supervision is comprehensive and candid in recognizing shortcomings in the banking supervision framework. The strategy proposes to strengthen the CBR's legal supervisory powers, and improve transparency, asset valuation, and corporate governance in banks. Adopting the proposed agenda and pending legislation will enhance the CBR's ability to conduct more intensive supervision, identify risks, and take timely corrective action.

55. **Current oversight of banking activities by the CBR relies on an integrated process combining offsite reviews with on-site inspections.** In the course of supervision exercised by the CBR's territorial offices, as well as by the CBR's central staff with respect to systemically important financial institutions (SIFIs), frequent contact is maintained with bank management. Since the 2007 FSAP, the CBR has been working on legislative changes required to enable the CBR to appoint resident inspectors at SIFIs.

56. **Legislation granting the CBR increased professional judgment to implement international best practices without always requiring a revision of existing legislation would enhance the safety and soundness of the banking system.** Currently, the CBR is unable to require banks to implement best practices in many areas of corporate governance, and risk management or to perform consolidated supervision because of a lack of regulatory authority. Authority, within an approved legislative framework, to rely on professional judgment to implement best practices as prescribed by international standard setters, adjusted to the local market, is an essential element of supervision.

57. **The Russian banking sector is dominated by state-owned banks.** As of January 1, 2011 there were 1,012 banks operating in Russia, a decline of 46 from January 1, 2010. The number of banks is expected to decline further as a result of increased minimum capital requirements. As of January 2010, minimum capital was raised to RUB 90 million and will be raised to RUB 180 million on January 2012. The 50 largest banks control 80 percent of assets and the top 5 (all state-owned) control 48 percent.

58. **The level of nonperforming loans and overdue loans has declined recently.** As of January 1, 2011 banking system assets totaled 33,805 billion rubles and the capital adequacy level was 18.1 percent. Nonperforming loans (NPL), which are defined as loans classified in categories IV and V, amounted to 8.2 percent of total loans, a decline from 9.6 percent on January 1, 2010. Loan provisions cover 102 percent of NPLs but seem inadequate to cover possible losses in the remainder of the loan portfolio. Profitability has increased over the last year, with a return on equity moving from 5 percent in 2009 to 12.5 percent in 2010.

C. Preconditions for Effective Banking Supervision

59. **The Russian economy is emerging from a sharp recession with lower growth potential, at least in the near-term.** The economy contracted by almost 8 percent in 2009, reflecting plunging oil prices and a sharp reversal of capital inflows. A recovery started in mid-2009 led mostly by domestic consumption, which, in turn reflected a policy stimulus. The recovery remains modest, with growth projected at the 4-4½ percent range in 2010-12. While risks appear manageable in the short-run, the combination of a more modest pace of economic growth and abiding regulatory and governance shortcomings cloud the outlook for Russian banks.

60. **Russian standards and the application of international accounting and auditing standards are improving but further measures are still required.** Approval of new draft laws on consolidation, accounting and audit would benefit the effectiveness of supervision and regulation. In the meantime, progress has been made to converge Russian and international accounting standards, but important differences remain, for instance on revenue recognition, consolidation, employee benefit and pension accounting, impairment testing, the application of fair value accounting, and related party transaction disclosure requirements. Proposed laws on consolidation and accounting envisage the mandatory use of IFRS in the consolidated financial statements of banks, listed companies, insurers, pension funds and other public companies. All in all, a roadmap exists to enhance the quality of financial reporting in Russia. The CBR requires all banks to prepare supplementary IFRS financial statements, although there is no requirement to publish. Improving transparency and reliability of financial information is an important element of the strategy of the government to develop the financial system reporting and bring supervisory standards to meet international best practices. An extensive legislative agenda is being developed to achieve those goals.

61. **The CBR's response to the financial sector turmoil confirmed its ability to respond to the liquidity stresses in the system.** The CBR has powers to require early remedial action,

mandate change of management and intervene in a failed bank. A system for early intervention would enhance the CBR's powers, as well as powers to take action against individual managers and directors. Since 2005, Russia has a Deposit Insurance Agency, which has improved the level of confidence of depositors in the system.

D. Main Findings

62. **While there has been some improvement in compliance with the BCPs, the CBR's enforcement powers remain limited in critical areas such as corporate governance and related party supervision and identification.** The CBR Law and the BL do not give the CBR sufficient authority to implement many of the BCP requirements. The CBR lacks authority to set key requirements to prevent abuses arising from exposures to related parties and to address conflict of interest. The narrow definitions of related parties makes it difficult, if not impossible, to: (i) identify all the lending relationships of each related party with the bank, (ii) identify all of the bank's affiliates to monitor transactions and measure risk to the bank's financial condition from affiliates, and (iii) be able to capture all related risks under the lending limits as a percent of capital to limit concentrations. The CBR also lacks the authority to sanction individual Board members.

63. **Proposed amendments to the CBR Law and the BL are pending at the Duma that (when approved) are expected to address deficiencies noted by the previous and the current BCP assessments concerning consolidated supervision and related party supervision.** These legislative amendments would enhance the CBR's ability to conduct consolidated supervision by amending the CBR Law to expand the CBR's supervisory authority to regulate bank holding companies and to take supervisory actions to mitigate risks to the bank from affiliate operations, including the ability to limit or not allow them. Additionally, the amendments will expand the definition of control to capture not only direct ownership but also economic dependency.

64. **In an effort to continue strengthening the supervisory framework while the legislative process grinds on, the CBR has been issuing letters of recommendations to banks for implementing international best practices on risk management and corporate governance.** However, without the regulatory support, the CBR lacks enforcement authority over the recommendations made in such letters. For example, the CBR currently lacks regulatory power to require banks to implement the internal capital adequacy assessment process (ICAAP) under Pillar 2 of the Basel II framework, so the CBR is planning to issue a recommendation letter to banks in 2011 on implementing the Pillar 2 requirements. The CBR reports that through moral suasion, and the fact that the banks are aware that regulations are in process, it has been able to make progress in having banks implement some of the recommendations.

65. **Progress is noticeable in the risk supervision practices applied by the CBR.** Pursuant to Directive No. 2005-U, the assessments of banks' financial condition is based on the

analysis of quantitative indicators for the adequacy/quality of capital, assets, profitability and liquidity, and qualitative indicators characterizing the status of risk management systems, internal supervision systems, strategic risk management systems, and transparency of ownership structure. With a view to identifying problems in the operations of banks at an early stage, projected values for capital and profitability are reviewed using forecast values projected 12 months out, based on data for the two previous years and on trend models. Based on the results, banks are assigned to one of five risk categories.

66. **The enforcement actions/tools provided by the CBR Law do not allow sufficient options or flexibility to address imprudent practices at an early stage.** The CBR is provided with a number of supervisory tools to encourage banks to address violations or unsafe banking practices. However, the corrective actions set by Art. 74 of the CBR Law and Art. 20 of the BL have limitations. The CBR lacks enforcement authority to: 1. Penalize or otherwise sanction individual bank directors at open banks, 2. Suspend²¹ some or all of the shareholders from participation in the management of the credit organization, including their right to vote or accept dividends. 3. Establish limits on salaries and bonuses paid out to directors and key bank personnel. 4. Require additional capital levels to be maintained against the risks specific to the bank, except to impose higher CAR as sanction for violations of Federal law and limited to a six-month period. 5. Require prior consent of the supervisory authority to incur a major expenditure or take on a new liability.

67. **The following summarizes** the main findings of the detailed assessment of compliance with the BCP.

Objectives, independence, powers, transparency and cooperation

- **Licensing and structure (CP 5)**

68. **The CBR Law does not establish requirements for banks to seek prior CBR approval when making domestic investments in nonbank financial institutions.** Foreign investments by Russian banks require prior approval by the CBR, when they lead to the establishment of a subsidiary abroad, or acquisition of the status of parent company of a non-resident entity. A domestic acquisition of shares in a bank above a 20 percent ownership requires prior CBR approval. Acquisitions of over one-percent share require ex-post notification to the CBR. There is also an aggregate 25-percent limit on investments in banks and other entities. However, bank investments in nonbank financial firms do not require prior CBR approval. The CBR relies on the 25 percent aggregate limit to control that risk. Licensing regulations should provide for an approval/notification process for bank investments in non-banking institutions. Without such requirement the CBR is not able to measure the possible impact of acquisitions on a bank's condition or to determine whether the acquisition will affect

²¹ When not under temporary administration, as laid out in Article 74 of the Law on the Central Bank.

the transparency of the bank's organizational structure and affect the ability of the CBR to supervise it.

▪ **Prudential Regulations and Requirements (CPs 6, 7, 8, 9, 11, 12 and 18)**

69. **Capital adequacy rules generally meet Basel II, Pillar 1 guidelines but the CBR lacks a legal authority to implement the Pillar 2 component.** The standardized, simplified approach is being implemented but the CBR lacks the regulatory authority to implement the supervisory review process prescribed by Pillar 2. Under Pillar 2 the CBR plans to issue recommendations in the second quarter of 2011 on minimum standards for organizing internal procedures for assessing the adequacy of internal capital to cover potential and assumed risks and to provide for future capital needs based on stress testing, strategic plans and risk evaluation. Without legislation specifically stating the authority of the CBR to stipulate standards for risks and capital management, the CBR may not oblige credit institutions to implement said recommendations, to develop internal capital adequacy assessment procedures and to implement them.

70. **The existing risk management regulatory framework is complex and multi-faceted, but it does not provide the foundation necessary for full implementation of supervision by risk.** The CBR has issued numerous regulations, instructions and recommendations which directly or indirectly support banks' strengthening their internal risk management processes. The nature of existing regulations enable a compliance approach to supervision but limit the ability of the CBR to exercise professional judgment to rate the adequacy of risk management systems or Board of Director policies and governance. Addressing these deficiencies is an area where the CBR is focused but needs amendments to existing legislation.

71. **The concept of related parties has been identified in the regulations and the CBR collects reports on related parties, but the definition of related parties is narrow and based on legal relationships.** Legislation is being reviewed by the Duma that would expand the definition of related parties and allow the CBR to make judgments based on economic relationships or evidence of ability to influence decisions. The regulatory framework for related party transactions is also deficient in that it does not require that lending to related parties be on same terms and conditions as those generally offered to the public. The CBR has issued recommendations to banks on related party lending, however, they lack enforcement capacity.

72. **The CBR is considering amending Regulation 254-P to address country and transfer risk.** The current system does not impose country risk limits or provisions, except for operations with residents of offshore centers. The CBR has issued recommendations to credit organizations on the management of risk country based on the approaches specified in the BCBS document "Management of Banks' International Lending (Country Risk Analysis and Country Exposure Measurement and Control)" and also includes BCP requirements.

73. **The supervisors do not have the authority to directly share client information with other agencies and regulators, at home or abroad, which constitutes a serious deficiency.** However, it can share such information with the FIU. Also, the CBR is aggressive and very successful in closing banks that are involved in money laundering.

- **Corrective and Remedial Powers of Supervisors (CP 23)**

74. **The legal regime for corrective and remedial actions is clearly addressed in the regulations.** Enforcement powers are broad and clearly spelled out. The remedial powers of the CBR are deficient in some key areas, such as the inability to sanction Board members and to prevent transactions between the bank and its affiliates.

- **Consolidated supervision (CP 24)**

75. **An inability to limit transactions between affiliates, and request information from holding companies limits the ability to conduct consolidated supervision.** Legislation is pending with the Duma to amend the CBR Law and the BL that will extend the supervisory authority of the CBR to cover bank holding companies. The amendments will also expand enforcement authority over banking groups and bank holding companies by granting the CBR authority to limit transactions between affiliates. The CBR will be able to dictate the types of consolidated information that bank holding companies will need to provide. The CBR actively collaborates with foreign supervisors and the amendments will enable the CBR to exchange customer-specific information. Finally, the definition of direct and indirect influence is expanded. Absent such powers, the ability of the CBR to monitor transactions between affiliates is severely hampered, increasing risks that losses are hidden through affiliate operations or off-balance sheet transfers. In defining bank holding company the EU standard (to be a bank holding company, over 40 percent of the company's activities must be in banking) will be applied. However, in Russia that definition may not be adequate as a large banking group would not be included. The definition should be reviewed and adjusted to the Russian market and ensure that all SIFIs are covered.

Table 7. Summary of Compliance with the Basel Core Principles

Only principles 5, 6, 7, 8, 9, 11, 12, 18, 23 and 24 have been reassessed

Principle	Comments
CP 5	There is no requirement that banks seek prior CBR approval to make nonbank domestic investments. The lack of an ex-ante determination of an acquisition's possible impact on a bank prevents the CBR from being able to limit the exposure to the bank of undue risks. While ex-post the CBR may address risks, it does not meet a critical object of this CP; preventing adverse impacts by an ex-ante review.
CP 6	Russia meets the CP-6 essential criteria and has partially implemented the Basel II standardized simplified approach. Legislation is being drafted to permit Pillar 2 implementation.
CP 7	The CBR is endeavoring to improve the banks' risk management regulatory regime, strengthen the requirements on the board of directors and define the concept "independent directors" In addition, assess through regulation corporate governance, risk management and audit in banks
CP 8	The CBR has sufficient legislative and regulatory authority to enable the regular monitoring of banks' credit risk exposures through a robust reporting and inspection regime. EC3 is not complied with as CBR lacks the regulatory framework to be able to require lending to related parties be done at market terms and sanction banks that do not comply.
CP9	The CBR continues to strengthen implementation of its provisioning regime.
CP 11	A narrow definition of related parties and connected relationships prevents the CBR from linking all the exposures and applying limits or imposing supervisory restrictions. In addition, the CBR lacks to authority to sanction directors individually.
CP 12	The CBR has not issued guidelines for banks on provisioning for country and transfer risk.
CP 18	The CBR is prevented by privacy laws from sharing account information with other banking supervisors.
CP 23	While the CBR has the right to impose fines on the credit institution, it cannot sanction individual bank directors and officers (at non-intervened banks). Appropriate powers should be provided the CBR to administratively sanction (and/or remove if necessary) persons affiliated with banks: this is more efficient and expedient and would have a strong signaling effect to deter others. CBR announced plans to seek this authority.
CP 24	In performing consolidated supervision the CBR is unable to capture all related parties and affiliates due to the narrow definition in Russian legislation. The amendments will extend CBR supervisory authority to bank holding companies.

Table 8. Recommended Action Plan to Improve Compliance of the Basel Core Principles

Only principles 5, 6, 7, 8, 9, 11, 12, 18, 23 and 24 have been reassessed. The recommended action for the other principles is carried over from the 2007 BCP assessment

Reference Principle	Recommended Action
1.1 Responsibilities and Objectives	Implement action plans included in the Strategy for the Development of the Banking Sector through 2015.
1.2 Independence, accountability and transparency	Balanced by appropriate accountability structures, consider a higher level of representation of the CBR in the National Banking Council, request stronger political support for the CBR's work in the banking sector, and provide an explicit legal basis for the CBR's role in financial stability.
1.3 Legal Framework	Commence a project to streamline banking regulations, to make them more accessible to banks and supervisors.
1.4 Legal Powers	Continue work to introduce a stronger legal basis for the CBR's use of professional judgment in its work, accompanied by appropriate accountability.
1.5 Legal Protection of Supervisors	Prepare a written CBR guideline to confirm that the CBR will finance the legal defense of individual officials, from the beginning of the procedure, in advance, not just reimbursement after the fact.
1.6, 24 and 25 Cross border cooperation	Remove unwarranted legal barriers against exchange of individual client information.
3 Licensing criteria	Strengthen vetting of senior managers, shareholders, and Board members, allowing for the use of professional judgment by the supervisor, i.e., lowering the vetting threshold to 10 percent of shares, versus the current 20 percent.
4 Transfer of Significant Ownership	Lower threshold for the vetting of shareholders to 10 percent from 20 percent.
5 Major acquisitions	Require ex-ante CBR approval of acquisitions of domestic nonbank financial institutions.
7 Risk management	Continue to work on introduction of regulations on banks' risk management, e.g., by strengthening requirements of the BL with regard to the functions and composition of the banks' Boards of Directors, and amending the Central Bank Law to allow the CBR to issue regulations on bank governance.
9 Problem assets, provisions and reserves	Continue implementation and enhancement of provisioning standards to ensure an adequate level of loan loss reserves for the banking system.
11 Exposure to related parties	Reinforce ability of CBR to obtain information on nonbank group entities, including bank holding companies and "sister" companies. Amend Article 4 of Banking Law to broaden definition of related parties, Introduce 25 percent limit on exposure to "groups of connected debtors."
12 Country and transfer risks	Introduce regulations on provisioning of country and transfer risk.
14 Liquidity risk	Continue work to introduce a new approach to liquidity supervision, and issue new recommendations or regulations to banks, including that the Board of a bank approve the liquidity strategy.

Reference Principle	Recommended Action
15 Operational risk	Continue work to prepare methodological recommendations on IT and technology risks.
20 Supervisory techniques	Amend the Banking Law to permit follow-up inspections of a bank on the same topic, with appropriate safeguards to prevent the supervisory burden.
22 Accounting and auditing	Implement the new accounting rules, which are more closely IFRS based. Amend the Law on Auditing Activity and issue CBR recommendations on audits of banks and consolidated groups.
23 Corrective and remedial powers	Introduce sanctions against individual directors and officers of a bank.
24 Consolidated supervision	Introduce broader powers with regard to bank holding company supervision. Continue to improve the database on consolidated groups. Continue to work with the Ministry of Finance to update the main provisions of the rules on supervision on a consolidated basis.

E. Authorities' Response

76. The authorities were in general agreement with the conclusions and observations in this assessment. Written comments provided have been incorporated in the report.

APPENDIX VII. IOSCO CORE PRINCIPLES—SUMMARY ASSESSMENT

A. Introduction and Methodology

77. **An assessment of the level of implementation of the IOSCO Principles in the Russian securities market was conducted as part of the FSAP in April 2011.** The assessment was performed by Andrea M. Corcoran, an external consultant, and was based on the Objectives and Principles of Securities Regulation of 1998 (IOSCO Principles) and the related Assessment Methodology adopted in 2003 and reissued in 2008. The assessment was based on information available as of June 2011.

B. Institutional and Market Structure—Overview

78. **The FSFM is the primary authority responsible for the supervision of securities markets in Russia.** FSFM is the sole regulator of: solo securities market professionals (brokers, dealers, portfolio managers, and other intermediaries); issuers; collective investments (CIS); CIS management companies and special custodians; exchanges and market infrastructure, such as clearing and settlement arrangements, depositories, and registrars for securities corporate bonds, and other products, including futures. However, the entity within the MICEX Group market complex, which trades foreign currency, is overseen by the Central Bank of Russia (CBR) as is the government bond market. FSFM has certain company law responsibilities, in particular with respect to tender offers, mergers and other combinations. FSFM oversees the public issuance of securities and registers all corporate bonds and equity offers, except for certain short term debt, described as commercial paper. Many securities transactions, however, are conducted within banking structures as opposed to through separate securities broker subsidiaries. FSFM is the regulator for certain of the securities functions performed within banks, such as special custodial functions, brokerage, or asset management. However, FSFM is not the regulator of pooled investment funds offered by banks to their customers (bank managed mutual funds or BMMFs), though it may authorize the management companies. The assets under management in BMMFs are declining and overall, such bank funds are relatively small. The FSFM regulates the contents of disclosures by public companies and non-bank financial institutions engaged in capital markets transactions (professional market participants). The Ministry of Finance (MoF) is responsible for establishing accounting and auditing standards. As of March 4, 2011, FSFM assumed the functions related to insurance supervision. The alignment of responsibilities, leadership of the combined agency, and initial proposals for the distribution of powers and authorities were announced in April. These announcements would give additional authority to the MoF with respect to the issuance of regulations related to prudential matters, such as capital, but preserved the assignment of supervisory and operational functions in that area to the FSFM.

79. **FSFM has full licensing authority with respect to the professional market participants subject to its jurisdiction, and can grant, condition, suspend, revoke, or deny licenses, without approval by any other authority within the government.** FSFM has

administrative powers, including the power to issue secondary legislation or normative decrees, as specifically spelled out in primary legislation, the power to provide interpretations and guidance, and the power to impose monetary sanctions and to compel information from any person. FSFM has substantial authority under all of the laws referenced above and other laws that have been adopted and/or are pending such as the draft law, known as “On Amendments to the Securities Law and to Certain Legislative Acts of the Russian Federation (Prudential Supervision Law).

80. **The securities market has grown and become more sophisticated over the years.** As in other markets, there was a decline in volume and value in 2008, with recovery in 2009. Although the numbers are volatile, Russia’s equity markets are about mid-size among world markets. As of 2009, OECD reports indicate that Russia’s market capitalization as a percentage of GDP was at an approximate par with several developed countries, such as France, the Netherlands, and Japan, and above that of Germany. The numbers, however, appear to change radically, year on year, and market uncertainty, from global events, elections or other matters, can lead to dramatic changes. There is also some significant cross border foreign direct investment.

81. **The number of market participants continues to grow.** Nonetheless, less than one percent of the economically active population has individual brokerage accounts and less than 2 percent of GDP is invested in pension and other long term investment vehicles. Private pension funds (non-state funds), which are regulated by FSFM declined in number from 290 in 2005 to 150 in 2010. The collective investment industry is predominantly made up of unit investment trusts. Reports for 2010 disclose about US\$41 billion AUM in 1,461 funds distributed among three categories—open end, closed end, and interval. The largest number of funds, constituting more than 33 percent of the dollar amount invested, are real estate funds; these are mostly captive closed end funds used to finance commercial property development, that are disappearing due to the recent withdrawal of a tax benefit. Although there has been an attempt to develop a longer term bond market, most activity is in the shorter range (one to two year durations) and during the height of the crisis some issuers experienced debt servicing issues. In 2010, there were 364 issuers and 663 issues in the corporate bond market. There are 1,800 authorized professional market participants (that is, brokers, dealers, asset managers, special custodians and depositories) distributed within the Russian Federation.

82. **The Russian securities markets have been volatile in the last five years, reflecting the inflow and outflow of capital and the crisis.** Foreign investment banks report that US\$20 billion of foreign investment exited the markets in the first quarter of 2011. This volatility is continuing, and is reflected in the changes in market capitalization in relation to GDP. A large percentage of the securities traded by volume and value are carried out by banks for their own account, as they use equities for collateral, owing to a lack of other alternatives such as long term bonds. The top ten market participants account for almost 50 percent of trading and, in consequence, what impacts banks as large participants directly affects the securities markets and vice versa. RTS, in contrast, noted during interviews that much of its volume, which includes direct access trading, is now retail-oriented.

83. **While overall the markets are growing, there are concerns that capital formation is moving offshore and consolidation is occurring.** For example, Valars Group, one of Russia's largest grain trading companies, was planning an IPO on the Warsaw Stock Exchange in May. Consolidation is also occurring, some of it prompted by purchase of private by government-controlled entities; for example Sberbank, recently purchased 80 percent of Troika Dialog, the oldest and largest private investment bank in Russia. At the same time, on November 27, 2010, the Russian Government issued Resolution No. 2101-re-endorsing the Projected Plan/Program for Privatization of Federal Property and Guidelines for Privatization of Federal Property for 2011–2013 (the "Privatization Program"), under which multiple privatizations, including that of a portion of Sberbank are expected to occur. These steps, coupled with other structural changes and modernization of the regulatory system, may strengthen the securities markets if they ensure fair pricing and proper disclosure and shareholder protections.

84. **MICEX Group and RTS, the two main Russian exchanges, executed a binding merger agreement on June 29, 2011, following an expression of intent in March.** The two entities expect to conclude their combination by year-end. The total value of the combined deal is about US\$5 billion, with the majority ownership of 75 percent to be in the shareholders of MICEX. The new exchange will be 50 percent owned by state-controlled institutions, including CBR, Sberbank, VTB and Gazprom, though CBR indicated that it might reduce its stake prior to the deal's conclusion. The total market capitalization for all equities traded on both MICEX and RTS was about US\$1 trillion as of January 2011. MICEX is listed as among the top 20 exchanges per the World Federation of Exchanges. RTS's largest market is FORTS, or Futures and Options RTS, which settles through a central counterparty (CCP).

85. **There is a large number of registered public companies,** but only a tiny fraction (less than one percent) is listed on the exchanges. Of these listed companies, the 10 largest issues account for 56.8 percent of market value and over 80 percent of market activity; the 30 largest account for 81.4 percent of market capitalization. Exchanges can admit companies to trading without listing, and also without authorization of the issuer. In 2010, according to FSFM statistics, there were 499 issuers admitted to trading on organized markets.

C. Preconditions for Effective Securities Regulation

86. **Securities exchanges and capital markets are contractual and rules-driven ventures.** Although some of the rules are embedded in exchange trading platforms, the integrity and equity of the application of the rules and of the conduct of public offerings are critical to maintaining market confidence. Similarly, in that securities are a legally created negotiable form of property interest, the integrity of how those interests are created, held and transferred is critical to their intrinsic value as is the governance structure of the issuers. Russia has invested huge efforts, over a lengthy period, to try to improve the legal and operational framework within which its markets operate. Nonetheless, there remains significant uncertainty about the integrity of the legal system that supports contracts and market rules and as to the expertise of the courts in financial matters. Currently a number of initiatives are underway that would help address these "rule of law"-related issues, including: improved accounting standards, provisions for

finality of settlement, better rules of administration, initiatives that move toward the creation of a central depository, enhanced ownership and control reporting, provisions for an investor compensation fund, more intensive monitoring of market abuses and improved laws to address these, better means to enforce the proper conduct of business with retail market participants, and exploration of ways to enhance the availability and fairness of alternative dispute resolution regimes. Such improvements should be aggressively pursued.

D. Main Findings

(i) *Principles 1–5, Principles relating to the Regulator:* Improvements have been made in certain of the powers and authorities assigned to the regulator and certain regulatory as opposed to supervisory powers and authorities have been reassigned. At the present time, FSFM has the capacity to issue regulations in its remaining areas of competence, subject only to the condition of proper legal structure under the Federal Constitution, in consultation with other governmental entities as appropriate. Prior to the recent changes the FSFM operated substantially on a day-to-day basis, without political interference. Nonetheless, during the transitional period of uncertainty, there was a lack of transparency about ongoing legal initiatives that raised some concerns about whether the impending changes could adversely affect this existing level of regulatory independence. For example, the new alignment, as projected, will explicitly require MoF approval for certain matters. Although such consultation should not be a factor in day-to-day operations and supervision, the actual operational procedures have yet to be clarified.

(ii) *Principles 6–7, Principles relating to self-regulation:* Although the Russian SROs have the ability to make and enforce binding rules on their members, membership is voluntary and only a third of professional market participants belong. If the FSFM obtains the authority sought under the Prudential Supervision Law, currently in its second reading before the Duma, professional market participants that deal with the retail public will be required to belong to an SRO subject to FSFM oversight. FSFM will be able to use that SRO to improve the development and enforcement of conduct of business and customer fairness requirements and to institute more expeditious dispute resolution and mediation processes. Exchanges and other market operators are required to enforce their rules but are not regarded as self-regulatory organizations under Russian law.

(iii) *Principles 8–10, Principles relating to enforcement of securities regulation.* New rules to define the offenses of market abuse and insider trading, to require the maintenance of insider lists and to improve the ability to investigate violations against third parties as well as licensees are achievements as is the institution of new real-time trade monitoring capability within the FSFM. However, the sufficiency of these changes to detect and deter misconduct should be tested as they are implemented and cases are brought where warranted. Further, the ability to obtain general bank records for natural persons to conduct securities regulation and to investigate any securities law violation remains an issue. To the extent legal changes are needed to remedy this, they should be aggressively pursued.

(iv) *Principles 11–13, Principles for cooperation in regulation:* The powers to obtain information and to share it have been augmented since the prior report. Further improvements are pending in consolidated supervision/banking legislation which will remove certain remaining limitations, facilitating intergovernmental communication for financial market oversight. The FSFM should aggressively pursue becoming a full signatory to the IOSCO Multi-lateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMoU). It should also seek to document its cooperative and investigative information sharing arrangements with the CBR and other relevant authorities and to keep relevant performance statistics. (See also Principles 24 and 29.)

(v) *Principles 14–16, Principles for Issuers:* New disclosure rules requiring material event reporting and ownership and control reporting, which attempt to improve information on indirect and connected ownership and to guide continuous disclosure have been adopted, as has the requirement for preparers and management to be liable for the accuracy of disclosure. Pending legislation would treat Directors as fiduciaries and a new Presidential Decree requires Ministers to step down from the supervisory boards of government-sponsored enterprises. These are sound improvements, which need some testing in practice. Regulatory vigilance in enforcing these requirements should determine whether the requirements are increasing sufficiently the transparency of ownership and related transactions.

(vi) *Principles 17–20, Principles for collective investment schemes:* The FSFM has legislation that recognizes that CIS are vehicles for retail investment. In this regard it provides a framework of substantial protections. It is now in the course of adding some modernizations, which include more flexibility for sophisticated investors and broader use of derivatives under EU-like requirements for diversification and leverage. FSFM should take steps to ensure that surveillance programs keep abreast of the growth of products and structures in this market. All marketing of mutual funds should be covered by securities requirements.

(vii) *Principles 21–24, Principles for market intermediaries;* new capital requirements are being phased in albeit planned increases for brokers due in July were cancelled. FSFM is also adding new measures to determine the operational capacity of intermediaries as part of the licensing qualification process and considering an early warning process. These initiatives should be pursued. The legislative ability to appoint an authorized representative from FSFM to operate a professional market participant for which the license has been suspended or withdrawn, or to operate a provisional administration, to manage and/or wind down a distressed firm and to require enhanced risk management and other prudential measures are pending. The FSFM should take into consideration its experience with intermediaries in using these new supervisory powers and should move to update its existing periodic inspections regime/algorithm by adding some risk-based analyses and random checks for records, capital and other compliance requirements. The operation of the new alignment of functions should be kept under review. Prompt steps also should be taken to put into place the authority to create an investor compensation fund and to develop appropriate contingency plans.

(viii) *Principles 25–30, Principles for the Secondary Market.* New technical capacity to undertake real time surveillance of trading was obtained last year. Experience with the alerts generated through this surveillance facility, and the reporting by exchanges of defined non-standard transactions (potential market abuses), should enable the FSFM to better detect and deter market misconduct and to investigate/and or report suspicious transactions. Ongoing processes to revisit the listing, admission to trading and market structure should be continued to improve price reporting. As measures are adopted to provide the legal underpinning for a central counterparty and rationalization of the securities settlement system, the FSFM should ensure that its own regulatory methods and programs are adjusted so as to supervise the new operations in an effective, comprehensive way including back-testing of the extent to which margin/default coverage is achieved. Contingency and cooperative information sharing arrangements (or a crisis management plan, which addresses various types of crises) should be in place to address market disruption or failure of an intermediary.

Table 9. Russia: Summary Implementation of the IOSCO Principles

If material changes result from the realignment of powers and authorities to accommodate the transfer of insurance functions and the change in leadership of the FSFM, or otherwise, the rating contained herein may require further assessment.

Principle	Findings
<p>Principle 1. The responsibilities of the regulator should be clearly and objectively stated</p>	<ul style="list-style-type: none"> • The FSFM's powers and authorities, in so far as they pertain to securities functions and professionals, are set out comprehensively in the law, including relevant Presidential decrees and Resolutions of the Government of the Russian Federation. In combination, these laws grant the FSFM a number of normative authorities within its competence, including as to the securities functions conducted by banks. Not all marketing of bank-managed collective investments is under the direct oversight of the FSFM, however. • The accessibility of the applicable laws would be improved by attempting to provide a consolidated text and by reinstating a publicly available English translation. • There is an informal working arrangement with the CBR for the oversight of commonly supervised entities. This arrangement has not been documented to address the sharing of information to combat securities law violations. • All supervisory functions over insurance were transferred to the FSFM on March 4, 2011 as were such functions with respect to certain other non-banking financial institutions as of June. The alignment of functions between the FSFM and the MoF has not yet been finally agreed.
<p>Principle 2. The regulator should be operationally independent and accountable in the exercise of its functions and powers</p>	<ul style="list-style-type: none"> • FSFM currently has the authority to grant, condition, suspend and revoke licenses without interference. FSFM also has been granted broad inspection and sanctioning powers with respect to capital markets professionals and participants. These powers appear to be unaffected by the recent changes in the overall structure, functions and accountability of the FSFM. • Under the new structure, the FSFM will retain powers to issue secondary legislation (regulation or norms) in its areas of remaining competence, subject in certain matters of importance to approval by the MoF. With respect to capital requirements and the diversification requirements for mutual funds, the MoF will have normative powers in coordination with the FSFM. • It is premature to evaluate how this rearrangement of functions and authorities will operate in practice. The process for making these changes was not transparent. • The head of the agency is not appointed for a fixed term, there are no criteria for removal, and the agency itself does not have legal protection from liability for the performance of its mandates in good faith, all matters of concern to IOSCO and other financial standards setters.
<p>Principle 3. The regulator should have adequate powers, proper resources and the capacity to perform</p>	<ul style="list-style-type: none"> • The FSFM has made a substantial effort since 2008 to obtain all the powers and authorities necessary to be IOSCO-compliant. In this respect, FSFM has undertaken an enormous project to obtain expanded information sharing powers and to make clear its administrative authority with respect to third parties. • More authority is currently projected to be provided with respect to

Principle	Findings
its functions and exercise its powers	<p>access to (i) information regarding the general bank accounts of natural persons and (ii) information necessary for overall prudential supervision of groups, as the residual limitations on interagency sharing of bank records for regulatory and supervisory purposes are currently expected to be removed in pending legislation.</p> <ul style="list-style-type: none"> • FSFM's ability to obtain bank records apparently does not now extend to natural persons or to enforcement of securities laws generally. • FSFM will need sufficient resources to implement the beneficial new powers it has obtained and to enable it to attract sufficiently expert personnel to oversee the evolving markets appropriately, a matter of concern to the investing public. FSFM's existing budget may not be sufficient to accommodate adequate training to assure that the expertise of FSFM staff matches its expanded mandate.
<p>Principle 4. The regulator should adopt clear and consistent regulatory processes</p>	<ul style="list-style-type: none"> • The FSFM commits its general and specific actions to writing; all of its actions are subject to appeal in the courts; and procedures affecting the FSFM are documented both in a Federal Law, the Administrative Code, and also in an internal general regulation. While there is a means to be heard at least on the papers in individual proceedings in practice, this process could be made more explicit. • FSFM has oversight over the exchanges and organized markets, but disciplinary actions of SROs and exchanges are appealable only to the courts. • New proposals are published on FSFM's website and there is an opportunity for comment. The industry indicates that the opportunity for increased dialogue is welcome. Feedback statements on the handling of comments are not currently part of the consultation process. Interpretations must be given in writing and within a specified time frame. • FSFM removed its English language website and it was not operational during this assessment. A website that is accessible not only in Russian, but also in a language more broadly understood in the financial community, as previously was the case, is a factor in attracting offshore business. • The FSFM supports the use of alternative dispute resolution mechanisms, but does not mandate that financial market professionals w submit to this type of process on request of customers. • Complaints may lead to investigations; more statistics or performance metrics would make clearer how such matters are handled and disposed of.
<p>Principle 5. The staff of the regulator should observe the highest professional standards</p>	<ul style="list-style-type: none"> • FSFM staff is subject to general and specific law on professional conduct and confidentiality. They are not permitted to engage in personal trading. They are also subject to the Insider Law, which makes violations sanctionable. • FSFM has not consolidated the applicable requirements in a Code of Conduct or as a part of the Internal Code that could be made publicly available. It should also introduce monitoring processes. (See also Principle 2).
<p>Principle 6 The regulatory regime should make appropriate use of self-regulatory</p>	<ul style="list-style-type: none"> • The Securities Law contemplates the use of SROs that are like industry professional/trade associations. These have the ability to comment on agency action, can make binding rules of conduct for their members and offer dispute resolution services, pursuant to relevant law.

Principle	Findings
<p>organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets</p>	<ul style="list-style-type: none"> • As membership in any such SRO is voluntary, their usefulness in expanding the scope of the regulator’s capacity to oversee the market and to enforce protections to retail customers is limited. SROs do provide a mechanism for informed consultation on agency actions. • The Prudential Supervision Law that is pending a second reading in the Duma will make participation in an SRO mandatory for financial intermediaries that deal with retail customers and will create a securities compensation fund through such SRO for retail investors. • Planned initiatives to strengthen retail protections would be welcome by market participants. Over time the scope of these arrangements might be further evaluated, and extended to other types of clients, such as institutional clients representing the interests of retail clients like CIS.
<p>Principle 7. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities</p>	<ul style="list-style-type: none"> • The FSFM has a program both to oversee SROs—it conducted four reviews in 2010—and to cooperate with them on inspections and in deterring and detecting market abuses and other misconduct. SROs, however, are not subject to a legal obligation of confidentiality as is the FSFM. Membership in SROs also is now voluntary (See Principle 6 above). • Securities exchanges, although they must enforce their rules as a matter of contract and to satisfy FSFM requirements, and are obligated to report specific types of non-standard transactions by their members or subscribers to the FSFM, are not designated as SROs by the law (See Principle 25). • All SRO rules must be approved, and can be deemed effective in 30 days if there is no objection from FSFM. • The FSFM indicates that it intends to provide additional oversight to any SRO designed for protection of retail investors.
<p>Principle 8. The regulator should have comprehensive inspection, investigation and surveillance powers</p>	<ul style="list-style-type: none"> • The FSFM has comprehensive inspection powers, including the capacity to inspect brokers’ files and to trace transactions to a broker’s bank accounts. • There are plans either to further clarify or to amend relevant banking law to remove limitations on access to general bank accounts of natural persons for all regulatory purposes. Such accounts can currently be reached with respect to entities for manipulation and insider trading actions under the relevant securities laws, but as to natural persons the banking law has not been amended.
<p>Principle 9. The regulator should have comprehensive enforcement powers</p>	<ul style="list-style-type: none"> • FSFM has investigative and enforcement powers to bring administrative actions against third parties as well as licensees. • FSFM also has received brand new authority to combat market abuses, such as insider trading and manipulation that define the offenses with particularity. In fact, FSFM has already brought a case. • The new provisional administrator powers create the possibility to freeze assets and for FSFM personnel to act as an authorized representative to operate/or oversee the operations of a professional market participant that is revoked or suspended or otherwise put under administration. • The FSFM is continuing to pursue enhancement of its enforcement and sanctioning authorities.
<p>Principle 10. The regulatory system</p>	<ul style="list-style-type: none"> • The FSFM conducts an active inspection and investigation program. It has withdrawn and revoked licenses, and undertaken an energetic program

Principle	Findings
<p>should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.</p>	<p>of initiatives together with the Government, to get the powers to become IOSCO-compliant in the enforcement area.</p> <ul style="list-style-type: none"> • The FSFM has also recently obtained new surveillance tools and dedicated staff to identify suspicious transactions that can be modeled to implement its new authority to combat various market abuses. • FSFM also makes all of its sanctions public on its website. • Some period of observation of the use of these new enforcement powers and tools is necessary to determine how effectively they work in practice. • FSFM would benefit from improved performance indicators for its enforcement program.
<p>Principle 11 The regulator should have the authority to share both public and non-public information with domestic and foreign counterparts</p>	<ul style="list-style-type: none"> • FSFM has the ability to share public and non-public information in its files or available to it through inspection of licensees with domestic and foreign authorities, including information with respect to the bank accounts of legal entities (and maintained for business) to the full extent of its ability to obtain such information • There are plans to amend the Banking Law and or otherwise to clarify that FSFM has access to the general bank accounts of natural persons for regulatory purposes. In the interim, the FSFM has full authority to assist with respect to those bank records by going through a court process
<p>Principle 12. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts</p>	<ul style="list-style-type: none"> • The FSFM cooperates with both domestic and international authorities. • Although FSFM is still negotiating a protocol with the CBR, it has understandings with other domestic regulators and it has specific MoUs with 15 foreign authorities and a side letter with a 16th. Additionally it sits on several domestic and international committees where important contacts and informal networks are formed and where information is shared verbally as well as an internal task force of all financial authorities. • FSFM should continue to pursue information sharing arrangements with all jurisdictions that trade Russian equities or deposit receipts.
<p>Principle 13. The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers</p>	<ul style="list-style-type: none"> • The FSFM has full power and authority to share information with foreign authorities without dual criminality or an independent interest in the action to the full extent of its powers to obtain and use information itself, which powers have been expanded recently. FSFM may need to commence an investigation or inspection to do so, but has that power. • FSFM should commence a reasoned process to become a signatory to Annex A of the IOSCO MMoU within the deadline. In this regard, FSFM has received substantial additional powers since 2008, can seek to clarify those ambiguities within its power to clarify, and can confirm through IOSCO's process what further legal clarifications, such as, on bank records of natural persons, are expected. • Appropriate clarifications would raise the level of FSFM compliance.
<p>Principle 14. There should be full, timely and accurate disclosure of</p>	<ul style="list-style-type: none"> • FSFM requires prospectus, financial and non-financial disclosure and reporting. It defines what information must be submitted, conducts prospectus reviews, and the review of periodic and ad hoc statements and filings.

Principle	Findings
financial results and other information that is material to investors' decisions	<ul style="list-style-type: none"> • The prospectus and material event disclosure requirements for public companies, defined as companies with more than 500 participants are contained in the Securities Law. The Company Law also has disclosure requirements for public issuers. In addition to specific requirements, the Securities Law has a general provision for those issues it covers that requires that all information material to price be disclosed. • FSFM conducts reviews of issuers and public companies, both in the regions and at headquarters, mostly via review of filed disclosure documents, and periodic financial reports, but in some cases via on-site inspections. Preparers of statements are liable for the accuracy of disclosures, and the FSFM has in fact suspended and required the correction of filings. • FSFM has received important new authorities to look at indirect control of entities, and has added additional material event reporting to its disclosure requirements. Some experience with the application of these enhancements to determine their effectiveness is necessary before FSFM could be found to be fully compliant. FSFM and the industry report that the effects of these changes and other actions have been to increase the overall transparency of public companies (See also Principle 15). • Efforts also are being made to improve accounting standards. The efficacy of disclosure ultimately depends on the application of accounting and auditing, and ownership information reporting. While these matters are actively being improved, more experience is needed with their implementation for FSFM to move to a higher level of compliance. (See also Principle 16)
Principle 15. Holders of securities in a company should be treated in a fair and equitable manner	<ul style="list-style-type: none"> • A Code of Conduct for corporate governance was adopted in 2002. The RTS and the MICEX require compliance with this Code for their top tier companies. • The FSFM also oversees company law, including pricing, relative to take over transactions. The law provides for the protection of minority rights. • More experience with the application of new ownership and control reporting procedures is required, but such reporting, if enforceable and enforced, should materially improve the ability to provide the requisite protections . • Directors and officers are not required to disclose any interest in shares, only interests that cross a 5 percent or greater threshold. • Required annual “comply or explain” disclosure for public companies as to Code of good governance would improve the information provided to shareholders.
Principle 16. Accounting and auditing standards should be of a high and internationally acceptable quality	<ul style="list-style-type: none"> • IFRS for consolidated financial reports of issuers and financial markets participants is required after 2015. • While financial reports must still be filed in accordance with Russian Accounting standards, IFRS-compliant statements also must be disclosed now if IFRS is used for foreign offers or even for internal reporting. The top tier of listed companies also uses IFRS pursuant to exchange rules. • Accounting and auditing oversight procedures should continue to be strengthened. Additionally, as the requirement for IFRS is phased in, adequate oversight and training of accountants and the regulators will be

Principle	Findings
	important and will .need to be intensified.
<p>Principle 17. The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme</p>	<ul style="list-style-type: none"> • The FSFM has initial and ongoing licensing standards that involve fit and proper criteria, including competence, lack of disqualifying conduct, adoption of appropriate structures and controls and review. • FSFM also has rules to prevent or require disclosure of related party transactions, subject to certain exceptions comparable t those in other jurisdictions. • Firms that market funds must be licensed, except that banks can place bank customers in bank-managed funds, without a brokerage license. • There are some gaps among the customer protections, such as those related to best execution, although additional customer protection rules could be provided by the relevant SRO for the management company or possibly, otherwise, through the expected ability to mandate the use of an SRO for intermediaries doing retail related business.
<p>Principle 18. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets</p>	<ul style="list-style-type: none"> • FSFM has structural requirements for collective investment schemes (CIS), whether joint stock companies (of which there are only eight), or unit investment trusts, which treat their participants' interests as securities. • The law and related rules require the assets of the CIS to be maintained at a non-affiliated "specialized" custodian. The custodian is to maintain a register of unit holders, account for the transfer and investment of subscriptions, and monitor investments and activities of the management company relative thereto for compliance generally with the law. • The Investment Fund law recognizes that the portfolio assets of the CIS are not part of the investment management company's estate, nor are they amenable to the claims of debtors of individual fund participants or of the special custodian. Similarly in the case of fund companies, portfolio and other assets held for investors are available only to satisfy such investors' claims. • A special administration procedure also is provided by that law in the event of the need to wind down a fund or otherwise. • There is a process whereby auditors confirm that fund money and property are properly maintained, that custodial procedures are observed, and that portfolio structures and net asset value computations are correct. • Acquisition of funds by other funds should be monitored to prevent abuses.
<p>Principle 19. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the</p>	<ul style="list-style-type: none"> • Investment by laws and agreements, information on fund composition, price reporting and financial reports for managers and custodians, as well as specific and general qualitative disclosure is required for investment funds. Among other things these relate to the fund governance and management and their qualifications, investment policies, fees and costs, and to the fact that performance gains cannot be guaranteed. A particularly important disclosure is with respect to the volatility of markets where liquidity is not assured. • Risk warnings to retail investors should help to ensure they understand the difference between investment funds and bank accounts and/or bank offered funds to the extent that the protections are not identical. • The Investment Fund law provides specific requirements for SROs to which management companies are now voluntary members. These require

Principle	Findings
investor's interest in the scheme	<p>such SROs to handle complaints, monitor for compliance with applicable rules, cooperate with the FSFM, and bring disciplinary procedures.</p> <ul style="list-style-type: none"> • See Principle 4, 6, 7 and 23 with respect to efforts to require mandatory use of an SRO to provide more oversight of retail offerings and education of customers.
<p>Principle 20. Regulation should ensure that there is a proper and disclosed basis for assets valuation and the pricing and the redemption of units in a collective investment scheme</p>	<ul style="list-style-type: none"> • FSFM has specific requirements for the valuation of assets. There are special provisions that apply to illiquid assets to promote the use of fair/accurate valuations. Attentive oversight of the pricing of illiquid assets, and of any related evaluators, is necessary. Clear provisions for errors are needed, for example. • NAV for open-ended funds has to be published daily on the Internet site of the CIS management company and if funds are listed on a stock exchange, the price must also be published through on-line data feeds of authorized vendors. • Closed end funds and interval funds must report on redemption dates (which must be at least once yearly) and in the case of movable assets not less frequently than quarterly. (See Principle 18 for the role of auditors)
<p>Principle 21. Regulation should provide for minimum entry standards for market intermediaries</p>	<ul style="list-style-type: none"> • FSFM has fit and proper licensing requirements that include statutory disqualifications and capital and educational qualifications and professional competence requirements that apply to all intermediaries, including (except for capital) banks undertaking securities functions. • While currently licenses are issued on the documents, coupled with a review of a certification as to no criminal record from the Ministry of Interior, there is a pending project to add a due diligence review of operational capacity to conduct the business for which a professional market participant is licensed. • See Principle 22. As capital requirements become more complex, it will be important to have appropriately expert staff to conduct these reviews.
<p>Principle 22. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake</p>	<ul style="list-style-type: none"> • Minimum financial requirements for brokers were materially increased to Rub 35 million (US\$1.25 million) in 2010, and were to have been further increased in July, 2011. Special custodians and non-settlement related depositories' capital will be increased to Rub 80 million. as previously planned in July. • More specific risk-based measures and ratios related to credit and other risks are proposed to be added by the Prudential Supervision Law, which is in its second reading. • The development of specific requirements has now been reassigned to the MoF and planned increases due for brokers in July were postponed in May pending the projected adoption of the Prudential Supervision Law. • Existing requirements will be augmented by the ability to undertake appropriate due diligence, a new consolidated financial reports filing requirement when it is applied, by the Consolidated Supervision Banking Law ,if and when adopted, and by the full implementation of IFRS by 2015. • FSFM has no early warning requirements or procedures. • These changes will require adequate expertise to supervise and implement, including new inspection regimes and procedures, which might reasonably focus on identifying and prioritizing risks as well as random

Principle	Findings
	inspections to ensure that books and records are current and that the capital rules are being followed properly.
<p>Principle 23. Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters</p>	<ul style="list-style-type: none"> • The Securities Law and FSFM regulations contain broad duties of good faith, loyalty and fairness to customers. Recent regulations adopted in 2010 permit through new monitoring procedures the ability to better oversee customer first and other customer protection requirements in real time and the new Insider Law makes market operator personnel and professional market participants insiders with respect to information received from their clients. • The adoption, application and enforcement of business conduct standards and other customer protections could be improved with the use of a mandated SRO for intermediaries handling retail business. • Currently the order handling requirements are not very specific, so enforcement and oversight may be complicated---a general issue with using principles, as opposed to rules, of supervision. These issues could be ameliorated through use of an SRO that establishes best practices providing more content to the principles.
<p>Principle 24. There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk</p>	<ul style="list-style-type: none"> • There are new powers to deal with firm financial distress, including appointment of a temporary/provisional administrator, and, there are additional new rules pending final legislative approval. • FSFM and the exchanges and the other relevant authorities need contingency arrangements to deal with market and firm disruption, making full use of their administration and information sharing powers, which address several potential scenarios. See Principles 1 and 29. Such arrangements would need to evolve with the market and be kept under continuous review. • New authority to create an investor compensation scheme is expected to come on line with pending legislation.
<p>Principle 25. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight</p>	<ul style="list-style-type: none"> • The FSFM has a licensing procedure for regulated exchanges and organized markets, which includes fitness and financial requirements. • A new law known as the Law on Exchanges and Organized Trading is in the process of being adopted which may contain additional improvements. • Disclosure relative to the differential requirements as to each of the specific tiers of trading is important to customer protection and fairness.

<p>Principle 26. There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants</p>	<ul style="list-style-type: none"> • The FSFM conducts oversight reviews of exchanges. In this regard it visited the RTS in 2010. Inspections result in a report, an exit conference, and follow up. • FSFM also works with the exchange personnel on emerging issues. • The FSFM now has additional authority to do its own monitoring of suspicious transactions and potential violations and new technology to apply these. Additionally regulations adopted in 2010 require all organized markets and exchanges to submit various types of information about non-standard and potentially abusive transactions to the FSFM in a specified format. • The FSFM would benefit from more metrics for evaluating performance by exchanges of their compliance functions.
<p>Principle 27. Regulation should promote transparency of trading</p>	<ul style="list-style-type: none"> • Price and volume is reported by the market to the FSFM. The data feeds are licensed in real time to commercial providers and they are also available with a 15 minute time lag to the general public on line. • Reporting of OTC transactions has been improved, consistently with changes in the process being made globally, which are currently being refined after the crisis. Almost all OTC reports are made through RTS. • How to address the prices of the same product listed or admitted to trading at two exchanges in the same time zone continues to be subject to regulatory scrutiny. • The exchanges and the FSFM would benefit from staying abreast of developments more generally about market structure, transparency and related protections.
<p>Principle 28. Regulation should be designed to detect and deter manipulation and other unfair trading practices</p>	<ul style="list-style-type: none"> • Adoption of the law on market abuses, such as insider trading and manipulation is a step forward and includes the sanction of disgorgement of wrongful profits. • The systems to deter and detect such misconduct are in the process of being developed and tested as the law is being phased in. The FSFM has a new real time surveillance tool, and the exchanges are required also to enforce their rules against misconduct. Specific exception reports on non-standard transactions are required by the exchanges to the FSFM to be made in a common format. (See also Principles 7 and 26). • Some experience is necessary to see how these improved requirements work in practice and whether the penalties are dissuasive and proportionate.

<p>Principle 29. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption</p>	<ul style="list-style-type: none"> • The exchanges have some rules with respect to these risks built into their systems. The procedures for defaults are public. • The FSFM has power to demand additional information from direct market participants on clients within omnibus accounts. • This power is untested. • The FSFM should develop approaches that enable it to determine where risks are originating in the market, and to follow up with other regulators in conducting appropriate surveillance. • Contingency procedures are not currently documented nor are related cooperative arrangements with other regulators. There should be documented contingency plans to address both general market and firm disruptions (see also Principle 24 Key Q1).
<p>Principle 30. Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk</p>	<ul style="list-style-type: none"> • Adoption of the Clearing Law that provides a legal underpinning for final settlement in a central counterparty system and for close out netting and related risk management parameters is an important step forward. • It is important to assure that as implemented the risk management and oversight of the CCP system is sufficient to meet international requirements. • Such a system should bring more transparency to exposures, and further facilitate anonymous trading. As it concentrates risk at the CCP, however, the financial resources and margining and variation systems are critical and appropriate and ongoing back testing of the sufficiency of the risk management systems is important. • The system still permits the use of multiple registrars or transfer agents though issues relative to liability for custodianship obligations have been clarified and the number of such agents is declining. Use of a Central Security Depository which complies with the CPSS/IOSCO standards for securities settlement systems, and US law for US mutual funds investing offshore would send an important signal to the market as to the integrity of the system for transfer of securities.

Table 10. Recommended Action Plan to Improve Implementation of the IOSCO Principles

While legislative powers and authorities are now in place and more are pending, more experience is needed with how these new powers work in practice before IOSCO expectations can be said to be fully implemented.

Reference Principle	Recommended Action
<p>1. The responsibilities of the regulator should be clear and objectively states.</p>	<ul style="list-style-type: none"> • The CBR and the FSFM should document a protocol for cooperation with respect to the oversight of entities or groups in which they have a common interest. • A consolidated version of law and regulations with linkages should be on the website, ideally in English as the language of finance, as well as in Russian. • The distribution of powers in the new authority should be promptly clarified and made readily accessible together with an explanation of how the arrangements are expected to operate in practice.
<p>2. The regulator should be operationally independent and</p>	<ul style="list-style-type: none"> • The new structure of the FSFM should be kept under observation to ensure that the new alignment of functions does not lead to day-to-day

Reference Principle	Recommended Action
accountable in the exercise of its functions and powers.	<p>operational interference by the MoF.</p> <ul style="list-style-type: none"> • Even if it is accepted protocol to resign upon a change of political administration, under existing standards, the executive director of a regulatory agency should be appointed for a fixed term and the criteria for removal should be specified. • Legal protection for good faith performance of the regulatory mandate by FSFM should continue to be pursued.
3. The regulator should have adequate powers and resources.	<ul style="list-style-type: none"> • The skills, technical competences, IT facilities and human and monetary resources of FSFM should keep pace with the complexity and scope of its regulatory mission. • The FSFM should determine if it needs additional types of resources and a different skill mix than it has currently for its resources to be equal to market demands; it should do a needs assessment, prepare an action plan, and use it in constructing the next rolling budget or amending this one. In particular FSFM should retain the ability to hire external experts and should be exempt from the government-wide headcount reduction. • FSFM resources must be sufficient to enable it to attract sufficiently expert personnel to oversee the evolving markets appropriately, a matter of concern to the investing public. The budget should also accommodate training to assure that the expertise of FSFM staff is sufficient to implement more complex and nuanced requirements, to conduct due diligence, and to implement new powers and authorities. • FSFM's ability to obtain bank records should extend to enforcement of securities laws generally and proper oversight of regulated entities. The law should be amended if necessary to provide FSFM sufficient powers to meet the requirements for joining the IOSCO MMoU as a full signatory (see also Principles 8 and 13)
4. The regulator should adopt clear and consistent regulatory processes.	<ul style="list-style-type: none"> • FSFM should maintain logs of complaint dispositions, inspections, investigations and cases, and use them to determine whether penalties are proportionate, consistent and dissuasive. • The practice and procedure for an opportunity to be heard in administrative proceedings should be documented giving content to the Investor Protection Law. • The regulator should continue to assure that to the extent possible its processes are transparent, restore its English website, consider the publication of feedback statements after consultation, and support measures to provide expanded access to mediation and alternate dispute forums.
5. The staff of the regulator should observe the highest professional standards.	<ul style="list-style-type: none"> • FSFM should consider having a Code of Conduct for employees specific to the agency and establishing monitoring processes to ensure compliance. -Publication of professional procedures and the internal regulation at the FSFM can help promote confidence in the regulatory process (see also Principle 2 on liability).
6. The regulatory regime should make appropriate use of SROs that exercise some direct oversight responsibility for their respective	<ul style="list-style-type: none"> • The FSFM should continue to actively use what Russian law deems as SROs to provide some oversight of professional qualifications and business conduct standards and serve as a type of conduit or trade association for obtaining comment from more than one perspective on the

Reference Principle	Recommended Action
areas of competence and to the extent appropriate to their size.	<p>costs and benefits of rule proposals and other matters.</p> <ul style="list-style-type: none"> • The FSFM should explore how best to use of its pending authority with respect to a mandatory SRO for market professionals serving retail customers (i) to provide additional resources for customer protection, (ii) to ensure a high level of consistency in the rules relative to retail customer protection, and (iii) to develop a sufficient capital base for a risk-adjusted compensation fund. • FSFM should promptly implement any such authority once obtained.
7. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.	<ul style="list-style-type: none"> • SROs have access to sensitive information as the result of their inspection activities. It may be that the information is protected in their hands from improper use by internal rules or membership agreements. • FSFM should adopt an explicit requirement that an SRO must treat non-public information in accordance with professional standards of confidentiality equivalent to those required of FSFM, or of any other authority whose information the SRO may be using if higher.
8. The regulator should have comprehensive inspection, investigation and enforcement powers.	<ul style="list-style-type: none"> • The FSFM should seek a declaration or legislative amendment confirming its ability to directly access general bank records for all regulatory purposes. • FSFM might consider exploring whether at headquarters, using a methodology that identifies key risks, coupled with random reviews of the currency of records would increase the efficiency and effectiveness of the inspection process (see also Principle 22).
9. The regulator should have comprehensive enforcement powers.	<ul style="list-style-type: none"> • The FSFM should evaluate the operation of its new enforcement powers relating to insider trading and manipulation during the phase-in period to determine whether they are achieving enhanced deterrence of misconduct. • In this respect FSFM should develop appropriate performance metrics relative to whether the remedies and procedures are dissuasive and proportionate.
10. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.	<ul style="list-style-type: none"> • FSFM should determine how best to measure and present performance objectives and statistics for enforcement and related monitoring activities. • See also the comments under Principles 4, 6, 7, 8, and 9.
11. The regulator should have the authority to share both public and non-public information with domestic and foreign counterparts.	<ul style="list-style-type: none"> • Information sharing among domestic authorities may be improved with the adoption of the Banking Law amendments related to consolidated supervision and completion of a formal protocol with the CBR (See Principle 1). • The regulator can share non-public information (subject to the clarification above and referred to in Principle 8) in its files under a Memorandum of Understanding with appropriate confidentiality protections to the same extent as such information is obtainable by FSFM. • FSFM should take steps promptly to meet requirements to sign the IOSCO MMoU.
12. Regulators should establish information mechanisms that set out	<ul style="list-style-type: none"> • FSFM should consider whether the cross listing of securities, through ADRs and GDRs, or as the basis of indexes, such as the MSCI,

Reference Principle	Recommended Action
when and how they will share both public and non-public information with domestic and foreign counterparts.	<p>favors the execution of additional specialist, bilateral MoUs.</p> <ul style="list-style-type: none"> • See Principle 8, 9, 11, and 13.
13. The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and powers.	<ul style="list-style-type: none"> • The FSFM should document its assistance activities. (See also Principle 4) FSFM should support prompt adoption of changes and/or clarifications that will expand its access to bank records and move forward to become a fully signatory of the IOSCO MMoU. • (See also Principles 8 and 11)
14 There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.	<ul style="list-style-type: none"> • FSFM should report on the extent to which ownership and control reporting is in practice improving transparency and protection of investors through disclosure. • Also, FSFM should evaluate the level of continuing disclosure compliance and consider automating more of the process.
15 Holders of securities in a company should be treated in a fair and equitable way.	<ul style="list-style-type: none"> • Useful amendments have been made to seek better ownership and control reporting (See Principle 14). The effect of these amendments should be kept under review. • FSFM now has power to review tender offer prices, and should document how the pricing review methodology works in practice. • Management and Board members of issuers should be required to disclose shareholdings even if they do not cross the 5 percent threshold. • FSFM should consider what qualifications and oversight is needed for independent evaluators, who currently are not required to be licensed. • Required "comply or explain" disclosure for public companies as to the voluntary Code of good corporate governance would improve the information provided to shareholders.
16. Accounting and auditing standards should be of a high and internationally acceptable quality.	<ul style="list-style-type: none"> • FSFM should work with the Ministry of Finance and other relevant authorities to determine the best way to (i) oversee accountants and auditors, (ii) encourage prompt movement of financial market participants and issuers to prepare for the institution of IFRS, (iii) assure appropriate capacity/training among the profession and within the regulator to implement the accounting changes, and to (iv) move concomitantly to prepare a plan to improve audit standards.
17. The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.	<ul style="list-style-type: none"> • See Principle 21 below.
18. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of customer assets.	<ul style="list-style-type: none"> • FSFM should keep under review the sufficiency of available information to determine whether the custodian of customer funds is in fact unrelated to the management company and otherwise to check on the proper custodianship and protection of customer funds and the proper pricing of units of interest. • FSFM should develop, as necessary, means to review on an ongoing basis whether new models of CIS, such as ETFs, require additional structural protections.
19. Regulation should require disclosure, as set forth under the	<ul style="list-style-type: none"> • If the Prudential Supervision Law, now in its second reading, is adopted, FSFM should commit some responsibilities for providing a

Reference Principle	Recommended Action
principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.	<p>complaints forum and overseeing conduct of business affecting retail holders of CIS as well as individual retail investors to the mandatory SRO for market professionals engaging in retail business.</p> <ul style="list-style-type: none"> • FSFM and the Russian Federation should promptly effectuate the authority to establish an appropriate investor compensation fund. (See also Principle 24 and 29).
20. Regulation should ensure that there is a proper and disclosed basis for assets valuation and the pricing and the redemption of units in a collective investment scheme.	<ul style="list-style-type: none"> • FSFM should assess how well the pricing methodology for illiquid securities functions in practice. (See also Principle 16).
21. Regulation should provide for minimum entry standards for market intermediaries.	<ul style="list-style-type: none"> • FSFM should promptly implement its plans for doing a limited initial operational capacity due diligence on applicants above a certain size. • Once adopted, the Prudential Supervision Law will enhance initial entry criteria, including for capital and internal controls, and ongoing compliance capability. FSFM should assure that it has the appropriate expertise and staffing to apply these new powers and authorities (see Principle 3).
22. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake..	<ul style="list-style-type: none"> • FSFM should institute specific early warning reporting to relevant FSFM personnel by the exchanges and professional market participants to permit prompt corrective actions to be taken as necessary. • FSFM should analyze whether current capital requirements are sufficient to address the various risks set forth in IOSCO standards, including credit, market, and operational risks, in preparation for applying new authorities to be granted by the Prudential Supervision Law. For example, FSFM should develop a means to test the outcomes of market moves above a specified size on capital. • Pending changes to capital requirements will require adequate expertise to supervise and implement, including new inspection regimes and procedures, which might reasonably focus on identifying and prioritizing risks as well as random inspections to ensure that books and records are current and that the capital rules are being followed properly.
23. Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interest of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.	<ul style="list-style-type: none"> • The FSFM requires professional market participants authorized by it to have compliance personnel. • More capacity to oversee intermediary risk management will be provided by introduction of the Prudential Supervision Law. FSFM should assure that it has sufficient expertise in place to conduct such assessments. (See also Principles 3 and 22) • Also, FSFM should exercise the power it receives from the Prudential Supervision Law, when adopted, to cause the mandatory SRO for professional market participants dealing with the retail public to develop more guidance on the implementation of conduct of business principles, such as best execution and marketing consistent with customer investment objectives.
24. There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to	<ul style="list-style-type: none"> • The appointment of an authorized representative in connection with suspension or revocation of a license or as part of a temporary administration proceeding will facilitate the management of a firm in distress.

Reference Principle	Recommended Action
contain systemic risk.	<ul style="list-style-type: none"> • The adoption of the Prudential Supervision Law should be progressed and implementation guidance for such representation should be considered once the law is finally effective. • The FSFM and the exchanges and other relevant financial authorities should have contingency arrangements to deal with market and firm disruption, making full use of their administrative and information sharing powers. The FSFM should attempt to determine in advance the steps of a wind-down plan. The plan should contain (i) means to communicate with other regulators, (ii) trigger points, such as changes in financial condition outside a specific tolerance and reductions in capital, that are early warnings and lead to initiation of prompt corrective action, and (iii) an analysis of the available measures and tools to minimize customer, counterparty and systemic risk. • Any plan also should include the procedures for non-routine communication with other regulatory authorities, including both domestic and relevant foreign authorities—and for determining whether market misconduct is related to financial issues in that such misconduct sometimes obscures financial distress. • Authority to establish an investor compensation fund should be promptly implemented.
25. The establishment of trading systems, including securities exchanges, should be subject to regulatory authorization and oversight.	<ul style="list-style-type: none"> • The FSFM in authorizing new trading systems, or in determining how to conduct ongoing oversight of merged markets, should update and refine its audit and surveillance programs. • Additionally it should use its new surveillance capability to assess on an ongoing basis the appropriate parameters based on experience with STRs or non-standard transactions (that may indicate insider trading, market manipulation or other abuses) for its own surveillance and for reporting by the exchanges or organized markets. • The different tiers of market structure should be transparent to customers; customers should be informed that the protections or risks relative to different tiers of trading are different. • See Principles 17, 21, and 26.
26. There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.	<ul style="list-style-type: none"> • The FSFM should develop a metrics for evaluating exchange performance of its compliance role and maintain performance statistics. • See Principle 25.
27. Regulation should promote transparency of trading	<ul style="list-style-type: none"> • The FSFM should keep under continuous review how price reporting is conducted and whether there is a need to consolidate pricing information on the market where the same product is listed or admitted to trading in the same time zone. In this regard it should take account of, or ask the exchanges to provide an account of, the completeness and timeliness of information being reported from OTC markets to the exchanges. • The FSFM should also ask the new SRO for retail investors, should

Reference Principle	Recommended Action
	<p>the authority be granted, to study whether the number of markets interferes with price formation and informs or confuses investors as to risk and how best to address any such confusion.</p> <ul style="list-style-type: none"> The exchanges and FSFM should keep abreast of developments more generally about market structure and protections and make needed adjustments in the related oversight programs.
<p>28. Regulation should be designed to detect and deter manipulation and other unfair trading practices.</p>	<ul style="list-style-type: none"> The FSFM should develop programs to surveil or otherwise to detect insider trading, manipulation and other market abuses using its new real time information feed and other information such as media reports. In this regard FSFM should determine whether the definitions used and penalties assigned are achieving their detection and deterrence objectives. To assist this process, FSFM should develop metrics for measuring the performance of market operators and FSFM surveillance systems in detection and deterrence (see also Principle 25).
<p>29. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.</p>	<ul style="list-style-type: none"> The FSFM should develop approaches that enable it (i) to determine where risks are originating in the market, (ii) to back test risk reduction measures and sufficiency of existing risk management at exchanges and financial market professionals, and (iii) to follow up with other regulators in conducting appropriate surveillance. There should be contingency plans to address both market and firm disruption. As stated in Principles 1 and 24, the FSFM should refine and document its existing arrangements for cooperation with the CBR with a view to further articulating the actions that can be taken to address the default or failure of a professional market participant or a market disruption through temporary administration, instructions to market operators, or exercise of any other oversight authority and to document how to address market abuse. Risk management and appropriate cooperation with the exchanges on surveillance also should include understanding the roles of each party in the event of a market disruption or firm failure before the fact. For example, FSFM should determine in advance how to use any and all additional authorities granted in pending legislation and conclude exemplary contingency arrangements for various scenarios.
<p>30. Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk</p>	<ul style="list-style-type: none"> FSFM should request an assessment of its clearing infra-structure once contemplated changes are implemented. Prior thereto, FSFM should design a program for appropriate oversight of any CCP, including back testing, that takes advantage of the new Clearing Law to assure that the risk management regimes in place operate properly and that netting, margining and related collateral and other risk mitigation arrangements provide the level of default coverage required by international standards (see also Principle 29). FSFM should also take steps to cause any CSD to meet the requirements of the IOSCO/ Committee on Payment and Settlement standards for securities settlement, payment systems, and CCPs, and best practices of G-20 countries for central securities depositories that apply to CIS investing offshore.

E. Authorities' Response to the IOSCO Assessment

87. **The authorities found the IOSCO report comprehensive and useful and welcomed advice on how to move forward on improvements, both pending and planned.** Most of the FSFM's suggested enhancements and corrections were incorporated in the final assessment report. In particular, the assessor has attempted to suggest how oversight of intermediaries might be strengthened in ways currently already in the planning process by FSFM. These include the enhancement of licensing procedures by adding on-site inspections and interviews to conduct due diligence on operational capacity and the development of contingency planning including appropriate cooperative protocols or memoranda of understandings with other financial authorities to address both financial and firm distress. To address FSFM concerns as to what should be next steps with respect to clearing improvements, the assessor further recommended a more detailed assessment of the new clearing and CCP authorities obtained in 2011 after some period of experience with the development by FSFM of an oversight plan and early clarification of the realignment of all new authorities. FSFM has taken this under advisement.

88. **FSFM indicated its belief that the accessibility of the law, rules and legislation affecting capital markets was sufficient and disagreed with the assessment of independence.** The assessor did not concur, and concluded that an evaluation of the level of independence of the newly combined regulator's capital market oversight operation would require a period of experience with the new arrangements.