RUSSIA

BANKING

SUMMARY

The collapse of Russia's financial system in August 1998 will result in a significant restructuring of the banking sector. Mergers, expansion of medium- and small-sized banks, greater roles for state banks and foreign financial institutions are all possibilities as the restructuring process unfolds.

Prior to the crisis, Russia's banking sector was already undergoing consolidation. After the first private banking license was issued in 1988, the number of private banks in Russia grew dramatically, to around 2,500 in 1995. Subsequently, the number has steadily declined to around 1,600 by mid-1998. Liquidity problems, stiffer competition from domestic and foreign lenders, as well as tighter Central Bank of Russia (CBR) regulations contributed to this trend. Despite the large number of banks, banking assets only accounted for 29 percent of GDP at the beginning of 1998, with state-owned savings bank (Sberbank) holding around three quarters of all retail deposits.

Banking activity is regulated by the CBR, an independent agency. The CBR's Chairman is nominated by the President but appointed by the State Duma (Parliament) to which the CBR is held accountable. The Federal Commission for the Securities Market (FCSM) has authorized the CBR to license and supervise professional securities market activities conducted by banks.

As of mid-1998, three wholly owned U.S. banks and nine with US participation were licensed to operate in Russia. U.S. banks report that they have not been subject to discriminatory treatment and have not been restrained from engaging in any of their planned banking activities. Formally, however, there are regulations that discriminate against foreign-owned banks. They are subject to higher minimum charter capital requirements than domestic banks, are required to have Russian nationals as 75 percent of their employees and 50 percent of local management, and must have one of the executive officers meet specific language and qualification criteria. The CBR also has imposed a 12 percent ceiling on the amount of foreign-owned paid-in bank capital as a percentage of total paid-in capital of all banks. However, in mid-1998, foreign investment was well below that ceiling. Also, while regulations permit foreign banks to enter Russia as branches, as a matter of policy the CBR restricts banks with foreign ownership to establishment only as subsidiaries. U.S. bankers report that these requirements have not impeded their operations in Russia.

DESCRIPTION OF THE MARKET

The collapse of Russia's financial system in August 1998 will have a profound effect on Russia's banking system. On August 17, the Russian government decided to simultaneously devalue the ruble, restructure its domestic Treasury bill obligations, and impose a moratorium on the payment of financial credits to nonresidents. Russian banks, including foreign-owned banks in Russia, faced a challenge to cope with the sweeping adverse effects of these decisions. Approximately, 30 percent of the banking system's assets were in traditionally safe government paper (Table I). In addition, 18 percent of the system's liabilities were to foreign creditors, often for short-term maturities, reflecting the increased access to foreign capital Russian banks had begun to enjoy in 1997. The cumulative effect of the government's decisions forced banks to scramble for survival and led to a breakdown of payments discipline in the banking sector. The CBR took measures to restore the payments system, provide liquidity to the banking system, and begin the process of restructuring the banking system.

In September 1998, the CBR had formulated initial ideas for restructuring the banking system. The CBR had begun to ascertain the financial viability of banks based upon balance sheet information as well as banks' ability to fulfill payment obligations in special one-day payments clearing operations. The CBR has indicated that it plans to place banks into four groups: (1) sound banks with a strong capital base with no substantial liquidity problems; (2) stable regional banks that should become the cornerstone of the regional banking system; (3) large banks that are unable to continue independently but may not be closed due to high social and economic costs; and (4) insolvent banks that have no future prospects. For banks in the first three categories, the CBR will develop individual strategies and methodologies for providing support, as appropriate. Banks in the fourth group will have their banking licenses revoked and liquidated. The CBR is also considering the creation of a special body for restructuring banks that would manage the assets of insolvent banks, including organizing their transfer to financially stable banks through mergers or acquisitions. Some mergers have already begun and medium and small-sized banks not effected by the market turmoil have increased their banking activities. Foreign banks may also have a larger role in providing capital and expertise. The bank restructuring process, however, is still at an early stage and will take months to unfold.

As of July 1, 1998, Russia had 1,598 licensed banks (Table II). Of these banks, 146 had foreign ownership participation, 17 of which were wholly owned by foreign interests. Despite the large number of banks, banking activity has been a relatively small part of Russia's overall economic activity. As of the beginning of 1998, total banking assets were R636 billion (US$106 billion), about 25 percent of Russia's GDP. Foreign banks account for roughly 7 percent of the total. Total capitalization for the banking system (excluding the state-owned savings bank, Sberbank) was R96 billion (US$16 billion) as of January 1, 1998, with foreign banks' share estimated at 4.3 percent of the total. Many Russian banks remain undercapitalized.

Banking activity has been concentrated in several large banks (Table III). The 200 largest banks accounted for 88.4 percent of the system's total assets as of January 1998. Sberbank is the largest and dominates the market, accounting for about one-quarter all banking assets. Other large banks are part of so-called financial industrial groups (FIGS) in which banks have cross share holdings in commercial groups. For example, Uneximbank is associated with the trading company Interros, the oil refinery Sikanko, Norlsk Nickel, the telecommunications provider Svyazinvest, Northwestern Shipping, Perm Motors and several newspapers. At the beginning of 1998, 75 FIGS were officially registered, linking around 1,150 industrial firms with 160 banks. A large number of banks are soiled "pocket" banks, entirely controlled by and dedicated to serving a single enterprise. Banking activity is concentrated in Moscow, with eighteen of the top twenty banks based in the capital city. Sberbank has the largest branch system with 1,907 registered branches (Table II).

Russia's private banking sector was already undergoing consolidation before the 1998 financial crisis. Liquidity problems, more intense competition and stricter supervision contributed to these trends. After the first private banking license was issued in 1988, the number of licensed banks exploded to more than 2,500. Since August 1995, the number of banks has declined steadily. Viable banks have tended to grow, often acquiring banks that have been liquidated.

After passage of the Law on Banks and Banking Activities in July 1995, the CBR began to use its new authority to revoke licenses when banks reported incorrect data, performed operations outside the area for which they were licensed, evidenced an unsatisfactory financial position and/or could not fulfill obligations to depositors and creditors. However, the CBR's powers are limited to revoking licenses; it cannot shut down the operations of unlicenced banks. Even though by July 1, 1998, the CBR had revoked 927 licenses (none of which were wholly-owned foreign subsidiaries), only 439 of those institutions had been liquidated (Table II). The CBR's powers to close banks will be strengthened with the passage of bank bankruptcy legislation currently pending in the legislature.

Although nearly half of the banking system's funding comes from deposits, the vast majority of retail depositors opt for Sberbank. This preference is largely due to the implied government guarantee on its deposits as well as Sberbank's extensive national branch and agency network. At the beginning of 1998, Sberbank accounted for 77 percent of all personal bank deposits, up from 68 percent two years earlier. This share will increase since, in response to the August financial crisis, the CBR has permitted depositors to transfer their accounts to Sberbank in order to secure a government guarantee for their funds. Some private-owned banks had begun to work to attract retail deposits, however, the absence of deposit insurance, according to some analysts, has impeded the growth of retail deposits outside of Sberbank. Legislation is pending that would enact such an insurance program, and the CBR has recently eased regulatory requirements that limited retail deposit taking.

Other activities of Russian banks include investments in securities (equities and government bonds), inner-bank lending, foreign exchange, futures operations, export financing, custody services, the servicing of government budget accounts (although this was supposed to be phased out by July 1, 1998), the issuance of tradable debt instruments, and investment banking activities (i.e., dealer/broker, asset management, depository and clearing services).

Weak credit analysis capability, the generally poor quality of data from most enterprises and ineffective bankruptcy laws and enforcement of bankruptcy judgments are cited as reasons that have hampered the growth of bank lending to enterprises, particularly those outside a bank's FIG. A new general bankruptcy law enacted in March 1998 should help strengthen the legal infrastructure. In addition to improving the legal infrastructure and banks technical abilities, the future growth of lending to enterprises is also likely to depend upon reduced government demand for borrowing, contributing to substantially lower interest rates.

The financial condition of Russia's banking system has generally been considered fragile. Unfavorable macroeconomic trends (high inflation and government borrowing), weak management, risky credit policies in not adapting to more stable inflation and exchange rate regimes, the need for stronger regulation and supervision over diverse and fast-growing activities, the infrequent use of internationally acceptable accounting standards, and low profitability contributed to the weakness of banks.

Beginning in April 1996, the CBR instituted a reporting system to help them evaluate banks' financial condition. According to this system, at the beginning of 1998, 39 percent of the banks had no signs of financial problems, while 27 percent were showing the first signs of problems. These banks accounted for 85 percent of all banking assets. The rest of the banks either exhibited temporary difficulties, the first signs of possible bankruptcy, or were financially insolvent. The later condition was reported by 23 percent of all banks, but they accounted for only 3 percent of all banking assets; 34 percent of all operating credit institutions were termed as "problem." The portion of bad loans (i.e., those classified as "loss") has been between 4-5 percent since 1996.

Debit cards have become increasingly popular. At the beginning of 1998 Russian banks had issued cards of major companies: 828,000 Visa; 878,000 Europay/MasterCard; 3,700 American Express; and almost 700 Diners Club. Nearly 28,000 retailers accept debit cards. Additionally, there are three major interregional domestic card systems: Union Card, Zolotaya Corona, and STB-card, each having several hundred thousand cards active at the beginning of 1998. Local card systems also exist. Very few of the cards issued in Russia are credit cards.

The number of ATMs approached 1,200 at the beginning of 1998, with most concentrated in Moscow and St. Petersburg.

Regulatory Structure

The banking sector is regulated by the CBR, an independent agency. The Chairman and members of the Board of Directors are appointed for four year terms and make decisions based on a majority vote with a quorum of seven, including the Chairman. The CBR is accountable to the State Duma (parliament) since the Chairman and the 12 member Board of Directors are submitted by the President or, in the case of the Directors, with the President's approval, but are appointed by a Duma vote. Moreover, the CBR is required to submit an annual report to the Duma. The CBR works with the government of the Russian Federation to elaborate and conduct a uniform monetary policy aimed at ensuring and protecting the stability of the ruble. The CBR also is statutorily responsible for issuing cash for circulation, being the lender of last resort for banks, establishing rules for conducting payments settlements and banking operations, and issuing and revoking bank licenses.

The CBR also licenses and supervises professional securities activities of banks under a three-year general license granted by the Federal Commission for the Securities Market (FCSM) in July 1997. The CBR and the FCSM have collaborated on drafting the regulations for professional market activities, including depositories, trust management and clearing and settlement, and have worked jointly on the adoption of qualification examinations for banking professionals involved in securities activities.

The Law on Banks and Banking Activities passed by the Duma in 1995 lays out rules for licensing bank operations and requiring reports to the CBR. This law provided a legal and regulatory framework for the CBR to monitor banking activities and revoke licenses based upon a bank's failure to meet its obligations. The CBR has strengthened its supervision and regulation of the banking sector, including the formation of a special unit, OPERU-2, to oversee the activities of the 14 largest institutions. The CBR has been gradually raising capital adequacy ratios, introduced a new Chart of Accounts at the beginning of 1998 as a major step toward international accounting standards, tightened licensing procedures, required banks to establish internal controls, and adopted provisioning requirements for non-performing loans.

The CBR plans further progress on prudential regulation. Minimum capital for banks will be increased to 1-5 million ECU (US$0.9-4.5 million), effective January 2001. Only those meeting the ECU 5 million minimum will be given full banking licenses, with smaller institutions limited in their banking activities and their geographic scope. Mandatory capital adequacy ratios will be raised to 8 percent for all banks in 1999. The CBR has adopted provisions for 1999 requiring the reporting of two-tier capital, with both tier-1 and tier-2 capital being used to meet prudential provisions. The CBR also plans to require off-balance sheet positions to be covered by capital requirements in line with Bank for International Settlements standards. The CBR also is seeking stronger legislative authority to deal with problem banks, to require consolidated reporting from nonbanking organizations affiliated with a bank, and to continue moving toward international accounting standards. Tighter licensing procedures and enforcement of new money laundering legislation (in the revised criminal code and narcotics law as well as stand-alone legislation pending before the Duma) are designed to reduce the use of the banking system for such purposes by criminal elements.

U.S. PRESENCE IN THE MARKET

Three wholly-owned U.S. banks and nine with U.S. participation are licensed to operate in Russia. Several U.S. banks have license applications pending.

U.S. banks are engaged in a variety of activities including: international trade financing, foreign exchange operations, corporate lending (including syndicated loans), cash management, money market operations, international (Eurobond) debt placements for both corporate and public issuers, custody services and wholesale banking. U.S. institutions are among the organizations licensed to act as primary dealers on the Russian government debt market. To date, U.S. banks have chosen not to offer ATM services in Russia. Most U.S. banks operate primarily in Moscow, although one has opened a branch office in St. Petersburg. Due to the current state of development of the Russian banking sector, U.S. banks are major players in most market segments in which they operate, as they are often more experienced and better-capitalized than their Russian counterparts.

TREATMENT OF US FINANCIAL INSTITUTIONS

The Law on Banks and Banking Activities permits foreign banks to establish subsidiaries, branches, and representative offices in Russia. However, as a policy matter, the CBR in recent years has permitted foreign banks to establish only as subsidiaries instead of as branches. The statutory licensing requirements are the same as for domestic banks except foreign institutions have to provide balance sheet data and audits for the most recent three years and the written consent of the supervisory body in the home country consenting to the establishment of the new entity (if required by the home county). The law also allows the CBR to impose additional requirements on foreign-owned banks, pertaining to mandatory regulations, endorsement of managing personnel, listing of permitted banking operations, and minimal capital requirements. Since January 1996 foreign-owned banks have been able to establish full service subsidiaries that provide retail and commercial services to Russian clients. These activities had been restricted by a 1993 Presidential Decree. Russian firms are now permitted to have more than one ruble account, allowing them to have different accounts with different banks.

Foreign-owned banks are allowed to establish new banks or to engage in joint ventures. With respect to establishing a new bank, in April 1997 the CBR adopted a two-step licensing process. The CBR headquarters first reviews the license application and issues a "Protocol of Intent." The applicant then presents the necessary documents to the local CBR branch in the territory in which it wishes to establish. Subsidiaries of foreign banks are permitted to open branches in Russia, with the permission of the CBR headquarters and OPERU-2 or the local CBR branch in the territory in which the branch is to be established. Nonresident banks can participate in joint ventures in any proportion, but are required to have permission from the founders of the bank in question as well as the CBR. Resident credit organizations may be issued a permit allowing the sale of shares to a nonresident if the foreign share holdings do not exceed 1 percent of its charter capital. Permission is required from the CBR if nonresidents are to own more than 1 percent of participatory shares in a resident bank's charter capital.

There are several areas where U.S. and other foreign banks are subject to different regulatory requirements than their Russian counterparts. For example, the minimum capital requirement for foreign banks is ECU 10 million, versus ECU 1-5 million for domestic banks. Under the Law on Banks and Banking Activity of 1996, the CBR can impose a ceiling on the amount of total foreign investment in the banking industry. The current ceiling is 12 percent. Additionally, the CBR has the legal right to use reciprocity in specifying the scope of licensed activities of foreign banks in Russia. Some Russian-controlled banks have urged the CBR to exercise this reciprocity, claiming that Russian banks are unable to open branch offices in the United States. Vneshtorgbank and Promstroybank have opened representative offices in the United States, and in early 1998 three-private banks had pending applications. Some U.S. banks have reported delays in the processing of their applications. The CBR maintains, however, that its licensing procedures are guided by objective criteria and not a policy of reciprocity.

In April 1997, the CBR adopted new regulations relating to the staffing of foreign banks. According to these regulations, 75 percent of the staff must be Russian citizens. If the head of the foreign-owned bank is a foreign citizen, then 50 percent of the local management board must be Russian citizens. The regulations also require the head and the chief accountant (roughly equivalent to the Chief Financial Officer) of foreign banks to be Russian speakers. Heads of banks in Russia are required to have an appropriate degree and two years of relevant banking experience.

U.S. financial institutions report that, in practice, they are not subjected to discriminatory treatment which adversely affects their ability to operate in the Russian market and can engage in any banking activities they wish. U.S. banks contacted for this study have indicated that the higher charter capital requirements are not an issue, as most already have charter capital in excess of the minimum. U.S. institutions voiced little concern about the overall capital ceiling imposed on foreign banks, noting that the foreign banks' share, at around 4.3 percent as of July 1, 1998, is well below the ceiling. Some banks, however, believe the ceiling could be a deterrent to new banks seeking to establish a presence in Russia or Russian banks seeking foreign partners as the share of foreign bank capital approaches the ceiling; others believe that the CBR will raise the ceiling if it became a constraint.

Most U.S. institutions operating in Russia have small expatriate staffs and report no problems complying with Russian staffing pattern requirements. Difficulty in getting education and language credentials approved by Russian government officials stems from cumbersome bureaucracy rather than discriminatory treatment.

RUSSIA – BANKING

Financial services will be an important issue in Russia's accession to the WTO. As of July 1998, the Russian government had not yet submitted its offer on financial services. As a general principle, the CBR states that it supports an open and competitive financial services market.

Table I
Russian Banking System Consolidated Balance Sheet

	1/1/96		1/1/97		1/1/98	
	Rub (bn)	%	Rub (bn)	%	Rub (bn)	%
			Assets			
Reserves	36.6	10.7	48.3	9.3	72.9	11.5
Foreign Assets	46.1	13.5	73.7	14.2	81.6	12.8
Claims on Extended Government	62.6	18.3	150.9	29.0	191.1	30.1
Claims on Non-Financial State-Owned Enterprises	62.5	18.3	80.2	15.4	64.3	10.1
Claims on Private Enterprises	133.8	39.1	166.5	32.0	225.9	35.5
Claims on Other Financial Institutions	0.5	0.2	0.2	0.0	0.0	0.0
			Liabilities			
Demand Deposits	69.3	20.3	92.4	17.8	133.7	21.0
CDs and Savings	126.4	36.9	169.3	32.6	189.3	29.8
of which: *Deposits in Foreign Currency*	*57.1*	*16.7*	*72.0*	*13.9*	*85.0*	*13.4*
Money Market Instruments	11.9	3.5	26.7	5.1	27.9	4.4
Foreign Liabilities	30.0	8.8	60.7	11.7	115.4	18.1
Deposits by Extended Government	9.7	2.8	12.1	2.3	17.4	2.7
Credits by Monetary Authorities	8.0	2.3	12.8	2.5	8.8	1.4
Capital Accounts	66.7	19.5	124.8	24.0	150.0	23.6
Other Accounts	20.2	5.9	21.2	4.0	-6.6	-1.0
BALANCE	342.2	100.0	520.0	100.0	635.9	100.0

Note: From data supplied to International Financial Statistics published by the IMF. Includes Sberbank and eliminates double counting.
Source: Central Bank of Russia

Table II
Banking Establishments, License Revocations, and Liquidations

Banks	1/1/95	1/1/96	1/1/97	1/1/98	7/1/98
Total Number	2,517	2,295	2,029	1,697	1,598
With Foreign Participation	n/a	n/a	152	145	146
-- 100%	n/a	n/a	13	16	17
-- 50-100%	n/a	n/a	10	10	11
Bank Branches	5,486	44,148	39,549	6,353*	4,987*
of which:					
-- Sberbank	*n/a*	*38,567*	*34,426*	*1,928**	*1,907**
-- 100% Foreign	*n/a*	*n/a*			*4*
Banks With Licenses Revoked	65	n/a	570	852	927
--Of which: Liquidated	*45*	*317*	*351*	*408*	*439*

* Break in data. New data records branches registered in the state registration book and assigned a number.

Source: Central Bank of Russia.

Table III
Top Ten Banks Ranked by Assets
(Ruble Billions)

A. As Of 7/1/98

Banks	Assets	Capital	Deposits
1. Sberbank	379.8	17.3	155.2
2. SBS-Agro	72.3	2.9	11.7
3. Inkombank	49.5	3.0	17.4
4. Rossiyskiy Credit	31.4	1.7	8.2
5. Menatep	30.3	2.0	6.4
6. Uneximbank	23.9	5.1	7.6
7. International Industrial Bank	22.6	2.1	11.7
8. Alfa-Bank	21.9	0.8	2.1
9. Vneshtorgbank	21.7	5.2	6.9
10. Gazrombank	14.9	2.3	4.0

Table III
Top Ten Banks Ranked by Assets
(Ruble Billions)

B. As of 1/1/98

Banks	Assets	Capital	Deposits
1. Sberbank	324.6	19.9	136.6
2. SBS-Agro	41.3	2.5	9.4
3. Inkombank	41.2	2.3	20.5
4. Rossiyskiy Credit	31.8	1.8	8.5
5. Menatep	26.0	2.0	6.9
6. Uneximbank	25.0	5.9	8.2
7. Vneshtorgbank	21.9	6.3	7.3
8. International Industrial Bank	19.0	2.0	12.1
9. Alfa-Bank	15.0	1.1	6.2
10. Mosbusiness-bank	13.2	1.0	2.2

Table III
Top Ten Banks Ranked by Assets
(Ruble Billions)

C. As of 1/1/97

Banks	Assets	Capital	Deposits
1. Sberbank	256.5	15.3	106.0
2. Vneshtorgbank	27.9	6.1	7.5
3. Inkombank	22.2	2.0	11.2
4. Uneximbank	20.6	2.9	11.0
5. Mosbusinessbank	17.8	1.0	0.6
6. Rossiyskiy Credit	16.3	1.2	3.7
7. Tokobank	14.5	1.1	1.1
8. SBS	13.9	1.3	3.3
9. Menatep	12.3	1.0	3.2
10. National Reserve Bank	11.2	1.6	2.2

Table III
Top Ten Banks Ranked by Assets
(Ruble Billions)

D. As of 1/1/96

Banks	Assets	Capital	Deposits
l. Sberbank	119.8	6.1	61.1
2. Vneshtorgbank	26.1	3.8	9.6
3. Agroprombank	18.6	0.3	5.0
4. Uneximbank	17.7	1.4	8.1
S. Inkombank	14.7	1.1	7.6
6. Mosbusinessbank	13.1	0.7	3.1
7. Rossiyskiy Credit	12.0	0.6	1.7
8. Mfk	11.3	1.1	1.9
9. Imperial	10.1	1.0	1.3
10. Moscow Industrial Bank	10.0	0.5	2.0

Note: Data from published reports and is not compatible with data in Table I.
Source: Financail Izvestia.

Table IV
Size Of Russian Banks by Capital
(Percentage of All Banks)

Bank Size by Capital	1/1/95	1/1/96	1/1/97	1/1/98	7/1/98
Over R 20 Million	1.2	4	9.3	17	2.2
R 1-20 Million	33	54.5	62.8	64.5	64.3
Rl Million or Less	65.8	41.5	27.9	18.5	13.7

Source: Central Bank of Russia