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Russia

The Banking System in the Transition

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EXECUTIVE SUMMARY

i. This report discusses the reforms needed to enable the banking sector in Russia to become more efficient in performing its roles in a market economy: specifically, in the mobilization of financial savings, the allocation of resources, and the processing of payments. The focus of the report is on the next three to five years.

ii. The reforms in the banking sector need to be integrated into an economy-wide strategy to improve resource allocation. Such a strategy should include a rationalization of government subsidies and other transfers, especially to the enterprise sector. Besides reducing the overall volume of transfers, the Government of Russia should provide these transfers through instruments that do not interfere with the price system and that do not blur the distinction between loans and grants. The Government should also develop the institutions and legal framework needed to clarify and guarantee the enforceability of property rights. The transformation of many aspects of the Russian economy, and especially the development of the banking system, are being hindered by the unstable macroeconomic situation. This report does not address the issue of how to design a credible stabilization program, but it warns that in many other countries financial sector crises were triggered during or shortly after periods of high inflation.

iii. The strategy proposed in this report has three main policy components:

- Phasing out directed credit
- Improving the soundness and efficiency of the commercial banking system by creating a new tier of good banks (the International Standards Bank program)
- Restructuring the large specialized banks.

The report also contains recommendations on how to upgrade Russia's banking sector infrastructure and how to finance investment, housing, and agriculture.

iv. Directed credit programs are the main instrument used by the Central Bank of Russia to effect monetary policy. The extensive use of directed credit complicates any attempt at stabilization and delays progress in reforming the banking sector. Lending under these programs does not require activities commonly linked to bank lending: raising deposits and credit assessment. These credit programs channel funds to specific enterprises, regions, and sub-sectors in the economy in a manner that reflects the recipient's bargaining and political power, not on economic or financial considerations. As a result, these programs also delay adjustment in the enterprise sector.

v. The Central Bank uses directed credit programs for two purposes: to provide liquidity to the banking system and to support particular enterprises and different sectors of the economy. Directed credits are not an efficient method for accomplishing either purpose and should be phased out. As a means for providing liquidity to banks, they can be replaced by a discount window at interest rates that will ration credit or by credit auctions.

vi. As a means of providing support to specific sectors, most of the directed credit programs can be phased out quite rapidly, leaving commercial banks free to allocate the resources they borrow from the Central Bank. During the next three to five years the Government and Central Bank may need to continue some of the directed credit programs as transition measures and to avoid further disruptions in the economy. Phasing out each program should coincide with dismantling the distortions and institutional rigidities that led to their creation in the first place. Some programs may be eliminated or replaced by other instruments immediately, while other programs may need to be phased out over several years.

vii. Budgetary subsidies should replace three of the directed credit programs: the program for converting military sector enterprises to civilian uses, the program aimed at the Northern Territories, and the program for Investment projects. Many of the borrowers under these programs would then be able to borrow from banks on regular commercial terms. However, it is likely that banks will consider some of those enterprises not creditworthy, even after receiving subsidies. In such cases, the costs of keeping some of these enterprises in business will become transparent and the Government will have to decide in which cases it will increase the subsidies and in which it will let the enterprise or the project disappear.

viii. The Working Capital program can also be discontinued. In most cases, once commercial banks have access to non-directed Central Bank funds, they will be able to fund the working capital needs of enterprises without need for intervention by the Government or the Central Bank. However, banks may not be willing to lend to enterprises that were borrowing to cover operating losses rather than to finance working capital. This will enable the Government to evaluate more clearly the costs of keeping those enterprises in operation, since it would have to provide them with direct budgetary subsidies. The programs for energy and, to some extent, the program for agriculture compensate for distortions created by government policies such as price control and trade restriction. Once these policies are changed, there will be no need for a program to support the energy sector and it will be possible to reduce the program for agriculture.

ix. Between 20 and 30 leading commercial banks in Russia are evolving into real banking institutions. They are working to strengthen their balance sheets and their banking skills, and some of them are also trying to reduce their single borrower and connected party exposure. While their number and the volume of their operations is still relatively small, they are growing faster than the rest of the banking system and are involved in the more profitable and important activities: lending to the emerging private sector, lending for foreign trade, and raising foreign currency deposits. Because enterprises are the main shareholders, most commercial banks are gradually becoming private, as their shareholders are converted into joint stock companies and privatized. This ownership structure is worrisome, as it helps perpetuate the common practice of connected and insider lending.

x. The recommended strategy has a gradual and largely voluntary approach to banking reform, providing incentives for banks to improve their standards and submit to stricter supervision. These incentives should lead to a continuous increase in the number and the market share of better banks. While this gradual approach will minimize disruptions to the economy, it will only gradually improve the overall soundness of the banking system and its

efficiency in allocating resources. This report discusses but rejects the feasibility and advisability of an alternative big-bang comprehensive restructuring of the banking sector. In any case, some degree of gradualism cannot be avoided, since improvements in the banking system need to move in parallel with the transformation in the economy in general, which is occurring only gradually.

xi. The core of the recommended strategy to improve the soundness and efficiency of the commercial banking system is the International Standard Bank (ISB) program. The ISB concept consists of creating a separate tier of banks that will be more capitalized, will adhere to better banking practices, and will be more closely supervised than other banks. Banks will be encouraged to become ISBs voluntarily by providing them with a series of benefits over non-ISB banks. This report presents a blueprint for the program, consisting of three components: a set of standards that ISBs will have to meet, a set of benefits that will entice banks to become ISBs, and a set of administrative procedures necessary to run the program.

xii. The standards proposed for ISBs in the long run are those being used in developed countries under the Basle Convention. The report recommends a gradual phasing-in of high standard requirements; the alternative is to call for the immediate enforcement of sub-standard requirements or of regulations that may not be met by any bank. For example, the long run ISB standard for the risk weighted capital-asset ratio would be set at 8 percent. To qualify as an ISB, a given bank will need to increase its risk weighted capital-asset ratio to 4 percent, 6 percent, and 8 percent, by the beginning of 1994, 1997, and 2000, respectively. The benefits package should be calibrated to produce enough ISBs to form the core of a good banking system.

xiii. Launching the ISB program is likely to accelerate the adjustment of those banks that are already upgrading their operations. It is likely that most of them would very rapidly become ISBs, if the standards are phased in gradually. The number of ISBs will gradually increase, as will their market share, especially in those market segments in which the program provides them with an advantage, such as dealing with households or with foreigners.

xiv. The ownership structure of banks will be the main constraint to the expansion of ISBs, since many banks may not be able or willing to reduce lending to shareholders. On the other hand, if the Central Bank begins to close and liquidate insolvent banks and imposes losses on depositors, such actions could be an important catalyst for ISB expansion. Closing insolvent banks is not only important for the success of the ISB program but also to insure adjustment in the enterprise sector. No reform strategy will work if there are no penalties for bad performers. Eventually the Central Bank will have to force ISB standards on all banks. This will require de-licensing and possibly liquidating many banks. It is therefore advisable that extending ISB requirements to all banks be done once ISBs account for the bulk of the banking sector activities, in order to minimize the consequent disruption to the economy.

xv. Assuring rural areas access to credit, in particular to finance agriculture, is of great importance to the Russian economy. The Russian authorities use subsidized directed credits to assure access to credit, to compensate for price distortions, and to subsidize agriculture, as

well as to finance the centralized state procurement and marketing of agricultural products. The main factor that would complicate any attempt to reduce the Government's intervention in financing agriculture is that farmers cannot yet use their land as collateral to secure loans.

xvi. In the short run, directed credit programs must continue to serve as the basis for financing agriculture, although several important changes should be made to current programs. Directed credits should be restricted to agriculture and to small scale processing activities that take place within farms. Enterprises in the large agro-industrial sector should finance themselves directly from commercial banks as other enterprises do. Credits should have clear, even if concessional terms. Authorities should enforce those terms as a means of instilling financial discipline to the sector. Preferably, the Central Bank should raise interest rates on loans to agriculture to the level prevailing in the rest of the economy. Subsidies would be more effective and cheaper if they are directly linked to the Government's objectives in agriculture.

xvii. Over the medium-term, the need to finance agricultural procurement through directed credit programs will be reduced as private retail and wholesale markets replace centralized procurement and marketing systems. Providing clear titles to private farmers, allowing them to mortgage lands, and allowing banks to foreclose farms in the event of default on loans will be critical to enhance private farmers' access to credit.

xviii. Rosselkhozbank is adjusting very slowly to the new economic environment. While it could continue to serve as the main channel for directed credits to agriculture, this bank is likely to shrink as these credits are reduced. Some of its branches may be able to develop a new deposit base and engage in new commercially oriented activities. The authorities should promote the creation of new financial institutions such as credit cooperatives in rural areas, which in some regions could be structured around present branches of Rosselkhozbank and Sberbank.

xix. The authorities have two options for determining the role of Sberbank over the next three to five years. Under the first option, Sberbank would be able to lend to enterprises as it did during 1992. It would be like any other bank, except that its liabilities are guaranteed by the Government. Lending by Sberbank increases competition in the loan market but puts government guaranteed household deposits at risk. If this option is chosen, the Central Bank should direct most of its supervisory resources to monitor Sberbank, because of its size and because it is the only bank where households savings are at risk. The Central Bank should also consider downsizing Sberbank to facilitate more effective management.

xx. Under the second option, Sberbank would be geared to raising household deposits, playing a role similar to that of postal banks in many countries. Under this option, Sberbank should not be allowed to lend to enterprises, and it should be restricted in the size of its lending to households and the interbank market. The rest of the deposits would be used to purchase government bonds carrying a variable interest rate equal to a few points under the Central Bank's discount rate. Under this option, Sberbank will provide households

throughout Russia with a safe window to deposit their savings, access to the payments system, and a source of credit. It would also continue to serve as an instrument for the Central Bank's policy.

xxi. Promstroibank mainly channels funds from the budget to large state owned enterprises. The movement to a market economy has eliminated the main functions of Promstroibank; given its internal dynamics, this bank could become an obstacle to the reform program. Promstroibank's operations will shrink dramatically as directed credit programs are phased out. Their high rate of non-performing loans, and the continued tendency of its branches to secede will also contribute to its shrinkage. Some of its former regional branches have become relatively dynamic banks, suggesting that further breakup may be desirable. The Central Bank and the Government should consider actively promoting a gradual and orderly downsizing of Promstroibank.

xxii. The creation of development banks is being proposed as a means to augment the level of investments and to provide new, market-oriented channels for allocating investment funds. Based on the World Bank's extensive experience lending to and working with development banks around the world, the report recommends that these banks concentrate on Apex type operations rather than direct lending for projects. This report stresses the importance of the emergence of a viable housing finance system, and it identifies the two main impediments to its development: macroeconomic instability and confusion about ownership, including the possibility to enforce foreclosure on collateral.

xxiii. Financial infrastructure comprises the foundations of law, regulation and accounting, public institutions, processes and systems in which financial institutions operate. This report describes the most important reforms needed in the financial infrastructure to support development of a strong and efficient market-based financial system. In particular, it discusses further work needed to establish a legal framework that protects private property rights and the efficient transfer of such rights, and that supports debt recovery, liquidation and bankruptcy, and enforcement of the law. It also suggests adopting accounting and auditing standards similar to those accepted internationally, which will measure the condition of enterprises and banks transparently and consistently. This report discusses a program to train bankers in modern methods of savings mobilization, credit evaluation, resource allocation, asset and liability management, and other aspects of market-based banking. The report also supports the recent establishment by the Central Bank of a steering committee to coordinate the overhaul of the Russian payments system, and it suggests a program to follow.

xxiv. The Central Bank should consider limiting the issuance of new bank licenses only to international standard banks (ISB). As an interim step, it should tighten licensing process to discourage further proliferation of unsound banking practices. Following a decision to launch the ISB program, the Central Bank would have to draft and issue prudential regulations for ISBs. Some regulatory changes need to be made for the whole banking system, including non-ISBs. For example, the Central Bank should revise risk weights used to calculate reporting ratios in line with the Basle Conventions, and it should redefine the capital adequacy ratio to focus on banks' assets and not on their liabilities. These definitional changes will help monitor the evolution of the system as a whole in its conversion to ISB standards and will make reporting more transparent to potential foreign

investors. The Central Bank should require all banks to fully capitalize their non-lending investments, and should set a cap on the size of these investments as a share of the bank's capital.

xxv. Strengthening the supervisory capacity will be a long process, since it requires the progressive build-up of specialized skills and experience that are almost non-existent in the Russian economy. It is necessary to focus the limited Central Bank resources on prioritizing banking institutions and issues where progress can be achieved rapidly. The Central Bank should give priority to the supervision of ISBs, large non-ISB banks, and any non-ISB bank that continues expanding after the launching of the ISB program. It should study the possibility of subcontracting part of the supervisory function to specialized firms and teaming foreign bank examiners with its own supervisory staff.

xxvi. A properly designed deposit insurance program would contribute to the general promotion of competition in the Russian banking sector. It is strongly recommended to limit coverage to relatively small deposits, which would effectively restrict the coverage to deposits of households and small scale enterprises. The insurance scheme should differentiate between ISBs and non-ISB banks and charge a lower premium to ISBs. More important, it could require non-ISB banks to invest insured funds in a low yielding account with the Central Bank or in Government paper.

1. INTRODUCTION

1.1 This report discusses the reforms needed to enable the banking sector in Russia to become more efficient in performing its roles in a market economy: specifically, in mobilizing financial savings, allocating resources, and processing payments. The development of financial markets, and in particular of the banking system, is essential for the transition to a market economy. These markets are needed to take the place of the central planning mechanisms that were abandoned over the last several years. This report focuses on the banking sector, which in most countries was the first segment of the financial market to be developed. (The Annex describes recent developments in securities markets.)

1.2 Besides problems inherent in the transition to a market-based economy, such as shifting relative prices and ambiguity about property rights, the development and the efficiency of the banking sector in Russia is also hindered by the unstable macroeconomic situation.¹ The resulting degree of uncertainty makes it very difficult and not very useful to design a long term strategy for the financial sector. Therefore, this report focuses on the next three to five years.

1.3 In the long run, the Government of Russia should aim at developing financial markets similar in structure and importance to those of large market economies. While this report acknowledges this as the long term objective, the strategy proposed has a horizon of only three to five years. Hence, it is geared towards achieving the following critical, but more modest objectives:

- Today the Central Bank of Russia conducts monetary and credit policy mainly by using directed credit programs, and the Government's main domestic source of finance is the inflation tax. Within the next three years, the Central Bank should have instruments available that will enable it to conduct monetary and credit policy by controlling the monetary base or by setting the discount rate, as is done in market economies. At the same time, the Government should be able to finance a large part of its greatly reduced budget deficit by borrowing in the domestic financial market.**
- Within the next five years, most financial resources in Russia should be allocated by private agents, in an environment where market prices reflect relative scarcities of goods and resources. In particular, private commercial banks should allocate a substantial share of the credit in the economy and almost all credit to the emerging private sector. As a means of achieving this, but also as an important long run objective in itself, the Government and the Central Bank should set up a legal and regulatory framework that will enable banking and capital markets to develop. It is also important to clarify**

1. The report focusses on the reforms needed in the banking sector at the micro level and it does not deal in more than a passing way with the policies needed to achieve stabilization.

what each player in these markets (banks, investment funds, insurance companies, brokerage firms) is allowed to do, and what changes each should expect in the future.

- As soon as is possible, the Central Bank must develop the physical infrastructure needed to allow commercial banks to fulfill their roles efficiently. The most urgent priority is to set up a payment system adequate for a market economy. The Government and the Central Bank should also contribute to the training of people required to operate the banks, as well as to supervise them. This includes sponsoring the training of professionals in accounting, auditing, credit analysis, and finance.

1.4 The structure of this report is as follows: Chapter 1 discusses the economy-wide problems that hinder development of the financial system and suggests required reforms. Chapter 2 describes Russia's banking system, the monetary and credit operations of the Central Bank, the large specialized banks, and the emerging commercial banks. Chapter 3 discusses the proposed strategy for developing the banking system and phasing out directed credit programs, which will probably lead to downsizing the specialized banks. Chapter 4 addresses the development of the banking infrastructure. Chapter 5 briefly examines issues specific to the financing of three important activities: agriculture, investment, and housing.

2. THE FINANCIAL SYSTEM AND ECONOMIC REFORM

2.1 This chapter discusses the economy-wide problems that hinder the development and efficiency of the financial system resulting from distortions in the real side of the economy, such as distortions in the price structure and ambiguity about property rights. It discusses the effects of the Government policy of using directed credits as a means of conveying subsidies. Finally, it touches on how the present macroeconomic situation complicates financial reform.

2.2 Banks allocate financial resources according to the demand for credit by the real sectors in the economy. Distortions in the price structure and the ambiguity of property rights prevailing in the Russian economy affect the demand for credit and have important effects on the functioning and efficiency of its banking system. Under such circumstances, lending risks are much more difficult to assess. This situation hinders the development of the banking industry because it limits the types of operations that banks are willing to get involved in and makes them more costly.

2.3 The efficiency of banks in allocating resources depends on incentives facing the real economy and incentives prevailing in the financial markets. Allocating resources in an economy with distorted prices and incentives for borrowers is likely to be highly inefficient, even if banks are efficient and profitable. Therefore, banking reform needs to be integrated into an overall strategy to improve the allocation of resources in the Russian economy.

2.4 The main economy-wide problems impairing the functioning and efficiency of the banking system can be divided into four broad categories:

- (a) **Lack of Transparency in the Price System.** Prices of goods and factors of production are highly distorted and do not provide good estimates of costs and demand. Many government policies contribute to the distortions in relative prices: price controls, impediments to the mobility of goods and factors of production, and restrictions on foreign trade. These policies are intended to subsidize certain sectors or enterprises. The widespread use of barter and other non-monetary forms of trade, used to a large extent as a hedge against inflation, also reduces the informational content of prices in Russia. The price mechanism must be allowed to provide market signals in order for efficient financial markets to develop. The Government has a large degree of control over this, as most of the lack of transparency in the price system is caused by its policies on subsidies. The Government shall provide subsidies in ways that minimize the distortions in the price mechanism, such as lump sum payments or payments targeted to particular commodities or services.
- (b) **Ambiguity about property rights.** For the financial system to be able to play its role, property rights must be well defined to include the possibility of providing collateral for loans and the enforceability of contracts must be credible. Procedures for bankruptcy and foreclosure of collateral need to be developed and applied. The Parliament and the Government have laid down

some of the legal groundwork required to define property rights.² However, much work is still needed in this direction (see Chapter 5), as the situation still remains ambiguous with respect to rights and their enforceability.

Confusion about ownership of enterprises creates severe incentive problems and makes the appraisal of loans very difficult. Managers may be tempted to "cannibalize" the enterprises, that is, sell their assets at low prices, save on maintenance expenditures, and distribute higher profits as bonuses. Such problems are especially acute during the present transition process since the owner of the enterprises (the state) may not be able or willing to monitor the actions of management closely. (This problem is commonly referred to as the principal-agent problem, the principal being the state as the owner, and management being the agent.)

Many banks are owned by enterprises that use them as a means of channeling resources to themselves. (This problem is referred to as connected lending and it is discussed in more detail in the following chapters.) The ongoing privatization program is, and should continue to be, the Government's main tool in dealing with problems arising from the unclear situation regarding property rights. The Government should gradually expand the program to include agriculture and large state owned enterprises, which are not yet covered.

- (c) **Directed Credit Programs and Government Subsidies.** Presently, one of the main roles of the banking system is as a means for the Government to transfer resources to enterprises. About half of all commercial bank loans extended in 1992 were in the form of directed credits funded by the Central Bank or the budget. These loans often serve as (i) subsidies to compensate for distortions affecting the borrower, such as price controls, (ii) as a means to compensate enterprises for the provision of social services, or (iii) as a means to subsidize employment. In many instances both the borrower and the lender relate to these loans as if they were grants. This blurs the distinction between government subsidies and bank loans, between fiscal and monetary policies, and between the roles of government, enterprises, and the banks in the economy. This confusion diminishes the informational value of market signals, distorts the incentives of lenders and borrowers, and in general impairs the development of the banking system.

For the next few years the Government may need to continue subsidizing some enterprises. A clear separation must be established between the banking system and the fiscal functions of the government. Bank loans should not be the conduit to provide subsidies to enterprises. Subsidies to enterprises should

2. Three related laws were enacted by Parliament: the law on property rights in December 1990, the law on collateral in October 1992, and the bankruptcy law in March 1993.

be provided directly as transfers from the budget and not as cheap credit.

These subsidies should be directly linked to the objectives that the government wants to achieve. For example, subsidies to support employment should be directly determined as grants or tax credits based on the number of employees. Enterprises that provide services as agents of government, such as education and health care, should be paid directly.

Substituting budgetary transfers for directed credits would increase the explicit budget deficit, since most of the current directed credit programs are funded directly by the Central Bank and do not appear in the budget. However, this difference is only an accounting issue and has no great economic significance in the present Russian context, since both the deficit and the directed credit programs (part are part of what is referred to as the quasi fiscal deficit) are financed through inflation tax.³ Once these subsidies are conveyed in a more transparent manner it will be easier to reduce their volume, as it will be simpler to uncover redundancies in the transfers and because the Government will be able to evaluate its priorities on the basis of more transparent information.

- (d) **Macroeconomic instability.** Russia's financial system will not be able to develop and play its role in mobilizing and allocating resources as long as the present unstable macroeconomic environment continues. High inflation and highly negative real interest rates have led to a disintermediation of the ruble economy (the ratio of M2 to GDP has fallen steadily during 1992 from more than 70 percent in January to less than 20 percent in December). Interest rates and prices cannot convey clear market signals in the present environment of high and highly variable inflation. In addition, the present macroeconomic situation complicates the design of banking sector policies because it makes it very difficult to assess the financial situation of both banks and their clients. Indeed, banks and enterprises can move very quickly from high profitability to insolvency, and vice versa. For the development of the financial system, the Russian economy needs to be stabilized, and a reduction of the overall volume of subsidies and financial transfers needs to be at the center of any stabilization program.

There are other linkages between macroeconomic and financial sector policies. Experience in many other countries shows that banking sector crises are commonly triggered during periods of high inflation or shortly after implementing a stabilization program. When deciding on its macroeconomic policy and in particular when designing a stabilization program, the Government needs to assess the linkage between financial crises and inflation. On the other hand, the lack of a well developed financial system complicates

3. For example, there is no difference between the macroeconomic effects of directed credit programs funded by the Government, which are in the budget, and those funded by the Central Bank.

implementation of a stabilization program, since monetary and credit policy need to play a role. The experience of the first half of 1992 shows that it is difficult to implement tight monetary policy because it may lead to unintended results, such as the accumulation of inter-enterprise arrears. This distortion in the transmission mechanism is due mainly to the rudimentary state of the financial system as well as to the ownership structure of enterprises.

In summary, reforms in the banking sector need to be integrated into an economy-wide strategy to improve resource allocation. Such a strategy should include a rationalization of government subsidies and other transfers, especially to the enterprise sector. In addition to reducing the overall volume of transfers, the Government should provide these transfers through instruments that do not interfere with the price system and that do not blur the distinction between loans and grants. The ongoing privatization program, which is helping to clarify property rights, should be gradually expanded to include new sectors such as agriculture and large state owned enterprises. The Government should also develop the institutions and legal framework needed to guarantee the enforceability of property rights. The transformation of many aspects of the Russian economy, especially the development of the banking system, are being hindered by the unstable macroeconomic situation. This report does not address the issue of how to design a credible stabilization program, but it raises two important related points; under current circumstances it is impossible to design and implement a comprehensive restructuring of the financial system; in many other countries, financial crises were triggered during or shortly after periods of high inflation.

3. DESCRIPTION AND DIAGNOSIS OF THE RUSSIAN BANKING SYSTEM

3.1 This chapter describes the present structure of the Russian banking system.⁴ It focusses on its main institutions, their organization and principal activities, and its main problems. It discusses monetary and credit policies of the Central Bank of Russia.⁵ It then discusses the operations of commercial banks and offers a taxonomy of the types of banks operating in Russia. Finally, it examines the structure and activities of the three largest specialized banks: Sberbank, Rosselkhozbank, and Promstroibank.

The Central Bank of Russia: Monetary and Credit Policies

3.2 The Central Bank has a discount window at which banks can, in theory, borrow under certain conditions. The interest rate on Central Bank credits to commercial banks, the discount rate, was raised from 40 to 80 percent in June 1992, and to 100 percent in March 1993. With inflation running at over 1,000 percent, a discount rate of 80 or 100 percent cannot be expected to ration the use of resources. In practice, the discount window serves almost solely as a channel for the directed credit programs.

3.3 In 1992, the Central Bank disbursed about 2.8 trillion rubles (R) in directed credits, which represented more than 95 percent of its credit to commercial banks and more than half of the expansion in the monetary base in that period. Borrowers under these programs negotiated the amounts and the terms of the loans with the Government, the Central Bank, and local authorities. In general, banks played only a passive role as the conduit for the funds. Table 3.1 shows that almost all funds were disbursed under four programs: agriculture (46 percent), industrial enterprises (18 percent), fuel and energy (14 percent), and Northern Territories (11 percent).⁶ The program for agriculture was targeted at activities broadly linked to agriculture, ranging from loans to farmers and procurement agencies, to loans to agro-industry and tractor factories. Disbursements under these programs were

4. A description of the evolution of the banking system since 1987 can be found in *Russian Economic Reform: Crossing the Threshold of Structural Change*, The World Bank, 1992, box 7-1, page 106.

5. Other activities that affect the banking system are discussed in detail in Chapter 4. The organization and functioning of the Central Bank are discussed in several reports issued recently by the International Monetary Fund.

6. This section draws on "Explicit and Implicit Subsidies and Financial Transfers to Enterprises: a Strategy for Downsizing and Reform", by The World Bank and the International Monetary Fund, March, 1993.

approximately R100, R200, R700, and R1,800 billion in each of the quarters of 1992.⁷ It is evident from these figures that directed credit programs were the main instrument of monetary policy in 1992.

3.4 The extensive use of directed credit programs delays progress in the reform of the banking sector, since lending under these programs does not require development of activities commonly linked to bank lending: raising deposits and credit assessment. These credits channeled funds to specific enterprises, regions, and sub-sectors of the economy in a manner that reflected their recipients' bargaining and political power, not economic or financial considerations. Furthermore, directed credit programs as they are currently implemented weaken the Central Bank's ability to control credit expansion, complicate any attempt to stabilize the economy, and delay adjustment in the enterprise sector.

Table 3.1 Directed Credit Programs, 1992

	<u>Value</u> <u>(billions of rubles)</u>	<u>Percent of</u> <u>GDP</u>
Central Bank credits	2,800	18.0
Agriculture	1,300	8.3
Fuel and energy	400	2.6
Northern territories	300	1.9
Industry	500	3.2
Other	300	2.0
Government credits	780	5.0
Working capital	600	3.8
Investment and conversion	180	1.2
<u>Total</u>	3,580	23.0

7. In addition, during 1992 more than R800 billion in directed credits were disbursed under three directed lending programs funded from the budget. These programs were targeted mainly at industrial enterprises: about R600 billion were earmarked for "indexation of working capital" and disbursed directly to enterprises. The rest was earmarked for investment and for the conversion of military-linked production and was disbursed through the banking system.

The Commercial Banking System

3.5 The Russian commercial banking system has existed for at most five years, and both the structure and the purpose of the banking system are changing very fast. Rapid change is also occurring within most individual banks. Because the magnitude, character, and speed of these changes is unprecedented, it is extremely difficult to analyze commercial banking in Russia or to compare it to experiences in other countries.

3.6 One of the main characteristics of the Russian banking system is the split that exists between the role of Sberbank (Savings Bank) and all other banks. Sberbank is geared to raising household sector deposits, which until recently were automatically channeled to financing the Government deficit. Other banks raise deposits from and provide loans to enterprises. Although the legal restrictions that generated this duality have been abolished, the situation is changing only gradually. It will take some time before Sberbank becomes important in the enterprise sector or before other banks attract a substantial portion of household deposits. This duality greatly reduces the extent of competition in the banking system.

3.7 **Banks' size.** There are over 1,700 independent commercial banks in Russia. While this number may seem relatively high, most of these banks are very small (table 3.2). More than 75 percent of the banks (1,295 banks) have authorized capital of less than R50 million, and less than 5 percent (65 banks) have an authorized capital of over R200 million. In August 1992, the Central Bank raised the requirement on minimum authorized capital to R100 million from the R5 million established in 1991 and ruled that all existing banks will have to increase their capital to that level by July 1993.

3.8 The largest 65 banks account for about 70 percent of total assets and loans in the system. The five largest banks hold about one third of total loans in the banking system and a similar proportion of total assets: Rosselkhozbank - 15 percent, Sberbank - 8 percent, Mosbiznesbank - 5 percent, Promstroibank - 3 percent, Moscow Industrial Bank - 2 percent (see Table 3.3).

3.9 While the size of banks in terms of capital and assets has been increasing since 1991, the increase has barely kept up with inflation. Raising the minimum capital requirement will lead to the emergence of larger banks, either through recapitalization by shareholders or through mergers, although the recent increase was too small and has already been offset by inflation.

3.10 There are about 43,000 bank branches or offices in Russia, about one branch for every 3,500 inhabitants. In theory, this density is in line with many market economies, being lower than in the US but higher than in Japan. The distribution of banks according to the number of branches is even more skewed than is the pattern of capital and assets. Only two banks have a network of branches that extends over most of Russia: Sberbank (the savings bank) with about 40,000 branches, and Rosselkhozbank (the agricultural bank) with over 1,000 branches; together they account for over 95 percent of branches in the country. Most other banks have no branches, and only a few of the larger banks have more than 10 branches or have branches located in more than one city. For example, Mosbiznesbank has

36 branches, 16 in Moscow; Tokobank has 10 branches, 2 in Moscow; Vozrojdeniebank has 47 branches, 37 in Moscow. More than 45 percent of bank branches are concentrated in the Moscow area (table 3.4).

Table 3.2 Distribution of Banks by Capital Assets

Capital	Number of Banks			
	01/01/92		01/01/93	
Less than R5 million	484	36%	318	18%
between R5 to R25 million	589	43%	714	41%
between R25 to 50 million	129	9%	263	15%
between R50 to R100 million	106	8%	211	12%
between R100 to R200 million	33	2%	142	8%
Over R200 million	19	1%	65	3%
Total	1,360		1,713	

Table 3.3 Twenty Largest Banks in Russia
January 1, 1993 (billion rubles)

Banks	City	Assets	Assets Ratio	Loans	Loans Ratio	Capital	Income	Loan/Asset Ratio
Rosselkhozbank	Moscow	1,684	17	782	15	10	-	0.5
Sberbank	Moscow	900	1	407	1	9	65	0.5
Mosbiznes	Moscow	695	13	250	-	2	16	0.4
Promstroibank	Moscow	451	4	135	10	2	12	0.3
Moscow Industrial	Moscow	313	8	83	8	2	9	0.3
Tokobank	Moscow	271	57	27	9	13	-	0.1
Unicombank	Moscow	263	-	68	-	1	1	0.3
Promstroibank	St. Petersburg	235	10	27	7	1	3	0.1
Kredobank	Moscow	218	39	26	8	9	3	0.1
Incombank	Moscow	215	25	42	6	5	5	0.2
Electrobank	Moscow	186	74	151	71	2	3	0.8
Imperial	Moscow	167	-	6	-	38	2	0.0
Zapsibcombank	Tyumen	166	7	37	5	1	5	0.2
Agroprombank	Rostov	124	17	48	13	1	4	0.4
Kuzbasprobank	Kemerov	121	12	54	18	1	4	0.4
Vozrojdeniebank	Moscow	119	7	44	7	1	6	0.4
Moscow Mejregion	Moscow	114	11	45	9	2	8	0.4
Omskprombank	Omsk	105	-	16	-	0	3	0.2
Avtovazbank	Toliaty	100	10	30	5	2	4	0.3
Chelindbank	Cheliabinsk	95	-	43	-	1	6	0.5
TOTAL (top 20)	-	6,542	-	2,351	-	-	-	0.4
TOTAL (top 100)	-	9,809	-	3,662	-	-	-	0.4

NOTES: The list was compiled from the data provided on a semi-voluntary basis by banks. Some of the data may be biased, and there may be banks that were not included because they chose not to report.

Assets Ratio = the ratio of assets as of January 1, 1993 over assets as of January 1, 1992

Loans Ratio = the ratio of loans as of January 1, 1993 over loans as of January 1, 1992

Loans/Assets Ratio = the ratio of loans over assets as of January 1, 1993

Table 3.4 Geographic Concentration of Banking System
October 1, 1992

Region	Number of Banks	Number of Branches
North	58	57
Northwest (excluding St. Petersburg)	18	28
St. Petersburg	31	59
Central (excluding Moscow)	153	217
Moscow	166	1,254
Volgo-Vyatka	72	33
Central Chernozem	38	81
Volga	126	209
North Caucasus	247	209
Urals	158	283
Western Siberia	137	136
Eastern Siberia	70	99
Far East	127	145
Kaliningradskaya oblast	24	15
TOTAL	1,634	2,786

NOTE: Sberbank is not represented in this table.

3.11 Overall, the description above points to a banking system without much competition. Outside Moscow and St. Petersburg, the great majority of households and enterprises can find at most one bank within a reasonable distance where they can conduct their banking business. Moreover, this problem is exacerbated by the poor state of telecommunications.

3.12 **Origin and ownership.** Almost all banks are joint stock companies and have been created within the last two years. About 700 banks, including most of the larger banks, are spin-offs of the former Soviet specialized banks. The remaining 1,000 banks were created from nothing by their shareholders after 1990. These banks are referred to as zero-banks and tend to be quite small.

3.13 The ownership structure of these two groups is very different. Large banks are often owned by hundreds or thousands of shareholders. The state, through GKI, the Central Bank and other agencies, retains partial ownership in many of the larger banks, including Sberbank and Rosselkhozbank. On the other hand, ownership in most zero-banks tends to be concentrated, with some banks owned by only a few shareholders.

3.14 Privatization of the larger banks is gradually taking place in parallel with the privatization of the enterprise sector. Initially, all the larger banks were directly or indirectly owned by the state. Their shareholders were almost wholly state owned enterprises or government agencies. This is changing quite rapidly as shares (existing or new issues) are being sold to cooperatives, joint stock companies, private companies, and private individuals. Banks are also being privatized, in practice, as the state owned enterprises that are their main shareholders become joint stock companies and are themselves privatized.

3.15 The new ownership structure in which banks are owned largely by enterprises is not advisable. This ownership structure helps perpetuate the practice of connected and insider lending common in the Russian banking system.⁸ Initially, most banks lent almost entirely to their own shareholders. This still represents a substantial portion of lending in the system, although large banks are gradually lending to unconnected borrowers as well. This still represents a substantial portion of lending in the system, although large banks are gradually lending to unconnected borrowers as well. Connected and insider lending are very restricted in developed countries, since such practices can lead to serious problems of fraud and put household deposits, and indirectly government funds, at risk. In Russia, the risks are not yet as serious as in other countries, since there is only a negligible amount of household deposits outside of Sberbank. Still, this issue will become more important over time and prudential regulations must be adopted to deal with it.

3.16 **Assets, liabilities and interest rates.** During 1992, commercial bank loans grew ten fold, from about R600 billion to about R6 trillion. About half of these loans were funded by the Central Bank and Government directed credit programs. In general, the banks' role is only a passive one, since the borrower and the conditions of loans under these programs are specified by the government, the Central Bank, or local authorities. The Central Bank funds these loans through an advance to the lending bank at the discount rate, and sets the bank's spread at 3 percent a year regardless of the borrower's credit standing. Interest rates for borrowers range from 8 to 83 percent, and the Government (through the budget) is supposed to pay the lending banks the difference between these rates and the Central Bank discount rate plus the spread. In theory, the maturity of these loans ranges from two months to

8. This ownership structure could also complicate any attempt to stabilize the economy and delay the process of restructuring of the enterprise sector. This occurred in Yugoslavia, where banks were also largely owned by enterprises; they continued to lend to insolvent enterprises thus retarding the development of both sound enterprise and banking sectors. See the World Bank report No. 7869-YU, Yugoslavia - Financial Sector Restructuring: Policies and Priorities, 1989.

several years. In practice, however, many borrowers are able to rollover these loans through negotiations with government or the Central Bank. Sometimes this becomes an automatic rollover of the advance to the lending bank, but at other times the bank has to negotiate the rollover on its own.

3.17 Loans under these programs can be quite unprofitable for the lending bank. In the present inflationary environment, the 3 percent spread cannot compensate banks for their operating costs and the risk of late interest payments. Furthermore, for loans in which the bank had no role in choosing the recipient, it is not clear who bears the credit risk. It is not surprising that most directed credits are channeled through the less progressive banks or those that act on behalf of borrowers who are also important shareholders. Some of the most dynamic banks try to avoid being involved in these programs.

3.18 The other half of bank lending was funded largely from enterprise deposits, with only a negligible portion funded from household deposits. Banks are free to set deposit and lending rates. In general, banks pay very low interest or no interest at all on current accounts, and enterprises maintain the minimum balances they need for their transactions. It is commonly assumed that some banks use the float as an additional source of cheap funding. The float consists of funds that are supposedly in the process of collection, which some banks keep for a few days for their own use. To a large extent, these cheap sources of funding compensate banks for the costs of their own float in the clearing system.

3.19 The remaining resources come from short term deposits by enterprises and the interbank market. The average maturity of these resources has been falling steadily, and currently it stands at less than three months. Interest rates on deposits differ widely depending on the size of deposits, the type of customer, the type of bank, and the region in the country. In the last quarter of 1992, such interest rates ranged from less than 60 to more than 150 percent. Sberbank, which holds over 90 percent of total household deposits (about R570 billion), placed about R100 billion in the interbank market, to be borrowed by commercial banks and lent to enterprises. The interest rates in the interbank market ranged between 100 and 150 percent.

3.20 Lending rates also vary within a wide range, from about 60 to more than 150 percent. Some banks lend at rates substantially lower than their marginal cost of funds. In some cases, this reflects the fact that the borrower is an important shareholder in the bank, but in other cases loan pricing includes, explicitly or implicitly, compensating balance requirements and up-front fees. Under present circumstances, banks need to charge interest rate spreads of at least 40 percent a year just to break even on a relatively safe loan. For example, on a one year loan, a minimum spread of 15 percent is required to keep the real value of the bank's capital. This is the case if 1 percent of the loan is funded by owned capital, if inflation is expected to be about 1,500 percent over the life of the loan, and if interest is paid at maturity. In addition, banks need to charge more than 25 percent to compensate them for the costs of non-interest bearing reserve requirements of 20 percent. The spread should also compensate banks for operating costs and credit risks. Hence, spreads of about 50 percent for low risk loans are not exorbitantly high as claimed by some, but are actually relatively low.

3.21 In table 3.3. it is possible to see that the rate of growth of assets and loans differed greatly among the twenty largest banks. In all but two of these banks, assets expanded faster than loans. An interesting observation is that assets tended to expand fastest in those banks with a low loan-to-asset ratio. In most cases, this low ratio is linked to the bank's holding foreign exchange accounts whose ruble value has risen with the depreciation of the ruble. This link is most striking in the case of Tokobank, Kredobank, and Incombank, which are known for having large foreign currency operations. Not surprisingly, the growth in loans outstanding was much faster in banks that served as channels for directed credit programs, for example more than 7,000 percent in Electrobank, and more than 1,000 percent in Rosselkhozbank and Promstroibank.

3.22 Most banks have placed part of their assets in real estate, in equity investment in enterprises, and even in setting up voucher investment funds. Many banks are leveraging these investments by funding them with deposits. A superficial look at most banks' balance sheets may suggest that the volume of these investments is still quite small, around 1 percent of assets, but these figures can be misleading because of common accounting problems during high inflation.

3.23 Funding investments with deposits is a very risky practice, not commonly allowed in other countries. In most developed countries such investment needs to be fully capitalized. This raises the question of whether Russia's banking system should be modelled as a universal system, as in Germany, or should be split into two parts — a commercial and an investment banking system — as is the case in the United States. Suggestions on this question are presented in the section on regulations in Chapter 5.

3.24 Why are deposit and lending rates so highly negative in real terms, when banks are free to raise them? Inertia — inflationary expectations that lag behind actual inflation, implying measured ex-post interest rates lower than the ex-ante expected rates — and money illusion — the fact that some people may look at nominal rates and conclude that they are very high without relating them to the inflation level — are part of the answer. There are several other reasons why these low interest rates seem to be, in some sense, market clearing rates. First, the demand for loans is restricted by the fact that not many borrowers can provide the types of collateral or other forms of security that banks require in connection to their market based credits, as opposed to directed or connected credits. Second, if banks raise the deposit rates they also have to raise their spreads, at least proportionally. This would drive some of their better clients away, leaving a riskier pool of loans. Finally, many firms and banks prefer to invest their resources and energies in lobbying the Government and the Central Bank for low cost directed credits, rather than bidding for funds in the market.

A Taxonomy of Russia's Commercial Banks

3.25 The following taxonomy classifies banks according to their main activities, and takes into account other criteria such as ownership structure and management sophistication. The taxonomy is intended as an organizing tool to analyze banks' activities and identify problems. In practice many banks perform activities linked to more than one of the categories identified here and, over time, may change the nature of their main activities. For example, a bank

may change from being predominantly a "channel" or an "agent" bank to become an "emerging good bank" as the composition of its shareholders becomes more diversified and its management more sophisticated.

3.26 Sberbank. Sberbank constitutes a category by itself. Its structure and activities are discussed below in the section on specialized banks.

3.27 Channel banks. These are banks whose main objective is funnelling resources from directed credit programs from the Central Bank or the Government to state owned enterprises to which the banks are linked. These banks account for a large share of total lending, since directed credits amounts to more than half of outstanding bank credit. The remaining "former-specialized" banks, of which Promstroibank and Rosselkhozbank are the largest, are clearly the most significant channel banks. Typically, state owned enterprises own a larger share of stock in these banks than they do in "agent" banks.

3.28 Agent Banks. Agent banks are those created by an enterprise or a group of enterprises to manage their cash flows and to perform payment system transactions on their behalf. These services are presently more efficient and safer when performed by agent banks, rather than unrelated banks. In market economies, the treasury departments of enterprises provide many of the services now provided by these banks in Russia. Shareholders, depositors, and borrowers in agent banks are often the same entities, a more common practice than in other types of banks. Moreover, in this type of bank, management and shareholders objectives are closely linked. Presently, most Russian banks are at least to some extent agent banks, but banks that only act as agents tend to be very small.

3.29 Emerging "Good" Banks. There is a core of 20 to 30 leading commercial banks in Russia that are developing in the "right" direction, and they seem to be evolving into real banking institutions. The number of these banks is growing, as banks from other groups transform themselves. While this group still comprises only a small number of banks, it includes some of the largest independent banks.

3.30 One key factor contributing to their emergence as "good" banks seems to be the expansion of their shareholder base, which allows management to develop interests separate from their shareholders. Also, banks where employees receive or buy shares tend to develop faster. Another factor that serves as a catalyst to becoming a "good bank" is the exposure to foreign banks, through foreign trade operations, management of foreign currency accounts, or direct investment. The process is taking place quite rapidly in several banks based in Moscow and in St. Petersburg.

3.31 This group is characterized by management that is more or less independent from the enterprise-shareholders and tends to be more sophisticated than in the channel banks. These banks lend to their clients and shareholders only when they expect loans to be repaid; loan terms tend to be less dependent on whether the borrower is a shareholder or not than in other banks. Most loans in these banks seem to be secured with collateral, third party guarantees, or loan insurance. A substantial portion of lending is to private commercial structures and to joint stock companies that are either private or in the process of being privatized.

3.32 Some "good" banks offer credit cards and access to foreign exchange operations through the Swift network. Most have developed correspondent relationships with reputable foreign banks. Others are already engaged in partnerships with foreign banks, and many more are seeking such arrangements. Some of these banks have created groups comprising several institutions that are linked in their operations. Over time, and with the right type of incentives, these groups may merge and become larger banks.

The Three Largest Specialized Banks

3.33 The three largest specialized banks are Sberbank (the savings bank), Rosselkhozbank (the agricultural bank) and Promstroibank (the bank for industry and construction). Their names reflect their specializations under the former Soviet regime. Presently, the three banks are joint stock companies chartered to operate as universal banks, but their activities are still clearly biased towards their former specializations because of their comparative advantage in skills distribution and infrastructure and because they continue to serve as tools for Government policies in the corresponding sectors and activities.

3.34 The structure of each of these banks and their main activities are described below and summarized in Table 3.5. The report's recommendations with respect to Sberbank and Promstroibank are discussed in Chapter 4, while the recommendations related to Rosselkhozbank are presented in the section on rural financing in Chapter 6.

3.35 Sberbank. Sberbank is the most dynamic of these three banks. Historically, Sberbank differed from all other banks in that it raised household deposits, which were automatically channeled to the government to finance its deficit. In the last couple of years, the Government granted Sberbank's management greater independence and allowed it to expand into other activities. Sberbank is rapidly developing new activities such as lending to enterprises and households, and developing a deposit base from enterprises. It helped create the interbank market, where it is the main lender. It has over 100,000 shareholders, the majority of them employees, but its shares are not yet tradeable. The Central Bank is the largest shareholder and its chairman is also the chairman of Sberbank.

3.36 Sberbank still retains its near-monopoly on raising household ruble deposits, holding more than 90 percent of a total of R570 billion. Although all banks are now authorized to open household deposits, Sberbank has retained its position because:

- Its network of more than 40,000 branches and offices accounts for better than 90 percent of Russia's branch banks, making Sberbank the only bank in most of the country and in most neighborhoods in large cities
- Sberbank is the only bank that has an explicit Government guarantee on deposits.
- Sberbank offers many services not available from other banks, such as transfer payments for utility fees, taxes, and pensions.

- It is commonly assumed that the Government will compensate Sberbank depositors for the erosion in the value of deposits due to inflation, since this has occurred in the past.

Table 3.5 The Largest Specialized Banks
Main indicators of Rubles in billions
January 1, 1993

INDICATOR	Rosselkhozban k	Sberbank	Promstroibank
Assets	1,684	900	451
Capital	10	9	2
Loans(long term)	33	36	20
Loans (short term)	749	371	115
Loans (total)	782	407	135
Share of total credit to the economy (percent)	15	10	2.5
Deposits	486	571	170
Employees	20,000	200,000	2,500
Branches	1,040	40,000	38
Subsidiaries (over 50% owned)	0	0	12
Branches of subsidiaries	0	0	160
Number of shareholders (legal entities)	35,000 18,000	123,500 3,500	500 500
(physical persons)	17,000	120,000	0

3.37 Interest rates paid for household deposits are still determined in close consultation with the Central Bank and the Ministry of Finance. Annual interest rates for households are 20 percent on demand deposits and 100 percent for time deposits of over one year; this rate was raised from 60 percent in April 1993. Interest on deposits of over R100 thousand is 80 percent, 90 percent, and 100 percent for 3, 6, and 12 months respectively. Interest rates for enterprises are negotiated on a case-by-case basis and are presently over 100 percent. Because of these highly negative interest rates, deposits in 1992 increased by less than 100 percent, which implies a steep reduction in their real value. For the same reason, the share of time deposits fell from 46 percent in January 1992 to 28 percent in January 1993. Deposits from enterprises grew from almost zero in 1991 to about R50 billion in January 1993, representing almost 10 percent of total deposits.

3.38 Historically, all resources went automatically to finance the budget, but in the past two years Sberbank has expanded its lending to households and enterprises. A large part of the lending, more than 60 percent, is done on a decentralized basis. Regional branches are free to choose borrowers, although the head office sets interest rates and criteria that applies to all loans. For example, loans are distributed 40 percent in cash and 60 percent in deposits; debt service cannot be more than 30 percent of household income; loans for housing can only cover 75 percent of the cost. In 1991, 98 percent of loans outstanding were to the Government or the Central Bank.

3.39 In 1992 Sberbank began lending to households (total outstanding January 1993, R25 billion), to enterprises (R130 billion) and the interbank market (R100 billion). The share of government assets in its portfolio fell to less than half of the total by January 1993. In April 1993, the Government settled its R285 billion debt, giving Sberbank the opportunity to expand its lending operations. Interest rates on loans vary depending on whether the borrower is a shareholder or not; for interbank loans it charges 130 and 140 percent respectively. On loans to enterprises it charges 135 and 145 percent respectively. Interest rates are much lower on loans to households. Under Central Bank and Government rules, Sberbank has to lend at least 30 percent of all new deposits to households; interest rates are much lower on loans to households than they are to enterprises.

3.40 Sberbank lending to the public and to enterprises raises serious questions of public policy. On the one hand, its lending enhances competition to an extent that would not be possible otherwise. On the other hand, Sberbank's lending policy creates serious risks that household deposits may be lost through inadequate practices. Three factors make this risk especially serious under present circumstances:

- The Central Bank lacks the capacity to supervise Sberbank's lending practices.
- Most of Sberbank staff was not trained for lending operations.
- Lending risks are especially difficult to assess in the present unstable situation.

The possibility of bad loans leading to solvency problems in Sberbank is of special concern for the Central Bank and the Government because of the guarantee on its deposits.

3.41 **Rosselkhozbank.** Rosselkhozbank is the successor to the Agroprom bank, which under the Soviet system lent to the agriculture sector and related activities. It has a three-tier structure consisting of headquarters in Moscow; 67 regional offices, by oblast, and about 1,000 branches that provide services to clients.⁹

3.42 The management of Rosselkhozbank still operates under old procedures, and the bank is not profit oriented. Its objectives are defined in terms of "the need to protect farmers" and "the interests of the country". Its staff is not trained to evaluate loans, and its lending criteria are based on historical norms and the needs of approved business plans of state owned enterprises.

3.43 Rosselkhozbank was the main channel for loans under the directed credit programs for agriculture, accounting for almost half of such disbursements. About 75 percent of Rosselkhozbank loans were funded through this program, going to the agro-industrial complex, which includes private farmers (6 percent of loans), state and collective farms (19 percent), retail trade organizations in rural areas (11 percent), and many other activities related to agriculture such as food processing, tobacco, alcohol, perfume, tractor companies and fertilizers. Rosskhleboproduct, the procurement agency, received about 40 percent of these loans, some of which it passed on to enterprises under its control. Loans under the directed credit program were allocated by the regional offices and local branches, and were coordinated with local branches of the Central Bank, local authorities, and the Ministries of Agriculture and Economy.

3.44 Interest rates on these loans were set at 83 percent, leaving the bank a spread of 3 percent. The cost to the borrower was much lower, with private farmers paying 8 percent and others paying 28 percent; the difference was paid as a subsidy by the Ministry of Finance. In theory, Rosselkhozbank bears the credit risk on these loans, but in practice the situation is quite unclear, since this bank is perceived by enterprises and by its own management as a government agency disbursing budgetary funds.

3.45 **Promstroibank.** Promstroibank was founded at the beginning of 1992, when the Soviet Promstroibank was abolished. Many regional offices of the former Soviet Promstroibank seceded during the last two years and became separate banks, for example, Unicom and Promstroj-St. Petersburg. Some of these spin-offs have become quite dynamic commercial banks. Presently, Promstroibank has six regional and 32 smaller branches. Almost one third of its 2,500 employees work at headquarters, and over 75 percent of all loans are processed at headquarters. In addition, Promstroibank is majority owner of 12 banks that used to be its oblast branches, but it is not clear how much control Promstroibank has over these subsidiaries. The main shareholders in Promstroibank are large state owned enterprises in the industrial and construction sectors, although at least 20 percent of the

9. At the time the bank was created in 1991, 15 regional offices (about 25 percent of the total) seceded with their network of branches and created separate banks. These banks are owned by regional enterprises and some of them, Vozrojdeniebank in Moscow and Agroprom in Rostov, are quite large. Rosselkhozbank is planning to open new branches in those oblasts where it lost its branches.

shares are held by commercial structures, insurance companies, and private business. Management was appointed by the founding members and has not changed.

3.46 Most of Promstroibank's operations are linked to problematic projects and enterprises, and more than half of its loans are funded out of MOF directed credit programs. Promstroibank dealt with 60 percent of the funds under the conversion program, including loans extended through branches and subsidiaries, and a substantial portion of loans under the investment program processed through the headquarters. Promstroibank also participated in the Central Bank's directed credit programs, but to a lesser extent. It pays the Ministry of Finance 10 percent and the Central Bank 80 percent on these loans, and onlends with a 3 percent spread. Promstroibank management estimates a 20 percent default rate.

3.47 Summary. The main findings in this section are:

- Directed credit programs are the Central Bank's main instrument in effecting monetary policy. The extensive use of these programs complicates any attempt at stabilization and hinders the development of an efficient banking sector.
- Enterprises are the main shareholders in most commercial banks. Hence, most banks are gradually becoming "private" as their shareholders are converted into joint stock companies and privatized. Still this form of ownership is worrisome because it helps perpetuate the common practice of connected and insider lending.
- Twenty to thirty leading commercial banks in Russia are evolving into real banking institutions. While their number and the volume of their operations is still relatively small, they are growing faster than the rest of the banking system and are involved in the more profitable and important activities: lending to the emerging private sector, lending for foreign trade, and raising foreign currency deposits.
- Sberbank is rapidly expanding its lending operations, which will greatly enhance competition in the banking sector. However, this also creates the serious risk of household deposits being lost through inadequate lending practices. Rosselkhozbank is adjusting very slowly, if at all, to the new economic environment. This raises the issue of how agriculture will be financed once directed credits are phased out. Promstroibank is mainly channeling funds from the budget to large state-owned enterprises. Some of its former regional branches have become relatively dynamic banks, however suggesting that further breakup may be important to successful restructuring.

4. REFORMING THE BANKING SECTOR: A MEDIUM TERM STRATEGY

4.1 This chapter presents the proposed strategy for bank reform: phasing out directed credit, creating a new tier of good banks (the International Standards Banks), and restructuring the large former-specialized banks. The chapter suggests alternative instruments to replace directed credit programs as the Central Bank's main tools for conducting monetary and credit policy. It presents the recommended strategy for improving the soundness and efficiency of the commercial banking system, at the heart of which is the International Standards Bank program. It examines related issues, such as the feasibility of attempting an immediate, comprehensive restructuring of the whole banking system, as well as the role of foreign banks. Finally, it discusses possible options for Sberbank and Promstroibank. Recommendations with respect to Rosselkhozbank are discussed in Chapter 6.

Central Bank of Russia: Monetary and Credit Policy¹⁰

4.2 The Central Bank of Russia uses directed credit programs for two purposes: to provide liquidity to the banking system and to support particular enterprises and different sectors of the economy. Directed credits are not an efficient method for accomplishing either purpose and should be phased out.

4.3 As a means for providing liquidity to banks, they can be replaced by a discount window at an interest rate that will ration credit or by credit auctions. A combination of these two types of instruments is used by central banks in most developed countries to regulate liquidity in the banking system. While these instruments are utilized in different ways in each country, as a general rule they do not discriminate between banks or sectors in the economy, as is the case with directed credit programs.

4.4 As mentioned above, the Central Bank uses its discount window as the channel for disbursing directed credit at an interest rate of 100 percent. Central banks in market economies usually set the discount rate, the rate at which banks can borrow at the central bank discount window, high enough to restrict the demand for credit. In most countries demand is also restricted by the fact that borrowing has to be collateralized by either government paper or by accounts in the central bank, which usually carry lower interest rates than the discount rate. In some countries, the use of the discount window is limited to distressed banks or other special circumstances, such as seasonal borrowing by banks in rural areas. In other cases, the Central Bank has more than one window, with banks paying interest rates that vary with the amounts borrowed, the circumstances of the bank, or whether the bank has already recently accessed the window.

10. This section deals only with those aspects of CBR policy that have a direct bearing on commercial banks' ability to allocate credit. The instruments used for regulating liquidity in the banking system are discussed only because they are linked to the funding of directed credits. These and other aspects of monetary policy are analyzed in detail in "Russian Federation: Strengthening the Monetary Analysis and Central Bank Operations", IMF, October 1992.

4.5 Deciding on the discount rate is one of the most important aspects of economic policy. This rate usually serves as the anchor for other interest rates in the economy, and changes in the rate become a means to indicate changes in government policy. The discount rate is usually kept at about the level of expected inflation and is raised or lowered when the central bank wants to tighten or loosen monetary policy. Once stabilization is achieved in Russia, the cost of Central Bank funds should be kept at a level commensurate with expected inflation.

4.6 The appropriate level of the Central Bank discount rate in the present circumstances has to be determined as part of a comprehensive stabilization program. The design of such a stabilization program and the role of monetary policy in it is beyond the scope of this report. However, one comment that has to do with the stability of the banking system is appropriate. The first stages of stabilization are usually characterized by high real interest rates and by distressed borrowing on the part of enterprises, which often lead to banking crises. This is a clear possibility in Russia, where real interest rates may move from negative to positive quite rapidly. The Central Bank should take this into account when designing and implementing a stabilization program.

4.7 The Central Bank is planning to begin auctioning credit to banks by the end of 1993. Most developed market economies also use credit auctions as an important instrument for controlling market liquidity and setting interest rates, usually in conjunction with a discount window. In many countries, credit auctions are referred to as repurchasing agreements, reflecting the legal structure used to collateralize the credits. The use of credit auctions is more complicated than operating the discount window. For example, the transmission of bids from banks will be technically difficult, probably precluding most banks from participating in the auctions for some time. The Central Bank will also have to evaluate the bids and make sure that banks do not collude. On the other hand, auctions have several advantages, including the fact that they are market based. This will eventually allow non-banks to participate indirectly in the auctions, which will make the transmission mechanism more efficient. The Central Bank should initially auction only a small portion of its credits to commercial banks. The amounts auctioned will increase as technical problems are solved and the number of participating banks increases. In any case, over the next five years credit auctions are unlikely to replace the discount window as the Central Bank's main instrument.

4.8 One problem common to both the discount window and credit auctions is the issue of collateral. In general, banks need to collateralize their net borrowings from central banks. In developed countries, only government paper qualifies as collateral. This is not a realistic option in Russia, nor will it be for the next few years, since the amount of Government paper outstanding is negligible.¹¹ The Central Bank could consider allowing banks to use certain types of commercial loans as collateral for a transition period. This is common practice in many developing countries but is quite risky, especially in Russia because of the extent of connected lending. To reduce the risks of defaults, the Central Bank would have to require a substantial degree of over-collateralization, but even this would not eliminate the risks.

11. The Central Bank and the Ministry of Finance are considering auctioning three-month bills in 1993.

4.9 As a means of providing support to specific sectors, most of the directed credit programs can be phased out quite rapidly. This will leave commercial banks free to allocate the resources they borrow from the Central Bank, as they now allocate resources raised through deposits. During the next three to five years, the Government and the Central Bank may need to continue some of the directed credit programs as a transitory measure and in order to avoid further disruptions in the economy. The overall volume of directed lending can be reduced by about half, to about 25 percent of total bank lending, by replacing such loans with other instruments that minimize the ensuing disruptions. Furthermore, implementing the recommendations in this report will facilitate a further reduction, to less than 10 percent of total lending in five years.

4.10 To a large extent, the Russian authorities' choice of directed credit programs as the main instrument of monetary and credit policy is due to the need for dealing with the institutional rigidities and economic distortions facing the Russian economy in the initial stages of reform. In order to make the elimination of the credit programs economically and politically viable, it is necessary to deal in some other way with these problems. The phasing out of each program should take place in parallel with the dismantling of the distortions and institutional rigidities that led to its creation in the first place. While some programs may be eliminated immediately, others may need to be phased out over several years.

4.11 Three of the directed credit programs can be replaced almost immediately by other instruments:

- The program for the Conversion of enterprises in the military sector to civilian uses.
- The program aimed at the Northern Territories.
- The program for investment projects.

To attain these programs' objectives, the Government should replace them with direct budgetary subsidies. Many of the borrowers under these programs would then be able to borrow from banks on regular commercial terms. Realistically, however, it is unlikely that banks will consider many of those enterprises creditworthy even after receiving the subsidies. In such cases, the costs of keeping these enterprises in business will become transparent, and the Government will have to decide in which cases it will increase the subsidies and in which it will let the enterprise or the project disappear.

4.12 The Working Capital program can also be discontinued immediately. In most cases involving working capital, commercial banks will be able to fund the needs of enterprises without need for Government or Central Bank intervention. This is already the case with a large number of enterprises that have no access to the directed credit program. Once banks have access to non-directed Central Bank funds (e.g., through the discount window) they will be able to expand their lending to most of the enterprises that borrowed for this purpose from the directed program. However, banks may not be willing to lend to some of these

enterprises, such as those that were borrowing to cover operating losses and not to finance working capital. This will enable the Government to evaluate the costs of keeping those enterprises in operation, since it would have to provide them with direct budgetary subsidies.

4.13 The program for energy and, to some extent, the program for agriculture compensate for distortions created by other government policies, such as price controls and trade restrictions. Once these policies are changed, there will be no need for a program to support the energy sector and it will be possible to reduce the program for agriculture. It will be difficult to eliminate the program for agriculture over the next few years, however, because of farmers' lack of access to banks or other sources of credit and because of the way agricultural procurement is presently organized (these issues are discussed in Chapter 6). Commercial banks could very rapidly take over lending to agroindustry, and they could also take over the financing of agricultural procurement if the necessary institutional reforms are implemented. These two activities account for most of the lending under the agriculture program.

The Strategy for Commercial Banks

4.14 The recommended strategy has a gradual and largely voluntary approach to banking reform, providing incentives for banks to improve their standards and submit to stricter supervision. These incentives should lead to a continuous increase in the number of better banks, and in their market share. While this gradual approach will minimize disruptions to the economy, it will only gradually improve the overall soundness of the banking system and its efficiency in allocating resources. In any case, some degree of gradualism cannot be avoided since certain improvements in the banking system can only occur in parallel with the transformation in the economy in general, which is occurring only gradually.¹² The feasibility and advisability of an alternative "Big-Bang" comprehensive restructuring of the banking sector is briefly discussed at the end of this section.

12. Most East European countries have also pursued a gradual approach to banking reform, although different from the one proposed for Russia, due to the completely different structure of their banking sector. In Poland, all major commercial banks are directly owned by the state and are being gradually restructured and privatized (see "Enterprise Reform in Eastern Europe", S. Van Wijnbergen, The World Bank, WPS 1068, January 1993). In Hungary the state retains control of all major banks, although these banks are organized as joint stock companies and in some of them the public holds a minority stake. Banks are being restructured gradually, and the state is expected to reduce its holdings over time (see "Competition and Efficiency in Hungarian Banking", D. Vittas and C. Neal, The World Bank, WPS 1010, October 1992).

4.15 The International Standard Bank program. The core of the recommended strategy to improve the soundness and efficiency of the commercial banking system is the International Standard Bank (ISB) program.¹³ The ISB concept consists of creating a separate tier of banks that will be more capitalized, will adhere to better banking practices, and will be more closely supervised than other banks. Banks will be encouraged to become ISBs voluntarily by providing them with a series of benefits over non-ISB banks. This report does not deal with questions related to enforcing ISB standards on all Russian banks. While eventually the Central Bank will have to do so, this is not likely to occur within the next five years and therefore it is beyond the report's horizon.

4.16 The ISB program has the following inter-related objectives:

- Create a core of banks, the ISBs, which will follow better banking practices than the rest.
- Gradually raise the level of soundness of the Russian banking system, which will occur as the number ISBs and their share in banking activities increase.
- Improve the efficiency of the banking system to allocate resources by increasing the portion of credit allocated by banks on the basis of arms length transactions rather than through the currently widespread insider and connected lending.
- Provide the public with information to recognize the most appropriate banks for their specific needs.
- ISBs could form the basis from which the Russian banking system could be integrated into the international financial markets. The ISB designation will enable foreign companies and banks to identify the best banks for their transaction needs in Russia.

4.17 The following paragraphs present an example of a blueprint for the ISB program. It consists of three components: a set of standards that ISBs will have to meet, a set of benefits that will entice banks to become ISBs, and a set of administrative procedures necessary to run the program.

4.18 Program standards. The proposed standards can either be established immediately or can be phased in over the next five to ten years. In either case, the standards should be announced at the outset of the program, so that banks know how they should be adjusting. For example, the ISB standard for the risk weighted capital-asset ratio could be set at 8 percent from the outset of the program. Alternatively, it would be announced when the

13. Over the last year under the Technical Cooperation Program, the World Bank has been working with the Central Bank, especially the Moscow branch, on the development of the ISB concept.

program is launched that in order to qualify as an ISB banks would need to increase their risk weighted capital-asset ratio to 4 percent, 6 percent and 8 percent, by the beginning of 1994, 1997, and 2,000 (assuming that the program is launched in 1993).

4.19 While the gradual approach seems more appropriate for the Russian circumstances, the Central Bank will need to consider the trade-offs between the two approaches. The "immediate" approach guarantees that ISBs will become good banks right away, but very few banks would qualify as ISBs for a long period of time. On the other hand, under the gradual approach all that can be said about ISBs is that they are the "better" banks, with the meaning of better improving over time. A benefit of the gradual approach is that it requires a lower level of benefits to entice banks to become ISBs. Some degree of gradualism is bound to occur in any case, since supervision of ISB will become stricter only gradually, as the supervision capacity of the Central Bank improves over time.

4.20 A related question is: why not phase-in ISB standards and impose them on all banks at once? This is neither feasible nor advisable. First, if meaningful standards are to be imposed, they will drive a large part of the banks out of compliance. It would be highly disruptive as well as politically impractical to try to de-license all of them. Second, the Central Bank does not have the capacity to supervise or check compliance with standards by thousands or even hundreds of banks. On the other hand, it is advisable to immediately impose ISB standards on all new banks. Once the ISB program is launched the Central Bank should grant new bank licenses only to those applicants complying with ISB standards in place at that time.

4.21 The following nine standards can be adopted for defining ISBs. As explained above, some of these standards could be set immediately at their long term optimal levels, or they could be phased in over time. In either case, all existing banks would need substantial improvement to qualify as ISBs.

4.22 The first three standards could be phased-in over the periods designated in parenthesis:

- ISBs must meet capital adequacy standards similar to those of the Basle Agreement or the European Community, that is, a risk weighted capital-asset ratio of at least 8 percent, with additional limitations on the composition of capital. (five to ten years).
- ISBs cannot have an exposure to any single borrower in excess of 25 percent of its capital. In addition, the aggregate amount of all risk exposures to single borrowers that equals or exceeds 10 percent of the bank's capital cannot exceed eight times the bank's capital. (three years).
- ISBs cannot have an exposure to any single connected party in excess of 10 percent of the bank's capital. The aggregate exposure to all connected parties cannot exceed 20 percent of the bank's capital. All credit transactions to connected parties have to be done on commercial terms. (five years).

4.23 The remaining standards should be applied immediately upon the launching of the program:

- **ISBs must have capital of at least one billion rubles. The level of the minimum capital should be adjusted annually to take into account the level of inflation.**
- **ISBs have to submit to the Central Bank a quarterly report on all borrowers to which they have an exposure of more than 10 percent of capital, or of more than 5 percent of capital in case of connected parties.**
- **ISBs have to maintain a loan loss reserve adequate to cover potential losses from non-performing loans.**
- **ISBs must employ proper accounting standards and procedures, and must submit appropriate reports to Central Bank supervisors to monitor their financial condition.**
- **ISBs must submit to an annual external audit by an auditing firm chosen from a list prepared by the Central Bank.**
- **ISBs must adhere to a code of conduct designed by the Central Bank, regulating their relationship with customers and aimed at assuring that all customers are treated fairly.**

4.24 Benefits to ISBs under the Program. The benefits package should be calibrated to produce the "right" number of ISBs; that is, enough to form the core of a good banking system but not so many that the Central Bank would be unable to supervise them effectively. The following list contains examples of benefits that would be enjoyed by ISBs.

- **The right to be designated an ISB. Eventually, this will be of great value, as it will allow ISBs to pay lower interest rates on deposits.**
- **Lower cost of borrowing from the Central Bank, either through a lower discount rate or by allowing ISBs to provide cheaper collateral. This can be justified on purely commercial terms, given the lower risk of lending to ISBs.**
- **Preferential treatment with regards to insurance of household deposits. One way to structure this benefit would be for ISBs to pay lower insurance premium to insure household deposits. There is an alternative, more forceful, way to use access to deposit insurance as an incentive for banks to become ISBs. ISBs would have access to deposit insurance on their household deposits, and would be able to use these deposits to fund their lending operations, subject only to normal reserve requirements on these deposits. On the other hand, non-ISB banks would be required to invest 100 percent of their household deposits in a special low yielding account in the Central Bank in order to qualify for deposit insurance on them. This arrangement would**

guarantee that most household deposits would go to ISBs or to Sberbank. In addition to providing a very important incentive for banks to become ISBs, this would also help limiting the development of new systemic problems in the Russian banking system.¹⁴

- A lower risk-weight for purposes of calculating capital adequacy, thereby lowering ISBs cost of borrowing in the interbank market. The Central Bank could also limit Sberbank to lend only to ISBs in the interbank market.
- Easier expansion through automatic approval of new branches and preferential access to bidding for failing banks.
- Exclusive right to be accredited as participating banks under future APEX lending schemes in operations financed by the International Financial Institutions.
- Support in financing advisory services, management contracts, and other types of Twinning Arrangements with foreign banks.

4.25 The Administration of the ISB Program. The Central Bank should create a special ISB office to coordinate the program and to license and supervise ISBs in coordination with the Supervision Department of the Central Bank. This office could be based on the Moscow branch of the Central Bank that is already working on the ISB program.

4.26 Banks interested in becoming ISBs would apply to this office, providing necessary information about their compliance with ISB standards. The ISB office would be required to charter the bank as an ISB or to justify a rejection, within a short period of time. If any chartered ISB falls out of compliance with the required standard, the ISB office will notify the bank and request that the problem be addressed within a specified period, e.g. three months. If the problem is not solved within that period, the ISB office will revoke the ISB charter and the bank will lose the corresponding benefits, including the right to use the ISB designation.

4.27 Effect of launching the ISB program. Twenty to thirty leading commercial banks are already working on strengthening their balance sheets and their banking skills, and some are trying to reduce their single borrower and connected party exposure. Launching the program is likely to accelerate their adjustment, and most of them would become ISBs soon, if the standards are phased in gradually. The number and market share of ISBs will gradually increase, especially in those markets in which the program provides an advantage, such as dealing with households and with foreigners.

14. Otherwise, "bad" banks could raise interest rates and attract large amounts of insured deposits. They could lend these publicly insured deposits to "too risky" borrowers or to their own shareholders. Depositors would not have any incentive to monitor the use of their funds since they are insured.

4.28 The ownership structure of banks will be the main constraint to expansion of the ISB sector, since many banks may not be able or willing to reduce lending to shareholders. On the other hand, an important catalyst for expansion of ISBs would be if the Central Bank intervenes and liquidates insolvent banks and imposes losses on depositors. This would probably lead to a "flight to quality", i.e., a shift of business from non-ISB to ISB banks. Such a shift would help the Central Bank discover additional problematic banks, which it should also intervene as soon as possible.¹⁵ Liquidating insolvent banks is not only crucial for the success of the ISB program but also to insure adjustment in the enterprise sector. No reform strategy will work if there are no penalties for bad performers.

4.29 Eventually the Central Bank will have to force ISB standards on all banks. This will require de-licensing and possibly liquidating many banks. Therefore, it is advisable that extending ISB requirements to all banks be done once ISBs account for the bulk of the banking sector activities, in order to minimize the consequent disruption to the economy. This is not likely to occur in less than ten years, well beyond the horizon of this report.

4.30 Risks of the Proposed Strategy. There are two main ways in which the program may fail to induce an overall improvement of the banking system:

- The benefits of the program may fail to attract a sufficient number of banks, or the advantages granted to ISBs may not be enough to prompt a substantial increase in their market share. To reduce these risks, the Central Bank should reconsider the conditions offered to ISBs every six months in light of the developments in the relative size of the ISB sector.
- Non-ISB banks may behave in ways that worsen their own performance as well as that of the whole banking system, for example, by raising interest rates to a point that would complicate the operations of ISBs, or by lowering credit standards in lending.

In order to avoid these problems, the Central Bank should direct part of its supervisory capacity to those non-ISB banks which continue to grow after the introduction of the program.

4.31 Should the Russian authorities attempt a "Big-Bang" type, comprehensive restructuring of the banking system? The possibility of a massive restructuring, recapitalization, and privatization of the banking system has been raised by some who claim that most banks are insolvent, and their managers are captives of the enterprises that own the banks. This report takes a different view: that at this time it is not advisable to use public funds and political will to attempt such a massive endeavor for three overriding reasons:

- The amount of household deposits outside of Sberbank is very small. Also, large enterprises should, in principle, be able to monitor the lending practices

15. If a problem bank provides services in an area or sector that is under-banked, the Central Bank should consider taking it over, recapitalizing it and selling it to an ISB.

of banks where they keep their deposits. This is especially true in Russia where, in general, large enterprises keep their deposits in banks where they are both shareholders and borrowers. The banking sector's exposure to systemic risk is attenuated by these factors, and hence they present no clear justification for a massive government intervention.

- It does not make sense to use public funds to recapitalize banks that claim to be profitable, as do most Russian banks. This claim is plausible under the present conditions of low cost funding in the presence of very high inflation. Moreover, even if most banks were insolvent, recapitalization would be risky, since the Central Bank lacks the capacity to supervise banks and it will not be able to prevent the repetition of behavior that got banks into insolvency in the first place.
- The problems of connected and insider lending need to be dealt with by enforcing regulatory restrictions, not by attempting a massive change in the ownership structure. Especially, since it is likely that any attempt to change ownership will just reshuffle the same players, as there is no clear alternative source of skills and capital outside of the present management/owners.

All this may change, and a Government-led comprehensive restructuring of the sector may be needed in the future. However, it does not seem advisable to undertake a massive effort now in order to preempt the possibility of future problems.

4.32 How does the proposed strategy deal with the possibility of a financial sector crisis? Banking sector crises are commonly triggered during periods of high inflation or shortly after implementing a stabilization program. Such periods are sometimes characterized by high real interest rates that cause large segments of the enterprise sector to have sudden difficulties servicing their debts. Rapid structural changes can also lead to debt service problems in many sectors, since profitability may deteriorate as relative prices change.

4.33 Enterprises faced with debt service problems often respond by requiring banks to refinance principal and interest payments as they come due. Banks sometimes accede, since the declaring a loan in default requires recognition of losses, which in turn may impair public perception of a bank's financial condition or it may force a bank into noncompliance with regulatory obligations. This is referred to as distressed borrowing and lending. The magnitude of such problems often increases as enterprises and banks become increasingly insolvent.

4.34 Governments faced with potentially large fiscal costs are usually slow to intervene in such crises, but eventually banks become illiquid (i.e. unable to pay back depositors), and governments are forced to intervene. Depending on the magnitude of the problem and the structure of the specific banking sector, governments deal with problem banks through a combination of restructuring and recapitalization, liquidation, and merger with or sale to

good banks.¹⁶ An analysis of whether or how such crisis could develop in Russia is beyond the scope of this report and is not a useful exercise since the specifics of each crisis are impossible to predict, especially with the unique institutional situation in Russia.

4.35 The strategy proposed in this report is not designed to prevent such a crisis over the next five years, but it is unlikely that any banking sector strategy can insure that a crisis will not occur. However, the implementation of the proposed strategy could facilitate dealing with a future crisis. ISBs would provide the nucleus on which to restructure and strengthen the banking system in the event of a crisis. Also, implementing the report's recommendations on deposit insurance will protect the household sector as much as possible in a potential crisis.

4.36 **A Role for Foreign Banks.** Russian authorities should encourage the presence of foreign banks in Russia. The Central Bank should set clear guidelines for licensing subsidiaries and branches of foreign banks. Foreign banks, at least those from OECD countries, should receive a response within three months of applying for a license. Joint ventures and investment in existing Russian banks should be encouraged, and the Central Bank should consider selling part of the bank shares it owns to foreign banks.

4.37 Many developing countries have found that foreign banks can serve as a bridge to attract foreign capital. Banks serve as advisors to potential foreign investors and provide banking and other financial services to foreign companies with which they work in their home countries. An important benefit from the presence of foreign banks would be the transfer of banking know-how to Russian banks. In spite of the potential benefits, there is great opposition to the entrance of foreign banks, and their presence is minimal. The main opposition comes from Russian banks that fear that foreign banks will capture a large share of the intermediation of foreign currency deposits, which is a very profitable business. In spite of the restricted presence of foreign banks, this is already occurring.

4.38 The Central Bank could allay domestic banks' concerns by limiting the size of foreign banks by setting a ceiling to their capital and by requiring that branches be at least partly capitalized. The Central Bank could also require foreign banks to keep sufficient capital to back their foreign currency operations, or to lend domestically part of the foreign currency they raise in deposits, as is done in other countries, including some developed market economies.

16. Over the last decade, many countries (including several developed countries) underwent major financial crises, giving rise to a vast literature on this topic. The 1989 World Development Report, and Banking Crises: Cases and Issues, V. Sundarajan and T. Balino, IMF 1991, can serve as good references to this literature as well as a primer on this topic. They also describe recent experiences with financial crises and provide examples of how governments dealt with such crises in several countries, including Argentina, Chile, Korea, Spain and Turkey.

The Role of Sberbank

4.39 The Russian authorities have two basic options in deciding the role of Sberbank over the next three to five years. Under the first option, Sberbank would be able to lend to enterprises like any other bank, except that its liabilities are guaranteed by the Government. Lending by Sberbank increases competition in the loan market, but puts government guaranteed household deposits at risk. If this option is chosen, the Central Bank should direct most of its supervisory resources to monitoring Sberbank, because of its size and because it is the only bank where household savings are at risk. The Central Bank should also consider downsizing Sberbank to facilitate more effective management. This could be done through a combination of breaking it up into separate independent banks or subsidiaries and by selling branches in large cities to ISB banks.

4.40 Under the second option, Sberbank would be geared to raising household deposits, playing a role similar to that of postal banks in many countries. Under this option, Sberbank should not be allowed to lend to enterprises and should be restricted in the size of its lending to households and the interbank market. For example, it could be allowed to lend up to 10 percent of deposits in the interbank market and up to 15 percent to households for loans not exceeding five million rubles each, about the size of a typical car loan. Mortgage lending to households should also be considered a possibility. Initially, such lending should be allowed only for a small share of the portfolio, because Sberbank needs to develop its loan origination and loan service capacity. The rest of the deposits would be used to purchase non-tradeable government bonds issued specifically for this purpose, carrying a variable interest rate equal to a few points under the Central Bank's discount rate.

4.41 Under this option, Sberbank will provide households throughout Russia with a safe window to deposit their savings, access to the payments system, and a source for credit. It would also continue to serve as an instrument for the Central Bank's policy of providing a floor for interest rates. This is the preferred option, at least until enough commercial banks can perform these functions and until the Central Bank has the capacity to effectively supervise such a large bank. It will take a few years for these conditions to be fulfilled.

Restructuring Promstroibank

4.42 The movement to a market economy has eliminated the main functions of Promstroibank. Given its internal dynamics, this bank could become an obstacle to the reform program. Promstroibank's operations will shrink dramatically as directed credit programs are phased out. Their high rate of non-performing loans and the continued tendency of its branches to secede will also contribute to its shrinkage.

4.43 The Central Bank and the Government should consider actively promoting a gradual and orderly downsizing of Promstroibank using the following steps:

- The Government and Central Bank should consider requiring Promstroibank to sell its shares in the 12 regional subsidiaries where it is a majority owner. It is possible that some of these subsidiaries will follow other former Promstroibank branches in becoming relatively dynamic banks.

- **Promstroibank could also be asked to divest all other investments, including real estate, outside its core banking business. The proceeds from all these sales should not be made available for new lending but should be used to pay Promstroibank's debts to the Government and the Central Bank, or put in escrow to guarantee such debts.**
- **The Central Bank should ban Promstroibank from borrowing in the inter-bank market to prevent household deposits from indirectly funding Promstroibank's risky loans.**

4.44 It is possible that following this downsizing, Promstroibank could re-emerge as a relatively dynamic institution. If this fails to occur, the proposed actions will insure that this bank will continue to shrink gradually without causing major disruptions in the banking sector.

5. THE DEVELOPMENT OF THE FINANCIAL INFRASTRUCTURE

5.1 This chapter describes the most important reforms in Russia's financial infrastructure, needed to support the development of a strong, efficient market-based financial system. Financial infrastructure comprises the foundations of law, regulation and accounting, public institutions, processes, and systems, in which financial institutions operate. The chapter considers the following aspects of Russia's financial infrastructure: the legal framework, developing accounting and auditing, ensuring banking regulation and supervision, training of bankers, reforming the payment system, and the introduction of a deposit insurance scheme.¹⁷

The Legal Framework

5.2 The legal framework of the former centrally-planned economy emphasized administrative rather than contractual relationships and imposed substantial constraints on the private ownership of property and the rights of disposition thereof. The banking and financial system was treated as an integral component of the planned economy and operated largely on the basis of unpublished legislation. Market economy notions of freedom of contract and generally accepted principles of the rule of law were either unknown or rejected.

5.3 In the last 18 months, this situation has begun to change. Serious efforts have been made to enact laws that (a) are reasonably clear and ascertainable; (b) contain a framework for contractual rights against a background of property rights, including intellectual property and laws dealing with other obligations; (c) contain procedures to deal with failures in relationships so that rights are enforceable without undue delay, excessive cost, or political or other influence, and so that like cases are treated alike; and (d) recognize foreign laws while containing rules to deal with conflicts of laws.

5.4 Legislation has been passed at a record pace by both the Supreme Soviet and Presidential edicts: a Law on Bankruptcy (effective 1 March 1992), a Law on Currency Regulation (4 November 1992), substantial amendments to the Labor Code (25 September 1992), and a large number of enactments on aspects of privatization, intellectual property, trusts, securities, joint stock companies, partnerships of all types, securities regulation, oil and gas issues, accountancy, constitutional reform, foreign investment and land reform. Much of this legislation will require amendment as the market economy develops. Regulations and subordinate rules will also be required to give effect to the general principles enshrined in the various pieces of legislation. A second generation of legislation will also be required including measures dealing with:

17. A central bank that is staffed and equipped to formulate financial and regulatory policies is probably the most important aspect of the financial infrastructure. However, this issue is not dealt with in this report, since it is discussed in "Russian Federation: Strengthening the Monetary Analysis and Central Bank Operations", IMF, October 1992.

- **Insolvency.** A law exists but needs subordinate rules to make it work effectively. In particular, provisions are needed to deal with the criteria for recognizing insolvency of state-owned enterprises, division of responsibilities, financing losses of state firms, prudential regulations for restructuring insolvent companies, and criteria for bankruptcy.
- **Security.** A Law of Pledge exists is largely ineffective because it lacks satisfactory provisions for dealing with priority of creditors. Furthermore, no mechanism exists for the central registration of pledges nor for rules about the execution of collateral.
- **Laws on ownership of property.** While property rights in goods and intangibles are generally satisfactory, clarification of the law on ownership of land is required. Without significant changes in this area, the law on security cannot be effective and foreign investment will be impeded.
- **Company Law.** A new law on joint stock companies is under consideration. Measures that need to be addressed include establishment of commercial enterprises, limited liability status, exit and entry procedures, money lending, installment buying, and leasing.
- **Law on payments and payment systems.** Reform is needed urgently to increase the productivity of the payment systems, to promote security, and to allow for new technologies. The preparation of communication and structural organization concepts is a key priority. Improvements in technology have a direct impact on the law of evidence, contracts, and other property rights. The new technological environment will require other changes, such as regulations providing for electronic funds transfer.
- **Securities laws.** Provisions are needed to regulate the market for issuing and dealing in securities, including control over investment management activities. Such legislation is in preparation and should provide the legal basis for establishing a securities trading authority, stock exchanges, securities firms, mutual funds, and other such financial institutions.
- **Stock Exchanges.** The privatization program will be enhanced once improvements have been made to the marketability of securities. Provisions for formatting and regulating stock exchanges have been drafted but have yet to be enacted.
- **Insurance.** Legislation in the field of insurance is completely lacking. The establishment of a regulatory body and appropriate subordinate legislation governing the creation of private insurance firms, prudential regulations, participation of foreign insurance companies, and reform of the social security system are all necessary.

5.5 Improvements in the above areas will help to create the broad legal framework within which a market-based banking system can operate. In addition, specific provisions relating to banking and financial law are also needed. A number of structural issues still need to be resolved, such as the role and powers of the Central Bank and its links with the Parliament, the Ministry of Finance, and other line ministries, defining the role of and responsibility for banking supervision, general direction and development of the banking system and, in particular, the nature and extent of bank powers and duties.

5.6 Uncertainty over the objectives for the financial system, its structure, and limited understanding of basic concepts such as credit risk, collateral, liquidity, financial discipline, and bankruptcy make the task of establishing an appropriate legal framework for the financial infrastructure extremely difficult. A lack of enforcement mechanisms is also likely to impede the establishment of new commercial relationships and a fully functioning banking system. Mechanisms are needed to facilitate the recognition and enforcement of court decisions, a central registration facility for pledges, and agencies for the execution of collateral, collection of taxes, and similar duties. Specific banking services are also required, such as institutions responsible for research into statistics relating to companies, as well as filing systems for company records, unpaid checks, incidental payments and lost and stolen checks.

Accounting and Auditing

5.7 Banks and other financial institutions in Russia currently operate in the absence of an adequate accounting and auditing framework, without the tools for efficient and effective management. Russian accounting has historically been oriented towards the objective of ensuring that the state had full central control over the enterprises' use of resources. The accounting profession concentrated on bookkeeping and automatically followed detailed rules, giving little attention to accounting principles. Enterprise and bank accounting largely resembled accounting in Government departments, that is, a series of earmarked funds. Russia's economic isolation meant there was no need to deal with accounting issues related to foreign exchange. Because inflation was assumed to be negligible, inflation accounting was irrelevant. There was no proper auditing of bank and enterprises accounts; instead, tax authority representatives made bi-annual inspections to ensure compliance with rules and regulations.

5.8 The underlying inadequacy of current bank accounting systems, limited understanding of financial statements, rudimentary accounting principles, and the absence of appropriate reporting and supervisory guidelines constitute significant dangers for the financial system. The main weaknesses in the current system relate to the fact that financial statements do not present a fair picture of bank performance, solvency, profitability, and liquidity to depositors, shareholders, and third parties, and do not demonstrate that banks satisfy prudential criteria.

5.9 The Government has recognized the importance of raising accounting and auditing standards for foreign and local investors, lending institutions, Government authorities, and the domestic financial system. The first step toward accounting reform was the adoption in December 1991 of a set of new accounting principles and systems, in line with the main

orientations of a general accounting chart. The introduction of new accounting principles for banks is being carried out in four steps:

- The existing system is being adapted to bring it in line with international practices in term of principles and presentation.
- Instructions have been disseminated, explaining the initial steps, with the objective of bringing financial statements in line with the new standards by December 31, 1992.
- A new chart of accounts and detailed instruction manuals have been drafted, to be introduced not later than January 1, 1994.
- A detailed reform of the accounting system will be carried out over the next two to three years, pertaining to financial accounting, regulatory accounting, and statistical reporting.

5.10 To achieve these systemic changes, the Government is expected to prepare a new Accounting Law, laying out the general basis for accounting and auditing, including the establishment of the concepts of "generally accepted accounting principles" and "generally accepted auditing standards" in line with international standards. This would mean that accounts would be expected to show a true and fair asset value, and would follow the international principles of consistency, prudence, and solvency. The proposed law would also be aimed at:

- Putting in place strong regulatory and advisory bodies.
- Developing the institutional bodies, including a Russian Accounting Standards Board responsible for designing and implementing the transformation, and subsequently updating those bodies from time to time in line with changing conditions.

5.11 The auditing profession in Russia is still in its initial stage of development. Some auditing functions are currently carried out by a number of authorized Russian firms, as well as by some of the most important international accounting firms. The scope and quality of their work varies considerably and, in general, is significantly below that required for international auditing and reporting purposes. Presently, it is not realistic to expect that audits be performed according to international standards, given the novelty of the external auditing function in Russia and the lack of trained professionals.

5.12 A medium-term program for strengthening the accounting and auditing profession would be built around the following:

- Retrain and upgrade existing accountants and accounting firms, based on the establishment of a chart of accounts in general consistency with international accounting and auditing standards.

- Establish criteria for certifying new professionals entering the industry by a competent Accounting and Auditing Board; define the accounting curricula appropriate for secondary schools, institutes, and universities.
- Foster the development of professional associations in Moscow and regional centers.
- Encourage the development of private sector and state auditors.

Regulation and Supervision

5.13 The regulatory framework and the supervisory functions are essential elements to ensuring the soundness of the banking system. The Russian Law on Banks and Banking Activity vests the Central Bank with the responsibility for these functions. Accordingly, the Central Bank is in charge of (a) issuing bank licenses, (b) designing prudential regulations, (c) exercising off-site and on-site supervision and, (d) applying sanctions on banks that fail to comply with the regulations or represent a threat to the interest of their debtors or creditors.

5.14 The Central Bank issued in 1991 an instruction containing a set of regulations related to prudential ratios (table 5.1). These regulations are lax compared with that of most market economies and need to be tightened. The Central Bank also issues licenses and exercises some supervision of the banking sector, but with a very limited intervention and enforcement capability. Strengthening the supervisory capacity will be a long process, since it requires the progressive build-up of specialized skills and experience that are almost non-existent in the Russian economy. It is therefore necessary to prioritize issues where progress can and must be achieved rapidly, and to focus the limited resources of the Central Bank's Banking Regulation Department in these areas. It is recommended that priority be given to the implementation of the ISB Program and the containment of systemic risks, such as preventing non-ISB banks from putting public funds at risk and restricting the expansion of insolvent banks.

5.15 The Central Bank should consider limiting the issuance of new bank licenses only to ISBs. As an interim step, it should at least (a) tighten the licensing process to discourage further proliferation of unsound banking practices; (b) increase the minimum capital requirement and index it on domestic inflation; (c) strengthen criteria related to the experience, competence, and integrity of potential shareholders and managers; (d) require Central Bank approval of any substantial modification of a bank's capital structure.

5.16 Table 5.1 presents a brief description of the regulatory requirements faced by Russian banks. Risk coefficients used to evaluate assets are in general less stringent than those specified under the Basle convention. For example, under Central Bank regulations, loans to enterprises have a coefficient of between 20 and 50 percent; investments in real estate or joint stock companies carry a coefficient of 25 to 80 percent, compared to a risk coefficient under the Basle convention of 100 percent. While Russian regulations focus on the ratio of capital to deposits, the Basle convention focuses on the ratio of capital to risky assets.

5.17 Some regulatory changes need to be made for the whole banking system, including non-ISBs. The Central Bank should revise risk weights used to calculate reporting ratios in line with the Basle Convention, and should redefine the capital adequacy ratio to focus on banks' assets, not on their liabilities. These definitional changes will help monitor the evolution of the system as a whole and its convergence to ISB standards, and will make reporting more transparent to potential foreign investors. The capital asset ratio required from non-ISBs should take into account the present situation of the sector as well as the long term requirements indispensable for the development of prudent banking practices. It cannot be set at a level higher than that required for ISBs, and would probably need to be set at a much lower level.

5.18 Following a decision to launch the ISB program, the Central Bank would have to draft and issue prudential regulations for ISB banks, as described in Chapter 3. It is advisable to provide for a gradual introduction of high standard requirements rather than to call for immediate enforcement of sub-standard requirements or of regulations that cannot be met by any bank. In the short and medium term, the Central Bank should focus on five key areas: liquidity, credit exposure limits, loan classification and its impact on income statements and capital adequacy, interest rate and foreign exchange risks, and internal control management.

Table 5.1
Required Standards for Russian Banks

<u>Required Ratios</u>	<u>Former state banks</u>	<u>Zero-Bank</u>
capital/liabilities (minimum)	.04	
for closed-end corporations (minimum)		.05
for open-end corporations (minimum)		1/15
liquid assets/demand deposits	.20	.30
long term loans/long term deposits (maximum)	1.50	1.00
single borrower risk/capital (maximum)	1.00	
for banks licensed in 1990-91 (maximum)		.75
for banks licensed in 1988-89 (maximum)		.50

Note: Assets are risk-weighted averages.

5.19 Universal vs. Specialized Banking. The Central Bank should require all banks to fully capitalize their non-lending investments, such as securities of joint stock companies, real estate, and participation in the ownership of enterprises. Full capitalization means that

such investments can be funded only from the bank's capital and not out of deposits. Furthermore, the size of these investments should be limited to between 10 and 20 percent of the bank's capital. These requirements are common practice in countries with a universal banking system. The Central Bank should allow a period of two to three years for banks to comply with these regulations, since some banks may find it difficult to divest their investments or to raise the capital needed to substitute the present funding of these investments.

5.20 The development of off-site surveillance of both the banking system as a whole and individual banks would aim at monitoring the implementation of regulations and at progressively building-up an "early warning system". A surveillance program should be based on specific applications of the prudential, accounting, and credit reports routinely submitted to the Central Bank by the banks. Such a program should be designed in the framework of the automation strategy of the Central Bank to be as timely as possible and to include strong consistency checks. Such a program would also be very useful in preparing on-site examination reports, since it would enable the Central Bank to detect banks whose profile is deteriorating.

5.21 Improving the capacity of the Central Bank for on-site examination is the most important and the most difficult task confronting the Banking Regulation Department. This long-term challenge should be carefully planned in conjunction with — and should strongly rely on — the development of sound accounting and auditing practices that are a prerequisite for assessing the soundness of financial institutions. That would permit on-site examination to shift from the present emphasis on inspecting the banks' accounts to focus on prudential concerns about the safety of the sector and of individual banks. In this framework the two main objectives should be: (a) the development of a core group of qualified bank supervisors for comprehensive examinations of large banks mobilizing households' deposits; (b) the progressive introduction of simple and standardized examination methodologies, procedures, and reporting to be used on a large scale to review specific issues such as liquidity management, credit policy, loan classification, and internal control.

5.22 To meet these objectives rapidly, the Central Bank could subcontract part of these tasks to specialized firms, a practice still followed by some central banks in Western Europe. During the next three to five years, the Central Bank should also consider the possibility of teaming foreign bank examiners with their own supervisory staff. This would enhance supervision and provide on-the-job training for the Russian examiners. OECD countries are likely to make bank examiners available under their technical assistance programs. These joint teams should be deployed to supervise ISBs, large non-ISB banks, and any non-ISB bank that continues expanding after the launching of the ISB program.

5.23 To be effectively enforced, the regulation and supervision function has to rely on an array of powers covering disclosure of information, imposition of sanctions ranging from warnings and fines to replacement of management bodies, license removal, and bank intervention. The credibility of the Banking Regulation Department will rely more on the quality and the professionalism of its recommendations than on its power to impose severe

sanctions. Experience indicates that the better the regulatory and supervisory functions, the more credible the central bank's recommendations are, and the less severe the sanctions actually needed.

Training Bankers

5.24 Preparing Russian banks to operate in a market environment requires completely different methods from those applicable to the former Soviet banking system. To strengthen the banking profession in Russia, massive training and retraining programs are necessary for managing banks, marketing and delivering banking services, controlling risk, ensuring banks' financial viability and performance, and carrying out basic banking operations.

5.25 The institutional, legal and regulatory frameworks in which the financial system will operate in Russia are still evolving. The situation is unprecedented in that classical models of training for an established framework do not apply. For example, structuring a loan or a credit contract takes place within a legal context. In Russia, corporate law is still not well articulated, and credit training needs to concern itself with the evolving nature of contracts.

5.26 Because personnel in the banking system are almost totally unprepared to carry out the banking activities their new roles require, the need to initiate some basic training is urgent. Training within a framework undergoing radical transformation will likely be an interactive process that will require flexibility. A program of core skills could be introduced; those skills would permit bankers to participate effectively with foreign technical experts in institutional development of the banks as well as in the evolving financial markets. After defining a basic approach to managing the major banking functions, more bank-specific training programs would be developed.

5.27 Western governments and institutions have been providing different forms of training for Russian bankers. Most of this training has been through short courses that offer exposure to a different banking culture rather than intensive training. The magnitude of the training needs demands a training program with a much greater degree of consistency and depth. To provide a cost effective and broad venue for making training available to all banks in Russia, a network of banking institutes similarly to those in Poland and Hungary should be developed throughout the Russian Federation. A number of initiatives have already been made, including the creation of the Moscow Banking School, established with the support of the European Bank Training Network and the Commission of the European Communities. Other limited initiatives have been carried out in a number of Russian cities. This effort must be rationalized and extended through the nation.

5.28 Since credit is at the core of banking and is the area of highest risk, the elaboration of credit programs should proceed first. At this stage of development, banks also need to develop strategic, tactical, and financial planning skills to orient or reorient the way in which they are managed. Finally, the curriculum should gradually be extended to include such topics as money and banking, capital markets, international banking, trade finance, general management, marketing, and retail banking.

5.29 An additional vehicle for training bankers, as well as for strengthening the structure of Russian banks, is a program to twin Russian banks with leading foreign banks. Under such program, staff from the foreign banks provide advice on strategic planning and on the organization of their Russian counterparts. They would be involved in daily management and operations, which will serve as on-the-job training for their Russian counterparts. In compensation for their services, foreign banks could receive fees or equity in the Russian bank. A program of this kind is in place in Poland, supported by a World Bank loan.

The Payment System

5.30 The payment system is the apparatus through which obligations resulting from economic activity are discharged by transfers of monetary value. This section focuses on the segment of the payment system that deals with payments made using deposits held in banks. A payment system is efficient when clearing — the process of transferring payment information — is fast and reliable, and when settlement — the actual transfer of value — is certain as to timing, value and finality.

5.31 The present Russian payment system is based on the needs of a centrally planned economy. It does not deal adequately with the issue of certainty and speed of payments that are essential in a market economy. It is also unable to cope with the large increase in the volume of monetary transactions that characterizes the transition process. Most payments are executed through the Central Bank, which maintains 1,400 cash settlement centers (CSC). Every branch of a commercial bank maintains a clearing account with its local CSC. Consumer and retail transactions are generally cash-based, while enterprise and government transactions are executed largely through payment orders and payment demand orders. Payment orders are all executed via paper, and processing is manual. While the payee's account is debited as soon as the order enters the system at the payee's bank, the payer is not credited until the payment document is received by its bank. Since the payment process can take up to three weeks, a large float is created with a negative impact on the liquidity of enterprises.

5.32 The Central Bank has played a major role in the reform of the existing payment system. New checks have been introduced, while payment demand orders have been phased out. Intra-city clearing and settlements have been improved, particularly for large payments in Moscow, but inter-city clearing and settlements are still subject to significant delays. A new standardized payment order has been introduced, and the law governing payments is being modified.

5.33 One of the key problems in the development of the payment system is the lack of harmonization of objectives and goals. The Central Bank faces the difficult task of enforcing standards of payment instruments, procedures, and rules. The payment system must be national in scope to meet in an efficient manner the payment requirements of the Russian economy. Moreover, since national payment systems must be connected to international payments and settlement systems, domestic standards should conform as closely as possible to international payment standards.

5.34 However, in response to the present problems, some banks are developing their own intra-bank payment systems tied to local and regional clearing houses independent of the Central Bank. Also, several cities are seeking to develop their own systems and procedures that will make national standards and harmonization much more difficult to achieve. At the same time, experience in other countries indicates that an attempt by the Central Bank to enforce a top-down "planned" process may prove disruptive, since it may not have the power to deal with the conflicting interests involved and because it may derail some of the progress that is already taking place outside of the official system.

5.35 The solution to this conflict lies in the creation of a national forum where conflicting interests and objectives can be resolved. In April 1993 the Central Bank decided to establish a National Steering Committee (NSC) to oversee and coordinate the development of the payment system, and to establish policy and standards. The NSC will comprise 25 to 30 members, 10 from several departments of the Central Bank, and the rest from commercial banks, commercial banks' associations, and foreign experts from the IMF, the World Bank, other multilateral institutions, and Western central banks. The Central Bank has identified six components that need to be dealt with in developing the payment system: clearing, large value transfer system, new payment instruments, intrabank settlement, information system development, and training. The NSC has to structure task forces to deal with each of these components.

5.36 The NSC must develop and articulate a model for the payment system. It must define: payment instruments (debit/credit/both); settlement timing (same day/next day/future day with availability schedules); clearing operator (Central Bank/private/local/national); settlement technique (gross/net); payment applications and development priorities (wholesale/retail/interbank); delivery method (paper/electronic, batch/on line); communication and format standards and protocols with an evaluation of present transmission facilities; proposed rules and regulations, including enforcement procedures; risk management controls and monitoring technique; document standards; and accessibility (clearing houses/legitimate banks/other commercial enterprises).

5.37 The problems in the Russian payment system should be addressed in three directions:

- Procedures — short term efforts that will rapidly increase the efficiency of the present system with the least amount of disruption to present operations.
- Structure — legal, legislative, and regulatory changes to permit new processing techniques and more effective risk management control.
- Automation — efforts to automate and standardize existing procedures that will evolve into an electronic payment system.

5.38 Some procedural changes have already started. A standard prenumbered Payment Order form has been proposed, which will reduce processing errors and increase audit control of the paper documents. Bank courier routes rather than the postal system have begun to be used to deliver payment orders. This will control and reduce delivery times.

Availability schedules should be assigned to payment orders to reduce "in process" float, with penalties for late deliveries.

5.39 One major structural change required is to establish operating standards and a legal framework for local clearing houses. These clearing houses have been set up, and it is not likely that they will go away. The Central Bank should not monopolize what is legitimately a private sector functions, but it should set standards for systemic and temporal risk management control, as well as such operating standards as common formats, communication protocols, and settlement timing to eventually permit inter-regional clearings. The Central Bank can easily adapt and modify standards used in EC countries for the harmonization of clearing cross-border payments and settlement.

5.40 Once the private clearing houses have been recognized and standards adopted, new accounting and settlement procedures should be formalized by the Central Bank. This change has significant implications. It encourages setting up local clearing houses in major financial centers. It encourages larger, more technically advanced commercial banks to offer clearing and settlement services to smaller banks. Intra-bank network items stay within the bank service network, and intra-regional items stay within the regional clearing house. The Central Bank only sees interregional items or items for which one of the payment parties chooses to use Central Bank facilities. Since the majority of payment orders are intra-regional, the volume of items passing through the Central Bank is greatly reduced, eliminating a major paper processing bottleneck. It also introduces competition into the payment system process.

5.41 The establishment of local private clearing houses may lead to net settlement of transfers. This should be implemented very cautiously, because it requires strict risk management control techniques that must be added to present procedures. Each settlement point in the chain of clearing is a point of potential failure. Since the Central Bank may not be a party until the final settlement, a strict procedure must be established to control and monitor the systemic payment risk associated with this process. Because of the financial weaknesses of a great number of Russian banks, risk management procedures must be designed and implemented before this type of settlement arrangement is permitted.

5.42 Automation, with concentration on electronic funds transfer should be the long term direction for the payment system. Transmission facilities for electronic payments are more reliable and less expensive to build and operate than the transportation facilities necessary for physical delivery of paper payment instruments, especially given Russia's size. They are also easier to trace for audit control and, because of the precise schedules associated with electronic delivery, they are easier to settle for float control.

5.43 The design and implementation of the payment system in Russia will require substantial international funding and technical assistance. Substantial experience and international knowledge can be brought to assist the Central Bank and the Russian banking system by the World Bank, the IMF and other multilateral agencies. International experience dictates that technology should not drive the project until a more sophisticated infrastructure, including available manpower, is established. Speed and sophistication may be less important than reliability and robustness of the system as a whole. The development of

human resources to design, maintain and operate the system on a continuous basis will be an important factor in its success.

Deposit Insurance

5.44 The Law on Banks and Banking Activity provides for the creation of a deposit insurance system and calls on the Central Bank to develop the specific measures of the system. Deposit insurance is essentially a device for transferring losses stemming from a bank failure. These losses are typically transferred from certain depositors to a fund typically funded through premium payments of participating banks. In adverse circumstances, part of the losses might be transferred to the budget or to the Central Bank.

5.45 In July 1991, the Central Bank began collecting deposit insurance premium payments from commercial banks, and has deposited these amounts in a fund that presently is an account in the Central Bank. The program is not yet fully designed, but it had been intended to extend full protection to all depositors of failed commercial banks. It is likely that the Central Bank would be responsible for covering all deposits in failed banks above the funds accumulated in the account. This opens the possibility that in a financial crisis the Central Bank may have to absorb very substantial losses.

5.46 Another problem with the current approach is that, by fully protecting all depositors of a failed bank, the system would extend full protection to enterprise owners of banks, who maintain large deposits at their banks. Some such owners, through mismanagement and doubtful insider activities, could be directly responsible for the failure of the banks.

5.47 In order to minimize the potential problems, deposit insurance coverage should be limited to relatively small deposits, which in practice would restrict coverage to household deposits and small enterprises. Such a system would serve a social welfare function by protecting the general public from potentially severe losses in the banking system. Small depositors have neither skills to evaluate bank solvency nor ability to influence bank policies, while large depositors or enterprise owners should be better able to assess banks' strength and to influence banks' credit policies. By limiting the protection only to small depositors, the system would not protect those who might be subject to "moral hazard", but would extend to depositors of commercial banks essentially the same protection that is already being extended to household depositors of Sberbank through the Government's guarantee on its deposits.

5.48 As mentioned in chapter 4, the deposit insurance should differentiate between ISBs and non-ISB banks. It should charge a lower premium to ISBs, if all banks are allowed to lend the insured funds to the public. Alternatively, it could require non-ISB banks to invest insured funds in a low yielding account with the Central Bank or in Government paper.

5.49 A properly designed deposit insurance system would contribute to the general promotion of competition and soundness in the Russian banking sector. It has to be managed very carefully, taking into account all the perverse and financially important risks involved. It should be designed as conservatively as possible, its development depending on progress toward: (a) the implementation of sound accounting and auditing practices, and (b) the development of effective regulation, supervision, and intervention capabilities by the Central Bank.

6. **SECTORAL FINANCING**

6.1 This chapter deals with the special financing needs of three activities: long term investments, housing, and agriculture. It discusses specific problems that characterize each of these sectors, and how the current situation affects their financing needs and access to credit. In most developing countries there are specialized financial institutions that deal with these activities because of their special characteristics. This chapter also discusses the need for such institutions in Russia.

Financing Investment: The Emergence of Development Banks

6.2 The level of investment in Russia has fallen by about 50 percent since 1990. This is imposing severe adjustment costs on the investment goods sectors and threatens the ability of the economy to restructure. To a large extent this fall is due to demand side factors. Inflation, highly volatile relative prices, and only partial adjustment of the relative prices of internationally traded goods to their world levels make it exceedingly difficult and risky for enterprises to make investment decisions on the basis of expected future profitability. Also, the overall fall in output is reflected in excess capacity in many sectors which, in the short run at least, reduces the need for investment to increase capacity. However, the processes of enterprise restructuring and modernization are expected to lead to significant increases in investment demand, once the economy is stabilized.

6.3 Part of the fall in investment is also due to a fall in the supply of investible funds. The financial position of most enterprises has worsened, leading to reduced ability to fund investment through retained earnings. Also, in the past enterprises had to allocate a portion of their earnings to depreciation and investment funds which were expected to finance the bulk of their investment requirements. Under present rules, enterprises have more freedom to allocate profits to these funds or to other purposes such as higher wages for workers. State investment funding, which used to be the main source of outside financing, is increasingly limited because of fiscal constraints. At the same time, the new commercial banks are not yet capable of assessing investment projects and allocating financing to projects on the basis of expected profitability. Moreover, even those commercial banks that are otherwise ready to finance investment are unwilling to make medium or long term loans because in the present macroeconomic conditions they cannot fund these loans with long term resources.

6.4 The creation of development banks is being proposed as a means to alleviate these supply side problems. Their role would be to augment the level of investment in the country and to provide new, market-oriented channels for allocating investment funds. Foreign governments and the international financial institutions have expressed willingness to help fund investment in Russia, but for this it is necessary that institutions be in place that can efficiently handle and intermediate these potential funds. Development banks could play such a role.

6.5 Two development banks are being organized at the Federal level: the Russian Bank for Reconstruction and Development (RBRD) and the Russian Project Finance Bank (RPFb). A number of development banks are also being organized at the republican and regional

levels.¹⁸ Development banks differ from commercial banks in several respects, most significantly in their objective, which is the financing of medium-term and long-term investment. Typically, development banks do not take deposits from the public and do not provide a full range of banking services. Normally, development banks are created under the initiative of the public sector and with varying degrees of public sector financial support, ownership, and control. In addition to any governmental funds that might be invested in these banks, they are expected to raise additional debt and equity from Russian enterprises and commercial banks, and from foreign sources including the World Bank, the EBRD, and bilateral agencies.

6.6 Regarding the allocation of investment financing, those proposing and organizing development banks anticipate that, as institutions somewhat separated from Government, they would be less subject to political pressure than the present system, which has been supporting investment primarily through the budget and centralized credits. Being set up as profit making institutions, development banks presumably would have greater incentive to allocate funds according to profitability criteria.

6.7 The RBRD is being organized on the initiative of the Russian Government. The organizing committee and its staff have developed a concept paper that envisions the RBRD performing a wide variety of development banking services, such as direct lending to enterprises in priority sectors and to small and medium-sized enterprises, lending to commercial banks for on-lending to enterprises (apex banking), and assistance to enterprises in obtaining project finance. In these respects, the organizing committee sees the Polish Development Bank as a model. The RBRD would have government participation, but the objective is to have most of the equity privately held. Once operational, the RBRD hopes to raise \$100 to 200 million of equity capital. Regulations regarding its borrowings and leverage are still under consideration, as is the relative emphasis to be placed on apex versus direct lending. The next stages in the creation of the RBRD are its incorporation as a legal entity and bank, the completion of a business plan, and subscription of its capital. Important issues to be considered include ownership and control, capital structure, assessment of borrower demand, relationships with client banks (in its apex functions) in the context of the weakness of the banking system and its prudential regulation, and overall business priorities.

6.8 After several years of planning, the RPFB came into being in November 1992. The RPFB evolved from a development and project finance bank proposal sponsored initially by the State Bank of the USSR and later by the Central Bank of Russia. Its business plan was developed with assistance provided by the Know-How Fund, EC, and the EBRD. The initial capital of \$6 million equivalent was subscribed 51 percent by the EBRD, of which 16 percent is put into trust for employees of the RPFB. Most of the remaining 49 percent was subscribed by Russian commercial banks. Unlike the RBRD, the RPFB does not plan to become an apex lender. Its development is planned in three phases. In the initial phase, at

18. In addition to development banks, a number of investment funds are being set up. These include the State Investment Corporation, the Industrial Investment Fund, and the Russian Finance Corporation. These would be non-banking institutions whose objectives would be to channel funds to support investment.

least through 1993, it will operate like a merchant bank, providing advisory services in the fields of project finance and enterprise restructuring. It anticipates earning fees from these services and from arranging project finance for its clients. Direct lending on a small scale, as an agent for other banks such as the EBRD, will begin in the second phase which also is planned to last about a year. Only after this experience will the RPFB attempt to increase its capital to \$100 million or more and begin substantial lending operations.

6.9 The World Bank has extensive experience lending to and working with development banks around the world. Numerous analyses of experiences by the World Bank and others indicate that more often than not development banks have not been successful either in raising the level of aggregate investment nor in intermediating funds efficiently. The most common problem is a high rate of problem loans and the resulting poor financial condition of the development banks themselves. Typically, this problem is caused by political interference in the credit decisions, lack of professionalism, poor loan supervision, and poor supervision of creditor banks in the case of apex institutions. The problems tend to be more acute in conditions of macroeconomic instability and when lending occurs at highly subsidized interest rates. There is also some evidence that the presence of development banks often has retarded the development of the private financial sector, that is, capital markets and the investment financing activities of commercial banks.

6.10 For these reasons, the World Bank now recommends that wherever possible development banks should be as independent as possible from governments and should concentrate primarily on apex lending with commercial banks doing the bulk of the direct lending. Development banks should also minimize the targeting of specific industries to receive credit, leaving those decisions primarily to the market. They should evaluate projects solely on a commercial basis, taking into account the creditworthiness of borrowers and the expected profitability of projects, and should charge market interest rates. World Bank policy also discourages lending to development banks, either to apex banks or direct lenders, in an unstable macroeconomic environment. During periods of high inflation it is very difficult to assess the creditworthiness of enterprises and investment projects, and the interest rate structure is usually badly distorted. For these reasons, progress towards stabilization and relative price adjustment are among the necessary conditions for successful development banking in Russia.

6.11 Given the perceived need to begin investment financing on a commercial basis, it is an open question whether it is more effective to build up the investment lending capacity of existing banks and fund their activities through an apex bank, or to organize development banks that will engage in direct lending to enterprises. Undoubtedly, efforts will be taken in both directions. International experience indicates that Russia would be well advised to proceed with organizing development banks with great caution. Until greater experience is gained, the number should be held to a minimum. Those that are formed, such as the RBRD, should be structured carefully to avoid the well-known problems that have undermined development banks in other countries. This will be particularly difficult in the present circumstances where the capacity of the financial sector is so limited and the perceived investment needs are so great.

6.12 The RBRD is the main candidate to become an apex bank. In organizing an apex bank it is necessary to develop the technical capacity for investment banking (staffing, training, etc.) both in the apex and in its client banks, as well as the capacity to work effectively with foreign lenders and to ensure their procedures will be followed. Creating an effective apex bank will require substantial foreign technical assistance during the organizational phase, as well as during the initial operational phase. To minimize the portfolio risk, the apex bank should lend only to ISBs. It is essential to upgrade ISBs capacity to evaluate and process investment lending, as well as their capacity to handle intermediate funds provided through the apex bank. This requires substantial and continued foreign technical assistance, which could be organized through the apex bank.

6.13 As for development banks engaging in direct lending, the learning-by-doing approach of the RPFb has much merit and should be followed by other emerging development banks. In any case, direct lending institutions should be as free as possible from government interference; ideally, they should be privately owned. They should be adequately capitalized and made to assume risks associated with their lending decisions. The government should not encourage them to lend for non-commercial purposes, in order to maintain their independence and financial viability, as well as reinforce a culture of lending on the basis of profitability.

Housing Finance

6.14 Russia is a highly urbanized country, and housing assets account for a large share of national wealth. According to Goskomstat publications, housing accounted for 25 percent of the total assets in the economy in 1990. Evaluated at market clearing prices, it is likely that their share was higher. Hence, the development of a well functioning housing market and a viable housing finance system are essential components of the transition process.

6.15 Privatization of housing, including the right to sell or rent properties, is an essential condition for the emergence of a housing market and the development of housing finance. Until privatization started in 1990, less than 5 percent of housing assets in Russia were privately owned. By December 1992 about 2.5 million housing units were already privatized throughout Russia, representing 8 to 9 percent of the state housing stock. In Moscow the share was 11 percent and rising rapidly, with the possibility that one third of the state stock in that city will be privatized by mid-1993. The housing privatization law of July 1991 has been amended in December 1992 to allow the free transfer of housing. In most cities now, privatization is being done by giving property to those that presently have the right to live in it, eliminating the problem of financing the sale of existing housing. The main issue in housing finance is the development of instruments that will enable the financing of new housing and the use of equity in housing properties as the basis for collateral in borrowing for other purposes.

6.16 In addition to its social and political importance, private housing can have a positive impact on financial development and on the emergence of a strong small-enterprise sector, by creating an important and sound source of collateral for financial transactions. In market economies, lending to start new businesses is often granted on the basis of a housing collateral rather than income or project cash-flow criteria. In Russia, this is not yet possible.

Solving this problem would help the development of small-scale enterprise financing on a scale several times larger and considerably faster than through the complex and costly creation of specialized lines of subsidized credit for such businesses.

6.17 Long term finance for housing. The private provision of long-term finance for housing is easier than for other types of industrial and commercial long-lasting investments. This is largely due to the quality of housing as a loan collateral and the commitment of households to achieve full and clear ownership of their dwellings. However, several issues need to be solved for private financing of housing to become dominant in Russia:

- The price of housing must not be severely distorted by rent control, which destroys the value of housing as an investment and reduces the volume of voluntary, private housing production. Similarly, interest rate subsidies should not be used to subsidize housing. A better way of conveying such subsidies is by directly providing a grant to pay part of the purchase price. This would enable authorities to determine the size of the subsidy independently of changes in inflation or interest rates. Still, if the authorities choose to subsidize interest payments, they should compensate banks for the full opportunity cost of the funds and not force them to share the cost of the subsidy as in the present scheme with Sberbank.
- Credit risks are minimized when reliable property valuation and appropriate rules for evictions and foreclosures are a credible threat against willful default. Regarding valuation, initial steps are being taken to improve land registration, land valuation, the publicity of prices, and the development of the professions related to urban real estate markets. Much, however, remains to be done. In particular, there remains considerable confusion about land ownership and property boundaries in cities. As for private property rights and foreclosure, an important milestone was reached in December 1992 with the constitutional amendment allowing the private ownership of urban land. However, this right of private ownership of land is quite restrictive as it is limited to the use of plots for individual housing. This restriction is certain to impair the development of sound urban land markets and further improvements in the definition of land property rights are needed.
- Work is in progress on the draft of a mortgage law. For this law, the experience of Central and Eastern Europe in drafting effective and socially enforceable foreclosure rules should be taken into account. It will take some time before eviction and foreclosure becomes politically acceptable in Russia. In many developing countries where eviction is politically unfeasible, banks secure housing loans by requiring personal guarantees from a large number of guarantors, reducing substantially the need to foreclose on the property. However, these "quasi-mortgages" do not provide as solid a foundation for a housing finance market, since they remain unsecured loans. It is possible to improve the efficiency of these guarantees and to lower their costs through

specialized credit guarantees agencies. Such agencies are typically financed by charging borrowers a guarantee fee. Like mortgage insurance companies, these credit guarantee agencies enhance the quality of housing finance credit.

- The institutions providing housing finance should be able to manage liquidity risks. International experience suggests that lenders should have a diversified portfolio of lending activities and not be restricted to housing and other long-term credits. Interbank liquidity facilities can also play an important role in managing liquidity. The development of long-term contractual savings in the form of life insurance and pension plans is mutually supportive of long-term housing finance. Commercial banks can then issue either long-term bonds or negotiable mortgage-backed securities bundled in packages that are attractive to these demanders of long-term financial assets.
- Under the present macroeconomic situation it is impossible to manage interest rate risks. This is possibly the main problem that hinders development of a private mortgage market in Russia. Based on the experience gained in other unstable economies, the World Bank has been discussing with Sberbank and the Central Bank the development of adjustable mortgage instruments, including dual-rate adjustable mortgage instruments (DRAM) with both interest rates and payments adjusted periodically. For example, the interest rate could be a markup over the Central Bank discount rate, with debt service set at a function of average wages in the economy. DRAMs would allow banks to fund mortgages with short term deposits, since they are equivalent to short term loans that are repeatedly refinanced at maturity. This is particularly critical given the high volatility of nominal and real interest rates typical of inflationary economies. DRAMs are also advantageous for the borrowing households, because they link payments to income and can eliminate the front-loading of real repayments inherent in fixed-rate mortgages.

6.18 While DRAMs can be useful in a moderate inflationary environment, they are likely to encounter serious problems in the present macroeconomic situation. DRAMs are financially viable within a broad range of interest rate increases and declining real wages. Outside that range, however, several problems may make this a non viable instrument. For example: the share of equity in properties may fall over time and can become negative; the cash flow for the lending institution may become negative; and the maturity of the loan could become infinite, unless debt service is increased over time as a function of the size of the loan, independent of the borrower's income.

6.19 Analysis and experience show that even the best designed adjustable mortgage loan can never be a full substitute to macroeconomic stability. Implementation of adjustable mortgage instruments such as DRAM's in Russia may soon become conceptually feasible, yet it will present a series of requirements in terms of financial infrastructure that are not yet met, such as reliable economic and financial indices. Implementation will also have a significant impact in terms of the banks' management of origination, servicing, accounting, and taxation.

6.20 A clear distinction must be made between long-term lending for residential investment and for commercial real estate. Serious banking problems caused by reckless commercial real estate lending have recently been experienced in developed countries. Financing non-residential real estate investments (hotels, office buildings, commercial buildings) is quite different from long-term residential finance. Such lending is exposed to the same problems as is long-term financing of other durable capital investments, where the long-term quality of the collateral is much more volatile. It is likely that non-residential investment will develop for some time through equity-based financing schemes necessitating the contribution of a number of investors. Russian-style collective real estate investment trusts can already be found in major cities where profitable investments in city centers have been identified.

Rural Credit

6.21 Assuring access to credit for rural areas, in particular to finance agriculture, is of great importance to the Russian economy. Agriculture accounts for 15 to 20 percent of the gross domestic product and a similar share of the labor force. Better than 25 percent of Russia's population lives in rural areas. The size of the country and difficulties in transportation make agricultural production an important factor in guaranteeing food supplies in many regions. In addition, the Government sees supporting agriculture as a means of limiting migration to cities, where housing and labor markets are already strained. For these reasons, Russian authorities use subsidized directed credits to ensure access to credit and as a means of subsidizing agriculture.¹⁹

6.22 Russia is not unique in providing subsidized credit to agriculture. In most countries, including developed market economies, specialized public institutions and programs provide and subsidize credit to agriculture and to rural areas. In large part, this is due to farmers' political clout, but economic reasons also justify these programs, for example, the need to compensate for distortions in the international price of agricultural commodities due to trade restrictions and subsidies; the need to assure access to credit to remote areas; as a means to achieve food security.

6.23 What makes Government intervention stand out in Russia is (a) the extent of the directed credit programs (almost all credit to agriculture and many related activities is provided through these programs) and (b) the degree of explicit or implicit subsidization that converts these credits to implicit grants (in addition to the extremely low interest rates, both borrowers and lenders expect that most loans will eventually be forgiven). In all developed countries and in most developing countries, government programs play only a marginal role in the overall financing of agriculture, and the grant component in these program represents only a fraction of the present value of the credits.

19. "Food and Agricultural Policy Reforms in the Former USSR - Agenda for the Transition", Studies of Economies in Transition, The World Bank (1992), presents a thorough description of the agricultural sector.

6.24 Soviet agriculture in Russia was organized around 27,000 collective (*kolkhozes*) and state (*sovkhozes*) farms. The average farm had 8,000 hectares and 400 workers. Investment in these farms was financed mainly through the budget, and farms were allocated loans for working capital according to the central plan. Private farming consisted only of garden and vegetable plots (about 0.5 hectares each) allocated to urban workers. Several million household plots account for 3 percent of arable land but more than 20 percent of agricultural production. In general they are farmed by the owners for their own consumption, and production is mainly self-financed.

6.25 In the last two years the structure of agriculture has been changing. Collective and state farms are required to reorganize as individual private farms, producer cooperatives, or joint stock companies. About half of these farms have already re-registered in one of those forms, but there has been very little restructuring in most farms which registered as joint stock companies or cooperatives. The financial structure of these farms, reorganized or not, has not changed much: most of them rely on directed credits channeled through Rosselkhozbank for working capital, and very little investment is taking place.

6.26 A new type of agricultural unit has emerged since 1991, the private-family farm. Some were created as a consequence of the break-up of state or collective farms, but most were created on unused lands allocated or sold by the state. The number of private farms increased rapidly from 4,500 in 1991 to about 220,000 at the end of 1992. Private farms average about 40 hectares, and they now account for 3 percent of all arable land in Russia. Initial results indicate that productivity is higher in private farms than in state and collective farms. Most private farmers have become members of AKKOR, an organization of private farmers and agricultural cooperatives in Russia. Private farmers need substantial financial resources for their initial investments and to purchase agricultural inputs, but they are limited in their capacity to obtain loans since they cannot use their land as collateral. In general, Rosseikhozbank and commercial banks provide loans to recently established private farmers against AKKOR guarantees, which are backed by a fund created in 1992 from a budgetary allocation of R6.5 billion. The availability of credit is a real constraint in the expansion of the private farm sector.

6.27 **Factors hindering the development of rural credit markets.** Several factors complicate any attempt to reduce Government's intervention in financing agriculture:

- Land cannot yet be used as collateral to secure loans. The only exception are some 1.5 million family plots assigned to urban households in the outskirts of major cities. A recently passed law provides them with full private ownership rights, including the right to sell land.
- Financing centralized state procurement and marketing agricultural products needs to be done through directed credit programs, because the agencies in charge are too big relative to the banking system.
- Lack of banking infrastructure. In most rural areas there is no banking presence, except for Sberbank which until recently was not involved in lending. Also, most farms do not have the "skills" needed to seek commercial

loans. Most farms are not working at developing these skills since they deal only with Rosselkhozbank whose requirements for granting a loan are those of a government agency.

- Continued uncertainty as of agricultural policies, in particular prices and restrictions on trade, which complicates the creditworthiness evaluation of farms.
- Farmers' attitudes. Under central planning, credits to farms were seen as government transfers and were often forgiven. This has created expectations that will be difficult to change for private farmers, and almost impossible for state and collective farms.

6.28 Recommendations. In the short run, directed credit programs will have to continue to serve as the basis for financing agriculture, at least until farmers are able to borrow against their property. Furthermore, it is unlikely that most state and collective farms (given their debt service record as well as their uncertain future) could ever be financed by profit-oriented commercial banks.

6.29 However, several important changes should be made to the present programs. Directed credits should be restricted to agriculture and to small scale processing activities that take place within farms. Enterprises dealing with agricultural inputs, such as fertilizers, like other enterprises in the agro-industrial complex, should finance themselves directly from commercial banks. This would immediately reduce the size of directed credit programs by at least 25 percent. Directed credits to agriculture should be reduced gradually over time, as commercial banks and capital markets take over an increasing part of the financing of agriculture.

6.30 Credits should have clear terms, even if they are concessional and authorities should enforce those terms as a means of instilling financial discipline. Preferably, the Central Bank should raise interest rates on loans to agriculture to the level prevailing in the rest of the economy. Subsidies would be more effective and cheaper if they are conveyed directly linked to the objectives that the Government wants to subsidize.

6.31 Over the medium-term, as centralized procurement and marketing systems are gradually replaced by private retail and wholesale markets, the need to finance procurement through directed credit programs will be reduced. Providing clear titles to private farmers with a right to mortgage lands and allowing banks to foreclose farms in the event of default on loans will be necessary to enhance private farmers' access to credit.

6.32 Rosselkhozbank could continue to serve as the main channel for directed credits to agriculture. It should consider segregating those loans that it is required to make on an "agency basis" on behalf of the Government or the Central Bank from those that it makes on its own account. As directed credits to other activities which it currently finances are phased out, Rosselkhozbank is likely to shrink. However, it is possible that some of its branches may be able to develop a new deposit base and engage in new commercially oriented activities.

6.33 The Russian authorities should promote the creation of new financial institutions in rural areas. While these institutions could take many different forms, such as credit cooperatives, joint stock companies, or branches and subsidiaries of larger commercial banks, it is important that the focus of their activities be local. In some regions, branches of Rosselkhozbank, Sberbank, or existing commercial banks could serve as the basis for these new institutions. In other regions, completely new institutions could emerge and compete with existing banks.

ANNEX: RUSSIA'S SECURITIES MARKETS

- 1. Introduction.** This Annex presents a brief description of developments in securities markets. The successful development of an efficient securities market depends largely on reforms in other areas of the financial sector, including advancements in banking, corporate law, accounting, and auditing. In addition, it will require the adoption of specific securities laws, the creation of a dedicated regulatory capacity, and the emergence of specialized functions and institutions. Although securities markets include both debt and equity securities, given the importance of equity financing to private enterprises throughout the country, initial efforts in Russia should focus on creating a sound equity market.
- 2.** Russia's securities markets are at an early stage, requiring significant development in order to mobilize savings, to provide equity and long-term debt to enterprises, and to assist in the privatization process. Given the general underdevelopment of the legal and banking systems, the uncertainties concerning the political and economic framework, and the overwhelming need for educating the public and market participants, one would normally expect Russia's securities markets to develop slowly. However, the privatization of medium- and large-scale enterprises now underway will create a large number of equity securities very quickly, requiring rapid development of equity markets to facilitate trading and to protect investors. Some aspects of the market will improve more quickly than others and development will be uneven.
- 3. Early Developments.** The first Russian stock exchanges opened in the summer of 1991. Shortly thereafter, well over one hundred exchanges opened across the country, concentrated in Moscow, St. Petersburg, Eastern Russia, and the Urals. The initial optimism surrounding the opening of these exchanges was soon dulled by a shortage of desirable securities, the lack of standard market practices, and a dearth of serious investors. As a result, the prices of many securities fell or failed to keep up with inflation. The limited volume of trading at exchanges fell dramatically with many of the remaining transactions apparently occurring on the informal over-the-counter (OTC) market. Although reliable statistics are difficult to obtain, five of the largest stock exchanges in Russia reported that their aggregate trading volume fell from R81.3 million (US\$1.4 million) in October 1991 to R5.1 million (US\$35,000) in June 1992.
- 4.** In 1993, the Government expects to establish a market for short-term government bonds with the cooperation of the Moscow Interbank Currency Exchange. To the extent that investors are receptive to this initiative, it could represent a major step forward in terms of market mechanics, trading volume, and general public awareness of securities markets.
- 5. Market Institutions.** Russia's securities markets are highly fragmented, consisting of an informal private market, stock exchanges, the security departments of Commodity Exchanges, and the security departments of banking institutions. Anecdotal evidence suggests that the private informal market, which is similar to an unorganized OTC market, represents about 80 percent of total trading, although no reliable aggregate trading volume estimates are available. At the end of 1992, there were 109 licensed securities exchanges in Russia, with approximately 2,000 employees but little trading activity. Although roughly 1,700 banking institutions exist, with a potential role in the securities markets far superior to

that of the other market participants, banks so far have been fairly inactive in this area. These diverse market participants operate with limited cooperation, resulting in inefficient and non-transparent trading.

6. Russia's size and the rudimentary telecommunications system contribute further to the markets' fragmentation. For the immediate future, stock exchanges and other market institutions are likely to continue operating at the regional level without clear adherence to Federation-wide guidelines and regulations. This is largely because the privatization process will cause exchanges, transfer, and registration facilities to be developed at the oblast level. It will take time to ensure consistent application and enforcement of national standards at the local level, but Russia should aspire to implement a system of national standards in the long term.

7. While Russia has an overabundance of exchanges and banks, it lacks other needed market institutions, such as merchant banks, pension funds, mutual funds, insurance companies, and brokerage firms. These institutions help mobilize long-term savings and serve as the backbone of developed securities markets. Some investment funds, insurance companies, and brokerage firms exist in Russia, but they are generally rudimentary and will need to be significantly developed over time. Existing investment funds, for example, are very small and few funds have more than 10 percent of their assets in securities; most of their investments are in real estate, foreign currencies, and cash deposits. The level of investor protection in these funds is very low, with inadequate disclosure and financial reporting. Similarly, existing brokerage firms are poorly developed and generally unregulated. Typically, they offer little financial analysis or investment advice and often they charge irregular and excessive fees.

8. Rapid progress in privatization has recently put forth new financial institutions — voucher investment funds. A typical fund would initially exchange its own shares for vouchers that were distributed to the Russian population by the beginning of 1993. These vouchers can be used to bid for shares of privatized state owned enterprises. Voucher funds are registered both with Ministry of Finance and State Property Committee and, for the time being, are regulated by the decrees issued by the President. These regulations, for example, prohibit investing more than 5 percent of the funds assets in any particular company, and limit the holding of a single company to no more than 10 percent of the equity. A manager's compensation ceiling may not exceed 10 percent of assets under management per year. At present, there are over 300 licensed funds, with an average declared stock issue of about R1 billion. Over time the number of viable funds may reach 1,000. Some problems, however, limit the activity of investment funds: a national bidding system is not yet set up; the accounting system for funds is still to be developed; there is no systematic way to train fund managers. More detailed description of voucher investment funds is provided at the end of this attachment.

9. **The Legal Framework.** Russia's securities markets operate under a rapidly changing and widely dispersed legal framework that has been developed over the past two years. Relevant laws are embodied in parliamentary-passed legislation, presidential decrees, and guidelines issued by various ministries. Sustained development of the securities markets will

require a thorough revision of these laws. Although this could be accomplished by amending existing laws, it is preferable to enact a comprehensive securities markets law and, where necessary, amend other laws affecting market activities.

10. Regulation and Oversight. The largest portion of the market, the OTC market, is essentially unregulated. Transparency and customer protection are generally at very low levels. The large number of stock exchanges has placed a heavy regulatory burden on the Ministry of Finance, which is also responsible for monitoring the issuance of most new securities. The securities departments at commodity exchanges are also subject to Ministry of Finance licensing and supervision, although the commodity exchanges themselves are under the jurisdiction of the Anti-Monopoly Committee. In all cases, however, enforcement is exceedingly difficult because parliament has not passed legislation enabling a securities violator to be taken to court and penalized. Currently, authorities must rely largely on the criminal code if they wish to pursue legal action. Efforts by regulatory bodies are needed to protect minority ownership rights, to minimize and resolve conflicts of interests, and to monitor and enforce the fiduciary responsibility of corporate managers.

11. Securities Supply and Demand. Currently, most listed securities have been issued by Russian banks, insurance companies, and stock exchanges. The anticipated privatization of medium- and large-scale enterprises will significantly enlarge and diversify the supply of securities. Many of the shares in these firms, however, will be held for long-term investment by employees and managers. This will probably limit the number of shares available for trading. Many privatized firms will need to recapitalize their operations, and some will turn to the capital markets for financing, creating an important source of new shares. However, continued availability of cheap credits would eliminate the need for companies to seek market-based financing and limit any potential increase in the supply of securities.

12. The shortage of privately-held capital available for investment in securities makes demand for securities currently very weak. Policy makers must address the general lack of investor confidence in nearly all financial institutions. The public perception of banks and investment funds is very poor, and understanding of financial instruments is not widespread. Other problems inhibiting investment in securities include a shortage of information on companies, the need for accounting and auditing standards, and limited protection for minority shareholders.

13. Immediate Issues. Within the coming months, laws, operational guidelines, and institutions must be established to facilitate the trading of privatization vouchers for corporate shares. The auctioning of enterprises, and the collection, cancellation, and clearing of vouchers has been directly addressed in the privatization program. At the same time, provision must be made for the distribution, registration and transfer of corporate equity securities. The management of these initial security issues will determine the nature of Russia's future stock markets for many years. As the privatization process proceeds, it will be important to manage securities-related issues with a view toward the future. The integrity and efficiency of securities markets will affect Russia's economy long after the privatization process is complete.

14. **Technical tasks that must be addressed in the near future include: (a) identifying minimum requirements for share certificates; (b) creation of shareholder registries; (c) development of standard documentation for the transfer of shares; (d) creation of registrar and transfer agents, including staff training; (e) support for government regulation and oversight. The IFC is currently undertaking these tasks in several oblasts to facilitate the privatization process. This work has been undertaken with the cooperation of national and local government bodies as well as private institutions.**

15. **Further growth in the number of market participants should be limited, and professional standards should be upgraded. New stock exchange licenses should be restricted. The number of exchanges should be reduced through mergers and attrition. Security departments of commodity exchanges are difficult to justify and should gradually be eliminated or integrated with dedicated securities exchanges.**

16. **Success in developing strong securities markets will depend on clear political support from the Government. Equity market must be seen as a part of the financial sector that ranks equally with the banking sector. Practically, this requires that the Government appoint a senior individual with the same rank as the central bank governor to oversee securities markets.**
17. **Medium-term Issues.** Over the medium term, the securities markets will need to be developed through drafting legislation, developing a regulatory capability, and building market institutions. IFC is currently engaged with various parts of the government to develop legislation, and subsequent work on regulation and institution building is planned. Initially, the priority is to draft and adopt comprehensive securities legislation to cover exchanges, securities issuance and trading, and investment intermediaries. This must be well integrated with other parts of Russian law, including the company code, the commercial code, and banking laws. New legislation should be developed slowly and carefully to ensure that it is appropriate for Russia and enforceable.

18. **The implementation, execution, monitoring, and supervision of a comprehensive securities law should not remain dispersed among different government agencies but centralized in a single body responsible for securities and exchanges. This body should be independent and established at a sufficiently autonomous level within the government to remain immune from political influence in the performance of its duties. An October 1992 presidential decree provides for establishing a presidential commission to perform this function, but the commission has not yet been staffed and efforts in this area remain fragmented. Organizational issues, including the body's mandate, policy guidelines, structure, and staffing requirements need to be resolved. Technical training should be arranged for future regulators.**

19. **The activity of banks in the securities markets needs to be regulated to provide equal conditions for bank and non-bank intermediaries in the market. An unlimited role for banks in the securities markets often restrains development of the market, since banks tend to promote short-term debt rather than equity financing. For this reason, it is preferable to move toward a more limited role for banks in the securities markets, although this must be**

considered within the broader context of Russia's banking system. At a minimum, banks should be required to use specialized affiliates to segregate securities activities from bank lending operations.

20. With an appropriate legal and regulatory framework in place, securities markets will benefit substantially by increasing the supply of securities. Building market institutions such as brokerage firms and security underwriters will spur this process. Russia's brokerage firms need to evolve from small, undercapitalized offices to well capitalized firms with branch offices to serve customers throughout the country. These firms can help encourage companies to sell securities in the market, and they can educate potential investors on the benefits of security investment. Merchant or investment bank underwriters, which are virtually non-existent in Russia, can help develop the market by introducing new securities, and by encouraging companies to raise finance through public offerings of securities.

21. As the supply of securities increases, efforts should focus on stimulating the demand for securities. In this regard, developing institutional investors is critical. Insurance companies, pension funds, mutual funds, and other institutional investors should be supported through appropriate tax and legislative policies, and these institutions should be allowed to invest in securities as accounting and disclosure standards are upgraded.