Lending in a New Regulatory Environment

The Monetary Situation in Russia in the Summer of 1996

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Abstract

While the inflation rate hit a new all-time low in May, and exchange rate fluctuations have been considerably reduced, financial markets exhibit a high degree of volatility. This is an outgrowth of the central bank's monetary policy, which focuses on safeguarding monetary stability. The Bank of Russia has clearly been successful here, but it does not design its policies with a view to influencing interest-rate volatility. As a consequence, interest rates on GKOs are extremely high in relation to economic growth rates, and it is becoming increasingly difficult to cover the growing state budget deficit by issuing government bonds. Under realistic assumptions, only lower nominal and real interest rates and/or reflation will be able to keep Russia from falling into a debt trap.

The growing conflict between monetary and fiscal policy might turn into a "game of chicken". In order to prevent such a situation, in which either the central bank must abandon its restrictive course or the government must drastically reduce the budget deficit, it is necessary to "stabilise stabilisation policy", i.e. to more closely co-ordinate monetary and fiscal policy. Such improved co-ordination is not only necessary, but also feasible, and increased congruence between monetary and fiscal policy would support the goal of macroeconomic stability, while at the same time enhancing the financial stability of the banking system.

Both financial institution building measures, like those being undertaken in the framework of the Russia Small Business Fund (RSBF), and banking regulation and supervision, which are key elements of the new legal framework of the Russian banking sector, can increase the efficiency of the financial system. Thus, they also contribute to the broad goal of macroeconomic stability. While the RSBF supports the implementation of sound corporate governance structures and credit monitoring procedures at Russian banks, enabling them to better protect their own interests as creditors, the new regulations enable the Russian authorities to better monitor the intermediaries themselves, and hence to more effectively represent the interests of the banks' creditors.

The most important laws that have been passed since 1995 include the amended versions of the Law on the Central Bank and the Law on Banks and Banking Activities. They bring Russian banking legislation more closely into line with international standards and, in particular, strengthen the regulatory and supervisory functions of the central bank. Thus, the Law on the Central Bank requires the Bank of Russia to issue twelve different rules governing key aspects of the commercial banks' capitalisation, risk diversification and liquidity, three of which are defined not only in qualitative, but also in quantitative terms. These concern large-scale credits, equity participations, and loans to the banks' owners.

On this legal basis, the Bank of Russia has issued fundamentally revised capital and liquidity requirements, which are contained in the so-called Instruction No. 1. The requirements will be gradually tightened, with last of the final, definitive standards going into effect in 1999. A comparison of this new Instruction with the old version, and with recommendations presented by international financial institutions, shows that

- as far as possible, the new risk factors of assets now correspond to international standards, but that, at the same time, they also reflect peculiarities of the Russian banking sector;
- capital and liquidity requirements have been tightened;
- newly introduced requirements force banks to diversify not only their assets - for example, by setting upper limits for loans to their shareholders and to insiders - but also their liabilities;
- the former practice of stipulating different requirements for different kinds of commercial banks has been eliminated; and
- effective means of implementing incentive and control mechanisms have been created.

The new regulatory environment supports the goals of the RSBF. In particular, this is true with respect to the assets side of the banks' balance sheets. While the new requirements will induce Russian credit institutions to develop in a positive manner by forcing them to adhere to stricter standards, institution building measures within the RSBF are enhancing the capability of the partner banks to meet these standards.

I. The monetary situation in the summer of 1996

1. Inflation rate hits new all-time low

Just in time for the presidential elections, the Russian government was able to report a further success in its programme to achieve macroeconomic stabilisation: in May the monthly inflation rate was only 1.6% (see Table 1), which was an all-time low.

Table 1: **Monetary indicators, January 1995 - May 1996**

	Monthly inflation rate	Monthly nominal interest rate (CBR)	Monthly real interest rate (CBR)	Dollar exchange rate 1 US$ = ... Rb (end of period)	Rate of devaluation or appreciation (-): % change on previous month
Jan	17.80	16.70	-0.90	4,048.00	14.03
Feb	11.00	16.70	5.1	4,473.00	10.50
Mar	8.90	16.70	7.2	4,899.00	9.52
Apr	8.50	16.70	7.5	5,130.00	4.71
May	7.90	16.25	7.74	4,990.00	-2.73
June	6.70	15.00	7.78	4,539.00	-9.94
Jul	5.40	15.00	9.11	4,445.00	-2.07
Aug	4.60	15.00	9.94	4,447.00	0.00
Sep	4.50	15.00	10.05	4,499.00	1.17
Oct	4.70	14.20	9.07	4,504.00	0.01
Nov	4.50	14.20	9.28	4,580.00	1.69
Dec	3.20	13.30	9.79	4,640.00	1.31
Jan	4.50	13.30	8.88	4,734.00	2.02
Feb	2.80	10.00	7.00	4,818.00	1.77
Mar	2.80	10.00	7.00	4,856.00	0.79
Apr	2.20	10.00	7.63	4,940.00	1.73
May	1.60	10.00	8.27	5,031.00	1.84

Basic data: Russian Economic Trends

The successes that have been achieved by the fourth attempt undertaken since the beginning of the reforms to bring about macroeconomic stabilisation are indeed impressive: while in the first three years of reform the ground gained by the stabilisation measures initiated at the beginning of each year was regularly lost again during the summer months, a continuing trend toward stabilisation is now unmistakable.

The reasons for this success can be quickly enumerated, and are as follows:

- Termination of the flow of central bank credits via commercial banks to enterprises in the so-called "priority sectors" and the end of the Rouble Zone (since mid-to-late 1993);

- Abandonment of the practice of having the Central Bank finance the budget deficit (since the spring of 1995);

- An exchange rate-oriented monetary policy in conjunction with the use of an exchange-rate fluctuation band which initially was fixed, then was shifted on a discretionary basis, and in the meantime takes the form of a "crawling band" - the monthly devaluation rate amounts to approximately 1.5% (since the summer of 1995).[1]

These measures led to a decrease in the monthly growth rates of the money supply and the monetary base, but above all to a marked increase in real interest rates compared with the Central Bank's refinancing rate (see Table 1) - which is still used by the commercial banks as a benchmark for lending rates - and with the rate paid on government securities.

Since the beginning of the current year, the stabilisation process has been supported by a substantially lower M2 velocity and a decline in the money multiplier (see Figure 1). Both variables had scarcely changed in the preceding year and, despite strongly positive real interest rates, stubbornly remained at the level they had reached directly after the Rouble Shock in October 1994, which marked the unsuccessful end of the third attempt at stabilisation. This development was attributed to the continued existence of inflationary expectations - expectations which have obviously been revised in the meantime.

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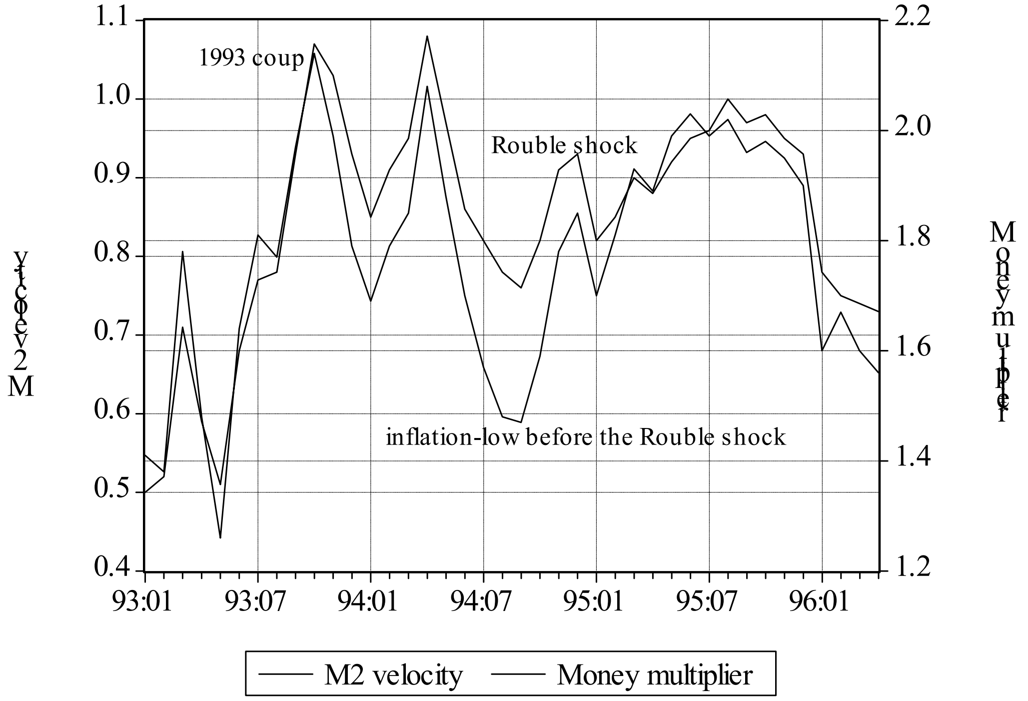
[1] The introduction of the "crawling band" represents an attempt by the Central Bank, among other things, to prevent a further real appreciation of the rouble, which posed an increasing threat to the competitiveness of Russian exports.

Figure 1: **Development of the money multiplier and M2 velocity**



Source: Russian Economic Trends

2. Stable foreign-exchange market - volatile financial markets

Prior to the presidential elections, there was speculation as to how the uncertainty regarding their outcome would affect the economic data. In this connection, particular attention was paid to asset prices, the interest rate and the exchange rate, all of which reflect the expectations of the market participants. Against this background, the answer to the question of how that uncertainty would manifest itself - namely, in a stable pattern of exchange-rate development and in a volatile pattern of development for interest rates in the GKO market (see Table 1) - is quite surprising, because it initially leads one to think that the expectations of the participants in the two markets must be very different. This, however, is not a very plausible assumption.

Another explanation that can be offered for this empirical divergence holds, in essence, that the differing results in the two markets are not attributable to differing expectations on the part of the market participants, but rather to the differing degrees to which the Russian Central Bank is, on the one hand, able, and, on the other, willing to intervene in the monetary markets to guide developments there. A brief look at the paths of the key components of central bank money supply between August 1995 and March 1996 (Table 2) shows that the claims on the central government and the commercial banks have developed steadily, i.e. they have increased slowly or stagnated. By contrast, the level of foreign assets has been subject to marked fluctuations, which obviously are a reflection of interventions by the Central Bank in the foreign exchange market. Thus, while the principle of "stable quantities, flexible prices" (which has also not changed as a result of the introduction, on a very limited scale, of a kind of lombard loan) applies in so far as domestic assets are concerned, when it comes to foreign assets, a policy of "stable prices, flexible quantities" is being pursued. And, in fact, in April and May the Central Bank is reported to have sold a total of US$ 3 billion in the market in order to stabilise the exchange rate.[2]

Table 2: **Selected sources of central bank money** (end of period; billion roubles)

	Foreign Assets	Claims on Central Government	Claims on Deposit Money Banks
Aug. 95	78,042.2	123,757.9	17,258.6
Sept. 95	81,361.4	127,502.1	19,036.7
Oct. 95	88,572.7	130,090.9	19,850.9
Nov. 95	87,704.2	137,325.9	20,936.5
Dec. 95	100,697.2	138,674.1	18,290.3
Jan. 96	88,470.6	140,804.8	18,941.9
Feb. 96	95,841.1	147,523.4	19,260.0
Mar. 96	114,604.4	151,626.0	19,406.5

Source: Bulletin of Banking Statistics

2 Cf. Russian Economic Trends, Monthly Update, June 13, 1996, p. 12. Since May 17, the Central Bank has even published, on a daily basis, an official buying and selling rate at which it is willing to carry out corresponding rouble/US$ exchange transactions.

One reason for this differing attitude towards the variables "exchange rate" and "interest rate" is to be found in the agreement concluded by the IMF and the Russian Central Bank. It defines a certain growth rate in the (net) domestic assets held by the Central Bank as a target in order to, on the one hand, control the growth rate of the monetary base and, in the process - it is assumed - control the expansion of the money supply as well, and, on the other, render indirect financing of the budget deficit impossible. It is one of the basic tenets of the theory of monetary policy that a policy following a predetermined money supply rule must lead to large changes in interest rates if there are corresponding fluctuations in the demand for money. And this is precisely what has happened during the last few months: Before the presidential election, many market participants exhibited a very sizeable demand for liquidity. Since the supply was not adjusted to meet the demand, the government had to offer very high interest rates on its paper in order to generate a demand for its securities. At one point though - in April - even this strategy of offering investors very high rates did not work: the ministry of finance was not able to sell the contingent of government securities which it had offered on the market. After the first round of the presidential election, a portfolio shift took place, with a decline in the demand for money and a corresponding rise in the demand for government debt. Annual interest rates, which topped the 200% mark during the second week in June, dropped to 130%.[3]

3. Growing conflict between monetary and fiscal policy

The high interest burden which the government must bear is worsening the already precarious state of the public finances. In line with expectations at the beginning of the year, as the presidential election campaign got under way in earnest it proved impossible to keep the budget deficit within the limits agreed with the IMF: at the end of April the deficit amounted to Rb 51.8 trillion; the target had been Rb 40.4 trillion.[4]

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3 The pattern of development on the interbank market was similar; shortly before the presidential elections, the interest rates for overnight money reached levels of 200% p.a. and more. Overall, the trend towards increasingly short maturities continued: For the past two months, the Russian European Centre for Economic Policy has only published interest rates for interbank loans with a maturity of up to 30 days in Russian Economic Trends. A continuation of the old time series, which contained the interest rates for credits with maturities of up to 3 months, no longer made sense or, rather, was no longer even possible, as scarcely any loans with such a long maturity were still being granted.

4 Cf. Russian Economic Trends, Monthly Update, June 13, 1996, p. 10.

Surprisingly, it was not so much the expenditure side as the revenue side that was responsible for the target being missed: Although - as had been announced by the president - a portion of the outstanding wage and salary payments was disbursed to the creditors, the workers, government expenditure reached only 70% of the level provided for in the budget law. The deficit turned out to be higher than planned because the minister of finance in fact only took in 50% of the projected volume of revenues.

There are several arguments that can be advanced to explain why revenues fell so far short of the projected levels. They cover a variety of factors and phenomena, ranging from structural problems - i.e. those exhibited by the tax system, which continues to be inadequate[5] - through a decrease in taxpayer honesty and in efforts to collect taxes since the beginning of the presidential election campaign, to macroeconomic factors, i.e. the continuing decline in real gross domestic product (3% in the first four months compared with the same period of the previous year) and a trend in the development of the inflation rate which is significantly more favourable than had been assumed when the estimates of tax revenues were prepared.

The result is that the government debt ratio, i.e. the ratio of outstanding government debt to gross domestic product, is growing by leaps and bounds: at the end of May 1995 it still stood at 2.3%, but by May 1996 it had already reached 6.5%, almost a threefold increase. This huge jump is due not only to the rise in the level of new borrowing, but also to the large gap between the interest rate that the government must pay and the growth rate of GDP - a factor whose potential implications had already been outlined in the last Monetary Report. Given the low initial ratio of government debt to GDP, it is not immediately apparent that Russia is already caught in a debt trap, but this is most certainly the case, and there are only three things that can rescue it from this trap:

- higher GDP growth,
- lower interest rates, and/or,
- a lower level of new borrowing, or - depending on the specific relationship that obtains between interest rates and growth - a positive primary balance of the public

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5 Nonetheless, the tax and accounting regulations that apply to small enterprises - i.e. enterprises with up to 15 employees - have, in the meantime, been simplified in so far as only a single tax is to be paid, either on total earnings (maximum of 30%) or on total revenue (maximum of 10%).

budget, i.e. a positive difference between government revenues (without interest income) and government expenditure (without interest expense).[6]

There are few if any indications that the Russian government will present a balanced budget in the coming years. While higher economic growth is to be expected, the real growth rate will probably average scarcely more than 5% during the next few years. This means that the only way out of the debt trap is via lower interest rates, both nominal and real, and/or through higher nominal growth rates, i.e. through reflation.

Given that monetary policy can guide the development of nominal interest rates and the inflation rate, there is a danger that monetary and fiscal policy in Russia will end up in a situation that can be characterised as a "game of chicken":[7] either the government must drastically reduce the gap between its expenditure and its revenues, or monetary policy must abandon its restrictive course, i.e. increase the money supply, which will cause nominal interest rates to fall and inflation to rise.[8] One of the two must give in. The only question is who will back down first - who is "chicken".

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6 Mathematically, this can be expressed as follows: Given that

δb = $[g - t] + [r - y]*b$, where
b = government debt ratio
δb = change in the government debt ratio
g = government expenditure ratio (government expenditure without interest expense/GDP)
t = government revenue ratio (government revenues without interest income /GDP)
r = interest rate on government securities
y = growth rate of gross domestic product
$[g - t]$ = primary balance as a share of GDP,

the government debt ratio can only be stabilised ($\delta b = 0$) if the primary balance is equal to the difference between the interest rate and the growth rate multiplied by the given government debt ratio.

7 The term was introduced by Thomas Sargent; see Sargent, T.J. (1986): Reaganomics and Credibility, in: Sargent, T.J.: Rational Expectations and Inflation, Cambridge et al., p. 35.

8 Sargent and Wallace thus speak of an arithmetic which is unpleasant for monetarist monetary policy because this makes it clear that monetary policy alone cannot ensure the stability of the overall price level - at least not over the long term - in so far as the central bank is able to - and will - keep the government from going bankrupt. See Sargent, T.J. and N. Wallace (1985), Some Unpleasant Monetarist Arithmetic, in: Quarterly Review, Federal Reserve Bank of Minneapolis, Winter, pp. 15 - 31.

4. Time to stabilise stabilisation policy

While the "game of chicken" metaphor we have used - one could also characterise the situation as a poker game between monetary and fiscal policy - seems to be an apt description of the situation, particularly in view of the current dispute over the transfer of Central Bank profits in the amount of Rb 5 billion to the government budget which was ordered by the Russian parliament, the Duma,[9] it is not entirely appropriate to use images of this type when speaking of the current state of affairs in Russia. The reasons for this are as follows:

a) Given the current gap between the rate on GKOs and the rate of economic growth, the magnitude of the budget surplus that would have to be achieved in order to stabilise the government debt ratio is so great that this can be regarded as an impossibility. In other words: the government would be unable to "back down" to the extent that would be necessary to enable it to escape from the debt trap on its own. It needs the support of monetary policy.

b) A real interest rate in the range of 8-10% per month is surely no longer necessary in order to stabilise the inflation rate and cause it to fall further. In this sense, the Central Bank has more room for manoeuvre than is implied by the "game of chicken" metaphor, i.e. it can, to a certain degree, "back down" without necessarily appearing to have lost the game.

c) In view of the low initial level of the government debt ratio, a drastic change in either monetary or fiscal policy - or in both - is not necessary. Rather, both sides must merely be willing to gradually, but steadily, adjust their positions to render them mutually compatible.

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9 It was President Yeltsin who had called upon the Central Bank to voluntarily transfer profits to the government budget. When the Central Bank declined to comply with this request, the Duma took action by passing a corresponding law, whose validity the Central Bank intends to challenge because it regards the legislation as a threat to its autonomy (in this connection, see also Section 2 of the second part of the present report). In order to counteract the expansionary effect of this transfer, which took place on the Monday following the first round of the presidential election, the minimum reserve requirements - which had only recently been lowered (in May) - were raised again (from 18% to 20% for rouble-denominated demand deposits with a maturity of up to 30 days, and from 1.25% to 2.5% for foreign-currency deposits).

In other words: once the elections are over, what will be required is a stabilisation of the stabilisation policy to ensure that it does not eventually turn into a "game of chicken".

As is shown by Russia's experience during the first three years of the reform process, a stabilisation of the overall price level cannot be achieved so long as the Central Bank is unable to control the sources of central bank money. Since the beginning of 1995 it has been able to do this and the progress that has been made in the meantime on the stabilisation front is a logical consequence of that capability. Control of the central bank money supply via monetary policy is, however, only a necessary condition for long-term stabilisation; it is not a sufficient condition for such a stabilisation. In particular, it is not an end in itself, as was demonstrated by the exchange-rate policy pursued during the past year, whose positive, stabilising effect can scarcely be denied. Monetary and exchange rate policy were co-ordinated and implemented in such a way that they were, by and large, consistent. This was, and is, an easy task because a single entity, the Central Bank, is responsible for setting policy in both areas.

The co-ordination of monetary and fiscal policy is more difficult, but equally necessary. In the long run it will not be sufficient to refrain from financing budget deficits with central bank credits; rather, deficits must be reduced to the greatest extent possible. On the other hand, there can be scarcely any doubt that interest-rate fluctuations of the magnitude seen in recent months are just as destabilising as significant movements in the exchange rate, and that real interest rates in excess of 1-2% per month are every bit as problematic as a marked real appreciation of the currency. Over the long term, not only the real exchange rate, but also the real interest rate, must be in harmony with the fundamentals in both the financial and the real economy.

Thus, the key question in Russia is not so much whether a restrictive or expansionary monetary or fiscal policy should be pursued, but, rather, whether the country will get the consistency and congruence in its monetary and fiscal policies that it requires. Only if there is such consistency in these two areas will the successful stabilisation itself prove stable and, at the same time, contribute to the upswing in the real economy which is sorely needed. Therefore, if monetary and fiscal policy do not begin to converge, a renewed destabilisation is very likely. From a financial-sector perspective, this would be all the more unfortunate because the financial system has only recently been given a new legal and regulatory framework which holds out the promise of greater financial stability. However, if this promise is to be realised, more, and not less, macroeconomic stability will be needed.

II. Lending in a new regulatory environment

1. The relevance of Russian banking regulation for the Russia Small Business Fund - some general remarks

The Russia Small Business Fund was basically designed as a credit programme to improve the financing situation of small and medium-sized enterprises, which, in the transformation process leading from a centrally planned to a market economy, serve as an engine of development in the real economy. For many different reasons, though, these enterprises found that they were scarcely accepted as (credit) customers by the formal financial sector. Therefore, it was - and is - the goal of the programme to reduce the extent of quantity rationing to which small and micro enterprises are subject in the credit market via the provision of funds and the implementation of an appropriate credit technology. Nearly two years after the disbursement of the first loans, it is clear that in the cities in which the Fund operates, and at its partner banks, small and micro businesses have been increasingly able to gain access to credit. This is illustrated by Table 3, which provides data for the Micro Loan Component of the programme, under which the first loans were granted in August 1994.

However, the objective of the Russia Small Business Fund is to improve the financing situation of the target group not only in the short term, but also over the medium and long term. Thus, in view of the relevant empirical evidence from the western industrial countries - where banks represent the most important source of external finance for small enterprises, and where credit is the most important form of financing[10] - it was decided that the role of the Russian partner banks should not be reduced to that of a mere instrument for the implementation of a credit window. Rather, it is envisioned that the banks will be made strong enough to serve as a major, sustainable source of financing for the economic activities of small and medium-sized businesses. In this sense, the Russia Small Business Fund, and the collaboration with the Russian partner banks which is taking place in the framework of the Fund, is part of the broad efforts being undertaken by the international donor community to develop the Russian financial system and the institutions that operate within this system.

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[10] See Edwards, J., and K. Fischer (1994): Banks, Finance and Investment in Germany, Cambridge; Mayer, C. (1990): Financial Systems, Corporate Finance and Economic Development, in: Hubbard, R.G. (ed.), Asymmetric Information, Corporate Finance, and Investment, Chicago, pp. 307 - 332.

Table 3: **Monthly flows and stocks of EBRD Micro Loans** (in US$)

	DISBURSEMENTS				OUTSTANDING PORTFOLIO			
	Number of loan officers	Number of loans granted	Volume of loans granted	Average loan amount granted	Number of loans outstanding	Volume of loans outstanding	Average outstanding loan amount	Exchange rate per 15th of month
AUG. 1994	25	3	19,121	6,374	3	19,121	6,374	2,120
DEC. 1994	27	55	143,430	2,608	95	231,023	2,432	3,292
JUNE 1995	35	97	200,326	2,065	240	466,932	1,946	4,700
DEC. 1995	85	234	1,037,995	4,436	699	2,351,121	3,364	4,630
MAY 1996	95	302	1,940,998	6,427	1,091	5,255,851	4,817	4,870
TOTAL or **AVERAGE** from beg. of Programme	67.5	2,845	12,587,000					

It is often not easy to assess the effectiveness of institution-building programmes. One is most likely to be able to gauge the success of such activities when dealing with a credit programme for small and medium-sized enterprises because here there are measurable criteria which can be used to quantify the impact: the number of loans disbursed; the quality of the loan portfolio, measured in terms of the percentage of the outstanding credit volume which is not in arrears; and the profitability of the portfolio. However, it is obvious that there are a number of activities entailed in a programme of this type that are primarily qualitative in nature - for example, the training of loan officers - and, on the other hand, there are a great many exogenous factors which affect the programme, and can thus reduce its chances of success. One of these exogenous variables is the development of the macroeconomic environment, as it is manifested in interest rates, the exchange rate, the inflation rate and the growth rate of the real gross national product. No matter how well it has been designed, and no matter how well it is being implemented, an institution-building project cannot be shielded from the consequences of large, adverse macroeconomic shocks because these shocks directly and indirectly affect conditions in the market for credit, both on the supply side and on the demand side, and the financial system as a whole. Various Monetary Reports have dealt with the fact that this, in turn, influences the behaviour and the attitude of the (partner) banks towards an institution-building programme.

The behaviour of institutions and economic agents is not, however, influenced solely by conditions at the macro level. Indeed, microeconomic conditions also play an important role. For example, the question whether new and efficient structures of corporate governance can be introduced is one of the focal points of the economic policy discussion in conjunction with the transition from planned to market economies in the countries of Central and Eastern Europe. Privatisation and liberalisation alone turned out to be incapable of improving the efficiency of enterprises because the providers of capital, both equity and debt finance, often had no interest in raising efficiency or, as the case may be, were either unwilling or unable to intervene in the management of firms with a view to ensuring that efficiency-improving measures were taken. In so far as approaches to the solution of this set of interrelated problems were concerned, it was assumed that the design and behaviour of financial institutions would play an important role because these entities - and the banks in particular - are often the most significant external source of finance for enterprises, as purchasers of equity stakes - e.g. in the loan-for-shares programme - but particularly in so far as they provide debt finance, i.e. credit.[11]

However, the fact that credit extension involves more than placing capital temporarily at the disposal of a person or entity, i.e. that credit serves as a control device, and that lending must be accompanied by corresponding monitoring activities on the part of the banks, was not something which the banks were able to - or forced to - recognise in the environment in which they operated prior to the collapse of the Soviet system. In most cases, the "history" of a loan was considered to have ended once it had been disbursed; payments - to the extent that any were made - tended to be more a matter for the accounting department than for the credit department. For this reason, efforts to underscore the necessity of monitoring, training of the loan officers in monitoring techniques, and the implementation of monitoring activities, have been accorded a high priority in the institution-building measures which are being carried out in the framework of the Russia Small Business Fund in collaboration with the partner banks.

But corporate governance proved to be a problem that was relevant not only to the enterprises of the non-financial sector, but also to the banks. The quantitative dimensions of this problem were surely greater in Russia's financial sector than in that of the other transition economies because most of the country's approximately 2,500 banks served as agent banks. In other words, their equity capital was provided by entities which were most decidedly not interested in enabling the banks to conduct their business operations efficiently and in such a way as to ensure that they generated a profit; rather, they were interested in obtaining financing on favourable terms for their enterprises which operated in the real economy.

As regards providers of debt finance as well, there was practically no one who would have been either willing or able to fulfil the corporate governance function: the bulk of the liabilities of the Russian commercial banking system consist of loro and settlement accounts maintained by enterprises which either have received loans from the banks, or use them to carry out their payments transactions, or both. Like the private households that hold deposits in privately owned banks, these enterprises are not capable of exercising monitoring or control functions as creditors of the banks, nor are they

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[11] On this point, see the detailed discussion provided in: Phelps, E.S.; Frydman, R.; Rapaczynski, A.; Shleifer, A. (1993), Needed mechanisms of corporate governance and finance in Eastern Europe, EBRD Working Paper No. 1, London.

interested in performing such functions. The reasons for this passivity are similar to those which have been identified in the western market economies: there is a lack of the requisite knowledge and - due also to the large number of providers of external finance - they also have no significant economic incentive to assume corporate governance tasks. The only option they have for monitoring the behaviour of bank managers and imposing sanctions on them is that of withdrawing their deposits or, as the case may be, refusing to deposit funds in the first place. The Russian private households in particular make use of this option by not depositing any funds at all in banks, or by only depositing at Sberbank, where the nominal value of deposits is guaranteed by the state.[12]

Since the liquidity crisis in August of last year, the banks which have surplus liquidity have behaved in a similar manner: they no longer grant interbank loans to any institutions except those which are very well known to them, or which can provide top-grade collateral, usually government securities, and they only provide loans with very short maturities.[13] The fact that the market for government securities has supplanted the money market as Russia's most important financial market is a further illustration of the parallels between the behaviour of the banks which have liquidity surpluses and that of private households which become surplus units: both prefer to lend to the state because, as providers of external finance, they are either insufficiently capable - or not capable at all - of monitoring the banks.

Thus, it is not surprising that, although interest rates are in the meantime positive in real terms, and although the macroeconomic setting is characterised by an increasing stabilisation, neither lending by the banking system as a whole nor the depth of the financial sector is increasing, and the reason for this is that, under the present conditions, there are, practically speaking, scarcely any other sources of funds available to the commercial banks.

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12 In April 1996, 67.7% of all individual deposits were held at Sberbank, up from 47.4% in September 1994, the month before the first major financial crisis, the Rouble Shock.

13 The fact that very short loan maturities must be regarded as a means of offsetting an inability to monitor and control - or, as the case may be, the lack of opportunities to perform these functions - is emphasised by Mayer; cf. Mayer, C. (1989): Myths of the West, Lessons from Developed Countries for Development Finance, World Bank Policy, Planning and Research Working Paper, WPS 301, Washington.

As has already been suggested, the corporate governance problems faced by commercial banks are not exclusively attributable to the specific transitional situation in which the Russian financial system finds itself. In particular as regards the providers of deposits and other forms of debt finance, which in developed market economies account for far more than 90% of all bank liabilities, there is (for the reasons mentioned above) an unwillingness - or, as the case may be, an inability - to monitor and intervene. It is paradoxical that banks - which (are supposed to) perform extensive monitoring and control functions in their credit relationships with enterprises - are themselves scarcely subject to control of this type. Viewed from this perspective, which is shaped by the economics of information, it is the task of the banking supervisory authorities[14] - the "active representation for depositors"[15] - to resolve this paradox.

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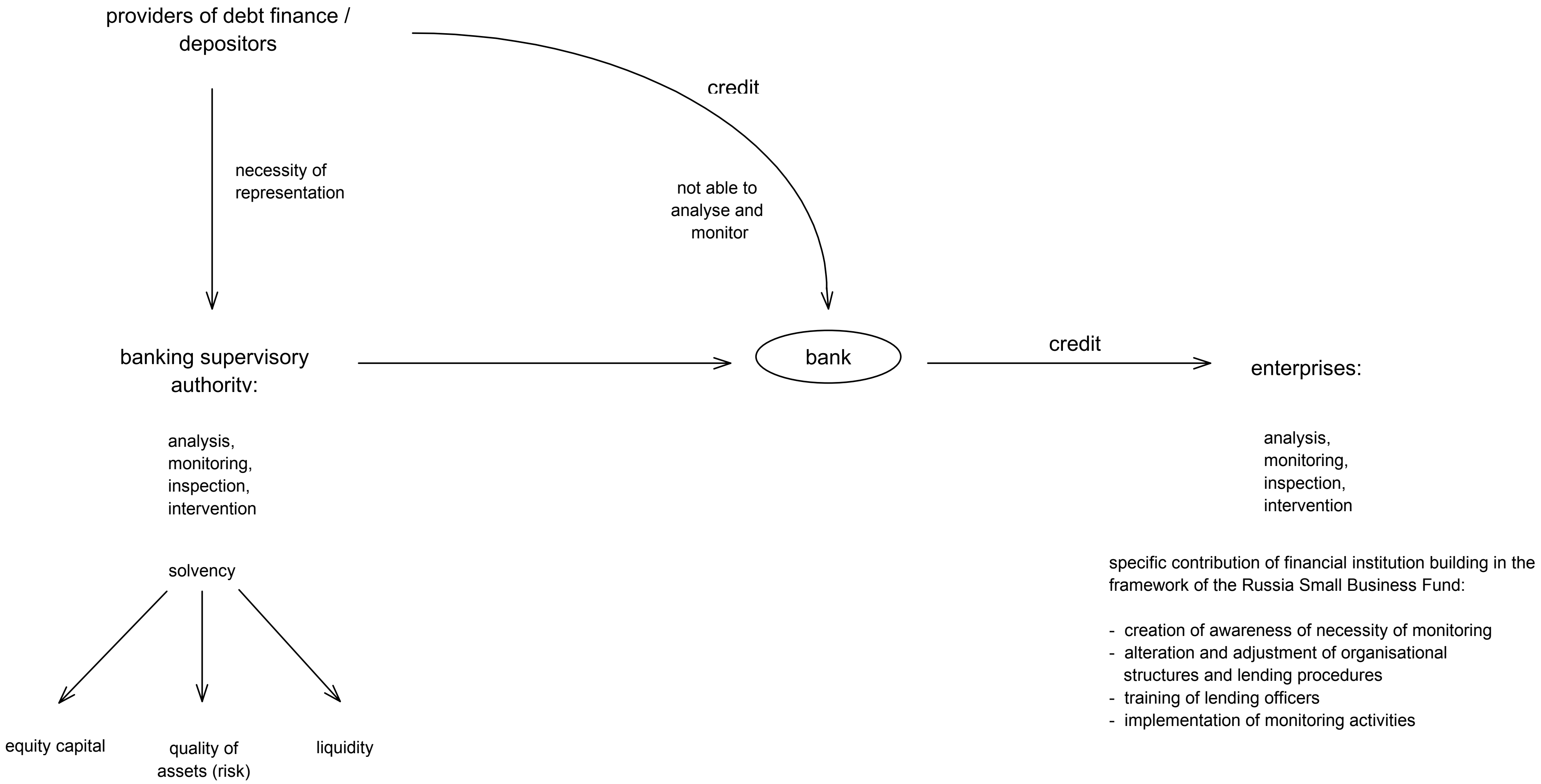
[14] It can be shown that under certain conditions - e.g. if the banks have a highly diversified, and thus basically riskless, loan portfolio; and if the banks are subject to so-called non-pecuniary sanctions if they fail to meet their payment commitments vis-à-vis their creditors - monitoring of the banks by their creditors, and thus the existence of a banking supervisory authority, is superfluous (see Diamond, D.W. (1984), Financial Intermediation as Delegated Monitoring, in: Review of Economic Studies, Vol. 51, pp. 393 - 414); however, the strictness of the conditions underscores that, in the real world, monitoring by the creditors is necessary, and thus that - taking account of the arguments mentioned above - a functioning banking supervisory authority is also necessary. In this sense, Diamond's article appears to provide more arguments for, than against, a regulatory system for banks.

[15] Dewatripont, M. and J. Tirole (1994), The Prudential Regulation of Banks, Cambridge and London, p. 6. Further goals of the banking supervisory authority are: "Stability or, as the case may be, stabilisation of the financial system" and the safeguarding of the payments system. The emphasis given to the goal of "representation for depositors" is an outgrowth of the theoretical perspective that has been selected.

Thus, there is a relationship between a financial institution building programme such as the Russia Small Business Fund, and developments in terms of the legal framework of banking supervision, because in both areas the idea is to enable the respective institutions to better perform the corporate governance function. However, the structure of this relationship is hierarchical, and, as a result, we can use the term "monitoring hierarchy" to describe its essential nature: On behalf of the banks' creditors, the banking supervisory authority monitors the banks, which in turn monitor the enterprises to whom they extend credits. Overview 1 depicts this relationship:

~~Overview 1~~: Links between financial institution building and developments in the area of banking regulation



Just as efficient monitoring by commercial banks which subjects enterprises receiving credit to rigorously enforced sanctions that induce changes in their behaviour (on a very elementary level: they must understand that a loan is not a subsidy, hence that it must be serviced and repaid; on a very general level: they must understand that an entrepreneur to whom capital has been provided must utilise that capital efficiently) serves to discipline borrowers, a functioning banking supervisory authority is an important means of disciplining when it comes to the activities of commercial banks. Consequently, financial institution building measures and banking regulation both support the same goal: that of increasing the efficiency of the financial system and of the institutions that operate within that system.

The specific design chosen for this disciplining mechanism is thus of great significance for the success of the institution building programme because it can encourage intermediaries (via incentives) - or force them - to improve the quality of banking services:

- over the short term, an appropriate design can have a positive impact because more efficient banking regulation increases the demand on the part of the banks for the services offered by the programme's components and increases their willingness to integrate these components into their ongoing operations;

- over the medium to long term, it can have a positive impact because efficient banking regulation can, on the one hand, contribute to the sustainability of the reforms implemented in lending operations in collaboration with the banks - i.e. make it more likely that they will remain in effect even after the termination of the financial and technical assistance provided by the EBRD - and, on the other hand, it makes banks more attractive for depositors, which means that their funding situation improves; this in turn means that, even without EBRD funds, the partner banks are able to continue credit extension to the target group, and indeed to expand the scope of these lending activities.

Since the initiation of credit extension in the framework of the RSBF, there have been major changes in the legislative and regulatory basis for the activities of banks in Russia (Section 2).

In addition, a number of important implementing regulations have been issued by the Central Bank, in particular on the basis of the amended Central Bank Law and the Law on Banks and Banking Activities (Section 3). These laws and implementing regulations will be briefly outlined and analysed. The goal here is to provide a framework for an evaluation of the new regulatory regime (Section 4) which will focus on ascertaining the extent to which institution building measures and reforms in the area of banking regulation support and complement each other.

2. New legal foundations for the financial sector

Since the beginning of 1996, four important laws have come into effect which will influence the development of the Russian banking sector directly and indirectly:

- the Law on Joint Stock Companies (January 1996),
- the amended Law on Banks and Banking Activities (February 1996),
- the second part of the Civil Code (March 1996), and
- the Law on the Securities Market (April 1996).

Together with the first part of the Civil Code (January 1995), the amended Law on the Central Bank (April 1995) and the Law on Financial-Industrial Groups (November 1995), they form the new legal foundation of the Russian financial and banking system.

The passage of the Civil Code meant that, for the first time ever in the history of Russian law, there was a systematic legal codification of the relations between citizens and firms on the basis of equality before the law, the inviolability of property, freedom of contract and the free movement of goods and services. While in Part I, which had already been passed in 1995, the focus was on the law of partnerships and corporations, the law of property, the law of contracts and the general legal aspects of obligations, the 30 chapters of Part II discuss in detail specific legal aspects of obligations, dealing with 28 types of contract. Financial relationships are addressed most directly in the provisions on bank-deposit and bank-account contracts.[16] The particular emphasis given to these types of contract is a reflection of the Russian or, as the case may be, Soviet tradition, but the position assigned to these two kinds of contracts within the

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16 For a detailed presentation of the points covered in the following discussion, see Schmitt, H. and Weber, A. (1996), Zum Inkrafttreten des Zweiten Teils des russischen Zivilgesetzbuches (The second part of the Russian Civil Code takes effect), in: Wirtschaft und Recht in Osteuropa, No. 3, pp. 86 - 89, esp. p. 88.

overall system of legal agreements defining obligations is in line with standard international practice: the deposit contract can probably be regarded as a subcategory of the loan agreement, and the account contract is probably a hybrid combining a specific type of loan agreement with a relationship involving a mandate.

The passage of the Law on Joint Stock Companies, which, in 94 articles, creates a comprehensive system for the regulation of open and closed joint stock companies, is a direct outgrowth of the new Civil Code.[17] Existing joint stock companies are required to modify[18] their articles of association in accordance with the new regulations and register them. With respect to changes in the regulatory regime for banks, the provisions of the Law on Joint Stock Companies which regulate large-scale and insider transactions, specifically:

- the execution of significant transactions, e.g. the acquisition or sale of assets whose value exceeds 25% of the balance sheet total, and
- the execution of legal transactions which positively affect the interests of shareholders or members of management, either personally or via so-called related parties,[19]

are particularly noteworthy.

In cases involving the execution of such transactions, the position of the board of management, the supreme administrative organ of a joint stock company, which is otherwise quite strong, is weakened somewhat by the law, be it through a limitation of the board's room for manoeuvre, or by stipulating that the approval of the shareholders' meeting, which is otherwise relatively powerless, must be obtained.[20] This represents a

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[17] Cf. Civil Code, Art. 96: "The legal position of a joint stock company (...) is determined in accordance with the present Code and the Law on Joint Stock Companies."

[18] This also applies to banks which operate as joint stock companies. The Central Bank published a model set of articles of association in the April 30, 1996, edition of Vestnik Banka Rossii. The deadline for the registration of modified articles of association, originally 1 July 1996, was postponed to 1 July 1997. See Kommersant Daily, 2 July 1996.

[19] As regards the details, see Lenga, G. (1996), Russische Föderation: Das föderale Gesetz "Über Aktiengesellschaften" - Teil 1: Art. 1 - 46 (Russian Federation: The federal law 'On Joint Stock Companies' - Part I: Articles 1 - 46), in: Wirtschaft und Recht in Osteuropa, No. 4, pp. 131 - 143.

[20] Generally speaking, the management structure laid down in the Law on Joint Stock Companies is modelled more on American than on German law.

legislative response to the widespread practice of "asset stripping", i.e. that of breaking up enterprises in such a way that the valuable parts were sold and operated as new enterprises by the same managers and/or by persons "associated" with them (related parties). As we shall show, large-scale and insider transactions are also one of the focal points of the new regulatory regime for banks.

In the completely revised Law on the Central Bank, the goals of central bank policy are defined as the safeguarding of the internal and external stability of the currency, the development and strengthening of the banking system, as well as the maintenance of an effective payments system. In line with these objectives, the tasks of the Central Bank, which are laid down explicitly in Article 4, can be subsumed under the following headings: monetary and credit policy, exchange-rate policy, "the banks' bank", and banking supervision. The measures which the Bank of Russia is permitted to take in terms of monetary and exchange-rate policy include nothing which is new or particularly surprising; the range of options comprises the entire repertoire of direct and indirect instruments which are available to central banks in the western market economies.

Great significance is given to the relationship between the Central Bank and the commercial banks.[21] The following are important elements here:

- a ban on the acquisition by the Central Bank of equity capital stakes in commercial banks;[22]

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21 The relationship between the Central Bank and the government - or, as the case may be, the parliament - was also redefined. The Central Bank is now no longer obliged to carry out the instructions of the parliament or the government. However, analogous to the Federal Reserve Bank in the U.S., it is required to report to the parliament on its activities; it is also required to consult and advise the government on matters of monetary and credit policy and on matters pertaining to the development of the banking system. There is also a passage stipulating that - as is the practice in Germany - the ministers of finance and economics can take part in the meetings of the Executive Board of the Central Bank in an advisory capacity.

Doubts are raised as to the separation between the state and the central bank in only one place in the law, namely Article 47, which states that the Central Bank can also carry out banking transactions "in order to supply the legislative and executive organs of the state (...), state off-budget funds and army units".

22 However, as regards Sberbank, Vneshtorgbank and credit institutions which were founded with the participation of the Central Bank on the territory of foreign states, this prohibition will not take effect until 1 January 2000. The Central Bank Law passed in 1990 did not contain a prohibition against the acquisition of equity stakes.

- a ban on the execution of banking transactions by the Central Bank with private non-banks;[23]

- formalisation of the collaboration between the Central Bank and the commercial banks in matters pertaining to the development of the banking system through the establishment of a National Banking Council, which also comprises representatives of both houses of parliament, the president and the government; moreover, the Central Bank is required to consult with the credit institutions, and their federations and associations, in all instances in which (new) rulings are to be made on matters of banking regulation.

A central point, however, is the strengthening of the bank regulatory and supervisory functions of the Central Bank.[24] Thus, for example, the number of rules on commercial banks' capitalisation, risk diversification and liquidity which the Central Bank is obliged to issue in the framework of its supervisory mandate was increased from six to twelve. With the exception of the rule on the absolute minimum equity capital level, these standards consist of ratios relating to certain categories of assets and liabilities that are relevant for commercial banks.[25] Most of these regulations are purely qualitative in nature, i.e. they merely stipulate the variables to be used in setting regulatory ratios. The task of defining specific quantitative standards is left to implementing regulations of the Central Bank, as embodied by Instruction No. 1 (see Section 3). Thus, it is all the more noteworthy that, in line with the provisions of the Law on Joint Stock Companies

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[23] Again, a provision of Article 47 - which was also contained in the old law - is confusing, and thus problematic: it gives the Central Bank the right to perform the functions of commercial banks in regions where no commercial banks operate. Given that Sberbank RF has a nationwide branch network, the purpose of this provision is not clear.

[24] By contrast, the powers of the Central Bank were reduced as regards the securities market and securities transactions. The new Law on the Securities Market increases the powers of the so-called Federal Securities Commission, which has the status of a ministry and is charged with regulating the capital markets. This means that the commission carries out tasks which were heretofore within the domain of the Central Bank. Specifically, it has the right to grant licences for so-called professional participants in the securities market. According to Article 39 of the Law on the Securities Market, banks are also subject to regulation by the new ministry in so far as they engage in securities transactions. Apparently, it is taking a restrictive approach to licensing: according to a report in Kommersant Daily on 18 April 1996, when the first group of licences was awarded in April 1996, only three organisations - out of a total of 98 which had applied - were found to be sufficiently qualified.

[25] The Central Bank is charged with defining the corresponding balance-sheet items - equity capital, assets, liabilities, criteria for risk-based classification of assets. However, the law limits the freedom of the Central Bank in so far as it stipulates that it must comply with international standards when doing so.

mentioned above, certain minimum and maximum permissible values are no longer to be set at the discretion of the Central Bank, but are defined from the outset by the law:

- The extent of large-scale credit risks (loans whose volume exceeds 5% of the equity capital) may not exceed 25% of the equity capital.
- Total holdings (shares) in other juristic persons may not be equivalent to more than 25% of a bank's own funds.
- The extent of the loans, guarantees and sureties which a bank provides to its owners (shareholders) may not exceed 20% of the equity capital.

In addition, the system of sanctions which the Central Bank can impose on commercial banks was modified so as to make it more differentiated. For example, the new law provides for fines which are calculated as a percentage of the minimum equity capital level. Moreover, the Central Bank can also prohibit banks from carrying out individual transactions or from opening branches if they violate federal laws or acts, or regulations of the Central Bank or do not respond to a demand by the Central Bank to terminate these violations. Under this arrangement, the act of placing a bank temporarily under Central Bank administration, or that of initiating licence revocation proceedings, more clearly becomes a measure of last resort.

Finally, in February 1996 a new version of the law "On Banks and Banking Activities" was passed which is in harmony with the new Civil Code and the revised Central Bank Law. In Article 1 it introduces the term "credit institution" as a generic term to permit a differentiation between banks and so-called non-bank credit institutions. It is apparent that this institutional separation is a reflection of the definitions given for the various lines of business, which also distinguish between banking operations and other types of business, e.g. trust transactions and leasing. Banks are defined as entities which have the exclusive right to engage simultaneously in the following types of banking transactions: deposit and lending business as well as the maintenance of accounts. By contrast, a non-bank credit institution may only engage in individual transactions listed in the law under the heading of "banking operations", with the Central Bank deciding which types of transaction are permissible in a given case. The last form of credit institution named is the foreign bank, which is in a separate category and is defined as a bank.

The significance of the individual types of banking and non-banking operations is also apparent when one looks at the licensing regulations set forth in the law: Article 13 stipulates that a licence to conduct banking business, which every credit institution must apply for at the Central Bank, must contain a list of all types of business in which the entity in question is permitted to engage as well as the currency in which these operations may be conducted. This arrangement makes it possible to issue differentiated, individual licences, even though the Law on Banks does not explicitly provide for this option.

In practice, the following types of licence - among others - have developed: "expanded licence", "general licence", "foreign-currency licence", "licence for precious-metals transactions":[26] Certain of these licences are, in turn, linked: for example, the licence for precious-metals transactions can only be awarded to banks which have a foreign-currency licence. Generally speaking, a commercial bank is only given permission to expand the scope of its business operations if it can demonstrate that its financial situation is stable. All in all, the Central Bank makes use of the discretionary powers granted to it by the law, which allow it to make much more sophisticated distinctions when dealing with intermediaries than the very basic one provided in the first article, namely that between banks and non-banks.[27]

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26 See, for example, Vestnik Banka Rossii, 9.4.1996, pp. 1, 64.

27 The Central Bank Law lays the foundation for the substantial discretionary powers of the Central Bank. Article 73, Paragraph 2, stipulates that the Bank of Russia has the right to define standards and methods of calculation which differentiate between various types of banks and other credit institutions. An example here is the Law on Financial-Industrial Groups. It stipulates that the Central Bank may grant privileges to credit institutions which join a financial-industrial group (FIG) in the form of reduced minimum reserve requirements and by making them subject to less restrictive norms in other areas as well. Generally speaking, the law regulates the establishment and operations of groups of companies which include at least one credit institution and one productive enterprise. Based on the countries in which the participating firms are domiciled, the law distinguishes between simple FIGs (all participating firms are domiciled in the Russian Federation), transnational FIGs (at least one participating firm is domiciled in another CIS country), and international FIGs. The government determines the nature and extent of the concessions that will be granted to each FIG in the form of special tax write-off facilities, trust administration of the shares of the firms belonging to the FIG which are held by the state, state guarantees, direct subsidies and customs privileges.

FIGs must be listed in a special state registry. The law does not specify when the groups as a whole are to be taxed, when consolidated financial statements are to be prepared, and what happens if an FIG becomes insolvent.

The goal of the law is to make it possible for institutions to evolve with which the investment crisis that has continued unabated since the beginning of the reforms can be overcome. Proponents of the law point to, among other things, the successful industrialisation process in continental Europe, Institutions accepting deposits from private customers are subject to special regulations. Banks must

- be able to demonstrate that they have been in business for at least two years,[28] and
- join the federal mandatory deposit insurance fund, which is to be organised with the participation of the Central Bank,[29]

before they are permitted to accept deposits from private customers.[30]

The fact that the new law seeks specifically to provide an adequate level of protection to depositors is also reflected in the expansion of the government's guarantee of the nominal value of private customers' deposits. While the old version of the Law on Banks provided only for a state guarantee of the value of deposits held at Sberbank RF, the scope of the guarantee has now been expanded - in accordance with Article 36, Paragraph 4 of the Law on Banks and in conjunction with Article 840, Civil Code - to cover all banks in which the state (the Federation, agencies or entities of the Federation, local authorities) holds an equity stake of more than 50%. However, this guarantee takes effect only if the funds of the deposit insurance scheme have been exhausted. In addition to the entities covered by relevant portion of the Civil Code, the new Law on

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above all in Germany, in the last century, which was also characterised by a high degree of interdependence between banks and industry. Critics, on the other hand, either feel that, in practice, the operations of this type of institution will result in the re-introduction of mechanisms of the old, socialist system, or are reminded of the agent banks. Problematic, in particular, is the fact that the government is authorised to award and revoke privileges (in accordance with Government Ordinance No. 191 of 28 Feb. 1996, the responsible decision-making body is the State Committee of the Russian Federation for Industrial Policy), and it is thus subject to political pressure to an unnecessarily high degree each time it must decide on such matters.

28 This does not apply to banks which were already accepting deposits from private customers when the new Law on Banks came into effect, i.e. they are not subject to the two-year "waiting period".

29 The Civil Code, Art. 840, makes it mandatory that deposits accepted from private customers be insured. While the former Law on the Central Bank provided for a mandatory insurance fund that was to be organised and controlled by the Central Bank, and was to be funded by the relevant commercial banks, the revised version of the law makes no mention of the subject. It is not clear whether the Central Bank would assume liability for the deposit liabilities of the commercial banks. The relevant passage of the Law on Banks (Art. 38) states: "Participants in the federal mandatory deposit insurance fund are the Bank of Russia and banks that accept deposits from private customers." Accordingly, all further provisions governing the establishment of the deposit insurance fund are to be contained in a separate law.

30 Accordingly, the Central Bank has introduced a new type of licence, the Licence for Operations with Deposits of Private Customers; cf. Pismo ot 19.04.96, No. 276 „O trebovaniyach k bankam, khodataistvuyushchim o polichenii litsenzii na osushchestvlenie bankovskikh operatsii" (On the requirements to be met by banks applying for a licence to conduct banking operations). In: Vestnik Banka Rossii, No. 17 (109), 23.04.96, pp. 33-34.

Banks also provides for deposits held by private customers at banks which "were founded by the state" to be guaranteed by the state. This wording is vague in the sense that one could, if in doubt, take it to mean all banks which have evolved out of Soviet state banks and enterprises, i.e. the guarantee would cover a significantly larger portion of private-customer deposits than would initially seem to be the case.[31]

Other important innovations contained in the Law on Banks are as follows:

- the deregulation of commercial banks' deposit and lending interest rates, which no longer have to be in line with the rates set by the Central Bank in the framework of its monetary and credit policy, as was required by the old Law on Banks;

- the prohibition against giving preferential treatment to shareholders of the banks when evaluating loan applications and in providing other banking services;

- the requirement that credit institutions execute customers' funds transfer orders and book incoming funds promptly.

Finally, under the new law the Central Bank retains the extensive interventionary powers which it enjoyed under the old law in matters concerning the activities of Russian banks in foreign countries and those of foreign banks within the Russian Federation. Russian banks wishing to set up branches and subsidiary banks abroad must obtain permission to do so from the Central Bank, and if representative offices are opened, this must also be reported to the Central Bank. The rules for entry by foreign banks into the Russian financial market, which, prior to the passage of the new law, were laid down by a Central Bank ordinance, have been included in the new Law on Banks. The fact that this matter is now governed by a proper law enhances the formal status of the regulations in question. The Central Bank continues to be authorised, and obliged, by law to set a maximum permissible level for the share of foreign capital in the total capital of the Russian banking sector.

3. The revision of Instruction No. 1

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[31] If a situation arises in which deposit insurance is really needed, one must in any case wait and see to what extent deposits which are not explicitly insured or guaranteed are in fact at risk. Experience in western countries shows that the amount of the implicit deposit guarantee is usually much higher than that specified in the relevant law, and also much higher than the level covered by a deposit insurance scheme.

In order for the new legal foundation created by the laws which were just described to become operational, numerous implementing regulations and ordinances are required. Moreover, it is necessary to either abolish or revise the old ordinances which were passed on the basis of the 1990 laws. This applies in particular to the instructions, letters and telegrams sent by the Central Bank to the institutions in the commercial banking sector. The most important of these implementing regulations is Instruction No. 1, entitled "On the System for the Regulation of the Activities of Credit Institutions",[32] in which capital and liquidity standards are specified. In February 1996 the Bank of Russia put a fundamentally revised version of this Instruction into effect which differs in both qualitative and quantitative terms from the one that had been in force up until then. It is directed at all commercial banks in Russia, with the exception of Sberbank.[33]

The old Instruction No. 1 contained six binding provisions (in this connection, see also Table 4):

- an absolute minimum equity capital level, expressed in roubles;
- a relative minimum equity capital level, expressed as a percentage of the risk-weighted assets;
- a relative minimum level of so-called liquid assets, expressed as a percentage of the liquid liabilities, i.e. liabilities with a term to maturity of up to 30 days;
- a relative maximum level of long-term assets, i.e. claims with a term to maturity of over 1 year, expressed as a percentage of long-term liabilities;
- a relative maximum for a large-scale loan to a single borrower, expressed as a percentage of the equity capital; and
- a relative maximum level for the combined total of all large-scale loans, expressed as a percentage of the equity capital.

Table 4: **Capital and liquidity standards :** The new Instruction No. 1 (CBR 1996) compared to the old version (CBR 1991)

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[32] Cf. Instruktsiya No. 1 "O poryadke regulirovaniya deyatelnosti kreditnykh organizatsii", in: Vestnik Banka Rossii, No. 5 (97), 8.2.1996, pp. 32 - 47.

[33] Cf. Prikaz CBR No. 02-23 "O vvedenii v deistvie Instruktsii No. 1 'O poryadke regulirovaniya deyatelnosti kreditnykh organizatsii'" (On the coming into force of Instruction No. 1 [...]), in: Vestnik Banka Rossii, No. 5 (97), 8.2.1996, p. 31.

Definition	Type of Limit	CBR 1996	CBR 1991
Equity capital	minimum	ECU 5.0 million[a)] ECU 1.0 million [b)]	Rb 5.0 million [c)] Rb 25.0 million [d)] Rb 0.5 million [e)] (not indexed for inflation)
Capital / risk-weighted assets x 100%	minimum	8%	4%
Liquid assets / liabilities in the form of demand and time deposits with a maturity of up to 30 days x 100%	minimum	70%	20% [f)] 30% [g)]
Loans outstanding with a maturity of over 1 year / capital and liabilities with a maturity of over 1 year x 100%	maximum	120%	150% [f)] 100% [g)]
Risk-weighted claims on a single borrower / equity capital x 100%	maximum	25%	100% [f)] 75% [h)] 50% [i)]
Large-scale loans / equity capital x 100%	maximum	800%	1500% [f)] 1000% [j)] 800% [k)]

a) credit institutions
b) credit institutions whose business operations are limited in scope
c) limited liability companies, closed joint stock companies
d) open joint stock companies
e) small enterprises, co-operatives, individuals
f) commercial banks which grew out of former specialised banks
g) commercial banks which did not grow out of former specialised banks
h) commercial banks founded in 1990-91 which did not grow out of former specialised banks
i) commercial banks founded in 1988-89 which did not grow out of former specialised banks
j) commercial banks with the legal form of limited liability companies or closed joint stock companies which did not grow out of former specialised bands
k) commercial banks with the legal form of open joint stock companies which did not grow out of former specialised banks

Source: Bank of Russia

To sum up, the old Instruction No. 1 consisted of four provisions which take into account the equity capital level and were designed above all to safeguard a commercial bank's solvency - namely, the two provisions on equity capital, the limit on individual large-scale loans and the limit on total large-scale loans - as well as two provisions which were intended to ensure that the commercial banks had sufficient liquidity.[34]

One notable feature of the old Instruction is that, in setting the minimum and maximum values, the Central Bank distinguished between banks according to their origins, legal form[35] and date of foundation. Banks which grew out of the former Soviet state banks, those set up as limited liability companies and closed joint stock companies, as well as older banks, were subject to less restrictive limits. The only ratio for which two different standards did not apply was the relative minimum equity capital level - the so-called capital adequacy ratio - which was 4% for all banks.

The most important features of the new Instruction No. 1 are as follows:

- the six standards which were already binding in nature in the old Instruction were retained (see also Table 4), but with the following modifications:
    * the distinctions made between various types of credit institutions were simplified,
    * in some cases, the definitions used in calculating the numerators and denominators for these standards were changed,
    * a completely new procedure for risk-weighting the banks' assets was defined, and
    * except in a few cases, the specific requirements set by the Central Bank were made more rigorous for each of these standards; and
- it contains nine additional standards, most of which are an outgrowth of the new Central Bank Law.

In the new Instruction No. 1, distinctions are no longer made between credit institutions on the basis of their origins, date of establishment and legal form. With one exception, all coefficients apply in like manner to all credit institutions. Only in so far as the definition of the absolute minimum equity capital level is concerned does the

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[34] A number of the standards set forth in the old Instruction No. 1 were, moreover, formulated as recommendations by the Central Bank to the commercial banks. Thus, for example, as regards the ratio of outstanding loans to demand and time deposits, a ceiling of 1.5 was recommended for banks that had grown out of Soviet specialised banks, while for all other banks the recommended value was 0.7.

[35] In accordance with the Law on Enterprises and Entrepreneurial Activity which was in force between 1991 and 1994.

Instruction distinguish between intermediaries - in line with the distinctions contained in the revised Law on Banks - based on the number of lines of business in which a bank is permitted to engage. This makes so-called credit institutions with a limited scope of business operations subject to a considerably lower minimum equity capital requirement, which, moreover, is now defined in ECU. It renders it impossible for the barriers to entry to the Russian commercial banking sector to be lowered by inflation, provided the rouble exchange rate more or less tracks the inflation rate, i.e. provided the real exchange remains approximately constant.[36]

Previously, minimum equity capital requirement applied only to the so-called *ustavny kapital*, i.e. the original capital as specified in the Articles of Association in accordance with the above-mentioned Law on Enterprises. The new Instruction defines this original capital as a component of the bank's equity capital, which means that a distinction must now be made between

- original capital (*ustavny kapital*) and
- equity capital (*sobstvennye sredstva*, *kapital*).[37]

This distinction is a significant one because the more broadly defined term "equity capital" is applied in the case of banks that have already been licensed, while the original capital is the relevant variable for new credit institutions which are to be granted licences, i.e. the ratios in which equity capital serves as the denominator are stricter with respect to banks entering the market than for banks which are already in the market.

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36 Under the provisions of the old Instruction No. 1, the CBR had to set new minimum values in roubles on a discretionary basis in an attempt to compensate for the loss in real value as a result of the high inflation.

37 The terms "capital", "own funds" and "equity capital" are used synonymously in the new Instruction. The following applies:

equity capital = original capital
+ earmarked reserves
+ undistributed profits
- cost of capital
- losses
- own shares purchased
- receivables with a maturity of over 30 days

According to Art. 73 of the Central Bank Law, the Central Bank is authorised and obligated to define the relevant terms.

However, the definitions provided for other terms also reflected qualitative changes. The following specific modifications were introduced in the new Instruction No.1:

a. an individual borrower was defined in such a way that "borrowers associated with each other", i.e. related parties, were regarded as a single individual borrower;
b. the criteria used to define a large-scale loan were made more stringent;
c. the risk-classification scheme for banks' assets was completely revised.

a) "Related parties" are defined in the new Instruction as "juristic or natural persons who are associated with each other as borrowers in such a way that financial difficulties of one of these borrowers lead to, or may lead to, difficulties on the part of another borrower or of other borrowers."[38] The limit on lending to individual borrowers is thus now also applied to related parties. This new aspect has also been incorporated explicitly into the revised provision on large-scale loans.

b) The new Instruction defines as a large-scale credit "the sum of all risk-weighted lendings by the credit institution to a borrower (or to a group of related borrowers), taking into account 50% of all off-balance-sheet claims (...) if this total is equivalent to more than 5% of the bank's capital".[39] In the old version, the provision on large-scale loans applied only to lendings whose total value was equivalent to at least 20% of the bank's capital.

c) Finally, a new risk assessment procedure for balance-sheet items which assigns specific risk coefficients to various bank assets represents an important qualitative change.

The overview provided in the following table allows us to compare key features of the weighting system set forth in the old Instruction with the system now in use.

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[38] Cf. Instruktsiya No. 1 "O poryadke regulirovaniya deyatelnosti kreditnykh organizatsii". In: Vestnik Banka Rossii, No. 5 (97), 8.2.1996, pp. 32 - 47, Point 5, Note 3. Further specifications also provided there.

[39] Ibid., Point 6 (p. 37).

Table 5: **The new risk factors of assets** (CBR 1996) in comparison with the recommendations of the Basle Committee (Basle) and the former Central Bank Instruction No. 1 (CBR 1991) (in %).

Balance sheet items as specified by CBR, 1996	**Basle**	**CBR 1996**	**CBR 1991**
Correspondent accounts at CBR	0	0	0
Reserves at CBR	0	0	0
Funds of commercial banks at the Central Bank for transactions with account-only cheques	not covered	0	10
Government securities	0	0	10
Government securities denominated in foreign currency („OVVZ“)	0	0	not covered
Cash on hand	0	2	0.5
Government-guaranteed credits	0*	10	15
Credits collateralised by government securities issued by the Russian Federation	0*	10	not covered
Credits collateralised by pledged precious metals	not covered	10	not covered
Debt instruments issued by local authorities	0 - 50	20	20
Foreign-currency balances in correspondent accounts at foreign banks in OECD member countries	20	20	not covered
Balances in accounts of foreign banks in OECD member countries	20	20	not covered
Credits collateralised by securities issued by agencies or entities of the Russian Federation and by local authorities	0 - 50	20	not covered
Foreign-currency balances in accounts of domestic banks	20	70	not covered
Rouble balances in nostro correspondent accounts at domestic banks	20	70	not covered
Balances in accounts of foreign banks in countries which are not members of the OECD	20,** 100	70	not covered
Buildings and other fixed assets	100	70	25
Securities in trading portfolio (valued as current assets)	100	70	not covered
All other assets	100	100	not covered
Off-balance-sheet guarantees that have been provided	50	50	not covered

* = If guaranteed by the central government: 0%; others: one of the following rates may be selected: 0, 10, 20 or 50%.
** = Time to maturity of 1 year at most.

Source: Dmitriev, M.E., et al. (1996), Rossiiskie banki nakanune finansovoi stabilizatsii (Russian banks on the eve of financial stabilisation), St.-Peterburg, p. 28; Vestnik Banka Rossii; Follak, K.P. (1993), Internationale Harmonisierung der Eigenkapitalanforderungen an Banken (International harmonisation of the equity capital requirements which banks must meet), in: Österreichisches Bankarchiv, No. 11, pp. 861 - 876.

As can be seen from the above data, the new risk-weighting system is based on the one set forth in the Basle Accords[40] in so far as claims on the government and claims on financial institutions in OECD member countries are concerned. In particular, this makes it attractive for banks to hold government securities, whose risk coefficient was reduced from 10 to 0. However, the comparison also makes it clear that the CBR regards claims on domestic banks as significantly riskier than do the Basle Accords (70% vs. 20%), a deviation from the international standards which is understandable when one recalls the liquidity crisis of last September. Against this background, it is also logical, from a Russian perspective, to treat claims on banks which are located outside of Russia, but not in OECD member countries, in exactly the same way.

Qualitative aspects of the six capital and liquidity standards that were already contained in the old Instruction No. 1 are not the only things that have changed; the coefficients, which serve as limits, have also been modified.[41] Table 4 shows that the new version of the Instruction is noticeably more restrictive than the old one, i.e. the revision has had the effect of raising the minimums and lowering the maximums.[42]

In addition to these six standards which were taken over from the old Instruction, the new version contains nine other provisions, most of which are based on the new Central Bank Law. Table 6 gives an overview of all values and ratios.

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40 The Basle Accords were drawn up in 1988 by the so-called Basle Committee, which is made up of high-level representatives of the central banks and banking supervisory authorities of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. This body, which was known as the "Cooke Committee" (its first chairman was Peter Cooke of the Bank of England) issued a definition of the term "equity capital", including a specification of its constituent parts, as well as a list of risk coefficients for the various types of bank assets which quantified the level of risk associated with each of these assets. The ratio between a bank's total assets (including its off-balance-sheet activities) - after applying the risk-weighting coefficients - and its equity capital is called the capital adequacy ratio, or Cooke ratio, and was set at a level of 8%.

41 For some standards, transition periods were defined during which the requirements will gradually be tightened. For the sake of simplicity, only those levels which the commercial banks must achieve by 1 Feb. 1999 are given in Table 4, column "CBR 1996".

42 The only category of institutions for which the standards have been relaxed in any way are commercial banks with the legal form of open joint stock companies which did not evolve from the former Soviet specialised banks: they can now grant loans with a maturity of more than one year with a total volume equivalent to 120% of their long-term liabilities - or, as the case may be, of their capital - instead of only 100%, which used to be the ceiling.

Table 6: **Capital and liquidity standards: The new Instruction No. 1 - an overview**

No.	Definition	Type of limit	Limit		Valid from
	Original capital, in million ECU	minimum	2.0 [a] 3.0 [a] 4.0 [a] 5.0 [a]	0.5 [b] 0.75 [b] 1.0 [b] 1.25 [b]	01.04.96 01.01.97 01.01.98 01.01.99
	Equity capital, in million ECU	minimum	5.0 [a]	1.0 [b]	01.01.99
N1	Equity capital /risk-weighted assets x 100%	minimum	5% 6% 7% 8%		01.07.96 01.02.97 01.02.98 01.02.99
N2	Liquid assets / liabilities in the form of demand and time deposits with a maturity of up to 30 days x 100%	minimum	20% 30% 50% 70%		01.07.96 01.02.97 01.02.98 01.02.99
N3	Highly liquid assets / liabilities in accounts for demand deposits x 100%	minimum	10% 20%		01.07.96 01.02.97
N4	Loans outstanding with a maturity of over 1 year /equity capital and liabilities with a maturity of over 1 year x 100%	maximum	120%		immedi-ately
N5	Liquid assets / assets x 100%	minimum	10% 20%		01.07.96 01.02.97
N6	Risk-weighted claims on a single borrower / equity capital x 100%	maximum	60% 40% 25%		01.07.96 01.02.97 01.02.98
N7	Large-scale loans / equity capital x 100%	maximum	1200% 1000% 800%		1996 1997 1998
N8	Liabilities to a single creditor / equity capital x 100%	maximum	60% 40% 25%		01.07.96 01.02.97 01.02.98
N9	Claims on a single owner / equity capital x 100%	maximum	60% 40% 20%		01.07.96 01.10.96 01.01.97
N9.1	Claims on all owners / equity capital x 100%	maximum	50%		01.01.98
N10	Claims on a single insider / equity capital x 100%	maximum	10% 2%		01.07.96 01.07.97
N11	Funds deposited by private customers / equity capital x 100 %	maximum	100%		
N12	Equity participations / equity capital x 100%	maximum	45% 35% 25%		01.07.96 01.10.96 01.01.97
N12.1	Equity participations in a single juristic person / equity capital x 100%	maximum	10%		01.01.97

[a] credit institutions
[b] credit institutions whose business operations are limited in scope

Two of the new provisions are aimed at safeguarding liquidity and set

- a relative minimum level of highly liquid assets,[43] expressed as a percentage of the liabilities payable on demand (N3), and
- a relative minimum level of liquid assets,[44] expressed as a percentage of total assets (N5).

They thus supplement the liquidity standards which were taken over from the old Instruction.

Another focal point of the new standards is diversification: in areas already covered by diversification requirements set forth in the old Instruction No. 1, minimum levels have been increased, and banks must now comply with such norms in new areas as well. On the assets side, the requirements which banks must meet as regards diversification - which had already been tightened in the Guidelines on Large-Scale Loans - have been made more rigorous not only in quantitative terms (loan amount), but also in a qualitative sense (the type of borrower[s] or, as the case may be, the type of claim involved). Specifically, upper limits - expressed as a percentage of the equity capital - were defined for the following types of claims:

- claims on a single owner (N9)
- claims on all owners (N9.1), and
- claims on an insider[45] (N10),
- claims in the form of an equity participation in a single juristic person (N12), and
- claims in the form of all equity participations in juristic persons (N12.1).

However, banks are also subject to diversification requirements in their liability-side operations, in so far as a relative maximum level of liabilities to a single creditor, expressed as a percentage of the equity capital (N8), is stipulated. Finally, the new

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43 Assets due on demand.

44 Assets with a time to maturity of up to 30 days.

45 Insiders are "natural persons: shareholders who own more than 5% of the shares, managing directors (...), members of boards, members of the credit committee, heads of subsidiary or parent organisations and other persons who can influence lending decisions; in addition, relatives of insiders, former insiders and other persons who are associated with third-party organisations with which insiders are also associated."

provision N11 limits the volume of deposits by private customers to the amount of the bank's equity capital.

Methodologically speaking, one of the most significant aspects of the new Instruction is that it stipulates transition periods during which compliance with the limits for each of the standards discussed above is to be achieved in stages (see Table 6, last column). This arrangement creates a firm, unambiguous basis for planning up to the year 1999 and gives the Instruction the character of a development programme for Russia's commercial banks.

Overall, it can be said that the new Instruction No. 1 seeks, on the one hand, to bring Russian regulatory standards for banks into line with international standards, and, on the other, to respond to peculiarities and weaknesses of the Russian banking system. In revising Instruction No. 1, the Central Bank can thus be said to have followed the recommendations of the multilateral financial institutions. In 1993, the World Bank was already calling for a reform of the core provisions of Russia's banking regulations with a view to bringing the regulatory regime into line with international standards.[46] Table 7 summarises the World Bank's recommendations and compares them with the corresponding provisions of the revised Instruction No. 1.

[46] Cf. World Bank (1993), The Russian Banking System in Transition, Washington.

Table 7: **Capital and liquidity standards:** The new Instruction No. 1 (CBR 1996) compared with World Bank recommendations (WB) for Russian banking regulation

Definition	Type of limit	CBR 1996	WB
Equity capital	minimum	ECU 5.0 million or ECU 1.0 million	Rb 1 billion in 1993, indexed to inflation
Capital / risk-weighted assets x 100%	minimum	8%	8%
Risk-weighted claims on a single borrower / equity capital x 100%	maximum	25%	25%
Large-scale loans / equity capital x 100%	maximum	800%	800%
Claims of the bank on an individual owner / capital x 100%	maximum	20%	10%
Claims of the bank on all owners / capital x 100%	maximum	50%	20%

Source: Bank of Russia, World Bank

The above comparison makes it clear that, to a large extent, the Russian Central Bank's new guidelines reflect the recommendations of the World Bank. As regards the higher ceilings stipulated for loans to owners, it should be remembered that large shareholders (i.e. those who hold more than 5% of a bank's equity capital) are subject to the insider provision of Instruction No. 1, which is, in turn, stricter than the corresponding regulation recommended by the World Bank: the new Instruction sets the maximum permissible volume of lending to an insider at 2% of a bank's equity capital, compared with 10% in the World Bank recommendations. Such requirements are eminently sensible, given that most Russian commercial banks must be regarded as agent banks, i.e. that they are controlled by a small group of shareholders and operated in order to permit the granting of subsidised loans, without the necessity of credit analyses, to the owners and/or their protégés - a state of affairs that has created serious problems for more than a few such institutions. This is precisely the type of lending which the provisions on owners and insiders are designed to eliminate.

Provision N8 also addresses the problem of insufficient diversification, but it approaches it from a different angle: it forces commercial banks to broaden their funding base. After all, the stability of a bank is a function not only of the degree of diversification exhibited by its assets and their quality - whereby the latter is assumed to increase in proportion to the former - but also of its liquidity. While Provision N3 is designed to gradually increase the volume of liquid claims as a percentage of liquid liabilities, Provision N8 is intended to reduce the risk of a sudden liquidity squeeze due to changes on the liabilities side of the balance sheet by ensuring that funding is obtained from more sources than have been tapped heretofore.[47]

However, the clearest indication that the Russian Central Bank was aware of the problems faced by the banking sector when it drafted the new Instruction No. 1 is that - with one exception - the requirements will gradually be tightened.[48] If the restrictive limits had been applied immediately, this would have almost certainly meant that many banks would not have been in a position to comply with them. This would have necessitated intervention by the Central Bank, with extremely serious consequences in terms of systemic stability. The Central Bank would have then very quickly faced a credibility problem, as it would either have had to admit in effect that the brand-new banking regulations were nothing but non-binding guidelines, or precipitate a crisis in the financial system. In this sense, the gradual phasing-in of the new limits should not be regarded as half-hearted, but rather as a sound approach which is appropriate to the conditions obtaining in the banking sector.[49]

This means, though, that it is more necessary than ever for the Central Bank to monitor and enforce compliance with the new regulations, and to bring sanctions to bear on

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47 While arguments can be presented both for and against the use of equity capital as the reference value when endeavouring to ensure a sufficient degree of diversification on the liabilities side, there can be no doubt that it is inappropriate to limit acceptance of deposits from private households to an amount equivalent to the equity capital, as is done in Provision N11. If this were actually implemented in practice, it would mean that once this limit had been reached, banks would have to turn private customers away who wished to make (additional) deposits - an abstruse notion. Persons with whom we spoke in Russia gave us the impression that Provision N11 will only be applied if the planned Law on Deposit Insurance is not enacted. However, there is nothing in the text of Instruction No. 1 to this effect. Be that as it may, the provision in any case fails to achieve the goal which it is presumably intended to accomplish: it does not create an additional safeguard for the deposits of private households. The safety of such deposits is, after all, not ensured by the size of a bank's equity capital, but rather by the quality of its assets.

48 N4 does not provide for a gradual change in the limits. This may be attributable to the fact that this provision is currently of little practical relevance because the banks have scarcely any longer-term claims and liabilities. In this sense it is in fact an exception that proves the rule.

49 In view of the fact that it is the purpose of the transition periods to give existing commercial banks time to re-orient their operations, it is only logical that newly founded commercial banks must meet all final limits set forth in Instruction No. 1 no later than six months after they have been registered, i.e. that they are not given the option of complying with the new limits in stages.

institutions which do not comply with them. In this respect, the regional offices of the Central Bank serve as monitoring agencies. Since 1 April 1996, every commercial bank must send forms each month to the responsible regional office in which, as an annex to its balance sheet, it calculates all of the values for the ratios set forth in the Instruction. The Moscow headquarters of the Central Bank - specifically, the Department of Banking Supervision - is involved in the monitoring in so far as it must be informed by the regional offices if violations of Provision N6 (large-scale loans),[50] N8 (large-scale deposits), N9 (loans to owners), N10 (insider loans) and N12.1 (participations) are found to have occurred.[51]

If violations of the capital and liquidity standards are discovered, the new Instruction No. 1 provides for - with reference to Article 75, Central Bank Law - a range of possible sanctions. As regards a commercial bank, they can, for example, take the form of fines up to a certain limit or of a temporary prohibition against the conduct of certain types of banking business. The most extreme measure which the CBR can take is to revoke a bank's licence.

In addition to the threat of sanctions in case of non-compliance with the new regulations, the Instruction also creates positive incentives for compliance. Specifically, the CBR will only permit banks which meet the standards to

- establish new branches,
- take up new lines of business, and

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50 As regards large-scale loans, the old Instruction also required banks to submit reports. Under the new arrangement, the stock of large-scale loans reported in a bank's balance sheet must, however, be reported to the CBR every month, and not just when new credits are granted, as was required under the old version. Moreover, the CBR has announced that in the future information on large-scale loans will be entered in a special data base. The goal is to publish the aggregated data at regular intervals.

51 The commercial banks are required to submit reports to the Central Bank not only by Instruction No. 1, but also by Instruction No. 17, which came into force in October 1993. Instruction No. 17 requires the commercial banks to submit their balance sheets and profit and loss statements on a quarterly basis and also to inform the CBR of any changes in their ownership (or shareholder) structure. Moreover, there are 14 Notes which oblige the banks to file reports on, among other things, the most important accounting policies and principles, the quality of loans, the geographical and sectoral distribution and the maturity structure of assets and liabilities, income tax expenses, real assets (property, plant and equipment) and the relevant valuation and depreciation policies, revaluation policies for different kinds of assets, off-balance-sheet accounts, and foreign exchange transactions.

Instruction No. 17 introduced a new system of accounts that is more in line with international accounting standards than the domestic Chart of Accounts. This means that the information provided in the reports that are prepared on the basis of Instruction No. 17 will not necessarily agree with the information provided in accordance with Instruction No. 1.

- participate in programmes being implemented by multilateral financial institutions (World Bank, EBRD).

However, the Instruction provides for a transitional arrangement under which the banks subject to its provisions are assured that, up until 1 August 1996, the sanctions will only be imposed if they are unable to maintain the values for the capital and liquidity ratios that are reported in the annex to the monthly balance sheet at the levels achieved on 1 April 1996, regardless of whether violations have been committed or not. Only after 1 August 1996 does the Central Bank intend to impose sanctions in every instance in which a violation of the provisions of the Instruction is found to have occurred.

In April the Central Bank published a communication to its regional offices in which it recommended the use of a new procedure for classifying banks so as to recognise problems in a timely fashion.[52] The classification system shown in Table 8 is based on criteria drawn from Instruction No. 1, Instruction No. 17, the Central Bank Law and the Law on Banks. Thus, it takes into account key aspects of the entire range of banking regulations currently in force in Russia.

[52] Cf. Vestnik Banka Rossii, 9 April 1996.

Table 8: **Classification of commercial banks in accordance with the severity of their financial problems**

	Unproblematic banks	Banks showing the first signs of problems	Banks facing temporary problems	Banks showing the first signs of insolvency
Loss reported as at one balance sheet date; minimum value for provision N1 not met; minimum reserve requirements not met; 5% of all outstanding loans in arrears; substantial changes in the ownership structure or in the bank's management; delays in payments to customers on 4 days per month.	does not apply	at least one element applies	applies	applies
Loss reported in each of the past 3 months; minimum value for provision N1, and for other provisions, not met during the past 3 months without counter-measures having been taken; share of overdue loans in portfolio has increased to more than 6%; insufficient loan-loss reserves; delays in payments to customers on 6 days per month.	does not apply	does not apply	at least one element applies	applies
Loss reported in each of the last 12 months; minimum value for Provision N1, and for other provisions, not met during the last 12 months, without counter-measures having been taken; positive auditor's report cannot be provided; uninterrupted decline in quality of loan portfolio over the last 12 months, increase in the share of loans that are in arrears; loan-loss reserves equivalent to 60% or less of the required volume; delays in payments to customers on 11 days per month.	does not apply	does not apply	does not apply	at least one element applies

Source: Bank of Russia

Finally, the Central Bank has also devised, and put into effect by the issuance of an ordinance, a temporary solution for the problem of bank liquidation which is to remain in force until the passage of a bankruptcy law for credit institutions. The Central Bank took action because the lack of a system of bankruptcy law for commercial banks is a continuing source of problems in Russian banking regulation. The legislative process has come to a halt here due to a procedural problem: Although, according to the parliamentary Subcommittee for Banking Legislation, a draft law entitled "On the Insolvency of Credit Institutions" was approved after the first reading on 24 Nov. 1995, the bill exhibits a number of weaknesses. Subsequently, a new, improved draft law that had been formulated by the Central Bank was submitted. It is, however, unclear, whether this bill can be dealt with so long as the original version is still formally under consideration by the parliament.

The urgency of the problem was underscored in the aftermath of the liquidity crisis last year when many commercial banks lost their licences, but proper bankruptcy proceedings could not be opened because the requisite legal foundations did not exist. According to banking industry sources, in such situations "informal" bankruptcy proceedings are initiated which sometimes result in the largest shareholders coming to an agreement as to which assets they wish to remove from the bankrupt institution's estate, while the small shareholders and creditors come away empty-handed. It is also reported that individual commercial banks whose licences have been revoked continue to conduct banking business because their customers do not all immediately learn of the revocation, and because the Central Bank does not always have sufficient monitoring capacity to prevent such practices.

The new ordinance draws upon the laws discussed in Section 2, in particular the Civil Code, and on the 1992 law "On the Insolvency of Enterprises".[53] It lays down basic procedures to be followed not only in cases where a bank is liquidated voluntarily, but also in instances of court-ordered liquidation. The sequence in which the claims of the bank's creditors must be satisfied has been determined in accordance with Article 64 of the Civil Code. The ordinance also stipulates that reconstruction (reorganisation) of an institution by its owners is an option only if "there is a real possibility of restoring the

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53 Cf. "Polozhenie ob otzyve litsenzii na osushchestvlenie bankovskikh operatsii u bankov i inykh reditnykh organizatsii v Rossiiskoi Federatsii" (Ordinance on the revocation of the licence of banks and other credit institutions to conduct banking operations in the Russian Federation). In: Vestnik Banka Rossii, 9 April 1996, pp. 48 - 53.

bank's solvency" (Paragraph 25). The Central Bank will only accept an application for the award of a new licence if a positive decision has been rendered by a court of arbitration which confirms that all claims of the creditors have been satisfied and that the solvency of the bank has been completely restored.

4. The new regulatory environment - implications for lending in the framework of the Russia Small Business Fund

There can be no doubt that the reform of the basic laws governing the operations of the financial sector, especially the Central Bank Law and the Law on Banks, as well as the revision of numerous banking regulations, has placed the Russian financial system on a more solid foundation. The institution-building efforts being undertaken in the framework of the Russia Small Business Fund are supported in particular by the various diversification requirements with respect to the assets side of the banks' balance sheets:

- The stricter standards employed in defining large-scale loans, and in calculating the maximum permissible volume of such loans, points to the necessity of granting smaller loans on an increased scale.[54]

- The limit on the share of total claims that may be accounted for by claims on owners, both on individual shareholders and on the group of owners as a whole, forces the banks to lend to a greater extent on the basis of an analysis of creditworthiness and debt capacity.

- The limit on the volume of participations as a share of the institutions' equity capital, both as regards stakes in individual entities and the total extent of participations, enhances the significance of other assets-side operations, including lending.

It is also important that the significance of these diversification requirements has been enhanced in formal terms, through the definition of certain minimum and maximum

54 The shift in the structure of commercial-bank lending from a focus on a few large-scale loans to a policy of building a more diversified portfolio consisting of a large number of smaller loans is also supported by the requirement that banks submit monthly reports on all outstanding large-scale loans.

permissible values - not only in Instruction No. 1, which the Central Bank can change at its own discretion, but also in the Central Bank Law itself.

On the other hand, the adjustment of the risk coefficient applied to holdings of government securities - it was reduced from 10% to 0% - provides an additional incentive for banks to increase their activities in the GKO market, which may have an adverse effect on their willingness to lend to enterprises. In implementing this change, the Bank of Russia has - as has been shown - brought its standards into line with international standards. However, given the high degree of volatility exhibited by the GKO market, this highlights the basic weakness of the Cooke committee's approach of measuring and evaluating risk solely on the basis of the identity of the bank's debtors while ignoring risks associated with interest-rate and price movements. The assumption that, in recent weeks in particular, certain banks have suffered high losses as a result of price and interest-rate fluctuations on the GKO market is, at the very least, not an implausible one. This aspect should be pointed out to RSBF partner banks which may regard the GKO market as a relatively safe haven compared with lending in the framework of the Fund.

Overall, we can thus say that the new system of banking regulation not only gives the banks incentives to improve the quality of their services, but also, in some instances, forces them to do so. It is important, though, to ensure that compliance with the new standards is also monitored. This must be seen above all as a task for the on-site inspection teams, which must check to determine whether the coefficients given in the reports are correct or, as the case may be, whether they provide an accurate picture of each bank's operations and financial status. For example, the fact that a given bank meets the capital adequacy standard will turn out to be irrelevant if, due to an inadequate evaluation of the quality of its loan portfolio, the loan-loss provisions are insufficient, and the equity capital figure that has been calculated is thus too high.

This also highlights the inherent limitation of the "regulation by ratios" approach to banking supervision as it has been outlined here: the fact that one must assess quality on the basis of quantitative indicators. Compared with the laws and regulations that were passed at the beginning of the 1990s, the current regulatory framework clearly makes it much easier to undertake such assessments, but their reliability is still by no means guaranteed. On-site inspections help to alleviate this problem. But this is a very time-consuming monitoring process whose implementation, in turn, presupposes the availability of a great many qualified inspectors; and, particularly in view of the large number of banks involved, this is a prerequisite which is simply not given in Russia at present.

This is an area in which the qualitative nature of the institution-building approach can support the efforts of the banking supervisory authorities to create an improved banking system. In the framework of the Russia Small Business Fund, this support is provided by measures such as the (re)design of appropriate credit risk management and loan administration procedures, the formulation and implementation of control and monitoring policies, training programmes for loan officers, and close collaboration with the counterpart on a day-to-day basis - all of which enhance the quality of the (partner) banks in the most important - and riskiest - area of their assets-side operations: credit extension. In this sense, the relationship between developments in the areas of banking regulation and institution building can without doubt be characterised as a "monitoring hierarchy", as was outlined in the first section of this chapter; but it is not a one-way street. Rather, it must be assumed that there exists a relationship of interdependence: the new regulatory framework induces the Russian banks to develop in a positive manner, through the force of binding requirements and through the power of incentives; institution building enhances the capability of the institutions to meet these requirements and respond to these incentives.

As positive as this outlook may appear, it is important to point out that the passage of the new laws and regulations merely increases the chances that Russia's banking system will develop in a positive fashion. Specifically, we cannot assume that its future development will be a smooth, frictionless process. To use a sporting metaphor: If a given country adopts the internationally valid set of rules for football for use on its territory, this does not, by itself, mean that

- there will suddenly be only good football players in the country; or that
- no players will commit fouls, handle the ball, or break the rules in other ways; or that
- good players will not be chopped down by bad players, sustaining injuries in the process that may cause them to be unable to play for an extended period.

Both football referees and team managers should understand this.