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Russian Federation: Financial System Stability Assessment

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RUSSIAN FEDERATION

Financial System Stability Assessment

Prepared by the Monetary and Exchange Affairs and the European II Departments

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April 11, 2003

This Financial System Assessment (FSSA) is based on the work of the joint IMF-World Bank FSAP missions that visited Russia in April and September 2002. In several instances updates based on subsequent legislative changes through January 2003 were introduced. The principal objectives of the missions were to assist the authorities in identifying potential vulnerabilities in Russia's financial system that could have macroeconomic consequences, and identify measures to reduce those risks. Where applicable, the missions also tried to identify appropriate areas for further development of the financial sector.

The FSAP team was led by Arne B. Petersen and included (at various times) Angana Banerji, Margaret Cotter, Rupa Duttagupta, Jennifer Elliott, Julia Majaha-Jartby, Obert Nyawata, David O. Robinson, Gabriel Sensenbrenner, Svetlana Malysheva (Administrative Assistant, Moscow Office), and Joanna Meza-Cuadra (Staff Assistant) (all IMF); Tunc Uyanik, Noritaka Akamatsu, Irina Astrakhan, Thorsten Beck, Michael Fuchs, Gordon Johnson, Zeynep Kantur, Donald McIsaac, Zubaidur Rahman, Susan Rutledge, Sergei Shatalov, Marius Vismantas, and Cari Votava (all World Bank); Billy Clarke, (Financial Supervision Authority, South Africa); Stefan Niessner (Bundesbank); Risto Määttänen (Bank of Finland); Zoltán Dencs (Hungarian Financial Supervisory Authority); and David Sheppard (Bank of England). Geoffrey Barnard and Timo Välilä of the IMF Moscow Office were also instrumental to the missions' work. Svetlana Vtyurina and Igor Zakharchenkov of the Executive Director's Office participated in the discussions.

Given the small size of the financial sector, the macro-economy would be relatively little affected by the immediate impact of financial sector distress. However, combined with a possible further loss of confidence in the system, a major shock could have serious implications for macro stability and economic growth prospectus. While relatively well capitalized, there are serious weaknesses in the financial sector, and a multifaceted approach is required for its development so that it can fully support the growth of the Russian economy. Several interlinked issues cut across the banking, capital markets, and insurance sectors. In spite of recent improvements, a lack of transparency of ownership structures and poor corporate governance slows down the development of financial markets and impedes bank lending decisions and prudential supervision; data quality is weak; and prudential supervision and enforcement in all sectors needs further strengthening, in spite of broadly appropriate legal frameworks. The authorities will therefore need to push forward with financial sector reform as quickly as possible.

In discussing the development of the banking system, the authorities placed great emphasis on the potential role of deposit insurance in helping leveling the playing field between the powerful state banks (that enjoy a 100 percent guarantee on household deposits) and the much smaller private banks. Care needs to be exercised to avoid that unsound and imprudently managed banks enter the scheme, and its introduction should await a strengthening banking supervision, the introduction of IAS, and higher capital requirements.

The first section of this report provides an overall assessment of stability and developmental issues for the Russian financial system. As an input, the second section reports on the observance of key financial standards and codes. The report was edited by Arne B. Petersen and Jennifer Elliott based on team contributions.

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GLOSSARY

ACH	Automated Clearing House
ADR	American Deposit Receipt
AML/CFT	Anti-money Laundering and Combating the Financing of Terrorism
ARCO	Agency for Restructuring Credit Organizations
ARIA	All Russia Insurance Association
BCP	Basel Core Principles for Effective Banking Supervision
CBR	Central Bank of Russia
CCP	Central Counter Party
CP	Core Principle
CPSIPS	Core Principles for Systemically Important Payment Systems
CPSS	Committee on Payment and Settlement Systems
CSD	Central Securities Depository
DCC	Depository and Clearing Company
DCC	Depository Clearing Company
DIS	Insurance Supervision Department of the Ministry of Finance
DVP	Delivery versus payment
EU	European Union
FATF	Financial Action Task Force
FCSM	Federal Commission for Securities Markets
FDI	Foreign Direct Investment
FIG	Financial Industrial Group
FSAP	Financial Sector Assessment Program
FSSA	Financial Sector Stability Assessment
FSVC	Financial Services Volunter Corps
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
GDRs	Guaranteed Deposit Receipts
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IFAC	International Federation of Accountants
IOSCO	International Organization of Securities Commissions
IOSCO Principles	IOSCO Objectives and Principles for Securities Regulation
ISA	International Standards on Auditing
ISIN	International Securities Identification Number
ISO	International Organization for Standardization
KFM	Financial Monitoring Committee
MBS	Mortgage Backed Securities
MFP	Monetary and Financial Policies
MICEX	Moscow Interbank Currency Exchange
MoF	Ministry of Finance
NAUFOR	National Association of Securities Market Participants
NBCO	Non-bank Credit organizations

NCCT	Non-cooperative Countries and Territories
NDC	National Depository Centre
NFA	National Securities Market Participants Association
NPL	Non-performing Loans
OECD	Organization for Economic Cooperation and Development
PARTAD	Professional Association of Registrars, Transfer Agents and Depositories
RAS	Russian Accounting Standards
ROA	Return on Assets
ROSC	Reports on the Observance of Standards and Codes
RTGS	Real-time Gross Settlement
RTS	Russian Trading System
SDDS	Special Data Dissemination Standards
SIBS	System of Interbranch Settlements
SIPS	Systemically Important Payment Systems
SWIFT	Society for Worldwide Interbabk Financial Telcommunications
TARGET	Trans-European automated real-time gross express transfer system
VEB	Vneshekonombank
VTB	Vneshtorgbank

SECTION I. STAFF REPORT ON FINANCIAL SECTOR STABILITY

I. SUMMARY AND OVERALL STABILITY ASSESSMENT

1. **There are significant vulnerabilities and weaknesses in the financial sector, although given its small size, the macro-economy would be relatively little affected by the immediate impact of any financial sector distress.** A quite large shock to the banking system, in line with the 1998 financial crisis, would have an immediate impact equivalent to 3–5 percent of GDP, which could be deemed relatively modest by international comparison. However, the capital of the system would be significantly impaired, which combined with a possible further loss of confidence in the system would have serious negative implications for the financing of key sectors as well as for the monetary policy transmission, and, therefore, could have significant implications for both macro-stability and for the country's economic growth prospects. Given this overall picture, the report places considerable emphasis on development issues, and concludes that the authorities should push forward with financial sector reform as quickly as possible.

2. **Several interlinked issues cut across the banking, capital markets, and insurance sectors and contribute to the identified vulnerabilities.** A lack of transparency of ownership structures and poor corporate governance slows down the development of financial markets and impedes bank lending decisions and prudential supervision; data quality is weak; and prudential supervision and enforcement in all sectors remains weak, in spite of some recent improvement and broadly appropriate legal frameworks.

A. Banking System

3. **According to official data (calculated using RAS), banks are in general well capitalized, but the quality of capital is questionable, and loan loss provisioning may not fully reflect risks.** There are a number of private banks which are engaged in building banking business according to best market-based practices, but many—including some larger banks—evidence poor asset quality and/or largely perform convenience functions for their owners. Some of these operate in transgression of fundamental supervisory norms, in particular as regards loan concentration especially to the energy sector. The banking sector is, therefore, potentially vulnerable to a downturn in energy prices. The pivotal role of Sberbank and the fragmentation of the private banks pose particular challenges.

4. **Stress tests imitating the events of the 1998 crisis demonstrate the continued vulnerability of the system.** A similar decline in asset quality, for example caused by a sharp reduction in raw material prices, would have an impact equivalent to 3-5 percent of GDP and would significantly impair the capital of banks accounting for some 80 percent of system assets. However, state banks would not be allowed to fail because of a state guarantee on deposits, and a nucleus of smaller independent banks and subsidiaries of foreign banks would likely withstand the shock. Importantly, the legal and regulatory framework would be in a much better position than in 1998 to address such a crisis.

5. **Barring major adverse exogenous developments, the banking system would not incur any major financial crisis.** However, its weakness would likely exacerbate the situation should a macro shock occur. Equally important, the system is currently not able to provide the desired level of support for rapid economic growth.

6. **While overall data point to high liquidity, some banks have difficulty meeting temporary liquidity needs in a thin and fragmented market.** The CBR is currently in the process of strengthening the liquidity management framework and the efficacy of monetary policy instruments, but still have some way to go.

7. **Banking sector reform is a matter of the highest priority if Russia is to achieve its growth potential in the coming years**. This will require a multifaceted approach aimed at strengthening the supervisory framework; enhancing the transparency of ownership, governance and financial reporting; and facilitating the consolidation of the fragmented private banks, and evening the playing field between private and state banks in part caused by the large size of Sberbank and by the 100 percent guarantee of household deposits for state banks. In the process of strengthened regulations and supervision, the CBR needs to move forcefully to close (or restrict licensing to no longer allow soliciting of household deposits) those banks which are non-viable, overburdened with connected lending, or in transgression of supervisory norms.

8. **Particular care will need to be given to ensuring that Sberbank is held to the same standards as other banks (including all prudential ratios), operating on a fully commercial basis with a hard budget constraint.** Given the recent rapid increase in its loan portfolio a thorough review of risks in its lending activities should be conducted. Over the medium-term, options for Sberbank ranging from privatization to transformation into a narrow bank (with limitations on permissible lending) should be developed in the context of a comprehensive strategic review. Concrete plans need to take into account progress in strengthening the private banks. Meanwhile, the authorities should press ahead with the privatization of VTB.

9. **The authorities intend to use the introduction of a deposit insurance scheme not only as a key element in leveling the playing field but as a mechanism to withdraw licenses from unsound and imprudently managed banks**. Ideally a deposit insurance scheme should be introduced only after the banking system is fundamentally sound and a strong supervisory framework is in place. Therefore, the authorities should only proceed with the proposed scheme if they are fully committed to take the necessary difficult decisions and after the introduction of IAS and higher capital requirements. The entry criteria proposed by the CBR are broadly appropriate but need to be fleshed out further and to be assessed for individual banks during a comprehensive on-site examination.

B. Developing Other Financial Markets

10. **The Russian capital markets remain small and underdeveloped.** Successful implementation of reforms to accounting standards and issuer transparency and disclosure is

essential to promote investor confidence in equity and corporate debt markets. Further rationalization of market infrastructure including clearing and depository functions, share registration, and trading would reduce costs and promote efficiency. The FCSM requires additional resources to fulfill its mandate and is impeded by unresolved jurisdictional issues concerning regulation of securities activities of banks, derivatives regulation, and regulation of related-party transactions and takeover bids. There is also a tendency to formalistic regulation—including a large number of reporting requirements for intermediaries, exchanges, and issuers which should be addressed. The lack of jurisdiction over derivatives and related-party transactions/takeover bids should be remedied. Better coordination between the FCSM and the CBR is required.

11. **Russia's debt management practices need improvement.** The system is fragmented and there is no clear-cut legal demarcation of authority over public debt management among branches of the government. If fully implemented, the authorities' proposed new debt management system will go a long way toward meeting best international practices.

12. **The insurance sector is small and characterized by a large number of mostly small companies.** An estimated 10 percent of all licensed companies do not possess the minimum capital required by current legislation, and more will not be able to meet the newly proposed $1 million target. Owing to resource limitations and the outdated legislative framework, the system of regulation and supervision fails to conform with international best practices in areas such as corporate governance, internal controls, and reinsurance.

13. **Insufficient access to finance is one of the major constraints for SME development.** Key measures to increase lending to SMEs include establishment of a credit information service and a movable property registry (pledge registry). While the leasing sector is developing at a healthy pace, the lack of consolidated supervision poses potentially a systemic risk.

14. **The payment system in Russia has improved substantially, and it is not a major source of systemic risk.** Nevertheless, a single unified system is still not in place and there are major shortcomings in efficiency. A revised CBR draft concept paper on payment system reforms should be adopted, and the development of a national RTGS system initiated.

C. Other Structural Issues

15. **Russian enterprises and banks lack transparent ownership and control structures and frequently evidence poor corporate governance.** While the list of nominal shareholders is publicly available, transparency of ownership and control structures is undermined by the common use of offshore intermediaries. Unreliable financial reporting, reflecting in part weaknesses in enforcement of accounting and audit standards, also erodes investor confidence. The insolvency regime fails to prevent manipulation to the detriment of creditors and the use of fictitious claims to effect hostile takeovers.

16. **The introduction of IAS will be a welcome development, but it is of concern that the move has recently been postponed from 2004 to 2006 or 2007.** It will be crucial to put in place a proper enabling institutional framework, including the following: (i) preparing and disseminating official translation of the IAS and related interpretations; (ii) increase IAS-trained accountants and auditors; (iii) develop the CBR and FCSM's capacity for monitoring and enforcing IAS requirements; and (iv) revise Chapter 25 of the Tax Code which currently requires enterprises to maintain separate books of account following specific tax accounting rules.

17. **The drive toward further liberalization of the capital account should be complemented with key financial sector structural reforms.** In particular, in light of the recent liberalization of controls on external borrowing, a strict enforcement of prudential rules on market and credit risks would be required to limit potentially excessive foreign currency exposures. For an orderly process, liberalization could be sequenced in three stages. The first stage would involve phasing out the more distortionary regulations—e.g., controls on the making of import payments, restrictions on nonresidents' ruble denominated bank balances, and surrender requirements on export proceeds. Repatriation requirements and controls on long-term non-debt-creating capital flows could be phased out in the second stage. The remaining controls should be liberalized more gradually as the financial system is strengthened and a sound regulatory framework is achieved. The liberalization framework should be flexible to accommodate developments in the balance of payments, which should be carefully monitored at all stages of liberalization. In this context, the November 2002 draft law appears to send somewhat mixed signals, further relaxing the capital account regime in some areas—but tightening it in others.

18. **Having enacted an AML law in February 2002, Russia has made significant progress in a short time frame in developing and implementing an AML and anti-terrorist financing regime.** As a result, in October 2002, the FATF removed Russia from its list of non-cooperative countries and territories (NCCT list). The major foundations of an anti-money laundering framework are in place, but some issues relating to legal framework and implementation remain. Existing laws still prevent financial institutions from minimizing the risks of dealing with money launderers, and enforcement mechanisms need clarification to be effective.

19. **Considerable progress has been made in improving transparency of monetary and financial regulatory agencies.** However, there is a need for improving the content and timeliness of disclosures, including in CBR transactions with precious metals and foreign subsidiary banks. The functional relationships among the banking, securities, and insurance regulators should be clarified and publicly disclosed.

D. Sequencing Issues

20. **While they should be firmly rooted in medium-term development plans, key measures need to be taken up front.** Several of the areas key to developing the financial system, such as banking sector reform, strengthening prudential supervision in all sectors,

enhancing corporate governance, accounting and transparency, improving the protection of creditor rights, and strengthening infrastructure including payment system reform, require persistent implementation over several years. It is important, however, in all these areas, to have a well thought-out and detailed time-bound action plan, with key measures implemented in the short term. These should include (i) introduction and enforcement of IAS; (ii) improvement and enforcement of auditing practices; (iii) increased CBR's focus on governance practices in the banking sector; (iv) approve a revised concept paper on strengthening the payments system; (v) pressing ahead with the authorities' plan for privatizing VTB; (vi) launching an in-depth strategic review of Sberbank's operations and its role in the banking system; (vii) enhancing transparency of ownership structures of public companies (including banks); (viii) carrying out an in-depth assessment of banks to ensure that only sound and viable banks are allowed to take household deposits before the proposed deposit insurance scheme is introduced; and (ix) implementing initial measures to liberalize the capital account. More detailed recommendations are included in Box 1, as well as in the text of the report.

21. **While some fine-tuning of the financial legislation is still desirable, the legal framework now in place permits the CBR to take more decisive action in strengthening the banking system**. As a matter of priority, the CBR therefore should proceed with the planned tightening of the definition of capital and immediately enforce this new definition and capital adequacy norms. Also, the CBR should redesign the loan loss provisioning rules to rely more on a qualitative assessment of risks, and vigorously enforce the likely higher loan loss provisioning requirements. Banks not meeting capital adequacy following these changes should be liquidated, unless owners are willing to immediately increase capital.

22. **The above measures should be taken irrespective of the decision to introduce deposit insurance.** But should the decision be made to go ahead with the introduction of deposit insurance it becomes even more crucial that these and other prior conditions for entry into the scheme be effectively implemented.

Box 1. List of Key Recommendations 1/

Banking system

- Tighten the definition of capital and transparency of ownership structures (immediate).
- Provide supervisors with enhanced training and move to risk-based supervision (ongoing).
- Address the uneven playing field in part caused by the large size of Sberbank and by the 100 percent guarantee of household deposits for state banks (medium term).
- Hold Sberbank to the same standards as other banks operating on a fully commercial basis with a hard budget constraint (immediate).
- Develop medium-term options for Sberbank in the context of a comprehensive strategic review (immediate).
- Press ahead with the privatization of VTB (immediate).
- Close (or restrict licensing to no longer allow soliciting of household deposits) those banks which are non-viable, overburdened with connected lending, or in transgression of supervisory norms (ongoing).
- Ensure that only viable banks enter into the proposed mandatory deposit insurance scheme (medium term)

Debt management

- Improve the legal basis of debt management (medium term).
- Create a unified organizational structure and clear-cut mechanisms of debt management (medium term).

Payment systems

- Adopt a revised payments system concept paper and submit it to a limited period of public consultation before the launch of a properly managed and resourced project (immediate).
- Develop an RTGS system operating on centralized principles, with appropriate liquidity and operational risk management features (medium term).

Transparency

- Improve the disclosure of the relationship between the CBR and its various subsidiaries; increase clarity with respect to CBR transactions with precious metals; use of a broader set of disclosure channels; improving the content and timeliness of disclosure; and fuller explanation of the reasons underlying changes in monetary policy (immediate).
- Publish a clear explanation of the roles and responsibilities of the FCSM and CBR regarding banks (immediate).

Securities regulation

- Establish authority over derivatives regulation and takeover-bid/related-party transactions (immediate).
- Increase resources available for enforcement and develop enforcement processes that are focused on identified risks and use of on-site tools rather than off-site reporting (ongoing).

Insurance regulation

- Adopt new insurance legislation to increase capital requirements, mandate the appointment of an actuary by each life insurance company, and provide the supervisor with powers necessary to promote improvements in corporate governance (ongoing).
- Amend licensing requirements to include fit and proper tests for all owners, directors, and senior managers of insurance companies (immediate).
- Give the supervisor specific legislative authority to supervise the reinsurance activities of licensed companies (immediate).

Corporate governance

- Increase transparency of ultimate ownership and control structures (ongoing).
- Adopt legislation requiring disclosure of related-party transactions (draft Law on Affiliated Persons) and to halt insider trading (draft Law on Insider Trading, draft amendments to the Administrative Code and Criminal Code) (immediate).

- Strengthen financial reporting by requiring publicly traded joint stock companies and other large-scale enterprises to prepare financial statements in accordance with IAS (medium term).
- Establish a centralized securities depository (medium term).

Accounting and auditing

- Identify and amend restrictive provisions in the Civil Code, Accounting Law, Banking Law, Law on Central Bank, and other laws to create an enabling legal framework for IAS-based financial reporting (ongoing).
- Revise Chapter 25 of the Tax Code which requires enterprises to maintain separate books of account following specific tax accounting rules (immediate).
- Make necessary arrangements for preparing and disseminating official translation of the IAS and related interpretations on a timely basis (ongoing).
- Increase the number of IAS-trained accountants and auditors (medium term).
- Develop the capacity of the CBR and the FCSM for monitoring and enforcement of the IAS requirements (medium term).
- Develop official translations of the up-to-date IAS, auditor's professional code of ethics, and other audit-related pronouncements of the IFAC, and issue practical implementation guidelines on the auditing standards and ethical code (ongoing).

Insolvency regime

- Adopt amendments to the Civil Code and other laws to enable secured transactions in line with best international practice for movables, and establish a centralized registry for movable property (medium term).
- Establish a new creditor reporting agency to promote greater access and transparency to credit information on borrowers (medium term).
- Improve debt recovery and enforcement mechanisms, including inter alia, greater efficiency in judicial enforcement, non-judicial executions/sale, and auction procedures (ongoing).
- Refine auction procedures to limit unnecessary delays and court interventions (ongoing).

AML/CFT

- Amend laws and regulations to permit banks to refuse, or terminate, customer relationships when money laundering is strongly suspected (immediate).
- Further enhance the capacity of the financial intelligence unit (ongoing).

1/ The indicated time frame is tentative; "immediate" implies within a few months, "ongoing" implies efforts will need to be initiated immediately and sustained; and "medium term" implies efforts will come to fruition in two to three years.

II. Macro Context and Market Infrastructure

A. Macroeconomic Background

23. **Macroeconomic developments point to GDP growth of about 4 percent in 2003, similar to 2002, and gradually declining inflation rates (Table 1).** GDP growth continues to be driven by higher energy exports and consumption. As in 2002, the balance of payments surplus is expected to remain large in 2003. Foreign exchange reserves are high; the 2003 debt servicing spike appears to have been smoothed, and external financing needs are minimal. A strong balance of payments position due to high oil prices and lower net private capital outflows has generated pressures for the exchange rate to appreciate. The Central Bank of Russia (CBR) continues to resist these pressures through large-scale interventions in

the foreign exchange market that have been partially sterilized to limit inflationary consequences. Sterilization has to some extent been facilitated by fiscal surpluses in recent years. However, the fiscal stance has been eased gradually since 2001, and this increases the tensions between the inflation and exchange rate objectives of the CBR. There has been progress in implementing structural reforms in key areas—e.g., the agricultural land market, pension funds, small business taxation—but other reforms (including in the banking sector) have lagged. Reflecting pressures in global financial markets, asset markets remain volatile; nevertheless, the stock market has risen substantially, and Eurobond spreads have declined considerably from the level of end-2001.

Table 1. Key Macroeconomic Indicators, 2000–2003 1/

	2000	2001	2002	2003
	Est.	Est.	Proj.	Proj.
Real GDP growth	9.0	5.0	4.3	4.0
CPI Inflation (Dec.-Dec.)	20.1	18.6	15.1	12.0
Federal government				
Primary balance (in percent of GDP)	4.3	5.4	3.5	4.7
Overall balance (in percent of GDP)	1.8	2.7	1.4	2.9
Current account ($ billion)	44.6	32.4	30.4	42.4
(in percent of GDP)	17.2	10.5	8.8	10.1
Gross reserves ($ billion)	27.9	34.5	47.8	67.6
(in months of import cover)	4.6	5.1	6.3	8.0
(in percent of short-term debt)	89	118	154	237
Russian oil price ($/barrel)	26.5	22.9	23.7	29.7

1/ IMF staff estimates.

B. Systemic Liquidity and Markets

24. **The current levels of correspondent accounts balances and deposits with the CBR indicate high aggregate liquidity in the financial system**. However, some banks experience periodic shortages of liquidity and have difficulty in meeting their needs in a thin and fragmented interbank market. Money market interest rates have been subject to high volatility. Moreover, perceptions of wide funding gaps of some banks appear to be feeding into market uncertainty and fostering banks' reluctance to trade or commit funds. While the clean up of banks is critical, improvements to the payments system and reserve averaging would also be helpful to improving banks' liquidity management.

25. **As suggested by a recent MAE technical assistance report (Box 2), improving the liquidity management framework and the efficacy of monetary policy instruments is a major challenge facing the CBR at present**. Despite the plethora of instruments notionally available to the CBR, recently introduced deposit auctions are now the main intervention tool, in part because the lack of depth and liquidity in the government debt instruments has constrained the development of the repo market. Liquidity management needs to be better adapted to address the sterilization needs emanating from the CBR's foreign exchange

interventions. In addition, the policy framework is subject to a multiplicity of objectives, which are not always consistent.

26. **Lender of last resort policies appear appropriate in principle**. However, during the 1998 crisis liquidity support was frequently rather opaque, and care will need to be taken that such support only be extended to solvent banks.

27. **The foreign exchange market appears quite deep and liquid.** The decision to allow exporters to sell the mandatory surrender requirements in the interbank market is a welcome development.

Box 2. Key Recommendations of MAE Technical Assistance Report

- Improve the effectiveness of monetary policy instruments by selecting a single instrument—a short-term (two week) deposit auction interest rate—as the CBR's policy intervention open-market operation rate. Interventions at other points on the yield curve to be avoided;
- Improve banks' reserve management practices by allowing reserve averaging. Unify reserve requirement to remove distortions;
- Put in place an integrated liquidity forecasting framework with at least a two-week horizon with effective collaboration of the MoF and the CBR;
- Commit to a time-bound strategy of reforms in the national payments system; and
- Improve transmission of monetary policy by building confidence in and between banks through better bank supervision and further legal and regulatory reforms.

C. Public Debt Management

28. **Russia's debt management practices need improvement in several areas.** The system is fragmented and there is no clear-cut legal demarcation of authority over public debt management among branches of the government. Vneshekonombank plays a central role as the agent of the federal government in external debt management while the MoF focuses on domestic debt. Within the MoF there are several units working on various aspects of debt, but coordination among objectives of debt management, fiscal, and monetary policies is weak. Equally weak and fragmented are the data bases and analytical capacity of debt management. The system lacks overall risk management guidelines and practices.

29. **The authorities are aware of the weaknesses in their current practices and have adopted a conceptual framework (Box 3).** If fully implemented, the proposed debt management system will go a long way toward meeting best international practices in debt management. However, key elements such as the structure and degree of independence of the debt management agency still need to be clarified. The authorities should move urgently to implement the new system; currently it looks as if the planned phases of implementation may take a significantly longer time than initially envisaged.

30. **Debt levels appear manageable, with total debt to GDP estimated at 36.1 percent of GDP at the end of 2002.** More than 80 percent of the debt is in foreign currency, indicating significant exchange risk. There is scope for more active debt management and

substitution of domestic debt for foreign, to reduce exchange risk, help contain inflationary pressures, and help develop domestic capital markets.

Box 3. Proposed Debt Management System

- An improvement of the legal basis of debt management.
- The creation of a unified organizational structure and clear-cut mechanisms of debt management.
- The creation of a unified public debt accounting system and a unified public debt accounting database.
- The creation of a unified system of analysis of debt management risks and financial analysis.
- The formation of an integrated system of strategic planning within the public debt management system and of a system for evaluating borrowing effectiveness; the improvement of the mechanisms of interaction of the debt management system with the system for cash management of budget resources.

D. Payment System

31. **The payment system in Russia has improved substantially over the past ten years: the majority of noncash payments are now made electronically, payment delays have been much reduced, private sector initiatives have been encouraged, and a regulatory framework has been put in place.** The assessment of the CPSIPS indicated that the system is not in itself a major source of systemic risk. However, the picture is still one of a fragmented set of components rather than of a single unified system and there are efficiency shortcomings. Its inability to deliver a nationwide real-time same-day settlement service is impeding the development of the CBR's monetary and market operations; and the highly decentralized correspondent account framework creates liquidity management difficulties for the banks. The issue for the CBR is whether and how to press on with a major payment system reform program, to include an RTGS system. The mission reviewed a draft paper describing a new payment infrastructure strongly endorsed it, and urged that it be developed into a time-bound action plan. The staff understands that subsequently the CBR Board of Directors decided not to adopt the paper but instead is preparing a revised version of an earlier (1997) concept paper. This revision should be prepared without delay, and should contain the same key elements as the earlier mentioned draft, including an RTGS system.

32. **The securities clearing and settlement infrastructure is similarly fragmented and diverse.** The main organized securities exchanges and the over-the-counter market are served by two central securities depositories (CSDs) and a host of custodians and registrars, with the CSDs supporting settlement of cross-exchange trades in certain stocks. Delivery-versus-payment (DVP) in securities settlement is partial, and there are no plans at this stage to introduce a CCP clearing house for the securities markets. Introduction by the CBR of an RTGS system would enable full DVP to be developed and support the development of a CCP. A single national CSD should also then be explored.

III. FINANCIAL SYSTEM STRUCTURE, REGULATORY OVERSIGHT, AND TRANSPARENCY

33. **Development of the Russian financial system was severely jolted by the crisis of August 1998.** Growth since then has more than returned the system to its pre-crisis level. However, the banking system remains relatively small and fragmented by international standards. Broad money (M2) amounted to 24 percent of GDP, while claims on the private sector were 17 percent of GDP. The markets for longer-term financial instruments, such as bonds and equity, are also small by international comparison although the value of equity exceeds that of bank claims, see Table 2. The insurance sector is small and characterized by a large number of small companies, several of which do not meet minimum capital standards.

Table 2. Financial Market Depth (2001)

	M2 (Money and Quasi-Money		Claims on Private Sector		Total Bonds Outstanding		Equity Market Capitalization	
Country	US$ billions	% of GDP	US$ billions	% of GDP	US$ billions	% of GDP	US$ billions	% of GDP
Russia	74	24	54	17	11	3	78	25
Czech Republic	40	71	25	45	8	15	9	16
Hungary	22	43	18	35	13	26	10	20
Slovak Republic	14	66	5	25	2	13	1	3
Poland	75	43	46	26	35	20	26	15
France	656*	51*	1,232	95	661	51	1,844	142
Germany	1,336	71	2,442	130	1,048	56	1,072	57
Italy	559*	56*	871	80	995	91	672	62
Netherlands	326*	89*	668	178	321	86	1,844	492
United Kingdom	1,593	113	968	69	607	43	2,150	153
Japan	5,221	123	4,084	96	4,534	107	3,910	92
United States	6,509	64	7,741	76	11,672	115	13,984	137

*end of 2000.
Source: National authorities

34. **The supervision of the financial sector is divided among four agencies with autonomy over their areas of responsibilities.** While the supervision of credit institutions falls under the CBR, the FCSM regulates and supervises capital market activities. The regulation and supervision of pension funds falls under the Ministry of Labor, and insurance companies fall under the DIS of the Ministry of Finance. An anti-money laundering unit was recently established—the KFM—to monitor activities of the financial sector in relation to of illicit activities. The committee falls under the MoF for reporting purposes, but is fairly autonomous in the discharge of its day-to-day responsibilities. Information sharing among the four supervisory agencies must be enhanced to help develop a comprehensive supervisory framework.

35. **The legal framework has undergone significant reform with a view to bringing it into conformity with best international practice, and is now broadly appropriate for most financial sector regulation.** However, fine tuning is still required in some areas, and there are still in some cases stumbling blocks as to implementation. The criminal statutes relating to financial sector violations need strengthening. Also, while significant reform of the judicial system has been introduced its effective implementation requires persistent

efforts, as outlined in the authorities program for the strengthening of the judicial system for 2002–2006.

36. **While the legal foundation for banking supervision and banking regulations is generally well developed in Russia, improvements in supporting regulation for banking supervision and in actual practices are needed in several areas.** The assessment of observance of the BCP (Chapter IX) indicates that enhancements should include (i) moving toward proactive and aggressive assessment of the operating condition and integrity of banks; (ii) focusing on preventing the entry and facilitating the exit of problem banks; (iii) strengthening guidelines for "fit and proper tests" and enhancing the transparency of bank ownership; (iv) strengthening the definitions of capital and prompt enforcement of capital and capital insolvency; and (v) enforcing consolidated supervision. Efforts are under way in these areas, but they must be deepened and sustained.

37. **The assessment of the observance of the IOSCO Principles (Chapter XII) indicates the need for further strengthening of the regulatory framework.** The FCSM operates as an independent organization and has a broad range of authority over markets, market participants and issuers, but independence could be strengthened with a clearer separation from government in carrying out its day-to-day operations. Staffing and resource levels are insufficient to carry out the full mandate of the regulator and this is a particular problem with respect to attracting skilled and experienced staff. A number of legislative initiatives are underway to address various issues but as number of gaps remain, including a lack of authority over derivatives products and markets, and takeover bid and related-party transactions. Supervision of banks with respect to their securities activities is the responsibility of the FCSM, however there appears to be little coordination between the securities and banking authorities.

38. **The Department of Insurance Supervision of the Ministry of Finance has a small dedicated team of competent professionals but lacks sufficient resources and the IAIS assessment indicates that it falls short of best practice in several areas.** The number of personnel and technical resources must be increased. Existing legislation needs to be updated, and the supervisory authority has been pursuing such an update for several years. Owing to the resource limitations and the outdated legislative framework, the system of regulation and supervision fails to conform with international best practices in areas such as corporate governance, internal controls and dealing with controls over reinsurance. The approach to evaluation of assets and liabilities, and the measurement of solvency should be carefully reviewed to ensure that expectations with regard to liquidity and matching of assets and liabilities respond adequately to the economic circumstances of Russia.

39. **Information sharing among supervisory structures appears to be limited,** in part as the requirement to cooperate is not specified in the law (except in the case of the KFM). To overcome the absence of legislative support for the exchange of information among the domestic supervisors bilateral agreements need to be signed. Currently, a bilateral agreement is being formulated between the CBR and the FCSM. Regulatory powers affecting the oversight of banking, insurance, and securities must be designed to support a free flow of

information and to assist the development of a comprehensive supervisory system for the financial system overall. While consolidation of the supervisory responsibilities into a single supervisory body, as advocated by some interest groups, could be considered at a later stage, energies at present would better be focused on enhancing the operations of existing bodies and on information sharing.

40. **Considerable progress has been made in improving transparency of monetary and financial regulatory agencies.** However, the content and timeliness of disclosures could be improved and there is lack of clarity in CBR transactions with precious metals and with its foreign subsidiary banks. The insurance sector is lagging behind the rest because of institutional factors. In addition, the securities and insurance regulators do not publish annual reports.

41. **Further efforts should be made to clarify, publicly disclose, and explain the functional relationships among the banking, securities, and insurance regulators, including through public disclosure of arrangements between them.** Also, further changes and additions should be made to current legislation with the purpose of improving the conditions of interaction in information sharing with foreign supervisor agencies.

IV. Banking Sector

42. **The Russian banking sector is highly fragmented with a large number of banks (1,300) in relation to its small size.** Following the 1998 crisis, the relative role of the state banks, in particular Sberbank and Vneshtorgbank, has increased sharply. Gross loans of the larger Russian state banks rose from 20 percent of total bank loans (end-1998) to 35 percent (end-2001), in part reflecting a portfolio shift as Sberbank was no longer able to invest in government securities. Thus Sberbank plays a pivotal role in the financial sector—as a holder of 70 percent of household deposits (and 23 percent of banking sector assets), a processor of payments, and as the primary source of larger loans to the enterprise sector.[1]

43. **According to official RAS data, banks are in general well capitalized and profitable.** Return on assets (ROA) amounted to 2.4 percent in 2001 and increased to 3.1 percent in the first half of 2002 (Table 3). However, the quality of capital is questionable, and loan loss provisioning may not fully reflect risks. A recent CBR study of 30 banks indicated that several had significantly overstated capital and some had negative net worth.

[1] Other banks are too small to carry large loans without exceeding loan concentration regulation, and syndication is virtually nonexistent because of mistrust among banks.

Table 3. Indicators of Financial Stability of the Banking Sector

	1998	1999	2000	2001	End-June 2002
Capital Adequacy					
Ratio of equity (capital) to risk weighted assets (N1)	11.5	18.1	19.0	20.3	19.9
Ratio of equity (capital) to assets	7.3	10.6	12.1	14.4	14.3
Composition and Characteristics of Assets					
Ratio of loans issued in foreign currency to total loans	70.1	50.4	42.9	36.1	39.1
Ration of nonperforming (doubtful and bad) loans to total loans	17.3	13.4	7.7	6.2	6.5
Ratio of doubtful and bad loans minus reserves to capital	71.9	16.3	-1.0	-1.6	-3.1
Ratio of overall size of major credit risks to capital (N7)	450.2	275.7	249.4	216.1	214.1
Ratio of arrears on credits to total credit volume	11.1	6.2	3.0	2.7	2.8
Profit and Profitability					
Return on assets	-3.5	-0.3	0.9	2.4	3.1
Return on capital	-28.6	-4.0	8.0	19.4	22.4
Net interest income (billion rubles)	-0.2	21.5	59.8	121.2	84.7
Net income from trade in securities (billions of rubles)	-4.9	14.1	34.8	23.4	29.3
Net income from foreign currency operations (billions of rubles)	44.3	39.2	14.4	21.9	15.2
Net other income (billions of rubles)	-2.5	36.2	47.7	29.5	19.5
Ratio of interest margin to gross income	1.7	3.5	6.7	10.3	14.0
Ratio of noninterest expenditures to gross income	91.0	89.7	87.8	87.3	82.9
Ratio of personnel expenditures to noninterest expenditures	2.9	2.6	3.5	4.7	7.0
Ratio of commercial operation income and commissions to gross income	71.5	67.0	44.7	36.8	36.7
Spread between reference rates on loans and deposits	19.0	15.9	10.1	3.5	9.3
Liquidity					
Funds attracted from nonresidents (billions of rubles)	22.9	31.4	31.3	56.3	55.2
Funds attracted from residents (billions of rubles)	483.9	765.2	1,192.6	1,591.4	1,835.7
- from government sector	80.7	108.7	172.5	199.5	232.5
Of which: maturity less than 3 months	70.8	97.9	149.9	171.2	202.8
- from households	199.7	298.2	449.7	685.0	851.4
Of which: maturity less than 3 months	95.9	116.3	168.0	201.9	215.4
- from enterprises and organizations	171.5	313.5	538.0	670.7	672.8
Of which: maturity less than 3 months	146.2	261.0	443.0	550.6	532.6
Other attracted resources	32.0	44.8	32.3	36.3	78.9
Ratio of high-liquidity assets to short-term liabilities (N2)	46.7	68.4	69.4	70.6	69.2
Ratio of liquid assets to short-term liabilities (N3)	70.0	82.4	82.9	87.4	89.2
Ratio of client deposits to total loans (excluding interbank)	109.6	120.2	119.4	110.4	107.7
Ratio of foreign currency liabilities to total liabilities	47.0	37.6	32.8	32.1	32.4
Vulnerability to market risks					
Ratio of assets with claim date of less than 1 month to assets	30.8	36.1	37.8	36.3	35.2
Ratio of liabilities with maturity date of less than 1 month to total liabilities	58.4	61.6	64.0	60.3	57.7
Share of credits in rubles with repayment date of less than 1 year to total amount of credits in rubles (including arrears)	64.6	75.7	78.7	77.0	76.24
Of which with repayment date of less than 3 months	25.1	30.0	26.4	28.7	29.78
Share of credits in foreign currency with repayment date of less than 1 year to total amount of credits in foreign currency (including arrears)	53.2	48.0	47.3	53.4	56.18
Of which with repayment date of less than 3 months	24.2	22.1	17.3	18.7	22.25
Ratio of foreign currency risk to capital	n/a	107.9	42.9	22.6	33.1

Source: Central Bank of Russia

44. **A number of private banks are engaged in building banking business according to best market-based practices, but the economic foundation for the operation of many private banks remains weak.** Many of these weaker banks—including some larger banks—have poor asset quality and mainly perform convenience functions for the enterprise or conglomerates that own it rather than intermediation of deposits in the form of loans to third party, unrelated borrowers. Several of these are believed to operate in transgression of fundamental supervisory norms, such as those which are intended to limit loan concentrations or related-party operations. The authorities intend to raise the minimum capital requirement to the equivalent of €5 million for all banks in 2007 (currently it applies only to new banks) which should encourage some welcome consolidation of the smaller banks.

45. **Poor corporate governance, accounting and audit practices cause difficulties for both banks and supervisors.** Lack of transparency discourages bank lending, and opaque ownership structures make risk assessments difficult for banks and impede enforcement of supervisors' actions.

A. Stress Testing

46. **The FSAP team conducted the stress test for the banking system based on comprehensive data provided by and extensive methodological discussions with the CBR.** The scenario agreed upon by the joint team consists of a macro-style event similar to the 1998 historical shock in its effects on asset values, with the important exception of government default (for a description of the 1998 crisis, see Box 4). Specific vulnerabilities of Russian banking (exposure concentration and related party exposures) would amplify the disturbance. Because observers agree that these vulnerabilities are important in Russian banking, the joint team proceeded to explicitly quantify them in this stress test.

47. **The joint team divided the 64 largest banks representing 80 percent of system assets** into four peer groups: substantially state-owned banks; domestic private banks affiliated with broader financial-industrial groups (FIG); "independent" private banks; and foreign banks. Initial conditions are those of end-2001 financial statements. Some FIG banks are expanding into insurance, but penetration (0.5 percent of GDP) is yet too low to matter for a stress test.

48. **A highly labor-intensive dimension of the exercise was the mapping of RAS data into IAS data,** including correcting the under-provisioning bias of RAS. The mapping indicates that the sample banks have 8 percent less overall capital under IAS than under RAS, although the exercise suffered from the uneven quality of international audit work in Russia. FIG banks sustain the largest relative capital shortfall (30 percent), followed by Sberbank.

Box 4. 1998 Banking Crisis

The combination of the government's de facto default on its domestic debt and the sharp devaluation of the ruble in August 1998 had a severe impact on the banking system, though underlying weaknesses in banking supervision and the weak legal environment contributed significantly to the crisis.

The initial response to the crisis by the authorities focused on the twin aims of relieving the restrictions on the payments system and avoiding a run on deposits. Steps included:

1. **A massive injection of liquidity into the banking system**; direct support through a combination of the existing Lombard and other facilities, reductions in reserve requirements; and large-scale purchases of frozen government securities from commercial banks' portfolios. The CBR also established a special facility for extending rehabilitation loans to selected "systemically important" commercial banks on a case-by-case basis.

2. **An option for individuals to transfer their deposits from certain private banks to Sberbank**, where a deposit guarantee was offered. By end-1998, Rub 7.1 billion in deposits had been transferred to Sberbank.

3. **Regulatory forbearance for banks.** Key indicators of banks' soundness—required to calculate compliance with prudential regulations—were frozen at the levels prevailing prior to the crisis for 168 eligible banks, who then continued to value their capital at the pre-crisis level, and to use the exchange rate in effect prior to the devaluation in assessing compliance with prudential regulation. Eligibility criteria were not disclosed.

4. **A moratorium on the repayment of private external debt**, including forward contracts, for a period of three months. Several private banks used the window provided by the moratorium and legal uncertainty to strip remaining assets from their balance sheets.

While the direct fiscal cost was minimal compared to other crisis countries, indirect effects via disruptions to the banking system and exchange and interest rate volatility was significant. The injections of liquidity, both before and after the exchange rate adjustments, also served to add to the pressure on international reserves. Of the 1697 banks licensed at the beginning of 1998, 227 were delicensed and 8 merged in 1998 and 127 delicensed and 12 merged in 1999. It is impossible to link these closures directly to the crisis and worth noting that even more banks were delicensed in 1995, 1996 and 1997.

After the initial pressures had abated, the authorities took measures to identify and address the underlying structural weaknesses in the banking system including:

1. **Financial reviews of 18 large, mostly Moscow-based, banks** based on western accounting standards. The intention was that banks found to be insolvent and nonviable would be closed and liquidated or, if systemically important, restructured. Most of the banks were found to have substantial negative capital due to insufficient loan loss provisioning, excessive lending to related parties, inaccurate and incomplete reporting, reliance on speculative income, and over exposure to foreign exchange risk. Direct losses from the default on government securities were a relatively modest contributor to their poor financial condition.

2. **Enhancing the legal framework to permit banking system rehabilitation.** Amendments to the law on bank bankruptcy, the general law on bankruptcy, the law on banks and banking activity, the law on the central bank, and the civil code were enacted in June 2001 that: (i) introduce capital adequacy as a criterion for determining insolvency; (ii) require the mandatory write-down of banks' charter capital to reflect actual value; (iii) allow for early regulatory control of a bank's operations when it begins to fail; and (iv) strengthen licensing requirements as regards "fit and proper" criteria to restrict the scope of former owners and managers of failed banks to participate in new banks.

3. **Creating an appropriate institutional framework,** including both a strengthening of the supervisory capacity of the CBR and establishing an institution to oversee the rehabilitation of viable, but undercapitalized, banks. A specialized Bank Restructuring Agency (ARCO) was created. Second, the CBR consolidated its supervision functions and initiated the reform of its supervisory regulations.

49. The methodology of the stress test involves five components:

- "Baseline" losses are computed by applying to each bank's corporate loans and securities at the end of 2001 the actual peak change of NPL ratio observed for each bank in 1998–99.

- Off-balance corporate exposures are converted into loan equivalents and losses on those equivalents are computed using the same approach as for loans and securities.
- Banks' non-liquid assets (fixed and other assets) are written down by one-third under the large shock (one-fifth under a medium shock). Government securities maintain their full value.
- Banks with a concentrated loan book are riskier than other banks and need more capital to bear this risk. How much more (the capital shortfall) is calculated using exposure concentration ratios for each individual bank and portfolio theory.[2]
- Risks posed by related party exposures are calibrated on the experience of the Mexican banking system post-Tequila for which data exist on probability of default and loss given default in the case of related-party exposures.

Losses or capital shortfalls derived under these five components are not fully additive; data for each component are therefore presented separately to give a sense of orders of magnitude.

50. **Aggregate "baseline" losses from a shock to the banks' corporate exposures as severe as 1998 would amount to 3 percent of GDP (two-thirds of system capital), in line with the small size of the system.** A medium-sized shock would result in baseline losses of less than 1 percent of GDP. If sustained at "peak distress," losses would significantly impair the capital of state banks and FIG banks. Sustained "peak distress" would be a valid assumption if the price of a barrel of oil were to drop to low double digits for an extended period.[3] While the government will not withdraw support from state banks, exit of substantial numbers of FIG banks should have relatively little direct impact on economic activity, because their household deposits are typically limited to group employees and these banks mainly perform financial intermediation within their conglomerates of origin.[4] The secondary impact through a reduction in financing of key sectors would be more difficult to estimate but could lead to lower growth rates.

51. **Innovative features of the exercise are the treatment of exposure concentration and related party exposures, two often-cited vulnerabilities of Russian banks.**

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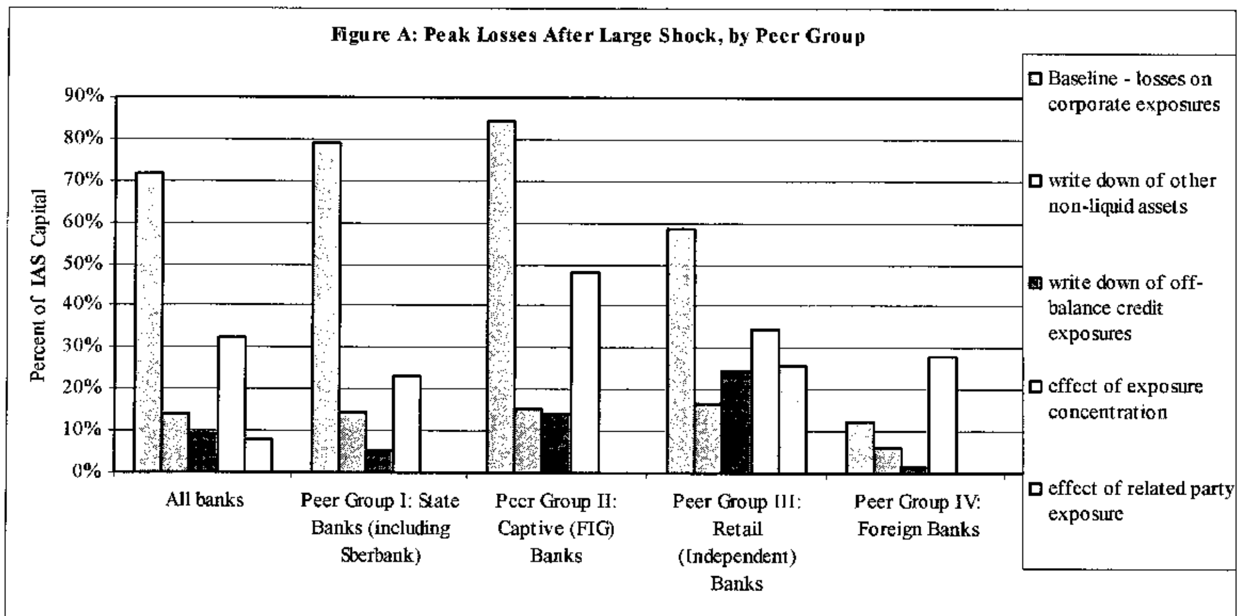
[2] The large credit risk/bank capital ratio increased from 170 percent to 700 percent in 1998–99 for the system as a whole.

[3] $12–14 for 9–12 months.

[4] If these treasury functions performed for related corporate parties were carved out, the Russian banking system may already be effectively as much as one-fifth smaller than currently measured, assuming that roughly one-half of credit activity performed by FIG banks is with related parties.

Vulnerabilities of this nature do not seem to have been quantified in other countries. Exposure concentration is estimated to magnify baseline losses by 40 percent in the aggregate, although variations across peer groups are pronounced. Foreign banks are affected most because of their focus on large exporters. Related party exposures, which are concentrated in FIG banks, are estimated to increase those banks' baseline losses by one-third. Losses in off-balance credit exposures also increase baseline losses by about 10 percent. **Altogether and assuming that these items are fully additive and reasonably permanent (a most adverse configuration), aggregate losses would amount to 5 percent of GDP for the system as a whole** (see Figure A for decomposition by peer group).[5]

52. **Market risk accounts for only a limited part of the above estimate.** Sensitivity analysis of currency risk suggests that a 10 percent *appreciation* of the exchange rate would result in mark-to-market losses of 0.01 percent of GDP (2 percent of system capital) in the aggregate, most of it on account of the state-owned banks' Eurobond portfolio. The CBR estimates interest rate risk to be of a yet smaller order of magnitude and this risk factor has therefore not been analyzed.



53. **Supervisory intervention would mainly be required for medium- to small-sized banks, which should be relatively more manageable because of reduced systemic concerns.** Having losses concentrated in a few larger banks can be more difficult to manage

[5] The CBR argues that several technical factors, including the assumption of additivity, unduly inflate these estimates of losses. According to their preliminary calculations using slightly different, but also plausible assumptions, losses would be half as high.

than having losses concentrated in a multitude of smaller banks or having small losses spread evenly.[6] A breakdown of the dispersion data indicates that independent banks of smaller size tend to have higher capital loss, supporting the view that the larger independent banks might be strong enough to emerge as the core of a new-privately owned domestic banking system.

B. Development of the Banking System

54. **Addressing the agenda for reform of the financial sector is a matter of the highest priority if Russia is to achieve its growth potential in the coming years.** By supporting the growth of a more diversified economic structure and improving access to credit—not least to small and medium-sized enterprises—the financial sector has a key role to play in ensuring the efficient allocation of resources in the economy and reducing the impact of economic shocks (such as changes in raw material prices).

55. **Developing the Russian banking system will depend on improving the infrastructure for banking**—in the areas which are the subject of other parts of this report (such as the strengthening of banking supervision, the protection of creditor rights and improved corporate insolvency practices, and bank and enterprise accounting)—and on leveling the playing field between state-owned and private banks. In addressing this broad agenda, the authorities will need to adopt and implement a strategy both as regards the private *and* state banks. Implementing this strategy will only be possible with the commitment of the CBR and the highest level of the Russian government. While broadly endorsing the framework set out in the joint CBR-government strategy paper (developed in 2001) for developing the banking sector, staff would like to highlight the following key elements:

- The new law "On the Bankruptcy of Credit organizations" introduces transparent and expedient procedures for addressing bankruptcies in banks. It also introduces the establishment of a corporate liquidator; defines the role of bank management in monitoring the condition of a bank; and introduces measures protecting the rights of creditors. Its implementation should contribute to timely liquidation of banks and to the ongoing efforts to restore trust in the banking system.

- It will be necessary to close (or restrict the activities so that they are no longer allowed to solicit deposits from households) those banks which are in transgression of supervisory norms and are found to be unviable. This would allow bank supervisors to focus on the essential task of upgrading and continually monitoring the remaining banks.

[6] 22 banks lose less than 20 percent of their RAS tier 1 capital (1 state owned, 7 FIGs, 6 independent, 8 foreign). 28 banks lose more than 50 percent; whether these banks would be critically undercapitalized would depend on the size of their capital cushion, which is not known.

- As part of the upgrading process it will be important to press ahead with the tightening of the accounting and disclosure requirements for banks and improvements in banking regulation—including through raising the minimum capital threshold for banks and improving the quality of bank capital.
- To ensure a level playing field and enhance competition the advantages conferred on state banks by the 100 percent household guarantees will need to be addressed, and a comprehensive medium-term reform strategy for Sberbank, in particular, needs to be prepared and implemented. Additional measures should be introduced in the short term (see next section).
- The authorities should press ahead with plans for privatizing VTB.

Sberbank

56. **The strategy for dealing with the development of the banking sector will require careful consideration of the role of Sberbank given the potential risk associated with banking systems dominated by one or a few banks.** Given its size, Sberbank is in a unique position to extend loans to large customers, and its loan portfolio has increased rapidly; although more recently the rate of growth has been in line with that of other banks. Publicly available information about its balance sheet would seem to indicate that it is a profitable enterprise. Nevertheless, the rapid increase in Sberbank's credit to the enterprise sector, together with the breach of the prudential limit on loan concentration and a (small) decline in loan loss provisioning, gives cause for concern. Moreover, as confirmed by the CBR, the bank's heavy exposure to the raw materials sectors would make it vulnerable to a significant downturn in commodities prices.[7]

57. **Measures are needed to address potential risk factors in the short term.** It is welcome that the CBR has instructed Sberbank to bring its operations in line with all prudential ratios, including risk concentration by June 2003. In view of the sharp increase in its loan portfolio, the CBR needs to pay particular attention to a review of the quality of Sberbank's loan portfolio during the next on-site examination. If necessary, the CBR may need to take measures to limit undue risk taking on the part of Sberbank by containing the growth of the bank's lending portfolio. Finally, as the major shareholder of the bank, the CBR should introduce—as a matter of priority—safeguards to strengthen the governance of Sberbank and to ensure that it is run on commercial principles, subject to a hard budget constraint.

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[7] It should be noted that the last two points relate also to many other banks.

58. **The authorities need to flesh out their plans for leveling the playing field between state-owned and private banks over the medium-term.** They see the introduction of partial deposit insurance for private banks as a key element followed later by a reduction in the rate of insurance coverage of Sberbank, and eventually by changes to the structure of Sberbank, including possibly privatization. While there may be some merit in the introduction of deposit insurance, this will require prior introduction of essential safeguards as discussed in the next section. Irrespective of this decision, but interlinked with its implementation, the authorities will need to consider when, and how to change the structure and/or ownership of Sberbank. In spite of firewalls, the ownership of Sberbank by the CBR continues to give rise to, at a minimum, the perception of conflicts of interest, and should not be maintained over the medium-term.

59. **A decision on Sberbank would need to be arrived at carefully in the context of an in-depth strategic review of its operations that should be undertaken on an urgent basis.** Concrete plans would need to be carefully prepared and their implementation would need to take into account the rate of progress in strengthening the private banking sector. For example, should a decision be made to transform Sberbank into a narrow bank by restricting its lending, one possible option, it would be crucial that deficiencies of private banks have been addressed sufficiently to permit them to safely take up the slack. Also, the authorities might wish to see the share of Sberbank in household deposits mobilization and in lending having been reduced to such a level that a quasi-monopoly no longer exists before privatizing it.

C. Deposit Insurance and Bank Failure Resolution

60. **Deficiencies in the bank failure resolution system have resulted in a large number of phantom banks and has undermined depositors' confidence in the banking system.** While the CBR has the power to revoke a banking license, until 2002 an arbitration court had to find the bank to be bankrupt before the bank could be liquidated. In many cases, this did not happen, which led to the phenomenon of phantom banks, delicensed banks that are still awaiting liquidation (around 60 according to the CBR). The bank liquidation process has proven to be highly ineffective, slow and costly, with currently more than 600 banks in the pipeline. While the legislation clearly establishes a priority for household depositors in liquidations, these rights have been watered down by amicable settlements, including amicable settlements in the context of restructuring activities undertaken by the Agency for the Reconstruction of Credit Organizations (ARCO).

61. **The authorities intend to use the introduction of a deposit insurance scheme not only as a key element in leveling the playing field, but as a mechanism to withdraw licenses from unsound and imprudently managed banks.** Ideally a deposit insurance scheme should be introduced only after the banking system is fundamentally sound and a strong supervisory framework is in place. Deposit insurance can only be successful in a transparent environment, with strong supervisory capacities, strict licensing criteria, and absent any political pressures. Therefore, the authorities should only proceed with the proposed scheme if they are fully committed to take the necessary difficult decisions to

(i) ensure transparency of banks' financial situation and ownership structure; (ii) enforce already existing regulatory standards; and (iii) close non-viable banks. Proceeding without these minimum prerequisites will endanger the financial viability of the scheme, impose a potentially large contingent liability on the Government of the Russian Federation and undermine confidence in the scheme and the banking system.

62. **The current draft law provides for a transition period of 21 months.** Given the large number of banks to be audited, this period might be too short. Further, the current draft law seems to imply that banks will not necessarily become members of the insurance scheme at the same time, but rather in some ordering over the period of 21 months after enactment of the law. This staggered accession might pose problems of financial fragility and instability. Depositors of banks that are not admitted yet, might shift their deposits to banks that are already admitted, since depositors might not be able to distinguish between banks that are sound but need a little bit more time to meet the criteria for accessing the deposit insurance scheme and those banks that would be denied access. This creates the risk of destabilizing the banking system through runs on basically sound banks. It would therefore be preferable that the introduction of deposit insurance be delayed until all preconditions are in place (including IAS and higher capital requirements to be introduced in 2005).

63. **Strict membership criteria and an incentive compatible structure of the deposit insurance are important in order to fulfill its promise of creating confidence and stability.** The CBR intend to apply strict membership criteria, which should include specific criteria, such as IAS accounts, tighter definition of capital, higher capital requirements and transparency of ownership structure, and an evaluation of the overall viability of the bank. Design features, such as limited coverage, mandatory participation, industry-based funding and management, and adequate pricing are important to reduce moral hazard risks and the risk of failure of the scheme. ARCO's governance and structure has to be reviewed before it can receive the deposit insurance mandate. Most important, however, is that only sound and prudently managed banks access the scheme.

64. **In the context of the transition period, a number of banks will lose their licenses to take household deposits and many may need to be liquidated.** Shifting the bank failure resolution process into an administrative rather than judicial context is expected to contribute to making the process more expedient and effective. Appointing a specialized agency as liquidator (as envisaged by the CBR) could increase the efficiency of the process substantially. A balance should, however, be attained by ensuring the banks subject to administrative decisions access to an appropriate judicial review.

V. Capital Markets and Non-Bank Financial Institutions

A. Capital Markets

65. **The Russian capital markets remain small and underdeveloped.** The equity market is estimated at $78 billion and the bond market at $11 billion in 2002. A small number of very large equity issuers are listed internationally (usually in the form of

depository receipts), and the corporate bond market has shown growth potential but there is generally limited participation in the market by equity and fixed income issuers and relatively few institutional or retail investors. Only a small number of shares qualify for listing on domestic exchanges, with the vast majority quoted without listing standards or traded over the counter.[8] The equity market is volatile but has recently delivered quite high returns. The RTS Index grew by 81.5 percent in U.S. dollar terms in 2001, making Russia one of the best performing emerging markets in the world, and a further 38.1 percent in 2002.

66. **There are few institutional investors but pension reform[9] and new collective investment schemes may create increased investor demand.** Asset management and trading is very concentrated. The recent *Investment Fund Law* provides a comprehensive legal framework for collective investment schemes, however the investment fund sector is still very small and not expected to experience strong growth in the short term. It would appear that institutional investor growth is impeded by lack of attractive investments—for example, insurance companies currently keep the bulk of their assets in the form of bank deposits since there are few investment opportunities that would provide sufficient liquidity and meet the necessary risk profile.

67. **Successful implementation of reforms to accounting standards and issuer transparency and disclosure would promote investor confidence in equity and corporate debt markets.** There is currently no insider trading law and no legal consensus on market manipulation—which together with low trade transparency and concentration of ownership leave the market prone to market abuse which may further undermine investor confidence and liquidity. Further rationalization of market infrastructure including clearing and depository functions, share registration, and trading would reduce costs and promote efficiency. Integration of clearing and settlement and the introduction of an RTGS system would also make possible future developments in the use of collateral and securities lending. A fully linked and supervised electronic system should be introduced for share registration.

68. **The main impediment for the development of a primary mortgage market seems to be the lack of long-term resources.** A first issue of mortgage-based securities (MBS) is planned for 2003. A secondary market for MBS may be the quickest—although complex—way to address the absence of a long-term lending base, while at the same time offering an investment alternative for pension funds.

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[8] Only 32 companies are listed at the two major exchanges; an additional 322 companies are traded on the exchanges in an unlisted market.

[9] Under the *Law on Mandatory Pension Insurance*, the second pillar pension scheme will be introduced in 2004 creating demand for investment. The second pillar pension scheme consists of multiple, defined contribution (i.e., funded) pension funds which are to be managed by competing private asset management companies.

B. Insurance Industry

69. **The figures for Russia's insurance business show that the volume of insurance premiums received has risen to 2.42 percent of GDP (end-2000 figure) although this statistic is quite misleading because a substantial portion of the life insurance premiums that are collected represent tax optimization programs.** Under such schemes, employers have been able to provide compensation to their workers and avoid the burden of social and other taxes on that compensation. Contracts are promptly surrendered within a short period following collection of the premium and, therefore, life insurance claim payments are at or near the level of premium collections. It is estimated that 90 percent of life insurance premiums may be from this "gray" business along with some smaller proportion of the premiums for non-life business. The "real" insurance business, after this gray business and certain mandatory medical insurance premiums are removed from the statistics, likely amounts to half of the published numbers.

70. **There are approximately 1,300 licensed insurance companies in the Russian Federation although it is estimated that 90 percent of all premiums written are collected by the top 100 companies.** Many of the licensed companies have very small, if any, premium revenue. It is estimated that at least 10 percent of all licensed companies do not possess the minimum capital required by the legislation. Companies in this situation have been required to submit plans for remedial action that must be completed in 24 months. Current minimum capital levels are trivial ($150,000) and companies who have trouble attaining this level will certainly not be able to raise the $1 million target that the supervisory authority is now proposing in a draft law that has yet to be presented to the Duma. Such companies should be delicensed within the timeframe envisaged in the draft law. Given the small size of the sector and of individual companies, identified weaknesses are not anticipated to have systemic repercussions.

C. Small- and Medium-sized Enterprise Financing

71. **Insufficient access to finance is one of the major constraints for SME development**, alongside with the well-known problem of over-regulation and administrative barriers. Retained earnings are the most important source of financing for firms of all sizes—they comprise more than two thirds of investment. Informal sources and supplier credit are the second and the third most important sources for small firms, respectively, while the share of bank credit in total financing is less than 6 percent.

72. **Most banks still do not have operational systems and procedures, expertise or skills to properly assess risks and customize financial products and services to meet the needs of SMEs.** Collateral-based lending prevails, explicitly supported by the CBR's instructions on loans classification and provisioning. Broad dissemination of cash-flow-based lending methodologies and standardized products tailored to SMEs would enable banks to decrease costs of lending to SMEs.

73. **Lack of collateral and credit history constrains SMEs' access to credit and drives up costs.** Problems regarding the enforcement of creditors' rights and the costs of collateral recovery cause banks and leasing companies to increase their collateral requirements, which SMEs find hard to meet. Typically, SMEs do not have documented credit histories either. Specific measures to increase lending to SMEs include: (i) establishment of a credit information service; (ii) improvement of secured transactions legislation; (iii) establishment of movable property registry (pledge registry); (iv) a review of regulations and procedures related to collateral registration and recovery; and (v) development of more appropriate and simplified procedures for low value asset repossession and liquidation.

74. **Government programs to support SMEs have not been effective in building sustainable financing mechanisms.** The initial attempts to use the state funding for direct lending to SMEs and loan guarantees failed. The development of new approaches to credit guarantee mechanisms has to be treated with caution, based on the international experience and lessons learned. The suggested partial subsidization of interest on loans to SMEs can not be sustainable, and will have distortionary effects on financial markets, create adverse selection problems, and could lead to political abuse and corruption. Moreover, the fiscal cost could be high and this instrument will not address the problem of SME access to finance as it is supposed to provide partial compensation of interest rate to enterprises that are able to obtain the bank loans.

75. **While the leasing sector is developing at a healthy pace, the lack of consolidated supervision poses potentially a systemic risk.** While leasing companies do not necessarily have to be regulated and supervised, as long as they do not take deposits from the general public, the lack of consolidated supervision of the Russian banking system together with equity and debt positions that banks have in leasing companies, poses potentially a systemic risk. The tax advantage of leasing in the form of accelerated depreciation does not really have an economic justification and should be abolished in the medium to long term.

76. **The cooperative financial sector has a large development potential.** Recent legislation improved the legal framework for credit unions of citizens, but cooperatives giving credit to physical persons and firms are still awaiting a legal framework, which must be carefully designed to prevent regulatory resolution. Regulation and supervision of individual credit unions and cooperatives should continue to be under self- and regional-regulation.

VI. Corporate Sector Issues

A. Accounting and Audit

77. **Russian banks will be required to prepare financial statements in accordance with IAS starting January 1, 2004,** but these reports will not be used for regulatory purposes until 2006 or 2007. Also, the move to IAS for listed companies appears to have been postponed from 2004 to 2006 or 2007. Although delayed from earlier plans (2004), this

is a welcome objective that will promote more transparency and a better estimate of the true position of banks. However, the application of IAS in form rather than in substance has great potential of misleading the users of financial statements. Therefore, it is crucial to put in place an enabling institutional framework for proper implementation of IAS in the very short remaining time frame.

78. **The experience of Russian accounting reform shows that increased efforts are needed less for legislative improvements than for institutional capacity building to bolster implementation, monitoring and enforcement of accounting and financial reporting requirements based on IAS.** Three to four hundred banks and other corporate entities voluntarily prepare either IAS financial statements or U.S. GAAP financial statements, many of which appear to be more in compliance with the form rather than the substance of accounting and financial reporting issues such as loan loss provisions, related party transactions, adjustments for hyperinflation, determination and disclosure of fair values, impairment of assets, segmenting reporting, and consolidation. Practicing auditors appear to lack capacity for substantially complying with the International Standards on Auditing, and in many cases auditors seem to ignore the concept of "auditor independence" and do not give proper attention to the professional code of ethics.

B. Corporate Governance

79. **Although the corporate governance framework in Russia has improved over the last two years, it needs additional strengthening.** The 2001–02 revisions to the *Law on Joint Stock Companies* strengthened shareholder rights, thus reducing the possibilities for share dilution and asset stripping and the Code of Corporate Conduct released in April 2002 established a benchmark for acceptable business practices and encouraged companies to revise their corporate charters. The creation of corporate governance scores by the U.S.-based rating agency, Standard and Poor's, and the release of companies' governance indicators by Russian investment banks and analysts have also contributed to stronger corporate governance practices. Investor confidence remains relatively weak—in an independent survey (February 2002)[10] Russia's corporate governance was ranked 19th out of 23 countries.

80. **The primary weakness in Russian corporate governance is lack of transparency of ownership and control structures.** Transparency is undermined by the common use of offshore trusts and other holding company structures, particularly those in Cyprus from which almost no public information is available. The problem plagues both the corporate and banking sector. In a survey of the top 20 Russian banks prepared by the FSAP mission, only the banks owned by the state or foreigners had transparent ownership structures.

[10] Prepared by Credit Lyonnais Securities.

81. **An additional issue lies with ineffective supervisory boards.** The fiduciary duties of supervisory boards are poorly defined, using concepts of reasonableness and good faith which are potentially viewed by Russian courts as "subjective" matters. The corporate governance code could provide a general set of principles for the conduct of boards and their committees, in order that such conduct might, if necessary, be more readily evaluated in legal proceedings.

C. Creditor Rights and Insolvency Provisions

82. **The business and financial community consider the legal framework supporting credit and creditor rights in Russia to be deficient in important areas, specifically with respect to the taking of security over movable property and enforcement procedures.** Following the adoption of a new bankruptcy law in 1998 (amended in 2002), the legal framework for corporate insolvency law in Russia has been improved. However, the system is still largely based on liquidations, and rehabilitations remain scarce. Implementation problems center upon manipulation of the system to inequitably favor management or particular creditors to the detriment of creditors in general, and include: "stacking" representation on creditor committees and disenfranchisement of other creditors; wrongful disallowance of valid claims and allowance of fraudulent claims; collusion between external managers and management/judges; use of bankruptcy proceedings as a form of hostile takeover; corrupt/irresponsible external managers paying no heed to demands/interests of creditors. The biggest areas for improvement remain strengthening of legitimate creditor rights and promoting rehabilitation.

VII. Capital Account Liberalization

83. **Liberalization of the capital account is currently under intense debate in Russia.** Assuming the strengthening of financial sector reforms and continued implementation of supporting macroeconomic policies and other key structural reforms, the investment climate could be significantly improved by (i) eliminating controls on the making of payments and transfers for current international transactions (i.e., controls on the making of advance important payments, restrictions on the repatriation of balances from nonresidents' ruble accounts (S accounts) and other nonresident accounts, and restrictions on the ability to effect moderate amounts of amortization from nonresidents' N accounts); (ii) phasing out surrender requirements on export proceeds; and (iii) eliminating registration requirements for enterprises with foreign capital shares for inward foreign direct investment.

84. **While some measures taken during 2001 helped to streamline the capital account regime, others introduced some risks.** The easing of controls on surrender requirements, FDI inflows and nonresidents' ruble accounts would encourage trade and investment activity. However, the liberalization of external financial credits raises concerns about excessive external borrowing by residents, which could cause the build up of unhedged foreign exchange exposures (especially in the absence of adequate prudential regulation and supervision and a well developed derivatives market) leading to economic stress should an abrupt reversal of the inflows occur.

85. **These risks could be minimized provided liberalization is complemented with key structural reforms.** A strict enforcement of prudential rules on exchange rate, interest, and credit risks would limit excessive market risks undertaken by banks and corporations. This process would be helped by other reforms—e.g., improving disclosure, auditing and risk management standards, and improving the legal framework to protect creditors' rights—which should also be initiated at an early stage.

86. **For an orderly process, further liberalization could be sequenced in three stages.** While a detailed analysis of explicit sequencing issues would benefit from targeted technical assistance in this area, some general recommendations could be made. With the initiation of the above structural reforms, the first stage would involve phasing out the more distortionary regulations. Repatriation requirements and controls on long-term non-debt-creating capital flows could be phased out in the second stage. The remaining controls should be liberalized more gradually, as the financial system is strengthened and a sound regulatory framework is achieved.

87. **The authorities' recently drafted *Foreign Exchange Law* proposes capital account liberalization in some of the key areas discussed above, but also envisages introducing new capital control measures.** The draft law (currently submitted to the Duma) proposes further reducing surrender requirements, permitting many capital account transactions on the basis of notification only (rather than requiring approval) but also placing a zero interest deposit requirement to discourage most types of capital flows. The authorities should avoid using zero interest deposit requirements on outflows, but could consider using them to limit short-term speculative inflows.

88. **Contingency plans should be clearly thought out in case the planned methodology for sequencing face difficulties**, arising from (i) increased capital flight with the partial liberalization of controls, (ii) sizable speculative inflows in response to improved economic conditions, or (iii) a reversal of capital flight involving the return of the massive stock of assets that has accumulated abroad during the last decade. Such plans should be consistent with macroeconomic policies. In addition, they should not be contrary to the obligations of the Russian Federation under Article VIII, sections 2, 3, and 4; should not be used to repudiate obligations to private creditors; and should take into account the administrative capacity of the authorities.

VIII. Anti-Money Laundering and Anti-Terrorism Financing

89. **Since the AML law was enacted in February 2002, Russia has made significant progress in a short-time frame in developing and implementing an AML regime.** The government has taken major steps relating to terrorism financing and has adopted amendments to its AML legislation to address a number of deficiencies. The Russian Federation's recent ratification of the international convention relating to the suppression of terrorist financing, its adoption of a criminal provision addressing terrorism financing, and its adoption of legislation with a suspension measure for terrorism funding should greatly enhance Russia's ability to combat the financing of terrorism.

90. **The regime for anti-money laundering has recently improved in a number of ways but the system is still at risk due to several remaining weaknesses.** The criminal anti-money laundering provisions in the AML law apply only if funds being laundered exceed a significant threshold; the existing laws require banks to accept all customers providing required documentation, and also prevent the institutions from terminating any customer relationships unless false documentation has been found, even if money laundering is strongly suspected; the law prevents license revocation for failure to report suspicious transactions; supervisory authorities do not perform adequate fit and proper screening of persons who control financial institutions; and the limited supervisory resources raise concerns regarding the sufficiency and depth of audit assessments of AML/CFT compliance.

91. **Russia has demonstrated a strong political will to effect changes and address the significant problem money laundering poses to the integrity of its financial systems.** Efforts should continue toward building a robust AML/CFT regime in compliance with international standards, including efforts to implement the amended AML law, build the capacity of the new financial intelligence unit, and adopt regulations and guidelines in support of AML.

SECTION II. OBSERVANCE OF FINANCIAL SECTOR STANDARDS

This section contains summary assessments of adherence to the major international standards and codes applicable to the financial sector. The assessments have helped identify the extent to which the regulatory and supervisory framework are adequate to address the potential risks in the financial system. They have also provided a source of priority areas for the ongoing legislative revision, and recommendations for improved financial regulation and supervision in various areas.

Detailed assessments of standards and codes were undertaken based on a collegial peer review process as part of the FSAP by Julia Majaha-Jartby (IMF), Risto Määttänen (Central Bank of Finland), and Stefan Niessner (Bundesbank) for the *Basel Core Principles for Effective Banking Supervision*; Zoltán Dencs (Hungarian Financial Supervisory Authority) and Jennifer Elliott (IMF) for the *IOSCO Objectives and Principles of Securities Regulation*; Billy Clarke (Financial Supervisory Board, South Africa) and Donald McIsaac (World Bank) for the *IAIS Insurance Core Principles*; David Sheppard (Bank of England) for the *Core Principles for Systemically Important Payment Systems* and the *IOSCO-CPSS Recommendations for Securities Settlement Systems*; Obert Nyawata, with the sectoral experts, on the *IMF Code of Good Practices on Transparency in Monetary and Financial Policies*; and Sue Rutledge (World Bank) for the *OECD Principles of Corporate Governance.*

The authorities had prepared self-assessments for several of the standards and codes, and these and other material were made available to the group of experts. The responses to the questionnaires and self assessments of compliance with the standards and codes were clarified and checked through discussion with the authorities and market participants during the missions in April and September, 2002. In several instances updates based on subsequent legislative changes through 2003 were introduced.

It was clear that legislative changes over the last few years and other efforts had improved compliance in all areas. Thus, in most cases the legislative framework had been enhanced and was broadly appropriate. However, further efforts were required in several areas to fine-tune the legal framework and, importantly, to enhance its implementation. In some cases, notably in the area of banking supervision, the authorities are well aware of the issues, and are in the process of introducing regulations aimed at improving the overall level of compliance.

IX. BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

General

92. The banking supervisory system of the Russian Federation was assessed for its compliance with the *Basel Core Principles for Effective Banking Supervision.* The assessment was conducted using the *Basel Core Principles Methodology*. The overall assessment was based on the discussions with the authorities and drew upon a completed self-assessment by the Russian authorities.

Institutional and macroprudential setting, market structure—overview

93. Russia has recovered strongly from the 1998 crisis, with economic outcomes representing a clear break from the pre-crisis period. More broadly, macroeconomic conditions have improved in recent years, with inflation considerably reduced to the level of 18.6 percent in 2001 last year and the fiscal position, a major factor in the 1998 crisis, dramatically improved, toward a surplus in the state budget.

94. The legal framework for banking supervision is based on a number of laws, including the *Federal Law on the Central Bank of the Russian Federation* (CBR Law), *Russian Federation Federal Law on Banks and Banking Activities* (Banking Law), *Federal Law on Insolvency (Bankruptcy) of Credit Institutions* (Law on Insolvency), *Federal Law on the Restructuring of Credit Institutions* (Law on Restructuring of Banks), *Federal Law on Countering the Legislation of Earnings Received in an Illegal Way* (Anti-Money Laundering Law), and their associated enforcement directives and regulations issued by the CBR and the joint CBR/Government of Russia *Strategy of the Development of the Banking Sector of the Russian Federation* (Strategy Paper) adopted in December 2001.

95. The Russian banking system is characterized by a large number of banks—more than 1,300 of which about 130 have foreign ownership. The CBR maintains a number of foreign subsidiaries and has controlling stakes in the large domestic bank (Sberbank). In the Strategy Paper, the authorities recognize that there is a need to consolidate the sector. The consolidation of the number of banks should facilitate the task of efficiently supervising the banks and support the creation of stronger, better-capitalized banks. As part of the post-crisis reconstruction, ARCO was established to administer a number of credit institutions and is at the stage of winding up its responsibility. The challenge ahead is to clean up the system of unsound banks and to lay the foundation for an effective prudential supervision of banks in readiness for the introduction of a deposit insurance scheme. However, the authorities perceive the scheme as the tool by which they will clean up the system.

General preconditions for effective banking supervision

96. The objectives and the institutional framework for the regulation and supervision of credit institutions are broadly defined in the CBR law and the Banking Law and provide the basis for the supervision of credit institutions. Although the supervisory staff of the CBR head office is well trained to efficiently discharge their responsibilities, there is scope for improving the focus and quality as it applies to enforcement of regulations and conduct of on-site and off-site supervision. Changes in the laws have not always been accompanied by immediate reviews of regulations and there is considerable overlap in a number of guidelines. There have been, however, marked improvements during 2002. The CBR is working on strengthening, simplifying and gearing prudential regulation toward the adoption of best international practice.

97. Although the CBR has developed an early warning system, the analytical work done by the off-site supervisors still concentrates on the completeness of the reports and the compliance with the prudential standards (rule and ratio-based), but not on the underlying risk reflected in the reviews. Therefore, the off-site supervision is not always able to direct the on-site inspectors to those areas in the credit institutions that need special attention. The CBR has embarked on the introduction of systems to enhance qualitative analyses through improvements in the on-site inspection tools. The CBR is concentrating its efforts in improving the supervisory standards at both headquarter and branch levels. To this end, there have been continued restructuring of supervisory responsibilities to create a more responsive framework for timely corrective action.

Compliance with the principles

98. **Preconditions for effective banking supervision and CP 1.** Although there is a system of business laws including corporate, bankruptcy, contract, consumer protection and private property laws, this system neither is consistently enforced nor provides a mechanism for fair resolution of disputes in a timely manner. The Russian Accounting Standards (RAS) are not comprehensive and do not command wide international acceptance since the accounts do not provide a true and fair view of the financial position of companies. The quality of audits is generally poor; only the international and a few domestic auditing organizations are respected for providing reliable financial statements. Supervision of other financial markets is weak or still in a nascent status.

99. **Licensing and structure, CPs 2 to 5.** The CBR broadly complies with the Basle Core Principles for Corporate Governance and Licensing (CPs 3 and 4). In order for the criteria for compliance of the management and members of the supervisory board of licensed institutions with qualification requirements and business reputation to be met fully, however, supplemental powers will need to be granted to the CBR by legislation. Systems for establishing the compliance of the founders and acquirers of banks with requirements accepted in international banking supervision practice need to be improved. The banking legislation should be expanded to include provisions stipulating that the banking supervision autority has sufficient powers to ensure transparency in the structure of ownership of banks.

100. **Prudential regulations and requirements, CPs 6 to 15.** A step was taken, in 2001, in the direction of encouraging the establishment of better-capitalized banks by increasing the minimum capital level for newly licensed banks to €5 million (the minimum capital level applied within the European Union). According to the Strategy Paper, commencing in 2005 a rule will be applied whereby the licenses of banks below €5 million are automatically revoked if their capital adequacy falls below 10 percent. This would represent a considerable tightening of the current legal framework as specifically applied to small banks. Currently, similar action can be applied to all banks, but only if their capital adequacy ratio falls below 2 percent. The 10 percent capital adequacy requirement rule will apply to all credit institutions and so will the €5 million minimum capital requirement.

101. **Methods of ongoing supervision, CPs 16 to 20.** The legal framework provided by the CBR law and the Banking Law broadly meets the requirements for banking supervisors to have the necessary means for collecting, reviewing, and analyzing prudential reports and statistical returns from credit institutions on a solo and on a consolidated basis. However, there is need for improvements in the quality of the information that goes into the various analyses, and at the same time reducing the extent of the reporting required from the credit institutions. Recently, the CBR enhanced the collaboration among the departments charged with the day-to-day responsibilities for the supervision of banks and the Department of Foreign Exchange Regulation and Control by having them sign a Cooperation Protocol for mutual access to supervisory information.

102. **Information requirements, CP 21.** The CBR materially complies with the requirement for the maintenance of adequate records for the assessment of the condition of a credit institution. However, the accounting standards established by the CBR and based on the RAS do not provide a reliable view of the financial situation of credit institutions.

103. **Remedial measures and exit, CP 22.** The CBR is largely compliant in taking remedial action for identified weaknesses. However, there are aspects of the organizational structures and relationships with the supervised banks that may delay prompt action. The relationship of the CBR as owner and supervisor of some of the banks is clearly a conflict of interest and may hamper an arms-length prudential relationship in case of the need to take remedial action and in avoiding forbearance.

104. **Cross-border banking, CPs 23 to 25.** Although Article 51 of the CBR law generally allows the necessary exchange of information with foreign supervisors, the still existing secrecy requirements in Article 51 and 57 of the CBR law are a hindrance to effective supervision. The CBR is not allowed to provide information on transaction of particular customers of the credit institution. Nevertheless, the CBR has engaged arrangements with domestic and with a number of foreign supervisors to allow sharing of information. The CBR has engaged in the signing of bilateral agreements with relevant foreign supervisors, which arrangement provides condition and procedures for exchange of supervisory information.

Table 4. Recommended Action Plan to Improve Compliance of the Basel Core Principles

Reference Principle	Recommended Action
Corporate Governance and Licensing (CPs 3 and 4)	Apply stricter qualification criteria for shareholders, directors and management of credit institutions and should embark on a program for the identification of real owners of credit institutions.
Capital Adequacy (CP 6)	Improve accounting standards to support a reliable calculation of the capital adequacy ratio.
Credit Policies, Provisioning and Loan Exposures (CPs 7, 8, 9 and 10)	Develop guidelines for specific requirements on prudential credit granting and investment criteria, policies, practices, and procedures. Participation of a creditor bank in a borrower company (group of borrower companies), with the exception of a bank's participation in subsidiary and dependent legal entities, as well as in resident credit institutions of the Russian Federation——in cases when the amount of participation is subtracted from the capital of the creditor bank, should be included in the definition of large exposure. The definition of "insider" should at least include companies owned or controlled by the "insiders."
Internal Audit (CP 14)	Enhance the internal control process by requiring, e.g., a segregation of duties and an appropriate balance in the skills and resources of the back office and the front office. Regular reporting by the internal service control to the supervisory board (at least twice a year). The CBR should work toward the adoption and implementation of the draft on Organization of Internal Control in Credit Institutions and Bank Groups.
Money Laundering (CP 15)	Establish a mechanism for receipt of data by the CBR from the KFM summarizing information related to money laundering activities and suspicious transactions.

Reference Principle	Recommended Action
On- and Off-Site Supervision (CPs 16 – 19)	Review on- and off-site supervision methods to facilitate better analysis for qualitative supervision. The CBR should consider opening cooperation lines with the credit institutions it supervises to facilitate on the job training for its inspectors.
Consolidated Supervision (CPs 20 and 23)	Legislation should allow for exchange of information between members of a consolidation group to facilitate risk management on the group level.
Accounting Standards (CP 21)	The CBR should promote the use of International Accounting Standards for the banks and for the corporate borrowers.
Remedial Measures (CP 22)	The legal powers to fine managers of credit institutions should be enhanced, to hold them more accountable.
Exchange of supervisory information (CPs 1 (6), 24-25)	Provide the CBR with the right to exchange information on customers based on the extent of exposure with both foreign and other domestic supervisory agencies.

Authorities' response

105. The authorities were in basic agreement with the assessments and highlighted areas where action is being taken to strengthen the process of supervision—through both proposals for necessary changes in the law or development of regulations and guidelines for the implementation of the provisions of the law. Where there were disagreements with the assessors' detailed assessments, the authorities provided details of the disparities in their assessment of the situation from that of the assessors. Although there was a basic agreement on some of the critical areas of weaknesses in the legislative framework, the assessors drew the authorities attention to the importance of effectively implementing and enforcing the existing legislative provisions and regulations. The authorities agreed that, indeed, the current legislation in the area of business laws including corporate law, protection of property rights, etc., needed improvement. However, they were of the view that it was being enforced and served as a foundation for settling relevant issues. They stressed that the Government of the Russian Federation and the CBR were contemplating a number of measures to improve regulatory procedures governing bankruptcy, enhancing property rights, and protecting consumers' rights. The authorities commented that subsequent to the assessment they had adopted or were in the process of adopting specific measures to address: the definition of capital and transparency of ownership structures; expansion of the definition of connected or insider lending to include companies owned or controlled by the "insiders"; qualitative off-site monitoring and appropriate linkages to on site examination; and methodologies for risk based supervision. Also, while the assessors were of the view that some aspects of the then prevailing organizational structure might delay prompt action, the authorities' response was that the procedures currently in force clearly define the relational responsibilities.

X. Payment and Settlement Systems

A. Summary Assessment of Observance of CPSS Core Principles for Systemically Important Payment Systems

General

106. This assessment focused on the CBR payment system, but also took into account other interbank and most especially intrabank networks (where the Sberbank's own internal payment network provides a major element of the payment infrastructure).

Information and methodology used for assessment

107. The assessment made use of the CBR's self assessment against the ten core principles, and detailed answers to the CPSIPS questionnaire, as well as the 'Red Book' descriptive chapter that the CBR is preparing on Russian payment and settlement systems for the CPSS.

108. The assessor had meetings with Deputy Chairman Chugunova, and with officials from the Department of Payment Systems and Settlements, the Legal Department and the Security Department. Outside the central bank, meetings were held with FSVC directors, the chairman of the Payment Systems Committee of the Association of Russian Banks, and with the Executive Director of the Russian National SWIFT Association.

109. While it could be argued that the CPSIPS assessment should focus on a particular CBR component/platform (e.g., Moscow or St. Petersburg), the assessor took the view that a unified approach to the assessment was the most appropriate. This approach has some parallels with the CPSIPS assessment of the TARGET system (another decentralized network); and is in tune with the strategic objective of developing a uniform, centrally coordinated RTGS for Russia.

Institutional and market structure—overview

110. The CBR not surprisingly dominates the payment system environment. The statistics suggest that the CBR payment system processes around two thirds by value (half by volume) of all non-cash transactions (including transactions of intrabank networks, notably Sberbank). In terms of oversight/regulation, Federal law provisions have clearly established the CBR's authority in the field, onto which the CBR has superimposed its own regulatory regime within which systems operate and (in the case of private systems) develop their own procedures and contractual arrangements. It is also the case that private systems/networks can only be operated by credit organizations, and as such have to be licensed by the banking supervisors.

111. The **CBR payment system** (to which all credit organizations have to belong) is a distributed gross settlement system, made up of 78 regional systems. Of these, 59 use centralized payment processing with the remaining 20 having a number of separate

processing sites. Most of the centralized regional systems provide continuous, item-by-item, processing of payments; the remainder provide designated time settlements. In the Moscow region, both methods of settlement are available. In all of the decentralized regional systems, batches of intraregional payments are transferred at designated times. All electronic payments and the vast majority of paper-based payments passing through the CBR system are credit transfers. Paper-based payments still make up a sizable but rapidly falling proportion of total payments processed (dropping from 25 percent in 1999 to 7 percent in 2002). Each regional system offers an intra-regional and an inter-regional service. Intra-regional transactions dominate: over 90 percent by volume, 85 percent by value. Electronic inter-regional payments instructions are routed between the 78 regional head offices via the CBR's Inter-regional Informatization Center, with settlement between the regional head offices on a bilateral basis.

112. Intraday credit can be extended by the CBR to banks in two regions currently (Moscow and St. Petersburg); the facility is being extended to other regions. The facility, which has to be collateralized, is not used extensively (daily average of Rub 400 million). Correspondent account balances are very high: Rub 143 billion at end-2001 compared with average daily turnover of around Rub 250 billion. In particular circumstances as laid down by the CBR, banks may be allowed to reduce their required reserves requirement for intra-month liquidity management purposes.

113. **Intrabank payment networks** are dominated by **Sberbank**'s payment system. The latter has five components: (a) the System of Interbranch Settlements (SIBS), which links its 1,500 branches and enables the customers of those branches to send non-cash payments to each other; (b) bilateral correspondent payment links with other commercial banks; (c) settlement agent function for Europay International payment card transactions; (d) cash settlement agent function for participants on the Moscow Stock Exchange; and (e) the SBERCART payment card settlement. There is a substantial volume and value of Sberbank customer payments which have to be settled across the CBR payment system (e.g., tax and other public sector payments); Sberbank therefore needs to have some CBR correspondent accounts to effect such payments. It is evident that many banks have a correspondent relationship with Sberbank and use its network to make funds transfers, as an alternative to the CBR system.

114. As of July 2002, there were 41 **private sector NBCOs**, settling on a gross basis. 16 of the NBCOs have the right to settle on a net basis and 8 settle the payment legs of securities transactions. All are licensed and regulated by the CBR. Membership varies substantially between the different NBCOs, depending on the nature of the transactions that are being settled. Thus, some have been established to settle the obligations of particular card schemes. Others are very local payment operations, and may have both bank and nonbank members or just nonbank members. The market participants on MICEX and RTS (the two securities trading systems) make up the membership of the special-purpose NBCOs created to settle the cash legs of securities trades. The bulk of NBCO payments by value and volume is accounted for by these securities market settlement vehicles. Bilateral **correspondent payment**

arrangements, established between pairs of banks, and often using the SWIFT communication network and standards, have become more important in recent years.

115. **Plastic cards** (particularly debit cards) are the only real non-cash retail payment instrument; their use is growing strongly but from a very low base. There are nearly 550 banks issuing payment cards or acting as merchant acquirers, and nearly 10.5 million cards in circulation. **Checks** are little used- mainly on a bilateral interbank or intrabank basis—and they are not settled through the CBR system. The **postal organizations** (federal and private) do not provide non-cash payment services directly, but use the services of commercial banks; they also provide the usual postal cash transfer services.

116. In 2001, the total volume of the non-cash payments to GDP ratio was low at around 12 percent overall and just 7 for the CBR system (compared with figures of over 50 for a number of EU countries), and the cash/GDP ratio (even before taking account of the very substantial stock of U.S. dollar banknotes also in circulation) is high at 6 percent (the EU average as a whole is less than 5 percent).

117. A new concept paper on the reform of the CBR payment system (including development of RTGS) is now being prepared within the CBR. This will again be presented to the CBR Board for approval, hopefully in the very near future.[11]

Payment systems infrastructure

118. The CBR has made substantial progress in developing a legal framework within which the payment systems, central bank and private, can operate. A substantial body of regulations has already been developed, and Federal laws relating to funds transfers and electronic documents are now in the pipeline. It remains the case that the contractual basis underlying the obligations within private payment systems remains untested in a court of law.

119. The need to redevelop the CBR payment system into an RTGS system appears to be accepted in principle within the CBR. The absence of a national RTGS system was also highlighted by another recent IMF mission as a factor inhibiting the development of effective monetary management techniques.

120. The view of this assessment is that the CBR has to adopt a forward-looking strategy, and develop a payment system that can meet both international standards and user requirements in an environment where the banking sector is generating a much higher non-cash payment turnover and is operating with more normalized liquidity levels.

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[11] The staff understands that subsequently the CBR Board of Directors decided not to adopt the paper. Instead, the CBR is in the process of preparing a revised version of an earlier (1997) concept paper.

121. The current decentralization of the CBR system extends to banks' settlement/correspondent accounts, where most branches of commercial banks have a correspondent account at their local CBR office. The aim should be to enable banks to operate with a single head-office account at the CBR, with back office efficiency and in resulting improvement in banks and CBR liquidity management. (Some banks' internal systems are, however, not currently geared to such centralization.) There would also be benefits to supervisory oversight.

122. The assessor was aware of a number of other difficult issues for the CBR that have to be addressed if the concept paper is to become a successfully implemented project. These include:

- whether the project should also include building of a bulk retail (ACH) system, and how (or if) this should relate to or involve the existing Sberbank payment network;
- how to develop the new system: in-house or purchase off-the-shelf;
- what data communication network to use: SWIFT or the CBR's own network;
- what data format standards to use;
- simplification of bank identification codes;
- how to achieve proper separation of the payment system accounting system from the CBR's general ledger accounting system. The latter is currently very complex, with a number of different systems in use; any project to rationalize it will be a major one, and will need to provide the necessary interfaces with the new payment system accounting module;
- the number of processing centers to build: one plus back-up, or multiple centers.

123. An early resolution of differences of views within the CBR is essential, particularly given the previous unsuccessful attempts to develop an RTGS project. After agreement **has** been reached, the CBR should (a) publish a consultation paper before committing to a time-bound action plan, and (b) appoint an experienced and full-time project manager with full decision-making powers on non-policy-related matters related to the project. The CBR should ensure that the internal risk management procedures of internal bank (intrabank) payment networks—and particularly those of Sberbank—are adequate. (Sberbank report that they are intending to tighten risk management procedures. This should be followed up) Similarly, were any NBCO payment schemes to develop SIPS characteristics, then the CBR would need to ensure that it had the oversight procedures that enabled regular monitoring and assessment of their CPSIPS compliance or progress toward compliance. The CBR should also be giving thought to how best to ensure that oversight of its own payment system and of individual private systems is in all aspects carried out consistently.

Recommended actions

Table 5. Recommended Actions to Improve Observance of CPSS Core Principles and Central Bank Responsibilities in Applying the CPs—CBR Payment System

Reference principle	*Recommended action*
Legal foundation *CP I – The system should have a well-founded legal basis under all relevant jurisdictions.*	• The implementation of new Federal laws on electronic documents and funds transfers should be speedily concluded. • The future RTGS project will need to address a range of legal issues. This should be flagged in the concept paper; and the issues addressed by a legal working group reporting to the overall project manager during the project itself.
Understanding and management of risks *CP II – The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks that they incur through participation in it.* *CP III The system should have clearly defined procedures for the management of credit and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risks*	• For the future RTGS, the CBR should consider a separation of the operating rules and procedures from the formal regulations. • The future RTGS should be designed with appropriate liquidity risk management capability (e.g., intraday liquidity, queue management, differential tariffs, throughput rules or guidelines).
Settlement *CP IV – The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day*	• The future RTGS service should incorporate clear and coordinated time-tabling for the intraday, real-time, settlement of payments between all regions and across all time zones.
Security and operational reliability, and contingency arrangements *CP VII – The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily settlement*	• The future RTGS should have remote back-up capability (based upon the arrangements now in place in the Moscow region) and a formal business continuity plan that is regularly tested with the participation of the major banks.
Efficiency and practicality of the system *CP VIII – The system should provide a means of making payments which is practical for its users and efficient for the economy*	• The CBR should urgently secure internal agreement on the concept paper for the future payment system, including the proposal for developing a bulk payment capability.
Criteria for participation *CP IX – The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.*	• The CBR will need to decide whether to maintain the existing 100 percent direct participation of all credit institutions in the future RTGS system. If it opts for a two-tier participation, the criteria will need to be clearly described. Exit criteria will also need to be defined.
Governance of the payment system	

Reference principle	Recommended action
CP X – The system's governance arrangements should be effective, accountable and transparent	• The CBR will need to consider how best to delineate internally the responsibilities of, on the one hand, the operators of a more centrally controlled payment system and, on the other, the responsibilities of the oversight department.
Central Bank Responsibilities in applying the CPs	
Responsibility A The central bank should define clearly its payment system objectives and should disclose publicly its role and major policies with respect to systemically important payment systems.	• The CBR should submit the payment systems concept paper to a limited period of public consultation once it has been agreed by the CBR Board.
Responsibility B – The central bank should ensure that the systems it operates comply with the core principles.	• See Recommended action under CP X above.
Responsibility C – The central bank should oversee observance with the core principles by systems it does not operate and it should have the ability to carry out this oversight.	• As part of its future payment systems strategy, the CBR should develop a more formalized oversight relationship with private sector schemes, whether systemically important or not. A closer oversight relationship with Sberbank is strongly recommended.
Responsibility D – The central bank, in promoting payment system safety and efficiency through the core principles, should cooperate with other central banks and with any other relevant domestic or foreign authorities.	• The CBR should ensure that there are contact lines in place with foreign overseers and regulators in case a Russian bank experiences liquidity problems in a foreign payment system or vice versa.

Authorities' response

124. The CBR was broadly in agreement with the report, though felt that the assessments for two of the CPs were unduly harsh (CP1 and CP4). There was also a general comment that in places the assessment attempted to be too forward-looking—i.e., many of the action points focus on issues that are being covered in the forthcoming 'concept paper', and its vision of a new CBR payment system infrastructure, rather than on measures that could be taken in the short(er) term to improve the CP compliance of the existing arrangements. However, the CBR understood the need to relate this assessment exercise to the longer-term objective.

B. Summary Assessment of Observance of CPSS-IOSCO Recommendations for Securities Settlement Systems

General

125. The assessment focused on the two central securities depositories (CSDs), the National Depository Centre (NDC) and the Depository Clearing Company (DCC). However, because a number of the CPSS-IOSCO recommendations concern issues other than simply

CSD operations, the assessment also looked at securities market infrastructure more generally.

Institutional and market structure

126. Russia's securities markets and supporting clearing and settlement infrastructure (including custody and registration) are extremely fragmented, with different pieces of the infrastructure being used by different sub-sets of market intermediaries for processing trades in particular stocks or groups of stocks. There are some signs that consolidation and rationalization is starting to take place (e.g., among exchanges and registrars).

127. Among organized exchanges, MICEX dominates. It is the only market for the majority of debt securities but also trades equities. But the biggest securities market is provided by RTS (Russian Trading System), primarily an OTC market but also now operating an organized securities exchange.

128. The markets are currently served by two CSDs. NDC settles MICEX members' trades (and is half-owned by MICEX); and DCC settles for RTS members. There is a bridge/link between NDC and DCC to enable settlement of cross-exchange trades. However, a major share of securities settlement in Russia takes place outside the two CSDs, i.e., across the books of the large number of custodians and other depository companies. Less than one third of Russian equity market capitalization is held on the books of NDC and DCC.

129. Stock registration is also highly fragmented, with around 100 stock registrars. Given the existence of so many custodians/depositories, ownership is often recorded in nominee form. A paper-based re-registration process for trades between customers of different custodians/depositories can add substantially to settlement cycles. (Trades settled across the NDC/DCC bridge do not require re-registration; and both CSDs provide their members with a service designed to short-circuit the process.)

130. NDC provides DVP for the majority of MICEX trades, though on a pre-funded basis. DCC also offers a DVP service (in rubles and U.S. dollars), but the majority of its transactions are settled on a free of payment basis. The funds transfer legs of ruble DVP transactions are settled across the books of specially licensed 'settlement chambres.'

131. The FCSM is the agency responsible for the regulation of the securities markets. Formal responsibility for regulation of the markets' clearing and settlement infrastructure has recently been clarified, with the FCSM responsible for securities clearing and transfer and the CBR responsible for the associated funds settlement.

132. Discussions are now underway on how best to create a more unified clearing and settlement infrastructure for Russia's securities markets.

Main finding—summary

Legal risk (recommendation 1)

133. There is a comprehensive regulatory and licensing regime governing securities market operations. The rules and procedures of both CSDs were not challenged during the 1998 crisis when a number of members failed. Federal law upholds the rights of beneficial owners of securities in the event of the failure of a custodian/depository whose name is on the register as holder of the securities concerned.

Pre-settlement risk (recommendations 2–5)

134. Trade confirmation for MICEX and RTS members takes place on trade date. Rolling settlement is used across all Russian markets, with ruble DVP settlement on a t+0 basis and DCC's U.S. dollar DVP service on t+3. Settlement cycles for free of payment transactions (i.e., much of DCC's settlement) are as agreed by counterparties. The re-registration process may substantially increase settlement cycles for equities. Russia currently has neither a CCP nor a securities lending facility. However, discussions are now underway on how best to reform securities market infrastructure, including clearing. Such discussions should also address securities lending, where a possible impediment is the lack of an effective legal basis for repo.

Settlement risk (recommendations 6–10)

135. Although debt securities are immobilized and equities dematerialized, settlement via book entry transfer is currently handicapped by a paper-based re-registration process. This is especially a problem for equities settlement, where less than a third of the market capitalization is held on the books of either DCC or NDC—the rest either held privately or on the books of one of the many other custodians/depositories. Both NDC and DCC provide a safe but relatively inefficient and costly DVP model, requiring pre-funding of cash accounts at the special-purpose 'settlement chambres.' Most DCC settlement is not on a DVP basis, as is presumably also the case with securities settlement arrangements outside of the two CSDs. The plans to develop a Russian RTGS payment system should make specific provision for the DVP settlement needs of the securities markets.

Operational risk (recommendation 11)

136. Both CSDs have reliable and secure systems and procedures. NDC has a separate back-up site (close by—a more remote location is planned) and DCC is in the process of developing one.

Custody risk (recommendation 12)

137. Federal law recognizes the nominee concept and provides protection to beneficial owners' assets in the event of the bankruptcy of a CSD/custodian/depository. FCSM

regulations require that CSD participants segregate proprietary and client assets, with the latter being held in omnibus accounts.

Other issues (recommendations 13–19)

- The current ownership structure of NDC (50 percent MICEX, 44.6 percent CBR) raises some questions as to the adequacy of representation of user/member interests. DCC has recently completed a governance restructuring specifically designed to improve member representation.

- DCC's access criteria appear objective and all members are subject to the same rules. (NDC's access criteria were not accessed; however, NDC has over 500 members.)

- A fragmented and relatively inefficient infrastructure is widely seen as an impediment to the development of Russian securities markets.

- Both NDC and DCC accommodate ISO 15022 message standards and use securities identification number (ISIN) codes.

- Both NDC and DCC appear to give adequate information to their members regarding the services they provide. This seems to be especially the case for DCC, which is appropriate given the emphasis on FOP delivery and the potential risks that that may present.

- The respective responsibilities of FCSM and the CBR as regards regulation and oversight of securities clearing and settlement have recently been clarified. Development of the oversight function should be a priority.

- There are as yet no cross-border links between NDC/DCC and other, foreign, CSDs.

Table 6. Recommended Actions to Improve Observance of CPSS-IOSCO Recommendations for Securities Settlement Systems

Reference principle	Recommended action
Pre-settlement risk	
4. Central counterparties	Once the CBR has embarked on a project to introduce RTGS, a debate should begin on whether the Russian capital markets would benefit from developing a CCP.
5. Securities lending	Securities lending facilities should be developed. Any legal impediments should be addressed by the appropriate authorities.
Settlement risk	
6. CSDs	The authorities should consider how to ensure that the greater share of dematerialized securities are recorded on the books of CSDs, whether in own or nominee name.

Reference principle	Recommended action
7. Delivery versus payment	The settlement needs of the securities market should be factored into the user requirements of an RTGS system, as and when the CBR launches such a project.
10. Cash settlement assets	See recommended action under reference principle 7 above.
Operational risk	
11. Operational reliability	The supervisory authorities should ensure that NDC and DCC develop appropriate remote contingency sites.
Other issues	
13. Governance	The authorities should review the appropriateness of the current ownership structure of NDC.
15. Efficiency	See recommended actions for reference principles 4, 5, 6 and 7 above
18. Regulation and oversight	The FCSM and CBR should consider how to develop the systemic oversight of securities market infrastructure, alongside the FCSM's prudential supervision and licensing activities.

Authorities' response

138. The authorities were in broad agreement with the assessment. The FCSM, however, stressed that according to the law "On the Securities Market", the FSCM was responsible for both securities clearing and transfer and the associated funds settlement, irrespective of the CBR's general role in the payments area.

XI. IOSCO Objectives and Principles of Securities Regulation

General

139. The assessment reviews the regulation of Russian Federation capital markets, which is the main responsibility of the FCSM. The objective of the assessment was to determine the levels of observance with the IOSCO Principles and to suggest areas where further development may be appropriate.

Information and methodology used for assessment

140. The assessment utilized the IMF/World Bank Guidance Note for Assessment of the IOSCO Objectives and Principles of Securities Regulation.

141. The assessment was based upon the responses to the IOSCO self-assessment questionnaires by the FCSM, in addition to a review of the Securities Law. and other relevant laws and regulations, interviews with staff of the FCSM, MICEX, RTS, NAUFOR, the NFA and market participants.

Institutional and macroprudential setting, market structure

142. **The Federal Commission for the Securities Market** is the supervisory agency responsible for implementing government policy on the securities market, regulating professional participants of the securities markets, and protecting the rights of investors and shareholders. The major laws governing the securities markets in Russia include Federal Law No. 39 FZ of April 22, 1996 *On the Securities Market*, Federal Law No. 46-FZ *On Protection of Rights and Legal Interest of Investors on the Securities Market*, the Federal Law *On Investment Funds* and the Federal Law No. 208-FZ of December 26, 1995 *On Joint-Stock Companies*. These laws are supplemented by several presidential and governmental decrees and regulations of the FCSM.

143. The responsibilities of the FCSM include oversight of issuers and professional securities market participants, licensing professional activities on the securities market, licensing investment funds, unit investment funds, management companies, special depositories and independent appraisers, registration of issues and reports on the results of securities issues, information disclosure on the securities market, development of regulatory legal framework on the securities market, determining key directions for development of the securities market, and review cases involving violations of legislation on protection of investor rights and impose sanctions on market participants.

144. The Ministry of Anti-Monopoly is responsible for regulation of related party transactions and changes of corporate control (take over bids etc.) as well as derivatives. This review was unable to assess the operations of the Ministry but evidence of market participants and the FCSM suggests that the Ministry is not active in these areas. There is no law specific to derivatives products or trading. The FCSM has proposed amendments to the *Securities Law* that would give it responsibility for derivatives regulation.

145. There are four **Self-Regulatory Organizations** (SROs) in the Russian Capital Markets licensed by the FCSM: the National Association of Securities Market Participants (NAUFOR) with a membership of organizations engaged in broker, dealer, trust management and depository activities, the National Securities Market Participants Association (NFA) with a membership of credit and non-credit institutions engaged in broker and dealer activities or trust management of securities, the Professional Association of Registrars, Transfer Agents and Depositories (PARTAD) established by professional participants of securities market engaged in registration, depository and clearing activities and the National League of Management Companies founded by investment fund management companies. The stock exchanges in Russia do not have SRO-status, although they have membership requirements and monitor the activities of their members in coordination with the FCSM in order to ensure the integrity and efficiency of the markets.

146. There are 11 stock exchanges in Russia, the most important ones being the RTS and the MICEX. There are also regional exchanges that are usually affiliated or technically connected to the major exchanges. According to data obtained by the clearing corporations 62 percent of trading is done in the OTC market, with a major part of the remaining

38 percent taking place in the "off list" market (securities not accepted for listing but with markets posted on the exchanges by market makers).

147. There are 1911 market operators (brokers, dealers and investment managers), including 670 credit institutions in Russia. Almost half of market intermediaries are located in Moscow, while the remaining have operate across the regions of Russia, mainly in St. Petersburg and the Urals. In spite of the large number of broker-dealers, the market is quite concentrated with almost half of all trading being carried out by 10 companies.

148. Russian securities law requires that all issuers should register and any transfer of security should be recorded in the issuer company's registrar. There are about 110 registrars in Russia; of which the Central Moscow Depository and the National Registry Company are the largest and best known.

General preconditions for effective securities regulation

149. IOSCO lists numerous preconditions for effective securities supervision, but perhaps the most critical ones include sound and sustainable macroeconomic policies conducive to investment and savings, enforceable property rights, a well developed infrastructure (such as legal and accounting practices, clearing and settlement systems, payment system), and an effective judicial system, as well as corporate governance and insolvency mechanisms. These appear only partially in place in Russia. The enforceability of property rights, for example, is impeded by legal uncertainties and a lengthy court process, accounting and auditing standards require improvement and the clearing and settlement infrastructure is cumbersome and inefficient.

150. The IOSCO also enumerates several attributes for effective regulation: no unnecessary barriers to entry and exit from markets and products, markets should be open to the widest range of participants who meet specified criteria, regulators should consider the impact of requirements when developing policy, and all who make financial commitments or promises must bear an equal regulatory burden. These appear to be generally met in Russia.

Findings and Recommendations

151. **Regulator**—The FCSM operates as an independent organization and has a broad range of authority over markets, market participants and issuers. Independence could be strengthened with a clearer separation from government in carrying out its day-to-day operations. Staffing and resource levels are insufficient to carry out the full mandate of the regulator and this is a particular problem with respect to attracting skilled and experienced staff. A number of legislative initiatives are underway to address various issues but there remain a number of gaps in regulation including a lack of authority over derivatives products and markets and takeover bid and related party transactions. Supervision of banks with respect to their securities activities is the responsibility of the FCSM, however there appears to be no coordination between the securities and banking authorities. The FCSM is active in consulting industry and provides a great deal of information to the public but it should improve its attention to transparency, for example, with annual public reports.

152. **Cooperation and information sharing**—The legislative framework allows for information sharing with both foreign and domestic counterparts and a number of information sharing arrangements have been entered into between the FCSM and foreign securities regulators. There appear to limitations on the ability of the FCSM to share confidential information regarding client identity and client transactions, even within the framework of a MOU. It is clear that domestic information sharing is hampered by a lack of consensus on jurisdictional issues and cooperation between the banking supervisors and the FCSM, between the Ministry of Anti-Monopoly and the FCSM. This may have implications for the supervision of the securities activities of banks (including depository, mutual fund and trading activity) and regulation of derivatives, respectively.

153. **Self-regulatory organizations (SROs)**—The Russian system makes self-regulatory organizations and exchanges to perform various regulatory functions. The supervision of both exchanges and the SROs could be strengthened in order to bring about strong enforcement of market regulation (both issuer and market intermediary activity). The current approach appears formalistic and duplicative. It is also unclear that the FCSM has sufficient authority to supervise the MICEX exchange which is controlled and operated by the central bank.

154. **Inspections, investigations and enforcement**—The FCSM generally has sufficient authority to carry out inspections, investigations, surveillance and enforcement activities although additional power to levy penalties on investment fund management companies and to revoke investment management company licenses, take prompt corrective action against failing intermediaries and investigate and sanction market abuse practices is required. In addition, a substantial increase in the amount of fine that can be imposed would improve the FCSM's effectiveness—the current level is insufficient. The practice of enforcing compliance with existing regulations is weak—there are relatively few inspections and those that take place focus on formal requirements rather than quality of information gathering. The number of investigations and enforcement actions appears to be low. Resolving the issue of insufficient funding of the FCSM would have a positive impact effect on the quality of enforcement as well. Enforcement by exchanges is also lacking—there appears to be a lack of willingness to take action against members and issuers and there are few investigations initiated at the exchanges. It is unclear that the FCSM has authority over derivatives trading and it is clear that no regulation of derivatives trading is taking place, other than real time market surveillance. The lack of trade reporting in the OTC market (the greater part of the market) impairs effective surveillance of the equity market.

155. **Issuers**—The framework for issuer disclosure is largely in place although prospectus and disclosure requirements should be expanded to include disclosure of major risks, business plan and governance policies. The lack of requirement to disclose beneficial ownership and weak accounting and auditing standards, a fragmented share registration system and limited resources at the regulator negatively impact quality of disclosure. The timing requirement for material event disclosure, currently 5 days, is too long and should be shortened. The monitoring of issuer disclosure by exchanges should be significantly

improved. Criminalization of insider trading and the development of an insider reporting system are required.

156. **Collective investment schemes**—The legislative framework for collective investment schemes is in place with amendments in the works. The legislative framework is new and there are a very small number of collective investment schemes in existence—it is therefore difficult to judge the level of implementation of legal requirements. The FCSM should be granted the authority to withdraw licenses from collective investment schemes.

157. **Market intermediaries**—Market intermediaries are subject to licensing and supervision. Rules are largely in place although improvement should be made to client account documentation, and minimum entry standards (especially the use of background checks and scrutiny of ownership structures). Supervision requires strengthening both at the SRO and FCSM level—a clear plan of division of labor between the various regulatory bodies is required. The FCSM does not have sufficient information or flexibility to act in case of market intermediary financial failing—this should be remedied both with additional powers and a more robust financial reporting system.

158. **Markets**—All exchanges are subject to licensing and oversight although the practical ability of FCSM to oversee the MICEX exchange is in doubt. The FCSM has an oversight program in place but it would appear that exchange's performance of regulatory responsibilities could be improved. The FCSM should have the ability to impose administrative sanctions on market operators and depositories. The FCSM does not have responsibility for derivatives markets and as a result there is effectively no regulation of derivatives trading. This situation will be ameliorated if the recently proposed *Securities Law* amendments receive final approval—the FCSM is encouraged to develop a full set of regulations in this area under the legislation once it is in place. Market abuse regulation requires the addition of an insider trading law, which is presently under development, and the development of a legal consensus on market manipulation as well as the enhancement of the FCSM's authority to successfully investigate and sanction both market manipulation and insider trading. Transparency in markets is weak since the greatest portion of the equity market trades over the counter where there is no trade reporting requirement. Further there is no requirement that a trade in a listed security reported to the exchange or at a price quoted on a exchange—a situation which further compromises transparency and prevention of market abuse. There is no best execution rule and no practice of protecting the customer's best interest with respect to trade conduct. Large exposure monitoring and risk management are weak as a result of a lack of coordination among entities with information regarding intermediary exposure, and by a lack of derivatives regulation. The clearing and settlement system, although consisting of a large number of institutions, appears to be adequate.

Recommended actions and authorities' response to the assessment

Recommended actions

Table 7. Recommended Plan of Actions to Improve Observance of the IOSCO Objectives and Principles of Securities Regulation

Reference Principle	Recommended Action
Principles Relating to the Regulator	Clearer demarcation of authority regarding derivatives, take over bids and related party transactions and the securities activities of banks should be established in legislation Improvement to coordination with CBR and Ministry of Anti Monopoly is required, ideally in formal agreements Greater independence from government on day to day basis Greater attention to transparency, including continuous publication of annual reports Development of confidentiality rules for the regulator and rules for handling of insider information
Principles for Self-Regulation	Oversight of SROs requires improvement, including an inspection and reporting plan
Principles for the Enforcement of Securities Regulation	Additional resources for enforcement are required Market abuse laws including criminalization of insider trading and market manipulation rules required. Clear authority over derivatives and take over bid activity should be granted to the FCSM FCSM staff require legal protection for actions in good faith FCSM should be granted the authority to compel regulated entities to take actions. Fine and penalty levels should be increased. SRO enforcement activities should be increased and closely monitored by the FCSM through inspections and monitoring
Principles for Cooperation in Regulation	Revision of the banking law would be needed to enable the FCSM to obtain all relevant information while discharging its duties, even if the information is protected by bank secrecy provisions. The ability to share information regarding client transactions should be clarified. Domestic cooperation should be enhanced, especially cooperation with the CBR.
Principles for Issuers	Transparency of ownership structures should be enhanced Material event reporting should be shortened Enforcement of requirements requires significant additional attention both from the FCSM and the exchanges The FCSM should be granted full authority to monitor and approve takeover bids and related party transactions and should be granted sufficient resources to adequately monitor this activity Accounting and auditing standards require improvement
Principles for Collective Investment Schemes	The FCSM should be granted full authority over collective investment schemes including the ability to impose administrative penalties and withdraw licenses

Reference Principle	Recommended Action
Principles for Market Intermediaries	FCSM's authority to review and approve ownership of market intermediaries should be established; background checks that include criminal and disciplinary records should be carried out Implementation of capital requirements more appropriately adjusted to risks would be helpful. The FCSM should establish an early warning system and contingency plan in place or were empowered to freeze assets, appoint an administrator.
Principles for the Secondary Market	A rigorous oversight program for exchanges should be implemented including inspection and reporting requirements Trade reporting for OTC equity and corporate bond trades should be considered in conjunction with rules regarding off exchange trades of listed securities FCSM should explore incentives for greater transparency in conjunction with the organized exchanges. Market manipulation and insider trade rules should be brought into force and actively enforced by the FCSM and the exchanges

Authorities' response

159. The authorities assert that the responsibility for regulation of derivatives is clearly outlined in legislation and that the FCSM is actively regulating trading in these products. The FCSM has pointed out that it follows from the Russian legislation that authorities to regulate the derivatives market are shared by several government agencies—the Anti-Monopoly Ministry (commodity-backed derivatives), the Central Bank of the Russian Federation (foreign exchange derivatives), and the FCSM (securities derivatives). Amendments proposed by the FCSM have already entered into force at this time. These amendments clarify the authorities of the FCSM with regard to the approval of specifications of futures and options contracts that call for the delivery of securities, or settlements depending on a change in securities prices and values of futures indexes (Article 13 of the Law "On the Securities Market"). The FCSM has regulated forward transactions in the securities market (futures and options contracts that call for the delivery of securities, or settlements depending on a change in securities prices and values of futures indexes) and the activities of professional securities market participants involving these transactions since 1998. The FCSM Regulation "On Requirements for Operations Involving the Performance of Forward Transactions in the Securities Market," approved by FCSM Resolution No. 9 of April 27, 2001 is currently in force.

160. The authorities also pointed out that the FCSM does have some authority over related party transactions and take over bids under its general authority to bring legal action against an issuer that is in violation of any law. The Russian legislation does not assign the Anti-Monopoly Ministry authority to monitor related-party transactions, including so-called "interested-party transactions," which are regulated by the Law "On Joint-Stock Companies" (Chapter XI). In accordance with the anti-monopoly legislation, the Anti-Monopoly Ministry monitors a change in corporate control to prevent the emergence of monopolies, however, the

Anti-Monopoly Ministry does not monitor compliance with takeover rules established by the Law "On Joint-Stock Companies" (Article 80). The FCSM does have certain authorities with regard to "interested-party transactions" and takeovers. For example, in the event that there is evidence of a violation of the rules for the approval of "interested-party transactions," the FCSM can file a petition on behalf of the shareholders to declare the transaction null and void in accordance with the Law "On Protection of the Rights and Lawful Interests of Investors in the Securities Market" (Article 14). Within the scope of the authorities provided for under that same law (Article 11), the FCSM has the right to issue binding orders to eliminate violations of the takeover rules. At the same time, the FCSM agrees with the assessment that its authority regarding these issues is insufficient and need to be strengthened.

161. The authorities stated that issuer disclosure requirements, including disclosure of major risks and business plan, and measures for the protection of minority shareholders have not been adequately acknowledged in the assessment. The regulation currently in force in Russia already stipulates the need for the disclosure of this information. The relevant requirements are contained in the Law "On the Securities Market" (the new version of Article 22, which went into force on December 30, 2002). This law provides that a securities prospectus must contain "basic information about the financial and economic condition of the issuer and risk factors," which includes information "about risks arising in connection with the acquisition of emission securities being placed," and information about "the issuer's plans for the future." On the basis of this article, the FCSM establishes the relevant requirements in its standards for securities issues (see, for example, item 29 of Annex 4 to the Standards for Stock Issues in the Establishment of Joint-Stock Companies, Supplemental Stocks, Bonds and Issue Prospectuses, approved by FCSM Resolution No. 47 of November 11, 1998, and item 35 of the Annex to the Regulation on Quarterly Reporting by an Issuer of Emission Securities, approved by FCSM Resolution No. 31 of August 11, 1998).

162. The FCSM also pointed out that it cooperates actively with the CBR, particularly in the supervision of professional participants in the securities market that are credit institutions. At the same time, the FCSM agrees with the need to clarify the provisions of Russian legislation regarding bank secrecy. The FCSM stated its acts are not subject to government approval. Regulatory acts of the FCSM are adopted by it within the scope of its authorities as established by the Law "On the Securities Market" and the "Issues of the Federal Commission for the Securities Market" Regulation approved by Presidential Decree No. 620 of April 3, 2000, and do not require the approval of the Russian Federation government.

XII. IAIS Insurance Core Principles

General

163. The main objectives of the assessment are to determine the levels of observance with the International Association of Insurance Supervisor (IAIS) Core Principles, and to suggest areas where further development may be appropriate. It focused mainly on the supervisory work of the Insurance Supervision Department of the Ministry of Finance (DIS). The

assessment was performed using the Core Principles Methodology report adopted by the IAIS at its meeting in October 2000.

164. DIS does not publish or otherwise make available, statistical information concerning the insurance industry and the companies it supervises. There are no readily accessible sources with information on the asset size of companies operating in the market, their financial strength and their operating performance. Through the All Russia Insurance Association (ARIA) it is possible to obtain information on premiums received and claims paid—both on an aggregate basis and on a by-line of business basis for a selection of the larger companies. However, this information does not provide indication concerning the financial condition. In the absence of such statistics, the assessment has been prepared with considerable reliance on assertions made by the supervisory authorities and the industry officials consulted without being able to confirm all findings through rigorous independent analysis.

Institutional and macroprudential setting—overview

165. There are over 1300 licensed insurance companies in the Russian Federation. However, it is estimated that over 80 percent of all premiums written are collected by the top 100 companies. There are licensed companies in virtually all parts of this very large country but it appears that the actual business written is concentrated in Moscow and the Moscow oblast, where an estimated 75 percent of the premiums were received in the year 2000.

166. Since 1999 foreign investors are permitted to acquire more than 49 percent of a Russian insurance company. Of the 1385 licensed companies, foreign investors have an interest in 50 companies and 7 of these are majority foreign-owned. Major international groups such as AIG and Allianz now have subsidiaries in Russia.

167. In 2000, the insurance market in Russia was estimated to have total premiums of US$6.1 billion. The market is small, in world terms, ranking 30th on the list of 88 countries where these results are monitored, although its aggregate premium income exceeds that of Luxembourg (US$5.3 billion and 31st), Turkey (US$2.8 billion at 37th), and Greece (US$2.3 billion and 39th). Premiums per capita are low at US$42, ranked 61st in the world and 28th out of the 32 European countries reviewed by Swiss Re for its Sigma statistics. Gross Premiums as a percentage of GDP, commonly referred to as "insurance penetration", stood at 2.42 percent at the end of 2000, ranking the country 51st in the world on this measure.

168. Russian insurance companies demonstrate a strong preference for holding assets in liquid form. If we exclude reinsurance items, then over 50 percent of total assets are held in cash or in banks. There will be an aversion to government investments as a result of the unfortunate experience during the 1998 crisis. In addition the nature of the insurance business in Russia dictates a short term position. The non-life business is all short term business. The unique feature is that the greater portion of the life insurance premiums collected (estimates as high as 90 percent) is paid under contracts that mature a short time after issue. In such an

environment, the insurance industry will not be a major contributor to capital market development.

169. Reforms to the insurance legislation have been prepared and are awaiting presentation to the parliament. An important feature is the proposal to raise minimum capital requirement to US$1 million, a significant increase over the present level.

General preconditions for effective insurance supervision

170. The accounting profession is struggling with the differences between Russian accounting principles and international accounting standards. Some of the insurance companies are audited by "Big Four" firms where others employ representatives of domestic audit firms. There is no requirement for advice to the supervisor or the appointment of an auditor and there is virtually no communication between auditors and supervisors. Audit work on insurance companies is of uncertain quality in some cases.

171. Companies are not required to appoint an actuary and there is no requirement for a report by an actuary to accompany the financial statements. There is a growing number of actuaries in Russia and extensive training programs at the universities. It should be possible to mandate actuarial reports for all companies.

172. The major problem facing the insurance supervisor is the large number of licensed companies. It is simply not possible to maintain a high-quality level of supervision in respect of 1300 companies with a staff of 100 or even 200 persons. The approach to supervision applied by DIS is to focus its attention on those companies with substantial portfolios of business.

Main findings

173. **Organization of an Insurance Supervisor.** DIS lacks the resources that it requires to carry out the tasks assigned to it. Because of budgetary constraints it is not able to hire sufficient numbers of competent staff for the very technical work it is expected to do. As a department in the Ministry of Finance it lacks the flexibility and independence that an insurance supervisory authority should have.

174. **Licensing and Changes in Control.** Present licensing rules do not provide the authority to apply "fit and proper" tests to all those persons who would be owners, directors or senior managers of insurance companies. Companies are not obliged to provide advance notice of changes in control to the supervisor and the latter has virtually no influence over such changes.

175. **Corporate Governance and Internal Controls.** The supervisor does not have the authority to require companies and their Boards of Directors to adopt and maintain good corporate governance practices. There are no established requirements with respect to internal controls and inspection procedures should be amended in order to focus attention in this crucial area.

176. **Prudential Rules.** The rules for valuation of assets and liabilities and for the measurement of solvency should be reviewed in light of developing international practices. Technical assistance should be arranged to ensure that prudential rules are adequate to provide early warning of companies that are facing financial difficulties. The supervisor should be given specific legislative authority to review all the reinsurance activities of licensed companies and the power to order changes in the treaties or the replacement of a reinsurance company if that seems warranted.

177. **Market Conduct.** The Supervisor should compile comprehensive statistical information for internal and for public consumption (taking into account confidentiality considerations). This information should include statistics on premiums, benefits, assets, liabilities and solvency of each registered insurer and aggregated for all insurers. Trends should be highlighted and explained. This would be an excellent consumer service and would lead to increased transparency.

178. **Monitoring, Inspection and Sanctions.** Consideration should be given to adopting a formal early warning process such as that followed in the United States, ensuring that inspections are focused where needed. The supervisor should adopt a risk-based approach to on-site work, focusing only on those companies and those topics that are identified as giving cause for concern.

Table 8. Recommended Action Plan to Improve Observance of IAIS Insurance Core Principles

Reference Principle	Recommended Action
Organization of an Insurance Supervisor	
i.e., CP 1	Increase resources and independence. Technical assistance to upgrade procedures.
Licensing and Changes in Control	
i.e., CPs 2–3	Apply fit and proper tests for all owners, Directors and senior managers of insurance companies. Transfers of ownership or control of an insurance company should be subject to approval.
Corporate Governance and Internal Controls	
i.e., CPs 4–5	Promote improvements in corporate governance including particularly internal control practices within insurance companies.
Prudential Rules	
i.e., CPs 6–10	Upgrade rules for valuation of assets and liabilities and for the measurement of solvency. Specific legislative authority to review all the reinsurance activities of licensed companies .

Reference Principle	Recommended Action
Market Conduct	
i.e., CP 11	The respective roles of the insurance supervisory authority and the Anti-Monopoly Authority in relation to consumer protection should be reviewed and clarified
Monitoring, Inspection, and Sanctions	
i.e., CPs 12–14	Adopt a risk-based approach to on-site work, focusing only on those companies and those topics that are identified as giving cause for concern. The legal environment surrounding insurance companies should be reviewed. In a case of bankruptcy, claims of policyholders should receive a high ranking in the distribution of the estate.
Cross-Border Operations, Supervisory Coordination and Cooperation, and Confidentiality	
i.e., CPs 15–17	Authority to enter into Memoranda of Agreement permitting the sharing of confidential information.

Authorities' response

179. The authorities stressed that, as the detailed IAIS assessment had indicated, the DIS duly enforces the functions of an insurance agency across most of the core principles. In this regard, they believed that the summaries at paragraphs 173–178 placed undue emphasis on the need for improvement. As regards the publication of statistical information concerning the insurance industry, they considered supervision to be under the jurisdiction of Goskomstat and not the mandate of DIS.

XIII. Observance of the Code of Good Practices on Transparency in Monetary and Financial Policies

A. Transparency in Monetary and Financial Policies

180. Overall, the transparency environment in the Russian Federation relating to monetary and financial policy is being enhanced to conform to the internationally accepted good practices under the IMF's *Code of Good Practices on Transparency in Monetary and Financial Policies* (*Code*). Over time, a systematic implementation of planned transparency practices will facilitate an improved understanding of the monetary policy framework and the regulatory and supervisory system governing the banking, insurance, and securities sectors. Improvements are observable in the areas of banking supervision and payments system oversight and securities regulation. However, the transparency practices relating to insurance supervision, as still weak.

Main findings

181. The main objectives of monetary policy as specified in the CBR statute are ensuring price and exchange rate stability. Other objectives set for the CBR include the development of the banking system and a smooth functioning payment system. The objectives are publicized on the central bank's website and are explained through written reports submitted to the State Duma. The CBR statute stipulates that the central bank should fulfill its objectives unencumbered by other bodies of state authority. However, the powers of the National Banking Council to determine the CBR's budget could compromise this requirement.

182. The monetary policy framework is characterized a multiplicity of policy goals and instruments, which could engender ambiguous policy signals. The CBR has taken measures recently that provide a high degree of transparency in monetary policy.

183. The CBR uses several vehicles for achieving transparency in objectives and implementation of monetary policy, including two annual publications, *The Basic Guidelines of State Integrated Monetary Policy* and *The Central Bank of the Russian Federation Annual Report* (the Annual Report). The CBR and the government also jointly draft and publish an annual *Declaration of the Economic Policy.* The main provisions of these documents are explained in public speeches and interviews to the mass media by the CBR officials. There is also a monthly *Bulletin of Banking Statistics* and the *CBR Bulletin* that is published weekly. Frequent press releases are issued as a means of communicating with the public. Extensive use is made of the CBR website in both Russian and English.

184. The **roles, responsibilities, and objectives** of the CBR are clearly defined in statutes and regulations. In October 2002 the CBR transferred itsshares in the Vneshtorgbank to the Government of the Russian Federation, in exchange for federal bonds. The institutional relationship between monetary and fiscal operations is clearly defined, as are agency roles performed by the CBR on behalf of the government. The CBR has been making additional efforts aimed at enhancing disclosure of equity interest in two domestic banks and in several commercial banks established abroad. Such participation is transparently described in the CBR law while the *Annual Report* provides additional disclosure on the relationship with domestic and foreign subsidiaries, including a summary of their main activities.

185. **With respect to the openness of the process for formulating and reporting monetary policy decisions,** the CBR law establishes the basic instruments and methods of monetary policy; specific plans for the year are presented annually in the *Basic Guidelines for State Integrated Monetary Policy.* Changes in the setting of monetary policy instruments are increasingly being announced publicly and explained through published reports, press releases, and on the website. Additional explanations are provided by officials in appearances before the State Duma and in the CBR's *Annual Report.* An advanced schedule for meetings of its Board of Directors (the monetary policy-making body) is not published. While policy changes are always announced immediately after a decision of the Board, an explanation of the main considerations underlying a change in monetary policy is not systematically

disclosed. The CBR has in the recent period begun formal consultations, on a regular basis, with the relevant market participants and the public as necessary.

186. With respect to the **public availability of information** and, as noted above, the CBR has an appropriate range of publications. Senior officials of the CBR also make public appearances before the State Duma, give speeches to financial groups, and give media interviews as a means of explaining CBR policy decisions and actions. The CBR regularly discloses its summary balance sheet and aggregate information on market transactions and the types of transactions on a monthly schedule in the *Bulletin of Banking Statistics* and posts this information on its web site. Apart from information on international reserves, the presentation and release of data are consistent with Special Data Dissemination Standards (SDDS). Texts of regulations issued by the CBR are readily available to the public and published in the CBR's weekly *Newsletter* and also posted on the CBR website.

187. Transparency practices are observed in the area of **accountability and assurances of integrity**. The CBR is accountable to the State Duma which appoints and can discharge the chairman and members of the Board for specified reasons. The CBR is required to submit its *Annual Report*, including audited financial statements, to the Duma. Twice a year, the Chairman of the CBR speaks before the State Duma about the operations of the CBR; the State Duma holds parliamentary hearings on the operations of the CBR with the participation of the CBR representatives. The CBR does not disclose a fuller explanation of the internal governance procedures, including the performance of the internal audit systems, and the current standards for the conduct of financial affairs and rules to prevent conflict of interest. Standards for the conduct of the personal financial affairs of officials and staff are established in the CBR law but there are no legal provisions to protect CBR staff in the conduct of their duties.

Table 9. Recommended Plan of Actions to Improve Observance of IMF's MFP Transparency Code Practices—Monetary Policy

Reference Practice	Recommended Action
I. Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy	
Practice 1.2	Clarify the institutional relationship between debt management operations, the CBR and the Ministry of Finance.
Practice 1.2.2	Disclosure of the terms on which interest is paid on government foreign currency and ruble deposits.
Practice 1.2.3	Provide a more complete description of the procedures for participation of the central bank in secondary markets.
Practice 1.2.4	Disclose the CBR's equity participation in certain domestic and overseas commercial financial institutions and publish their financial activities on well-recognized principles and procedures. Report the consolidated operations of the CBR and all its subsidiaries and disclose transactions relating to precious metals and gems.

Reference Practice	Recommended Action
Practice 1.3.2	Further clarification of the principles on which the division of responsibility for secondary market arrangements between the CBR and MoF are based
II. Open Process for Formulating and Reporting Monetary Policy Decisions	
Practice 2.1	Improve the timeliness and regularity of explanation of changes in monetary policy and the underlying considerations that led to them. Consider announcing an advanced schedule for monthly meetings of the Board of Directors.
Practice 2.3	Make more systematic and time bound the disclosure of the "main considerations" underlying a policy change.
Practice 2.4.1	A higher frequency of the presentation (e.g., Quarterly) of monetary policy operations and its underlying assumptions would be desirable.
III. Public Availability of Information on Monetary Policy	

Authorities' response

188. The authorities felt that the cases in which they did not fully disclose information to the market were covered by the Code's recognition of circumstances in which such disclosures could have adverse effects on the policy environment (e.g., foreign exchange reserves and intervention). This also applies to interest rates at which the CBR accepts deposits from the Ministry of Finance. They noted that these interest rates are specified in bilateral agreements, which are confidential and therefore not subject to disclosure. The authorities' response to recommendations 1.2.3 and 1.3.2 was that the rules and procedures governing the relationship between the CBR and its counterparts in the course of monetary operations are governed by the CBR regulatory documents published in the *Bulletin*. Regarding recommendation 1.2.4, the CBR argued that the language concerning the disclosure of transactions in precious metals and stones should be removed from the text since the CBR has not conducted any sizable operations of this nature in recent years. The CBR's response to the recommendation that the objectives, rationale, quantitative targets and key underlying assumptions be presented on a higher frequency was that the CBR publishes such information regularly and that timing and periodicity are not precisely defined in the code. Moreover, they disagreed with the Fund staff assessment that a higher frequency of release of information to the market would enhance transparency.

B. Banking Supervision

Main findings

189. The assessment found the CBR to be in broad conformity with the transparency code requirements in the implementation of banking supervision policies. The summary below provides details of the findings of the assessment. The CBR is the sole agency responsible for banking regulation and supervision.

190. The CBR's main responsibilities comprise: conduct of monetary policy; lender of last resort for lending institutions; formulation and implementation of policies for the conduct of the operations of credit institutions; registration of credit organizations and licensing of banking activities; supervision of the activities of credit institutions; regulation of credit institutions' participation in securities markets; and coordination of the payment system.

191. With respect to **clarity of roles, responsibilities, and objectives**, the broad objectives and institutional framework for the regulation and supervision of the banking system are clearly defined in the law, and are also disclosed and publicly explained through various publications. However, additional steps should be taken to clarify, publicly disclose, and explain the functional relationships among the banking, securities, and insurance regulators, including through public disclosure arrangements between the agencies.

192. **As regards the openness of formulating and reporting of financial policies,** the CBR law clearly specifies the framework under which banking supervision and regulation shall be conducted, and mandates that all normative acts be published. The CBR periodically issues its analysis of the state of the banking system in its *Annual Report* and in its other publications. Key changes in the regulatory framework are published and disclosed through official publications and also on the CBR's website. The CBR law was recently amended to allow for information sharing between the CBR and foreign supervisory agencies instead of relying on bilateral agreements as in the past. Domestic financial agencies still rely on bilateral agreements many of which are unspecified and not publicly explained.

193. There is a need to introduce changes in the legislation for information sharing among domestic supervisors and to allow for the exchange of customer specific information to enhance the home/host relationship of the CBR with foreign supervisory agencies.

194. The description covering **public availability of information** for monetary policy (as detailed under 1.1.1) applies equally for banking supervision. The CBR has a high level of **accountability** in the discharge of its responsibilities. Article 57 specifically provides for the publication of consolidated statistical information on the banking system of the Russian Federation. However, to enhance **assurances of integrity,** there is a need for periodic explanations to the public of guidelines in place, including procedures for ensuring internal good governance in credit organizations.

195. CBR personnel charged with supervision responsibilities of credit organizations, especially examination work, are not explicitly legally protected in the execution of duties. Consideration should be given to changing the law to protect the CBR's staff in their supervisory responsibilities for possible lawsuits against actions taken in good faith.

196. Financial reporting covered in the *Bulletin of Banking Statistics* is compiled on the basis of the RAS, which are quite different in disclosure and transparency requirements from the IAS. The planned implementation of the IAS by 2007 is expected to improve the quality of data released by banks.

197. Improvements are required in the areas of coordination of activities of agencies responsible for the supervision of the banking sector and securities and insurance markets. The CBR law was recently amended to provide for the exchange of non-data-specific information on the operations of the credit institutions and of their customers.

Table 10. Recommended Action Plan for Improving Observance of the MFP Transparency Code of the International Monetary Fund—Banking Supervision

Reference Practice	Recommended Action
V. Clarity of Roles, Responsibilities, and Objectives of Financial Agencies Responsible for Financial Policies	The CBR should inform the public about the signing of formal procedures for information sharing with other domestic financial supervisory agencies.
VI. Open Process for Formulating and Reporting of Financial Policies	The CBR should inform the public about signing of formal procedures for information sharing and consultation between financial agencies and about the content of the agreements.
VIII. Accountability and Assurances of Integrity by Financial Agencies	Changes should be made in the legislation to prevent possible lawsuits against staff for their good-faith actions in the performance of their official duties. Changes to regulations in support of accounting reform and compilation of financial reports in accordance with international standards—including preparations for switching lending institutions to IAS in 2007—should be continued.

Authorities' response

198. The authorities were in general agreement with the assessment. Subsequent to the mission, the assessors were furnished with information confirming the disclosure of agreements on cooperation with other supervisory authorities. The authorities indicated that they would continue to progressively work toward addressing the areas identified as requiring action in the table above.

C. Transparency of Payment System Oversight

Main findings

199. The CBR has sole regulatory responsibility for payment systems and for non-cash settlements generally. The Department of Payment Systems and Settlements is responsible for payment system oversight. As regards the CBR payment system, which has a very decentralized structure, the principal oversight tool is the framework of CBR regulations that has been developed to govern the system's (and its regional components') operating procedures. As regards private payment systems and networks, there are also CBR regulations that lay down certain operating principles. But in addition, and because only licensed credit organizations can provide funds transfer services, private systems/networks fall within the ambit of the banking supervisors.

200. Besides publishing all the relevant regulations as required by law, the CBR has also established a procedure for formally consulting the banking sector on technical and policy matters relating to payment systems. It is also involved in more widespread public disclosure of payment systems information, via articles in the press and on its website and through speeches, seminars etc. Since the fourth quarter of 2002, the CBR bulletin has included a section containing detailed statistics on the CBR payment system and private payment systems. However, the delineation of institutional responsibilities relating to overlapping issues among the various financial agencies, including payment systems overseers is neither clear nor publicly explained.

Table 11. Recommended Actions to Improve Observance of IMF's Monetary and Financial Policies Transparency Code Practices—Payment System Oversight

Reference Practice	Recommended Action
V. Clarity of roles, responsibilities, and objectives (5.2)	Clarify and publicly explain the delineation of institutional responsibilities relating to overlapping issues among the various financial agencies, including payment systems overseers.
VI. Open process for formulating and reporting of financial policies (6.1.5)	Establish formal procedures for information-sharing and consultation between financial agencies, domestic and international and explain them publicly.
VII. Public availability of information (7.2)	Publish detailed payment systems statistics.

Authorities' response

201. The authorities expressed general agreement with the assessment and recommendations. They added that CBR policy on payment system oversight is aimed at achieving maximum transparency and that in this context, they plan to release in 2003, jointly with the BIS, a detailed description of all aspects of the CBR payment system and private payment systems.

D. Securities Regulation and Supervision

Main findings

202. The FCSM is the supervisory agency responsible for implementing the government policy on the securities market, regulating professional participants of the securities markets, and protecting the rights of investors and shareholders. The FCSM has clear responsibility in the law for the regulation and supervision of market intermediaries, markets and issuers. However, the practice of the supervision of securities activities of banks and the responsibility for regulating trading in derivative products are not clear. Maximum advantage is not being taken of the scope to enhance transparency through consistent publication of annual reports.

203. The FCSM is accountable to the government through a number of reporting mechanisms, including the Chairman's inclusion in Cabinet and a rule approval mechanism. Rules are published on the website as is the licensing status of regulated entities and general information regarding regulatory standards.

204. The **role, responsibilities, and objectives** and most aspects of the institutional framework of the FCSM are clearly defined and described in the law, presidential decree, and regulations and orders issued by the FCSM. A need exists, however, to provide greater clarity regarding the formal mechanisms of the FCSM's accountability, and some steps have been recently been taken to enhance its public accountability. Since the FCSM has some overlapping responsibilities with the CBR, there is also a need for a clear, publicly announced demarcation of roles and responsibilities between the two institutions.

205. In order to establish a clearer and well-defined relationship with the ministries and departments, the FCSM has concluded a number of agreements with relevant agencies. These agreements constitute an important step toward enhancing transparency and accountability.

206. The conduct of financial policy emphasizes confidentiality considerations. There is an established process for public consultation for proposed substantive technical changes in the structure of financial regulations. Several formal council and consultative committees with various industry groups have been established and information relating to meetings of these councils and consultative groups is posted on the website. The constitution and the scope of activities of the Expert Council of the FCSM have been modified to further enhance the role of market participants in the policy-making functions of the FCSM.

207. Formal procedures for information sharing and consultative arrangements with international securities regulators have been entered into and are disclosed publicly. The goal of these agreements is to protect the rights of investors, maintain the integrity of the securities market via the exchange of information, and provide technical assistance in the course of carrying out regulatory functions. The Government of Russia has approved the Code of Corporate Governance developed by the FCSM.

208. Information is generally available to the public. The law requires that FCSM resolutions and regulations be published. In addition, the FCSM publishes in its monthly *Bulletin* information on the termination of licenses, administrative penalties, and court decisions against professional securities market makers and their self-regulatory organizations. A periodic report on how overall policy objectives are being pursued and a review of developments and operations in the securities market is provided in the *Annual Report* (although this is published infrequently).

209. Effective use is made of the FCSM website (http://www.fedcom.ru), which is available in both Russian and English. Officials make frequent public appearances to discuss securities market developments and FCSM initiatives. An important challenge confronting the FCSM relates to improving the quality and reliability of financial and nonfinancial information of listed enterprises. Higher standards of disclosure need to be introduced with adequate powers and regulatory and supervisory capacity to prevent material omissions or misstatements.

210. To ensure **accountability and assurances of integrity**, the FCSM reports to the government. The chairman, when requested, appears before the State Duma to report on the

FCSM's areas of responsibility. The *Annual Report* provides information on revenues and expenditures, although no balance sheet information is provided. The Accounting Chamber of the Russian Federation audits the financial activities of the FCSM. Standards of conduct for the financial affairs of officials and staff are governed by the Law on State Employees. Apart from audit arrangements, internal governance procedures are not disclosed. Officials and staff do not receive special legal protection in the discharge of their duties, except insofar as they receive the usual protections accorded to government employees.

Table 12. Recommended Actions to Improve Observance of the IMF's *MFP Transparency Code Practices*—Securities Regulation and Supervision

Reference Practice	Recommended Action
I. Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy	
Practice 5.1.1, 5.1.2, 5.1.3, 6.1, 6.3, 7.1	Require and regularly publish comprehensive annual reports, including detailed description of FCSM's policies and priorities of its regulatory activity.
Practice 6.1.5	The respective roles and responsibilities as well as the means and methods of the cooperation between the FCSM and the CBR should be publicly disclosed and comprehensibly explained.
Practice 6.4	Broaden the scope of the public consultation process beyond the statutorily prescribed manner and to disclose the drafts of proposed technical changes to the public.
III. Public availability of information	
Practice 7.1,7.2, and 74.1	In order to strengthen public awareness and understanding of the functioning of the capital market and its regulatory agency it is essential for the FCSM to publish periodic reports in the form of annual reports.
Practice 8.1	Base the appearances of FCSM officials before policy makers on an adequately regular schedule described by the law or regulation.
Practice 8.2.2	The FCSM, should disclose those internal governance procedures that apply to its operations.
Practice 8.4	Formulate and implement specific rules that adequately address the conflict of interest situations that the FCSM's head and staff may face.

Authorities' response

211. The authorities had no comments to this section of the report.

E. Insurance Regulation and Supervision

Main findings

212. The regulation and supervision of the insurance industry is the responsibility of DIS/MoF. The work with respect to transparency in the insurance industry somewhat lags behind the progress attained in other financial sectors. Practices need to be strengthened in

the areas of **open process for formulating and reporting of insurance policy framework, public availability of information, and accountability and assurances of integrity of insurance supervision**.

213. The **roles, responsibilities, and objectives** of the DIS/MoF are defined in the statutes and in regulations. The roles, responsibilities, and objectives are publicly disclosed and explained through written reports to the legislature and through public appearances by senior officials of the MoF. A major shortcoming of the framework is that the Insurance Law does not recognize the possible jurisdictional overlaps among the insurance, securities, and banking regulators and supervisors. Greater clarity and a simplified public explanation would greatly facilitate in defining the existing institutional framework. There is also a need for periodic and more formal consultations among the agencies responsible for the oversight of the financial sector with periodic public disclosure of their activities.

214. With respect to transparency in the area of **formulating and reporting of insurance supervisory policies**, the authority to conduct insurance supervisory policies, including enforcement powers and the right to carry out audits of insurance providers, is publicly explained in the laws and regulations. Normative legal acts regulating insurance activities (and elucidations thereof), lists of licensed participants in the insurance market, and letters of review and other information for insurance services market entities are published in the mass media. A State Register of Insurers (Reinsurers) is published annually. In case of violations, there is a reported mechanism for mutual exchange of information between oversight bodies for taking appropriate action. Procedures for compiling and submitting various types of financial reports to the MoF are published in professional publications. There is a need to strengthen public consultations on policy changes and not rely on ad hoc mechanisms.

215. The MoF publishes monthly data on the issuance and withdrawal of insurer licenses. The State Register of Insurers is a public document. In addition, a survey is also published in cooperation with the State Statistics Committee, providing consolidated data on the activities of the insurers. The MoF's website is used for providing public information on the policies and operations of the insurance market. On occasion, officials of the MoF speak to the press and make public statements relating to insurance regulatory policies.

216. The Insurance Law does not explicitly provide any formal mechanisms for **accountability and assurances of integrity relating to insurance supervision**. For its insurance sector activities, the MoF operates like any other government department. A mechanism is, being worked out to account for insurance-related expenses and revenues and to show them separately.

Table 13. Recommended Action Plan to Improve Observance of IMF's MFP Transparency Code Practices—Insurance Supervision

Reference Practice	Recommended Action
V. Clarity of Roles, Responsibilities, and Objectives of Financial Agencies Responsible for Financial Policies	
Practice 5.1.4.	Greater independence would be achieved if the appointment of the head, its duration and terms were disclosed.
VII. Public Availability of Information on Financial Policies	
Practice 7.2	Provide information on the asset holdings of insurance companies; on their profitability and their financial strength.
Practice 7.4	The insurance supervisor should perhaps establish a website and a visitor's area where it can distribute its publications and any important documents.
VIII. Accountability and Assurance of Integrity by Financial Agencies	
Practice 8.4.1	The legal protection of staff members should be clarified in legislation.

Authorities' response

217. The authorities had no comments to this section of the report.

XIV. Summary Assessment of Observance of the OECD Principles of Corporate Governance

218. The assessment of corporate governance in Russia was conducted between January and May 2002. The assessment was based on a review of several pieces of legislation and extensive discussions with Government officials, financial supervisors and segments of the private sector. In particular, the assessment reflects extensive technical discussions with the FCSM, the Center for Capital Market Development, the Ministry of the Economic Development and Trade, the RTS and MICEX, PARTAD, trade unions, investment and commercial banks, law firms, major Russian corporations management and supervisory board members, and numerous market participants. The review also is also based on discussions from a questionnaire prepared for the purposes of reviewing observance of the OECD corporate governance principles. Excellent co-operation was received from all agencies.

Background

219. For the purposes of the OECD Principles, corporate governance is "that structure of relationships and corresponding responsibilities among a core group consisting of shareholders, board members and managers designed to best foster the competitive

performance required to achieve the corporation's primary objective." (*A Report to the OECD by the Business Sector Advisory Group on Corporate Governance,* April 1998)

220. Note that the corporate governance assessment attempts to review three key components to corporate governance: (1) laws and ordinances that constitute the legal framework, (2) regulatory institutions responsible for enforcing the legal framework, and (3) common business practices that in some countries are as important as the legal and regulatory institutions.

Summary of main findings

221. Market capitalization in Russia is highly concentrated. The top ten "blue chips" represent 85 percent to total market capitalization, with Gazprom (which is 40 percent state-owned) accounting for 16 percent alone. In 2001, 26 percent of all trading was conducted on MICEX and 12 percent on RTS. However, it is estimated that almost two-thirds of trades were conducted outside the organized stock exchanges in the over-the-counter market. Although MICEX and RTS dominate trading on the Russian capital markets, there are an additional nine stock exchanges throughout Russia, including the Moscow, St. Petersburg, Urals and Ekaterinburg Stock Exchanges.

222. On MICEX, the four companies of RAO UES, LUKoil, Mosenergo and Sberbank represent 90 percent of all share trading, with RAO UES representing a full half of all share trading. However, even for RTS, 85 percent of all share trading relates to just seven companies: RAO UES, Mosenergo, LUKoil, Surgutneftegaz, Yukos, and MMC Norilsk Nickel. RTS has the capability to settle contracts in both rubles and U.S. dollars, while MICEX has settle only in rubles. Russian companies also access the international markets. More than 50 companies had ADR issues on the New York Stock Exchange, although only three companies met the high-disclosure requirements of Level III for ADRs. Eight companies also have GDRs issued on the European bourses. Although the shares of over 250 companies are traded on RTS, only 7 meet the 25 percent free float requirement for Tier I qualification. For most companies, the percentage of shares not held by controlling shareholders or company managers is well under 15 percent and often under 5 percent.

223. In the years following the financial crisis of August 1998, the legislation framework for corporate governance has improved dramatically. The most recent amendments in 2001–02 to the *Joint Stock Company Law* and the *Securities Law* were particularly helpful in addressing the issues of: (1) maintaining the preemptive rights of existing shareholders in new shares issues and (2) requiring approval of the shareholders' meeting for the sale or transfer of assets representing a large portion of a company's balance sheet or where such assets were sold or transferred to parties related to the company's management. In addition the FCSM has drafted legislation that would mandate disclosure of indirect ownership and control positions and related party transactions and would establish insider trading as a criminal offense. Since the changes went into effect only in January 2002, it may take some time before their effect can be measured. However, the common corporate governance issues

in transition economies—asset-stripping, transfer pricing and share dilution—often require more than changes to the legislation.

224. In April 2002, the FCSM released the Code of Corporate Conduct, a corporate governance code that had been more than a year in preparation and for which funding for international and domestic legal advice was provided by the Japanese Government (through the European Bank for Reconstruction and Development). Unlike most codes and legislation drafted in Russia, the Code of Corporate Conduct was reviewed and discussed extensively with all major sections of the Russian and foreign capital markets participants. While the Code is intended as a voluntary code, its main purpose is to influence common business-place practices and set a industry bench-mark against which actions by the corporate sector could be measured. While the Code has some weaknesses, it nevertheless represents the result of an extensive consultative process on corporate governance in Russia. It is interesting to note that even before the Code had been formally adopted, market participants saw improvements in common practices and the reduction of former abuses.

225. At the same time, efforts in the private sector have also been helpful. The US-based rating company, Standard & Poor's, has established a corporate governance scoring service, which has allowed them to give public comment on weak corporate governance practices, such as failing to disclose material changes in beneficial owners of the Russian airline company, Aeroflot. In addition the Institute of Corporate Law and Governance has published a set of ratings that rank about 30 Russian companies on corporate governance. According to market participants, the primary competition among major Russian companies is not to stand at the top of the list as the best corporate governance firm in Russia, but to ensure that they are not ranked last. The result has been seen, for example, in the increase in the number of non-executive members of the (supervisory) board of directors. To some degree, such improvements may be temporary since they result from voluntary actions by Russian companies but such improvements are nevertheless to be welcomed.

226. However, weaknesses in the regulatory framework have increased in the last year as the FCSM (and many Russian supervisory authorities) has limited authority to impose fines for infractions of the securities and joint stock company legislation. As of July 2002, the maximum penalty for any violation (including insider trading and market manipulation) was limited to Rub 150,000 or about $5,000. In addition the FCSM lacks specific authority to regulate the stock exchanges. Other issues are also covered in the assessment against IOSCO principles, notably the need to establish the FCSM as a fully independent regulatory body with a stable source of funding. At the same time, the decisions of the FCSM, notably those made in the regional offices of the FCSM, lack sufficient transparency to build the necessary investor confidence in the Russian securities markets.

227. Other corporate governance issues remain with regard to the lack of a centralized securities depository, unreliable financial reporting, and a weak and inefficient court system that hinders the effective implementation of a sound system of corporate governance. The issues are fully discussed in other reports submitted as part of the Financial Sector Assessment Program for Russia.

Key recommendations

1. Increase transparency of ultimate ownership and control structures.

    - Duma should approve amendments to draft legislation to require disclosure of direct and indirect ownership at international standards (draft amendments to Law on Securities).

2. Strengthen market for corporate control.

    - Duma should approve draft legislation requiring disclosure of related party transactions (draft Law on affiliated persons).

    - Duma should approve draft legislation to halt insider trading (draft Law on Insider Trading, draft amendments to the Administrative Code and Criminal Code).

3. Increase accessibility to corporate internal legal documents.

    - Government should designate (and provide sufficient funding for) a competent agency to establish centralized enterprise register ("companies' house).

    - Make copies of resolutions of shareholders' meetings publicly available for publicly traded joint stock companies.

    - Make information available on the internet.

4. Strengthen financial reporting.

    - Require that publicly traded joint stock companies prepare financial statements in accordance with IAS.

5. Establish a centralized securities depository.

    - Government should provide sufficient funding to establish centralized depository. FCSM to implement.

6. Strengthen the effectiveness of the FCSM.

    - Government should identify measures to ensure the self-financing of the FCSM.

    - FCSM to propose increases in maximum fines (and modifications to procedures) sufficient to encourage compliance with legal requirements.

- FCSM to issue regulations on the conduct of shareholders' meetings.
- Increase the authority of FCSM to supervise stock exchanges.
- Build investor confidence in transparency of FCSM decisions.

7. Improve the quality of court decisions.

   - FCSM should publish decisions on court cases where FCSM (including the FCSM Regional Offices) have been a litigant.

Authorities' response

228. The FCSM of the Russian Federation informally commented on the draft corporate governance ROSC, and the Commission's comments and suggestions were incorporated into the revised draft. The government authorities provided no additional comment on the final version of the report.