

# RUSSIAN BANKING SECTOR

*Fasten Your Seatbelts – We're Preparing for Takeoff*

*June 2004*



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## Executive Summary

### 1.0 Macroeconomic view

*Russia is destined to become increasingly influential in the world economy and every significant international financial institution must pay close attention to the country's development*

Brasil, Russia, India and China constitute the "BRIC" countries, which markets are believed to be of sufficient size and growth prospects to drive the world economy forward over the next 25 years.

On most measures, Russia is the most advanced of these countries and has a strong tradition of scientific innovation and world class educational institutions. Arguably, its cultural similarity to the West would also favour its adaptation to a Western economic model.

Moreover, Russia's vast mineral resources and territory provide a solid backdrop for its international political influence.

*The Russian banking sector is underdeveloped in relation to Russia's GDP*

Russia is a fundamentally "underbanked" country. This stems from many causes, not the least of which was the chaotic process of privatisation in the post-Soviet era.

Even amongst transitional economies in eastern Europe, Russia lags behind. Russian banking assets amount to approximately 40% of GDP as against 80% to 90% in eastern Europe. In the West the comparative statistic is over 200%.

While the Russian banking sector had developed quickly since the break-up of the Soviet Union, the August 1998 financial crisis, during which the government defaulted on its foreign debt and domestic treasury bills ("GKOs") caused the near collapse of the banking sector.

The 1998 financial crisis caused the failure of several banks, including some cases where the banks' management diverted performing assets to external entities, with individual depositors left holding the bag.

Understandably, Russian citizens still have a persistent scepticism towards banks, which has stymied the level of consumer deposits and general interaction with the banking system. This will surely change as the banking sector undergoes sound structural reforms, including the introduction of deposit insurance to protect individual depositors. This evolving attitude toward adoption of Western-style banking practices provides further impetus to the rapid growth of the banking sector, beyond accelerated economic growth which is anticipated for the Russian economy over the next several years.

*However, banks are not functioning effectively as financial intermediaries*

Overall deposits have been growing strongly, yet there has been no commensurate growth in lending. A meagre 4 percent of fixed investments were financed by bank credits in the first half of 2002, according to Goskomstat. Moreover, such credits have been directed to large, resource-intensive conglomerates which have not introduced dynamism or innovation to the domestic economy. In 2001, approximately 70% of all investment went into the oil & gas sector, or consisted of government expenditures.

Banks have been using their growing deposit bases to generate

income from trading, treasury operations and other non-lending areas.

Part of the problem has been that many banks are part of connected conglomerates which direct lending primarily to group companies. Such banks have not been interested in lending to the general corporate or retail customer, and indeed do not trade much with other banks.

Other than the lack of trust, poor transparency and a lack of credit information have also been hampering banks from playing a vibrant financial intermediary role. There is also a lack of clarity over enforcement of claims and realisation of collateral.

To the extent that banks have been lending to non related parties, it has been primarily to large corporate borrowers. As all banks have been concentrating on this same economic base, the margins have shrunk and are destined to continue doing so given the country's expected upgrade by S&P, opening access to international capital markets.

Unfortunately, corporate lenders have little alternative. The mass privatisation process of the post-Soviet era led to significant concentrations of asset ownership and wealth amongst the so-called "oligarchs". As a legacy of this process, small and medium-sized enterprises (SMEs) are particularly underdeveloped in Russia. Some Goskomstat data indicate that their share of GDP may be as low as 10-15%, compared to the typical 50% range in advanced transition economies. Moreover, the SME sector has been sluggish and is not growing, at least as far as the official statistics are concerned.

*While the overall sector is adequately capitalised, many Russian banks have insufficient long-term capital bases*

Another peculiarity of the Russian market is the short-term nature of corporate lending. Only about 25% of corporate loans are for maturities longer than 1 year, which has been partly necessitated by their matching of their liability structure.

A Russian civil code rule mandates that depositors can withdraw their deposits at any time, even those which are for a fixed term. This effectively forces banks to hold a higher level of cash on hand, as even long-term deposit accounts are in effect current accounts as far as bankers are concerned. The banking sector is lobbying the government to change this rule.

In addition to the negative impact on financing of investment, this has increased the riskiness of short-term liquidity crises.

*Retail banking has great potential for growth*

Retail banking has been hampered because of the relatively recent experience with Western-style banking, bank failures which occurred during the August 1998 financial crisis, and the continuance of unstable, politically-connected banks.

Most Russians do not have bank accounts. Recent estimates place bank account holders at only 25%-30% of the adult population versus 90%-plus in western Europe and the US. Russia is still largely a cash-based economy.

Even those who have bank accounts often store large amounts of cash in their homes. A recent survey commissioned by American

Express indicates that 92% of educated 25- to 35-year olds keep money in their homes. Estimates of the total amount of cash kept outside of the banking system range from \$20 to \$100 billion. The most frequently cited reason for this practice was fears about Russia's financial stability, cited by 30% of respondents. Another 27% of respondents claimed the cash they had at home was not sufficient to deposit into a bank account, while 26% claimed it was simply more convenient.

Banking reforms, particularly the recently passed deposit insurance laws, as well as the growing awareness and education that comes with wealth accumulation, should bring these statistics more in line with Western trends.

*Foreign direct investment is increasing, but remains at relatively low levels*

Foreign direct investment has not recovered from pre-1998 levels. Most of the foreign investment flow consists of commercial and trade credits and bond investments, suggesting a return of Russian capital from abroad.

The recent track record of foreign investments in the energy sector has been poor. Investors cite problems with the legal environment and the difficulty of establishing ownership rights to assets. British Petroleum's \$6.7 billion investments in Tyumen Oil and Sidanko have been the only large investments which have closed.

Consequently, there are few opportunities for banks to finance foreign direct investment such as greenfield projects. Nevertheless, substantial amounts of infrastructure investments are needed to modernise the Russian economy. For now, any significant foreign investments would likely be arranged through the auspices of export credit agencies. Thus, project financing opportunities would exist in arranging structured trade finance and trade finance.

*Lending to domestic corporations is very competitive*

Domestic corporate interest rate spreads are tightening, stemming from increased competition and the banking sector's emergence from the crisis years. Loans to enterprises earned one to two percentage points less at the end of last year from over 8% a year before and 25% in 1999. For the largest enterprises, they are expected to weaken further with competition from domestic and international debt capital markets. Sberbank, the dominant bank in Russia, has the market power to dictate corporate interest rates. With Sberbank's low cost of funds, they are a formidable competitor in any lending area which they choose to pursue.

*However, there are also substantial deposits offshore*

It is no secret that hundreds of billions of foreign currency deposits are parked offshore, mainly in Cyprus, in bank accounts controlled by the oligarchs.

## 2.0 Russian capital markets

*Several Russian companies have raised money on international markets, listing equities in New York and London, and raising Eurobond issues.*

There has been significant investor interest in Russian equities. The following is a selection of companies which have completed ADR or GDR issues on foreign stock exchanges (mainly London, New York, and Frankfurt):

Company	Industry
LUKoil	Oil & gas
Gazprom	Oil & gas
Tatneft	Oil & gas
Tatneft	Oil & gas
Rostelecom	Telecom
Vimpelcom	Telecom
MTS	Telecom
Wimm-Bill-Dann	Food
UTD Heavy Machinery	Engineering
Surgutneftegaz	Oil & gas
Sibneft	Oil & gas
UES	Electricity
Mosenergo	Electricity
Golden Telecom	Telecom
Norilsk Nickel	Metals
Severstal	Metals
OMZ	Manufacturing
Sun Interbrew	Food & beverage

Source: Bank of New York, London Stock Exchange

The following is a selection of companies which have completed Eurobond issues:

Company	Final Maturity	Coupon	Current YTM
AlfaFin (\$)	19-Nov-05	10.75%	8.80%
MDM (\$)	16-Dec-05	10.75%	9.20%
UralSib (\$)	6-Jul-06	8.875%	10.18%
Sberbank (\$)	24-Oct-06	FRN	n.a.
Gazinvest (\$)	30-Oct-08	7.25%	8.10%
VTB (\$)	11-Dec-08	6.875%	6.93%
MTS (\$)	21-Dec-04	10.95%	3.59%
Vimpelcom (\$)	26-Apr-05	10.45%	4.01%
Rosneft (\$)	20-Nov-06	12.75%	6.07%
Sibneft (\$)	13-Feb-07	11.50%	9.32%
Gazprom (\$)	25-Apr-07	9.725%	6.53%
TNK (\$)	6-Nov-07	11.00%	7.67%
MTS (\$)	30-Jan-08	9.75%	8.71%
Sistema (\$)	14-Apr-08	10.25%	9.82%
Wimm-Bill-Dann (\$)	21-May-08	8.50%	10.36%
MMK (\$)	21-Oct-08	8.00%	9.05%
Sibneft (\$)	15-Jan-09	10.75%	10.29%
Gazprom (\$)	21-Oct-09	10.50%	7.15%
Gazprom (\$)	1-Mar-13	9.625%	8.80%
Gazinvest (€)	4-Oct-05	9.75%	4.19%
MMK (€)	18-Feb-05	10.00%	4.92%
Gazprom	27-Sep-10	7.80%	7.37%

(Source: Brunswick UBS, yields as at June 22, 2004)

These listings highlight the country's economic dependence on primary, "old economy" industries. Indeed, the World Bank has identified the lack of economic diversification as the most important barrier to economic growth over the medium term.

Moreover, there is a large degree of corporate concentration. Russia has lacked an entrepreneurial tradition and small and medium enterprises

(SMEs) are uncommon.

While this represents a barrier to overall economic growth, it also means that the same large companies attract the most attention from lenders and capital markets. Adding to this is the lack of reliable information on second-tier companies. It also affects the strategies available to corporate bankers because of the lack of diversification available in terms of industry portfolio concentration.

*However, Russia's split country ratings have hampered more active debt capital market issuance*

Moody's rates Russia's long-term sovereign debt at Baa3, the lowest investment-grade rating, while S&P rates Russia at BB+, the highest sub-investment grade level. Moody's upgraded Russia to investment grade in October, 2003 but S&P has not yet followed suit. S&P has stated its concerns over Russia's over-dependence on oil exports and is also concerned about the "rule of law" implications of the Yukos case.

Most market observers expect S&P to upgrade Russia shortly, after some additional experience of macroeconomic stability, of a legally sound resolution to the Yukos situation, and continued progress on negotiating such matters as its WTO accession.

An upgrade by S&P would enable more international investors to purchase Russian securities, although it is not expected to lead to significant changes in credit spreads for Russian issuers. Effectively, the market has priced in an S&P upgrade.

*The domestic capital markets are similarly underdeveloped as there are few established institutional investors*

In terms of capital markets, equities are relatively more important to the overall market capitalisation. However, this situation is a result of the mass privatisations of the 1990s and has not led to a large domestic investor base. The index is concentrated in the natural resources sector, with the five largest companies by market capitalisation all operating in the oil & gas sector. The stock market is also concentrated with respect to firm size. Roughly 80% of the stock market's capitalisation is concentrated in the top 10 companies.

Few of the stocks are actively traded, on a scale which would be comparable to western stock exchanges.

Development of institutional investors is a precursor to more active domestic capital markets. Reforms of the state pension scheme, private pension schemes, and insurance sector are ongoing.

The domestic bond market, while still small by international standards, has developed rapidly over the last few years.

GKO and OFZs (medium- and long-term ruble-denominated bonds) represent the largest part of the ruble-denominated debt market. According to a recent report by S&P, the outstanding stock of GKO and OFZs in February 2004 was approximately RUR323 billion (\$11 billion), less than a third of outstanding international debt. Sberbank is the largest investor in GKO and OFZs, owning more than 50% of outstanding issues.

The domestic corporate bond market started only in 2000, and according to S&P totalled merely RUR161 billion (\$5.3 billion) in February 2004. Very few such bonds are actively traded.

### 3.0 Competitive scenario

*The banking sector is dominated by state-controlled Sberbank*

Sberbank – Savings Bank of the Russian Federation, with its 20,100-strong branch network, towers over the rest of the banking sector. Indeed, Sberbank is larger than all the other banks in the country put together, and it has a 73% market share of retail deposits. Deposits at Sberbank are explicitly guaranteed the state, which owns 61% of the bank. The remainder of the stock trades on the Russian Stock Exchange (RTS), and is the only actively traded bank stock.

Until recently, the government guarantee (which expires in 2007) was a significant differentiating factor for the bank; however, with the new deposit insurance law taking effect, Sberbank will have to compete on other factors.

The privatisation of Sberbank is not currently in the policy platform of the government. Rather, the aim of reforms has been to create conditions that will foster the growth of private banks, with the expectation that Sberbank's domination will decline over time.

Indeed, Sberbank is not gaining its fair share in overall market growth. While total deposits tracked by the CBR were up 46% between December 2002-3, Sberbank's deposits grew by only 27%.

*Russia's largest banks*

	Assets (\$MM)
1. Sberbank – Savings Bank of the Russian Federation	\$34,200
2. Vneshtorgbank – Bank for Foreign Trade	\$7,277
3. Gazprombank	4,937
4. Vneshekonombank	4,711
5. Alfa Bank	4,118
6. MDM Financial Group	3,423
7. Bank of Moscow	3,100
8. International Moscow Bank	2,505
9. Citibank	1,905
10. Rosbank	1,788

*Source: The Banker, December 2003*

*State-controlled banks also dominate the corporate banking sector*

Vneshtorgbank (VTB) is 100% owned by the government and has a significant market share in corporate lending. Vneshekonombank (VEB, or the Bank for Foreign Affairs) specialises in being an agent for servicing Russian foreign debt. VTB and VEB are in the process of merging, and the EBRD is also in discussions with the Russian government about acquiring a minority interest in VTB.

The largest four state-owned or state-controlled banks -- Sberbank, VTB, Gazprombank, and Bank of Moscow --represent 55% of system deposits and 45% of system loans, according to recent estimates by Standard & Poor's.

*Certain privately-owned banks are introducing innovation to the sector*

Privately-owned banks are growing and introducing innovation to the sector, but individually remain economically insignificant stacked up against the state banks. According to recent estimates by Standard & Poor's, 85% of Russian banks operate with less than \$10 million in capital.

Structurally, many privately-owned banks operate within Financial-Industrial Groups (FIGs) whereby they provide treasury functions to industrial companies with common ownership.

<b>Major FIGs and Financial/Industrial Holdings</b>			
<b>FIG</b>	<b>Leader</b>	<b>Key banking holdings</b>	<b>Key industrial holdings</b>
Alfa group	Mikhail Friedman	Alfa Bank	Golden Telecom; Vimpelcom; Perekrestok (supermarket chain); 50% (together with Access/Renova) in TNK-BP
Basic Element	Oleg Deripaska	Bank Soyuz	RUSAL (aluminum producer); RusPromAvto (GAZ, PAZ, LIAZ); EuroSibEnergo; several pulp and paper companies
Gazprom	Alexei Miller	Gazprombank	Gazprom
GUTA group	N.A.	GUTA-Bank; Tver Bank; Lipetsk Regional Bank; Sverdlovsk Gubernsky Bank	Rot Front; Krasnyi Oktyabr (chocolate); Babaevsky Confectionery
Interros	Vladimir Potanin	Rosbank OJSC; OVK	Norilsk Nickel
LUKoil	Vagit Alekperov	Petrocommerce	LUKoil
MDM group	Andrei Melnichenko; Sergei Popov	MDM Bank; MDM Bank St. Petersburg; MDM Bank Urals	Pipe and metal works; energy companies (Sibirsko-Uralskaya Energeticheskaya Kompaniya); coal companies; fertilizers
MetalloInvest	Vitaliy Malkin; Boris Ivanishvili	Impex Bank	Ore treatment plants (Mikhailovsky and Stoylensky)
Rosneft	Sergey Bogdanchikov	Russian Regional Development Bank	Rosneft
Russian Railways (RZhD)	Gennadiy Fedeev	TransCreditBank	Russian railways monopoly
Russneft	Michael Gutseriev	BIN Bank	Russneft; real estate; trade companies
Sistema AFK	Vladimir Yevtushenkov	Moscow Bank for Reconstruction and Development	Telecoms (MGTS, MTS, MCC, Sky-Link, MTU-Inform, Combelga, Comstar); Detskiy Mir; Intourist.
Surgutneftegaz	Vladimir Bogdanov	Surgutneftegazbank	Surgutneftegaz
Tatneft	Controlled by Tatarstan government	Zenit Bank; Devon-Credit bank	Tatneft
Yukos/Menatop	Mikhail Khodorkovsky (detained and awaiting trial)	TRUST Bank; Menatop St. Petersburg	Yukos

Source: Standard & Poor's. FIG--Financial industrial group. N.A.--Not available.

Alfa Bank is one example of this practice. It is part of the Alfa Group which has significant interests in telecom, retail and energy, and is controlled by oligarch Mikhail Friedman. It is the largest privately-owned bank and was recently voted Global Finance's "Best Retail

Bank". Alfa is rapidly building new "Alfa Express" branches, and plans to have 70 by the end of 2004.

MDM Financial Group is also a dynamic player in the local markets.

*New entrants are pursuing specialised strategies*

Renaissance Capital, which is primarily a securities company, has announced its entry into consumer loans and has said it plans to buy a small bank for this purpose.

Insurance company Rosgosstrakh and investment bank Troika Dialog are teaming up to establish a mortgage bank with a capitalisation of \$40 million.

*Foreign banks are thin on the ground*

Since 2002, there have been no restrictions on foreign ownership of Russian banks. However, few foreign banks have an active presence in Russia.

Amongst the foreign players, ZAO Citigroup, Raiffeisen Bank Austria, Bank Societe Generale Vostok, and International Moscow Bank are the most prominent foreign controlled banks with local branches offering a wide variety of financial services.

Citibank has been in Russia since 1994, although it initially concentrated solely on the corporate sector. Citibank has three branches in Moscow and is opening another branch in St Petersburg, although it is not planning on establishing a nationwide branch network. It is concentrating on introducing convenient phone and Internet banking features, and had attracted over 10,000 retail customers as of May 2003. Citigroup began offering credit cards in 2003. The group is investing heavily in building its brand and in systems to support its anticipated growth over the next several years.

Raiffeisen is active in both corporate and retail markets and is entering new markets such as auto finance.

International Moscow Bank is a German-Nordic joint venture controlled by HVB Group, with Nordea carrying the minority share. It is the largest foreign-owned bank by assets, and concentrates on banking to top-tier Russian corporate groups.

Societe Generale is building branches in several cities in Russia.

ING, Deutsche, Dresdner, Credit Suisse, and HSBC also maintain local operations but are pursuing niche strategies.

HSBC is a relative newcomer to the Russian market, but has staffed up its branch operation rapidly and is focusing on private banking to wealthy Russians.

*Investment banks are experiencing boom conditions in the domestic capital markets*

UBS operates through a joint venture called UBS Brunswick formed in 1997. Now is the biggest trader of Russian American depository receipts.

Deutsche Bank's joint venture, United Financial Group, is also a leading local player. Deutsche bought a 40% interest in 2004.

Troika Dialog is a leading local player in the securities markets.

*And new competitors are poised to enter*

There has been a slew of announcements from leading international investment banks regarding their expansion plans in Russia. Most cite the sheer size of the economy and the recent track record of political and economic stability for causing their decisions at this time.

This is a significant change in their operating strategy as previously most transaction work was carried out in London, with only small representative offices in Moscow to maintain client coverage.

- Merrill Lynch announced in February, 2004 that it will open a Moscow office.
- Morgan Stanley announced in June, 2004 that it intends to apply for licences that allow it to trade domestic cash equities, government and corporate bonds, and to broaden its local offering to include foreign exchange and corporate loans. Morgan Stanley expects to invest \$50 million over 2.5 years to build its Russian business.

*Consumer finance is one of the most lucrative areas of banking*

Consumer lending is among the most rapidly expanding areas. Most Russians have little experience with personal debt: it is estimated that only around 10% have ever taken out a bank loan.

Over 20 Russian banks currently offer consumer finance for such items as major appliances and cars. Russian Standard Bank is the leading consumer lender. Its consumer finance portfolio grew to \$349 million at year-end 2003, from \$106 million a year earlier. U.S.-funded DeltaCredit Bank is the largest player in the small mortgage market. A Czech-owned finance company, Home Credit and Finance Bank, is present in the consumer finance sector.

Mortgages are potentially the largest consumer finance market, and the building blocks are coming into place to encourage rapid growth. The real estate market is booming in Moscow, underpinned by rapidly increasing incomes and limited stock of new housing. Prices have increased dramatically and are amongst the most expensive in the world.

However, most transactions are still cash based, and estimates of the total mortgage financing market at end 2003 were under \$200 million.

For now, mortgage lending remains an emerging area, and is hampered by existing legislation restricting a lender's ability to realise its security interest in real property.

Legislation governing mortgage-backed securities has recently been passed and will encourage further development of the mortgage finance market.

## 4.0 Regulation and reform

*The pace of reform is set to continue under the stable leadership of Vladimir Putin*

While the Russian people have mixed feelings about the breadth of economic reforms. The concentration of resources and wealth amongst the oligarchs is not only a political problem but an economic one as well.

Nationalisation of the energy sector, whether directly or indirectly, is being motivated by a desire for state control over the country's strategic energy assets. It also has the political benefit of removing power from the hands of the oligarchs, who are generally unpopular amongst regular Russians as they perceive the assets controlled by the oligarchs to have been acquired in an inequitable manner. Indeed, if the government were persistent it could probably identify legal irregularities with virtually every privatised entity.

Despite headlines about the government's selective application of justice, such as in the tax dispute with the Yukos Group and with the backtracking on agreements with international oil companies for developing portions of the Sakhalin Island deposits, most observers of the general business environment feel that the situation vis-à-vis the "rule of law" in business dealings is improving.

*The financial sector is regulated primarily by the Central Bank and the Federal Securities Commission*

The Central Bank of Russia ("CBR") regulates all deposit-taking institutions in Russia. It issues licences to new banks and inspects them for compliance with its rules, establishes minimum capital requirements, and approves senior managerial personnel, including for foreign-owned institutions. The CBR is also responsible for managing the value of the Russian ruble on international markets.

An important aspect of the CBR is that it is under the control of the legislative rather than the executive branch of government.

Licenses for operations with securities (e.g. broker/dealer) are issued by Federal Commission for Stock Market

*Types of banking licences*

A bank must obtain a license from the CBR before it can begin operating. Newly-established banks can receive the following licenses:

- (i) License to carry out banking activities with monetary funds in rubles (without the right to deposit monetary funds of private persons);
- (ii) License to carry out banking activities with monetary funds in rubles and in foreign currency (without the right to deposit monetary funds of private persons); and
- (iii) License to deposit and dispose precious metals.

Additionally, a bank that has been registered for at least two years can obtain the following licenses:

- (i) License to deposit monetary funds of private persons in rubles;
- (ii) License to deposit monetary funds of private persons in rubles and in foreign currency; and
- (iii) General license, which covers all of the above-mentioned activities.

*There are a number of licensing requirements to be fulfilled according to the type of licence sought*

	Standard license (RR/FCCY)	License for attracting deposits of individuals (RR/FCCY)	General license
General requirements	<ul style="list-style-type: none"> <li>Registered as a credit organisation</li> <li>Bank's premises are appropriately equipped</li> </ul>		
Capital requirements/ Capital adequacy (CA)	<ul style="list-style-type: none"> <li>RR 168 mln (\$~5.5 mln) for a newly established bank</li> <li>CA ratio – 10% (regulatory capital to risk-weighted assets and off-balance sheet items)</li> </ul>		
Management/ personnel	<ul style="list-style-type: none"> <li>Qualified management and personnel (education, experience)</li> </ul>		
		<ul style="list-style-type: none"> <li>Transparent shareholder structure</li> <li>Reputable directors</li> <li>Proper organisational structure</li> </ul>	
		<ul style="list-style-type: none"> <li>No less than 2 years from registration</li> <li>Financially stable for the last six months</li> <li>Compliance with regulation</li> </ul>	
Bank's track record			<ul style="list-style-type: none"> <li>Successful review of compliance by regulation authorities</li> </ul>

*The estimated timeframe to incorporate a bank with foreign investment is 10-12 months*



*The playing field is not level for foreign-owned banks*

There are higher capitalisation requirements for licences with foreign shareholdings. There are also rules restricting profit repatriation.

*However, Russia's entry into the WTO will reduce these barriers*

Russia and the EU have recently reached agreement on the terms of Russia's entry into the WTO, which terms included Russian of the Kyoto Treaty. Russia continues to discuss its terms of entry with the United States. Entry into the WTO (expected by 2006) should encourage upgrading of Russia's country rating, as it demonstrates its commitment to integrating with the international trading system.

The end result will be positive for the Russian banking sector, as more competition and new, more sophisticated products will be introduced to the Russian market.

*New Foreign Exchange Law*

The new Foreign Exchange Control Law passed in June, 2004 and overhauled currency regulation in Russia. Now, foreign currency

transactions can occur without specific prior permits – the opposite principal from the prior approach.

The new law allows residents and non residents to open a “special account” in an authorised bank in a number of instances. Moreover, Russian residents -- both individuals and legal entities – may now open accounts with banks in OECD and FATF countries without the preliminary approval of the Central Bank.

*International accounting standards*

Russia is introducing International Accounting Standards throughout the corporate sector, with the banking sector being the first to implement.

*New law on deposit insurance*

In December 2003, the Federation Council (upper house of Parliament) approved the laws to implement a deposit insurance scheme, which is a centrepiece of the CBR's reforms. Deposit insurance is being introduced on a voluntary basis initially, but will become mandatory by 2005.

Deposit insurance is expected to lead to consolidation amongst the roughly 1,200 Russian banks which have retail licences, as the institutions attempt to comply with the CBR's terms for entering into the deposit insurance scheme. Banks which cannot comply would lose their right to take retail deposits.

*The CBR has reoriented its inspection practices*

In line with the new deposit insurance scheme, the CBR is also initiating an active coverage-based inspection model, whereby it will assign onsite and offsite teams which will cover a specific list of banks. This continuity is expected to enable inspection officers to take a more judgement-oriented approach in their work. Formerly, the CBR's approach was more focused on banks submitting voluminous forms.

*Further reforms are needed*

Russian banks are lobbying for further changes.

One of the areas is with regard to the law allowing depositors to withdraw their money at any time, even those who have made term deposits.

Another area is a law requiring 10% of a bank's capital to be deposited in a non-interest bearing account with the CBR.

*There is still a long list of forthcoming reforms*

While impressive progress has been made in recent years, further reforms are needed to create a reliable backdrop for growth in the banking sector. These include:

- 1) establishing of a centralised credit bureau;
- 2) strengthening the rights of secured creditors in bankruptcy proceedings;
- 3) separating the CBR's regulatory role from its ownership of certain lending institutions.

**The full “Russian Banking Sector” report is available only to clients of Interstice Consulting Corporation.**

## **About the Authors**



### **Leighton S.P. Prabhu**

Mr. Prabhu is based in New York and is responsible for Interstice's consulting activities in the banking sector. Mr. Prabhu is a former Director of Investment Banking and Vice President of Project and Structured Finance with the BankAmerica and JPMorgan Chase organisations. Earlier in his career, he practiced as an audit, tax, and consulting advisor with PricewaterhouseCoopers and Ernst & Young. He has advised a wide range of organisations on financial policies, corporate development, financing, strategy, and valuation. Mr. Prabhu holds a B.Com in accounting and finance from McGill University (Great Distinction) and an M.Phil in Management Studies from the University of Cambridge, and holds an advanced certificate in e-commerce from New York University. He is also a qualified Chartered Accountant (Canada) and Certified Public Accountant (USA).



### **Demetrius A.M.-A. Floudas**

Mr. Floudas is based in Moscow and is Interstice's practice leader for the European region. He recently completed an EU-funded project to deliver technical assistance to the Russian insurance sector. Mr. Floudas has advised on a broad scope of consulting assignments in the private and public sectors, including international banking and competition law. At the same time he is a practicing attorney and academic of international distinction. In addition to several articles and papers, he has co-edited the "Overcoming the Barriers of the Single Market" volume, which circulated in 42 countries. Apart from his duties at Interstice, Mr. Floudas is a Senior Associate of Hughes Hall, University of Cambridge. He has been elected Fellow of the Hellenic Institute of International & Foreign Law and Visiting Fellow of the Centre for International Economic Research, Anglia Business School. He has also been appointed to the Editorial Board of the International Problems Journal. Mr. Floudas speaks five languages and holds an LL.B (magna cum laude) from the University of Athens as well as an LL.M from the University of Cambridge. He is a member of the British Academy of Experts and of the Athens Bar.