Regulation of Foreign Banks in Russia

by

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Abstract

In this paper, the issues of foreign investment in Russian banking sector are addressed. The study aims to shed light on foreign banks challenges in Russia and analyze their roots. The paper confirms the fact that fast development of new banking system, corruption, weak law enforcement and highly vulnerable banking legislation as well as undeveloped institutional infrastructure have a harmful effect on banking sector in Russia and it attractiveness for foreign investors.

The history and current situation with foreign investment into banking sector in Russia are examined. The author argues that development of strong and internationally competitive banking sector requires a state policy shift: from protectionism to regulated market competition. Current legal frame and infrastructure are analyzed, with special emphasis to different form of foreign investments into banking sector. Several proposals on legislative improvement are made.
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Introduction

Banking and banking law never were considered both legal scholars and general public as unimportant part of day-by-day life and legal regulation; moreover, the current financial crisis placed them on the top of people concern and political news. The meltdown of the financial “world order” raised a lot of questions on legal framework, law enforcement, governance and ethic issues in the banking and banking law.

Modern banking law is a relatively young discipline. E.P. Ellinger stated, “During the period following the end of World War II banking law has metamorphosed from one of the specialized categories of contracts into a discipline of its own. The process, which was evolutionary, benefited from advances in technology and from the emergence of multinational banks.”

Due to a global and interconnected world financial market, regulation of the foreign financial institutions’ activity in different jurisdictions seems a very important and interesting problem and legal scholars traditionally paid attention to this question.

Russia, due to its territory, natural resources, nuclear power and other numerous factors, definitely is the country interesting for consideration. Moreover, Russia’s banking system is unique in comparison to the banking system of the major developed countries as will be shown below. Nevertheless, even the most comprehensive research on foreign banks’ regulation, edited by M. Gruson and R. Reisner, ignored the Russian Federation. Further, few foreign researches on Russia’s banking law are

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3 Gruson, M. & Reisner, R., eds. Regulation of Foreign Banks: Banking Laws of Major Countries and the European Union, 4th ed. (LexisNexis/Matthew Bender: 2005); See also Baxter, Ian F. G., supra note 2 at 175 – 186; Frankel, William G.,
very short and descriptive and do not touch the problem of foreign banks' regulation in Russia.\textsuperscript{4} Quit surprisingly, the same little attention to foreign banks’ regulation has been paid by Russian lawyers.\textsuperscript{5}

This paper endeavours to fill the existing gap, critically analyzing the legal framework, identifying the problems being faced by foreign investor in the Russia’s banking sector and suggesting the possible ways to sort them out.

The focus of this thesis is on Russian banking law, relating to the regulation of foreign financial institutions’ incorporation and activity on the Russia’s financial market.

The purpose of the research presented by this paper is to critically assess certain aspects of state policy and law regulations now in place in Russia pertaining to the development of solid and internationally competitive banking system. This paper will emphasize the role of the Central Bank of the Russian Federation [hereinafter - Central bank, Bank of Russia] bringing banking sector reform forward. As a more concrete objective, I will propose several steps for increasing the Russian banking sector’ attractiveness for foreign investors.

The narrow aim of this thesis is reflected in certain features. Firstly, I have little to say about the nature of banking and definition of banking law.\textsuperscript{6} I agree with A. M.

\textquotedblleft Regulation of Commercial Banking in Russia”, (1997) 8 Entertainment L.R. 53-59.


\textsuperscript{5} See \textit{e.g.}: Tosun’an, G. A., ed. \textit{Банковское право Российской Федерации. Общая часть. Особенная часть в 2х т. (Banking law of the Russian Federation. Common part. Special part in 2 volumes)} [hereinafter translated by author], (Moscow: Jurist, 1999-2001).

\textsuperscript{6} The definition of banking and banking law (the common law perspective) see \textit{e.g.}: Ogilvie, M.H., \textit{Canadian Banking Law}, 2\textsuperscript{nd} ed. (Toronto: Carswell, 1998) at chapter 1; Ellinger, E.P., Lomnichka, E., \textit{Modern Banking Law}, 2\textsuperscript{nd} ed. (Oxford: Clarendon Press, 1994) at chapter 3; Cranston, Ross, \textit{Principles of Banking Law}, 2\textsuperscript{nd} ed. (Oxford: Oxford University Press, 2003) at chapter 1. For the civil law
Pollard that “banking law is at best an amorphous term” that covers not only the corporate establishment and operation of banks, but also the regulation of the many financial and related services provided by a bank.\(^7\)

Secondly, the thesis is comparative in nature. As K. Zweigert and H. Kotz mentioned, “comparative law has been proving extremely useful in the countries of Central and Eastern Europe where legislators face the need to reconstruct their legal system after collapse of the Soviet system.”\(^8\)

Thirdly, I will try to execute the strict (narrow) interpretation of the legislation.

Fourthly, the current global trends in banking (globalization and liberalization) and recent financial crisis are only touched due to a limited space and complexity of those questions. Arguably, the most significant result of the current financial crisis is a miserable failure of deregulated financial marketplace theory, based on the assumption of reasonable behavior of all market players. I assume that financial systems, both domestics and transnational, faced a regulatory, anti-free-market in its nature, revolution. Further, a protectionism and banking wars already replaced a mutually pleasant co-existence even between former ‘closely friends’ countries. For example, in attempt to save the national banking system, Iceland had frozen the accounts of hundreds of thousands of British savers, in turn; British government seized Icelandic accounts by using antiterrorist (!) legislation. The financial collapse in Iceland is becoming the worst crisis in relations between London and Reykjavik since the Cod War of the 1970s.\(^9\)


\(^9\) Available online at: http://www.timesonline.co.uk/tol/news/politics/article4916933.ece
As I mentioned the above, Russia’s banking system is unique in comparison to the banking system of the major developed countries. While in the developed countries like Canada, the initial catalyst for modern banking legislation reform was the evolution of technology and international market development\textsuperscript{10}, the modern banking system and banking law in Russia emerged from nowhere, as the consequence of the revolutionary in nature social and economic transformation. Russia’s banking system has been and is highly dependent on the state. Russia’s banks have not played an important part in support of the non-financial sector; their lending has been very short-term. Banks lack of a legal framework and have participated in corrupt practices. The formation of a commercial banking system in the context of a spontaneous movement to capitalism and a weak state has been contributory factors in its weaknesses. Banks’ role is heavily dependent on the wider environment and, under the conditions following the end of central planning; there is no reason to suppose that they will play a positive role in terms of the development of the economy as a whole. Capital flight, tax evasion and money laundering are the major problems of past-Soviet Russia, indicating an economic breakdown, the government’s failure to create a functioning state and the criminalization of society. Meanwhile, the legal and illegal capital flight\textsuperscript{11} and tax evasion are not a problem of banking regulation but rather a consequence of Russia’s general economic environment.

Foreign bank regulation, as a natural part of a banking sector of any given country, could not be considered without proper analysis of the banking sector in a whole. It is especially inevitable for Russia, where the only permissible form of foreign banking activity (\textit{de facto}, not \textit{de jure}) is foreign banks subsidiaries, established and acted under the Russia’s law.

This thesis is structured as follows: Chapter I provided an overview of the history, legal and institutional frame of the Russia’s banking system. In Chapter II foreign banks’ investment in Russia and permissible form of foreign banks activity are considered. Chapter III investigates essential problems, faced by


\textsuperscript{11} In 2008 capital flight out of Russia was USD 130 billion, 6 times more that after 1998 crisis, see \textit{Известия (News)} (14 January, 2009) at 7.
foreign banks in Russia, including policy and law enforcement questions and influence of corruption. Chapter IV suggests proposals for improvement of Russia’s banking sector stability and investment attractiveness.

Chapter 1

History and Background of Issue

1. History of the modern banking system

The history of the modern Russia’s banking system pushes towards the paradoxical, at a glance, conclusion: Russia’s banks were not banks at all until 1998 crisis. They looked and acted like banks but could be better described as quasi-banks. Even though Russia’s banking system has made a modest progress toward the real banking since 1998, there are few reasons to assess Russia’s banking system as a market economy’s system. And I am going to provide evidence in favour of this conclusion below.

[a] 1990–1998 years

Russia’s banking system has undergone a profound transformation over the past two decades. The modern Russia’s banking system and law are a result of transformation of the social and economic background. It originally designed to finance the planned economy; Russia’s banking system prior 1990 was largely a mechanism for allocating money to state-owned enterprises according to the state economic plan. All enterprises and organisations had an account with a local branch of the State Bank the USSR (Государственный Банк СССР) and were under obligation to pay all the money into this account and effect payments through the bank. This enabled financial resources to be pooled in the State Bank and be reallocated. This system was designed for the state to closely monitor state enterprises for the ultimate goal of fulfilling the state economic plan. General public could use only cash for payments and maintain saving accounts only. The socialist system of
banking was a mono-bank system in contrast with a present two-tier banking system of state bank (Bank of Russia) and commercial banks.

New social and economic conditions required a creation of fundamentally new mechanism of legal regulation of banking activity that was appropriate to the developing economic conditions.\textsuperscript{12}

The formation of the new banking system and legislation was influenced by the external (state regulation, technologies, international financial market) and internal (competitive activity both for the access to the budget money, and for the client) factors.

The forming of the new banking system and regulations in Russia became apparent in:

(i) Creation of new state banks and the commercialization of previously acting state banks, which derived profit by market instruments;

(ii) Changes in forms of the ownership;

(iii) Creation of a two-level banking system with at least legally independent commercial banks at the second level, the activity of which are regulated in accordance with the legislation;

(iv) Development of a new infrastructure for the financial market.

The first Russia’s banks – "Viking" (the initial name "Patent") and "Prime-minister" (the Moscow’ cooperative bank) had been registered by the State Bank of

the Union of the Soviet Socialist Republics (USSR) on August 26th and 29th, 1988 under the Law On Cooperation. Shortly the number of banks grown up to 2,500. The accelerated pace of financial innovation has forced bankers and practitioners to adopt 'innovative' legal instruments to overcome gaps, without analyzing general implications for the legal system. This has brought new conflicts related to its enforcement; however, as regulatory authorities and judges were not appropriately prepared to accept legal 'innovation' on financial matters, thus increasing legal uncertainty, legal and credit risks.

Russia’s modern banking legislation is relatively young. It came into force in December 1990, when the Supreme Council of the Russian Soviet Federal Socialist Republic (RSFSR), then the Russia’s parliament, adopted the Laws On the Central Bank of the Russian Soviet Federated Socialist Republic (Российская Советская Социалистическая Республика, RSFSR, then the Russian Federation) (Bank of Russia) and On Banks and Banking in the RSFSR.

Roughly, the history of banking in Russia is possible to divide into three stages. The first stage was the period of rapid growth under the conditions of quasi-liberal regulation, which ended up in 1998’ crisis. This period resulted in the adoption of the new versions of the Laws On the Bank of Russia in 1995 and On banks and banking in 1996. A number of other vital for the functioning of the banking system laws were adopted during this period, including the Civil Code of the Russian Federation (Part One) in 1995 and the Law On the Securities Market in 1996. In 1992, the Law On Currency Regulation and Currency Control in the RSFSR, which was based on a rigid currency regulation model, was also adopted. The next period was from 1998 to 2008, the period of attempt to build the real banking system. The current financial crisis turned the Russia banking system into new period of development.

There are two main reasons for defining Russian banks during this first period as quasi-banks. Firstly, they have played a minor role in the provision of capital for Russia’s industry and have been more involved in financial speculation on the ГКО (Государственные казначейские обязательства, GKO, T-bills) market. Another non-market target of Russia’s banks before 1998 crisis were a loans-for-shares
auctions. Secondly, Russian bankers were heavily over-involved into state policy making.

In 1996, B. Berezovsky, one of the first Russia’s oligarchs, introduced the term ‘семибанкирщина’ (it’s nearly impossible to translate into English, but meaning is that the real power in Russia belong to 7 leading bankers). This period ended up with V. Putin’s the President election in 1999; two of these top bankers (B. Berezovsky and V. Gusinsky) were forced to leave Russia; another – M. Khodorkovsky was sentenced to seven years in jail; others lost their political power and only M. Fridman (Alfa Group) and M. Potanin (Norilsk Nikel) somehow managed to save their capitals.

**[b] Crisis in 1998: causes and consequences**

In attempt to fill the budget gaps the Russia’s government created Ponzi scheme, using T-bills with yield exceeding 200%. But not only Russia’s banks over involvement into speculative markets (up to 16% of banking assets) and state default caused the August 1998 crisis.

Other principal causes were:

(i) The low level of capitalization (the total capital of banking system as of August 1, 1998 was 119,2 billion Roubles, less than volume of the 'frozen' T-bills - 119, 6 billion Roubles);

(ii) Narrowness of internal resource base and dependence on foreign loans;

(iii) High dependence on the financial market volatility (the share of incomes from T-bills in total banks’ income in 1998’ first quarter was 31,6 %);

(iv) Underestimation of the risk of investments in T-bills and currency risk;

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14 Available online at http://ru.wikipedia.org/wiki/Семибанкирщина
Absence of system of deposit insurance and banking insolvency law;

Lack of the system of bank supervision.¹⁵

Joseph J. Norton, analyzing the previous East Asian crisis, stated “…recent financial crises resulted, in large part, from a combination of macroeconomic imbalances, weak financial institutions, widespread corruption, inadequate legal foundations, moral hazard problems, improper sequencing in the liberalization process and political instability or uncertainties in each of the affected countries”.¹⁶ This statement is applicable to Russia’s 1998 crisis without any exception. As Thomas D. Willet counted, in the Asian and Russian 1998 crises international investors lost over $300 billion.¹⁷

As a result of the crisis the cumulative capital of bank system of Russia has decreased from 119,2 down to 76,5 billion Roubles, or 35,8%, and in a currency equivalent – from 19,1 down to 3,7 billion USD, or 5,2 times. After the August crisis of 1998, within one year the market volume of the Russian Trading System (Российская Торговая Система, RTS) stock market exchange has plunged from USD 70 billion to mere USD 5 billion.¹⁸

In 1998, after 8 years of market reform, Russia still did not have deposit insurance system, banking insolvency and credit history legislation. Strom C. Thacker mentioned re-current payments’ imbalances, pressures for currency devaluation, and macroeconomic instability associated with crises in Russia.¹⁹ Except macroeconomic

¹⁵ For more details see e.g.: Tosyn’an, G. A. and Vikulin A. U. Реструктуризация кредитных организаций (Restructuring of the credit organizations) (Moscow: “Business”, 2002) at 31-44; Trofimov, Kirill supra note 6 at 181-204.


¹⁸ Lang, Christine and Weber, Shlomo, supra note 12 at 285.

¹⁹ Thacker, Strom C. “The High Politics of IMF lending” in Globalization and the Nation State, supra note 17 at 111.
reasons, mutually important social one should be added: extremely short-term thinking among Russia’s bankers, derived from political uncertainty, when combined with the vagaries of economic liberalization and the free-for-all privatization.  

As a legal response to the crisis the Federal Law 144-FZ On Re-structuring the Credit Organizations was adopted on July 8, 1999. This Law was unique among others laws on banking, provided the right of the Government of the Russian Federation to accept the statutory acts adjusting activity of the banks (in all others laws only the Bank of Russia is empowered). The Government and the Central Bank also created the Agency on Re-structuring the Credit Organizations (hereinafter - ARCO) with participation of the Government and the Central Bank with the statutory capital of 10 billion Roubles in the form of not-bank credit organization (the closely held joint-stock company).  

Later the ARCO had been reorganized to the form of State Corporation.

The Constitutional Court of the Russian Federation in the Ruling on July 3rd, 2001, number 10-P specified, that the re-structuring of the credit organizations is not procedure of bankruptcy, but the special extrajudicial procedure directed to the restoration of solvency of a credit organization. This Ruling also recognized mismatching to the Constitution of the Russian Federation a number of positions of the Law On Re-structuring of the Credit Organizations and related with them positions of the Law On bankruptcy of the Credit Organizations.


22 ARCO was liquidated in 2004, official website www.arco.ru is not available at the present time.

provisions of the Law On Re-structuring were reassured as legitimate in the Constitutional Court Ruling on July 22nd, 2002, number 14-P.24

Created in a legal form of a commercial entity (the ARCO had the rights for securities market’ operations and buying and selling banks’ assets), nevertheless the ARCO was a part of the executive state power.25 The Board of 13 directors governed the ARCO, 7 of them represented the Government, 5 – the Bank of Russia, plus General director of ARCO. Totally the ARCO took part in the re-structuring and development of 21 banks from 12 regions of Russia.

Example with the ARCO’ creation and following liquidation is an unquestionable evidence of thesis that Russia’s banking law is highly politically dependent and vulnerable. The new law, while mismatched the Constitution, created the new executive, de facto, body in the banking sector. Moreover, this powerful market player totally disappeared after less than 5 years of existence. While the ARCO’ activity did not have any relations with foreign investment into the banking sector; such legislative and executive power experience definitely have a negative impact on the Russia’s legal risk assessment.

Quite surprisingly, but the overall results of the 1998 crisis are rather positive, that negative. Firstly, after August 1998 crisis Russian banks turned from currency speculations and privatization gambling to real banking activity, real sector and consumer lending. Secondly, the new laws were adopted. Namely, the Law On Insolvency (Bankruptcy) of Credit Organizations; the Law On Currency Regulation and Currency Control; the Law On Insuring Natural Person’s Deposits made with Banks in Russia; the Laws On Mortgage and the Issue of Mortgage Securities; the Law On Credit Histories; the Law On Counteracting Laundering of Illegal Proceeds and Financing Terrorism. Thirdly, the foreign investment in the banking sector significantly increased.


[c] Current situation and trends

Considering that Russia does not have neither a written policy document, nor the policy embedded in the legislation, it is nearly impossible to predict the vector on future banking sector’s development.

Generally, M. Gruson and R. Reisner mentioned a series of global trends.26 One of these has been a steep reduction in the number of banking firm in the most of the developed countries. The consolidation and concentration of the banking industry had primarily been the consequence of a high level of mergers and acquisitions activity. Secondly, it has been the growth of financial conglomerates globally. Thirdly, the internationalization of banking defined in terms of cross border bank establishment.

They also noted that changes in law and regulation have played a key role. In particular, the trend towards deregulation in numerous countries has cleared the way for market driven change to occur. Deregulation has, for instance, served to eliminate the laws of various countries that until recently divided banks into different classes with attendant restrictions on their line of business or geographic focus. Deregulation has also eliminated the legal barriers that in some countries precluded affiliations between commercial banks and other financial institutions or insurance companies.27

Speaking about deregulation as a global trend, I will argue that current crisis ended up both theoretical believes in a free market and a deregulatory practice, at least in the financial sector. Theoretically the free market is the best possible engine for a progress: competition stimulates the innovations and imaginations. However, when innovations go so far, the market and customers need the regulation. The lack of regulation of innovative, derivative financial products is, arguably, one of the major causes of the current financial crisis.

Legal changes also have affected the trend towards internationalization of banking. Numerous countries eliminated barriers to the foreign banks’ entry and establishment. Other modifications of the laws and regulations governing banking have been in response to the changed landscape and particularly the growth of large and complex

26 Gruson, M. and Reisner, R., supra note 3 at xvii-xxiv.

27 Ibid. at xx-xxii.
institutions that deregulation made possible. Such conglomerates are seen as posing special risks to the stability and safety of the financial systems. Regulatory approaches adopted to date fall toughly into three categories. One set of laws designed to increase transparency and public disclosure of financial data. Another set of laws has sought to counter the special risks associated with concentration and conglomeration by an expansion of prudential rules (supervision of both financial conglomerates and their constituent entities). Finally, the growth of conglomerates has led some countries to redesign their supervisory structures to achieve needed levels of supervision.28

Kent F. Moors stated that Russia cannot carry the present number of banking institutions and those that remain will progressively become international in operation and increasingly dependent upon a few domestics and a larger number of outside institutions until the industrial and financial markets stabilize.29 I will argue, that problem area is quality, not quantity of the banks. Quantity is not a question at all; while Canada has 22 Schedule I, 26 – Schedule II and 31 Schedule III financial institutions30, the USA have 8,246 financial institutions – members of the Federal Deposit Insurance Corporation.31 The question at hand is that 404 out of 1108 (over 36%) acting Russia’s banks have working capital less than 5 million euro. Therefore, the more correct will be prediction that numbers of banks in Russia continue to decline, primarily by disappearance of small, undercapitalized banks. From the first view, this tendency looks positive (more healthier institutions remain on the market). However, taking into account the level of banking capital concentration in Russia, customers in many regions will lose any alternative to choose a bank.

Joseph J. Norton mentioned that the necessary environment for the development of viable financial markets includes:

(i) Clear and defined property rights,

28 Ibid. at xvii-xxiv.


31 Available online at http://www2.fdic.gov
(ii) A regime supporting binding and enforceable contracts,

(iii) Adequate company law incorporating principles of good corporate governance,

(iv) Adequate lending infrastructure, including secured transactions’ law,

(v) Clear rules governing foreign investment and public-private partnerships (concession law),

(vi) Effective bankruptcy provisions, including for financial institutions,

(vii) Fair and reasonably predictable tax law.\(^{32}\)

Looking specifically at the overall problems likely to continue to affect the financial systems in many emerging markets for the near future, the following comes to mind: the weakness of banking institutions; the prevalence of corruption and crony-capitalism; the lack of effective and consistent regulatory enforcement; the lack of sophisticated and efficient judicial mechanisms for the resolution of financial disputes; the inexperience of market participants; and the shortage of domestic savings.\(^{33}\) This list of factors, contributing to financial crisis, looks unquestionable. However, the current financial crisis demonstrates that strong financial institutions, experienced market participant, the list could be continued, are not the shield from financial crisis. Moreover, Joseph J. Norton overestimates the role of the effectiveness of regulatory enforcement; the sophistication and efficiency of judicial mechanisms and the experience of market participants. We accept as the axiom that the developed countries, in comparison with the emerging markets, have all (markets, infrastructure, laws and participants) with opposite distinctive features. Nowadays, we should accept the lessons from the most developed financial market, the USA market, associated with the largest fraud in Wall Street history\(^{34}\), and the biggest loss in corporate

\(^{32}\) Norton, Joseph J. supra note 16 at 29-30.

\(^{33}\) Ibid. at 30.

history. These lessons, along with others from other developed countries, should prevent the countries with the less developed financial markets from blind import of institutional and legal frameworks.

A very interesting approach to trends in the banking sector demonstrated the Task Force on the Future of the Canadian Financial Services Sector. Not only globalization, technological advances and economic change are considering as a driving forces but also demographic trends in Canada: the aging of the “baby boomer” population, female employment (dual-income households), small businesses and self-employments, migration away from rural location (adequate access to financial services in depopulating communities). These demographic trends are the actual for Russia too; moreover, Russia experiences the reduction of the population and massive illegal immigration. Thus, the demographic factors should be taken into consideration when, and if, the banking sector’ strategy will be on the table.

The banking reform in isolation can achieve little: the development of the financial sector depends largely on what happens in the rest of economy. Broader structural reform of the economy and the strengthening of the legal system are necessary conditions for the banking system to develop and play a positive role in economic development.

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35 The USA government projected that 19 of the nation’s biggest banks could suffer losses of up to $599 billion through the end of 2010, The Wall Street Journal (8 May, 2009) available online at: http://online.wsj.com/article/SB124172137962697121.html

2. The legal background

Banking legislation is a branch of law that represents a system of normative acts regulating banking activities. The Constitution of the Russian Federation and the Civil Code of the Russian Federation provide the basis for the banks’ legal relations under loan and credit agreements, bank deposits, account agreements and the Central Bank’s legal status.\(^{37}\)

Russia is a partial foreign banking law recipient, indeed.\(^{38}\) In addition, Russia’s experience has shown that adopted and adapted law is not enough. Without institutional infrastructure, judicial reform, adequate level of legal culture and political will even well written laws will remain inefficient. Hiroshi Oda mentioned a huge gap between the law in books and the law in action, gap between law and its implementation in Russia. The gap primarily comes from often inconsistent and contradictory laws as well as their ineffective implementation.\(^{39}\)

The reception of civil law (гражданское право) is not obvious. Claes Sandgren stated that the Netherlands and Quebec’s codifications have been successfully used recently in Russia and Argentina.\(^{40}\) It would be interesting to see any evidence in favour of this statement, but C. Sandgren did not provide any. I cannot speak about Argentina, but in Russia the Netherlands and Quebec’s codifications probably were considered by the Civil Code’ Working Group, but definitely were not “used”, if this word means “copied” or “borrowed”.

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\(^{39}\) Oda, Hiroshi. Supra note 4 at 13.

[a] Constitution of the Russian Federation and the Constitutional Court of the Russian Federation' Rulings

The main constitutional provisions, related to banking are as following:

In accordance with the point ‘g’ of Article 71 of the Constitution of the Russian Federation, the competence of the Russian Federation comprises, among other things, financial, foreign exchange, credit and customs regulation, currency issue and the main aspects of the pricing policy. This provision signifies that the legal regulation of banking activities is the competence of the federal level only.\(^41\)

Part 2 of Article 75 of the Constitution lays down the principle of independence of the Bank of Russia from other state bodies when it fulfils its principal function of protecting the ruble and ensuring its stability.\(^42\)

The status, purposes, functions and power of the Central Bank of the Russian Federation (Bank of Russia) are also stipulate by the Constitution of the Russian Federation.

The Constitutional Court rulings\(^43\) are particularly important for applying the Constitution. The rulings of the Constitutional Court are considering as the source of law. Legal principles that the Constitutional Court has formulated in some of its acts are significant for both the development of banking legislation and its enforcement. In particular, the Constitutional Court considered it necessary to strengthen the protection provided to an individual citizen-depositor, as the weaker party to a bank

\(^{41}\) The Constitution of the Russian Federation in English available online at: http://constitution.garant.ru/DOC_11113000.htm

Article 71. “The jurisdiction of the Russian Federation includes: g) establishment of the legal basis for a single market; financial, currency, credit, and customs regulation, money issue, the principles of pricing policy; federal economic services, including federal banks;”

\(^{42}\) Ibid. Article 75.2 “Protecting and ensuring the stability of the rouble shall be the major task of the Central Bank of the Russian Federation, which it shall fulfil independently of the other bodies of state authority.”

\(^{43}\) The Constitutional Court of the Russian Federation Rulings available online at: http://www.ksrf.ru/Pages/Default.aspx
deposit contract. The Court also extended the principle of the Bank of Russia’s independence to the area of banking supervision, and determined the limits to the possible interference in banks’ activities on the part of the supervision authorities.

**[b] Federal Laws**

The first Law On the Central Bank of the RSFSR (Bank of Russia) was adopted in 1990. The current Federal Law No. 86-FZ On the Central Bank of the Russian Federation (Bank of Russia) was adopted on July 10, 2002 (hereinafter referred to as the **Law On Central Bank**). This law spells out the principle of independence of the Bank of Russia and stipulates that the Central Bank fulfill its functions and powers independently from other federal bodies of state power, the bodies of state power of the constituent entities of the Russian Federation and local self-government.44

The Law On Central Bank has established:

(1) The legal status of the Bank of Russia;

(2) The size of its authorized capital;

(3) The procedure for forming the National Banking Board and its principal functions;

(4) The functions of the bodies of management;

(5) The relations between the Bank of Russia and the bodies of state power and local self-government and between the Bank of Russia and credit institutions;

(6) The principles of organizing non-cash settlements and cash turnover;

(7) The principles of implementing monetary policy and its major instruments;

44 The Law On Bank of Russia, Article 1 “The Bank of Russia shall fulfill the functions and exercise the powers stipulated by the Constitution of the Russian Federation and this Federal Law independently from other federal bodies of state power, the bodies of state power of the constituent entities of the Russian Federation and local self-government bodies.”

The Law On Central Bank in English available online at: http://www.cbr.ru
The operations and transactions conducted by the Bank of Russia;

Banking regulation and supervision competence;

The Bank of Russia reporting and audit.

Article 4 of the Law On Central Bank specified the functions fulfilled by the Bank of Russia.\footnote{45}

\footnote{45} The Law On Bank of Russia, Article 4 “The Bank of Russia shall fulfill the following functions: (1) it shall elaborate and pursue in collaboration with the Government of the Russian Federation a single state monetary policy; (2) it shall be the sole issuer of cash money and organizer of cash turnover; (2.1) it shall approve the graphic representation of the ruble as a sign; (3) it shall be the last-resort creditor for credit institutions and it shall organize the system to refinance them; (4) it shall set the rules to effect settlements in the Russian Federation; (5) it shall set the rules to conduct banking operations; (6) it shall manage the budget accounts of all levels of the budget system of the Russian Federation, unless federal laws stipulate otherwise, by effecting settlements on behalf of the authorized bodies of executive power and state extra-budgetary funds entrusted with the task of organizing the execution of and executing the budgets; (7) it shall efficiently manage the international reserves of the Bank of Russia; (8) it shall adopt decisions on the state registration of credit institutions, issue licenses to credit institutions to conduct banking operations and suspend and revoke them;

9) It shall exercise supervision over the activities of credit institutions and banking groups (hereinafter referred to as banking supervision);

10) It shall register the issue of securities by credit institutions in compliance with federal laws;

11) It shall conduct on its own behalf or on behalf of the Government of the Russian Federation all kinds of banking operations and other transactions necessary for the fulfillment by the Bank of Russia of its functions;

12) It shall organize and exercise foreign exchange regulation and foreign exchange control in compliance with the legislation of the Russian Federation;

13) It shall establish the procedure for effecting settlements with international organizations, foreign states and also with legal entities and private individuals;

14) It shall set the accounting and reporting rules for the banking system of the Russian Federation;

15) It shall set and publish the official rates of foreign currencies against the ruble;

16) It shall participate in making a forecast of the Russian Federation balance of payments and organize the compilation of the Russian Federation balance of payments;

17) It shall establish the procedure and terms for currency exchanges to organize operations to buy and sell foreign exchange and issue, suspend and
Under the Russia’s law, the Central Bank is the only authority in the banking sector.

Article 7 of the Law On the Central Bank stipulates that the Bank of Russia issues in the form of ordinances, regulations and instructions normative acts binding upon the bodies of state power of all levels and all legal entities and individuals. In addition to issuing its own rules and regulations, the Bank of Russia actively participates in other forms of lawmaking, since law requires the draft federal laws and government acts relating to the Bank of Russia’s functions should be send to the Bank of Russia to take its opinion.

Another key federal law relating to banking activities is the Federal Law On Banks and Banking Activities in the Russian Federation (hereinafter – Law On Banks), which defines such terms as "a credit institution", "a bank", "a non-bank credit institution", "a banking group", etc.

This Law describes the components of the Russian banking system, specifies the banking operations and other transactions and the operations conducted by credit institutions on the securities’ market and sets up the procedure for registering credit institutions, licensing banking activities and opening branches and representative offices of credit institutions. It also sets out the principles of relationship between credit institutions and their customers and the state, establishes the grounds for the revocation of banking license, formulates the principles of ensuring stability of credit

revoke permits for currency exchanges to organize operations to buy and sell foreign exchange;

18) It shall analyze and forecast the state of the Russian Federation economy as a whole and by region, especially monetary, currency and price aspects, and publish the corresponding materials and statistical data;

18.1) It shall effect Bank of Russia payments on household deposits with bankrupt banks not covered by the mandatory deposit insurance system in the cases stipulated and according to the procedure established by the federal law; (Point 18.1 was introduced by Federal Law No. 97-FZ, dated July 29, 2004)

19) It shall fulfill other functions in compliance with federal laws.

institutions, establishes the banking secrecy regime and anti-monopoly restrictions for credit institutions and lays down the principles of organizing the savings’ business in Russia.

Article 2 stated, “The banking system of the Russian Federation includes the Bank of Russia, credit organizations, and also branches and representations of foreign banks” (emphasis mine).

Article 17 and 18 of the Law On Banks regulated state registration of banks with foreign investment and additional requirements for foreign investors and will be discussed in details below.

The adoption of the Federal Law No. 40-FZ On Insolvency (Bankruptcy) of Credit Institutions (hereinafter - the Bank Insolvency Law) on February 25, 1999, was a major step forward in setting up an effective, up-to-date and internationally accepted procedure for declaring credit institutions insolvent (bankrupt). The Bank Insolvency Law was amended significantly over the years after initial adoption.

The Bank Insolvency Law establishes the procedure and conditions for implementing measures to prevent insolvency (bankruptcy) of credit institutions and specifies the grounds and procedures for declaring credit institutions insolvent (bankrupt) and subsequently liquidating them.

The Bank Insolvency Law pays special attention to the bankruptcy-prevention measures implemented before the revocation of banking license. These are:

(i) Financial rehabilitation;

(ii) Appointment of a temporary administration;

(iii) Reorganization.

The main distinctive feature of the banks’ bankruptcy is that creditor’s suit in the Arbitration (commercial) court is possible only after the Bank of Russia had revoked the bank’s license.
Under August 20, 2004 amendments, an institute of the Official Receiver for the insolvent banks was established in Russia. The functions of the Official Receiver were delegated to the Deposit Insurance Agency (hereinafter – DIA).

To increase public confidence in the banking system, stimulate growth in household savings and reduce risks assumed by banks when building up a long-term resource base, Russia adopted the Federal Law No. 177-FZ On Insurance of Household Deposits with Russian Banks (hereinafter – the Law on Insurance of Deposits) on December 23, 2003. This Law sets out:

(1) The legal, financial and organizational principles of the functioning of the mandatory household deposit insurance system in Russia;

(2) The competence and operating procedures of the Deposit Insurance Agency;

(3) The procedure for paying deposit compensation;

(4) The relations between banks, the Deposit Insurance Agency, the Bank of Russia and the Government in the field of household bank deposit insurance.

As a next logical step in building the deposits insurance system in Russia was the adoption of the Federal Law No. 96-FZ On Bank of Russia Payments on Household Deposits with Bankrupt Banks Uncovered by the Mandatory Deposit Insurance System on July 29, 2004. This Law extended to depositors of the banks outside the mandatory deposit insurance system guarantees similar to those granted to depositors of the participating banks. Under the Law, the Bank of Russia shall pay compensation to depositors of non-participating banks from its own funds.

The adoption of the Federal Law No. 218-FZ On Credit Histories on December 30, 2004 aimed to help build a system for the collection and disclosure of information about individual creditability. A major role in implementing this Law is played by the Bank of Russia, whose division titled the Central Catalogue of Credit Histories will perform the functions of a single information centre where one will be able to learn free of charge in what bureau of credit histories one can find information about a particular entity.

Other Federal Laws related to banking are:
The Federal Law No. 115-FZ On Countering the Legalization (Laundering) of Criminally Obtained Incomes and the Financing of Terrorism was adopted on August 7, 2001. This Law sets the criteria for the value of operations subject to mandatory control, specifies these operations and determines what organizations, credit institutions among them, conducting operations with money and other property must inform the authorized agency about these operations.


[c] The Central Bank Regulations

Here I will explore only the foreign banks’ related regulations.

In accordance with Article 2 of the Law On Banks, the Constitutions, Federal Laws and the Bank of Russia’s normative acts regulate banking activity in Russia. Pursuant to Article 7 of the Law On the Bank of Russia, the Bank shall issue normative acts, which are obligatory for the federal bodies of state power, the bodies of state power governing Russian subjects and local government bodies, as well as for all juridical and natural persons. These acts shall refer to issues on the Bank of Russia’s jurisdiction set out in the Law On the Bank of Russia and other laws, such as monetary and credit policy, banking supervision, settlements and currency regulation.

The first Central Bank’s act related to foreign banks’ activity in Russia was Conditions of Opening of Banks with Participation of Foreign Investments in Territory of the Russian Federation from April 8, 1993.

Currently conditions of the admission of the foreign capital are certain by the Law on Banks (articles 17 and 18) and detailed by the statutory act of Bank of Russia - Position of the Bank of Russia from April 23, 1997 No. 437 On Features of Registration of the Credit Organizations with Foreign Investments and about the Order of Reception of the Preliminary Sanction for Non-residents to Increase in the Authorized Capital of the Registered Credit Organization.

The details of these two acts will be discussed below.

3. The institutional background

[a] Institutions subject to bank regulation

As of January 1, 2009, there were 1,228 credit organizations in Russia: 1,172 banks and 56 non-banking credit organizations, 221 banks with foreign investments, including 76 of them with 100% foreign investments.47

Overall, Russia’s banking legislation, at least on paper, is quite comprehensive and the Central Bank has enough power to regulate and supervise the banking sector.

A credit organization is defined as a legal entity which in order to derive profit as a principal purpose of its activity on the basis of a special authorization (or license) of the Central Bank has the right to effectuate banking operations provided for by the Law On Banks (Article 1 of the Law On Banks). A credit organization could be established only in legal form of an economic society (joint stock, limited or extended liability company). Under the Russia’s law, credit organizations are subdivided into banks and non-bank credit organizations.

A bank shall be a credit organization, which has the exclusive right to effectuates in aggregate the following banking operations:

(1) Attracting deposits of monetary means of natural and juridical person;

(2) Placement of the said means in its own name and for its own account on conditions of repay ability, pay ability and demand;

(3) Opening and conducting the bank accounts.

The Law On Banks (Article 1) defines a non-banking credit organization as a credit organization having their right to effectuate the individual banking operations provided for by the Law On Banks. The admissible combinations of the banking operations for the non–bank credit organizations shall be established by the Bank of Russia. Currently admissible forms of banking operations for non–bank credit organizations are: clearing/net settlement, deposit taking and credit operations or cash collection operations. The majority of non-banking organizations perform as clearinghouses to settle the payments of currency or stock exchanges. Non-banking organization could execute only one, not combination of the banking operations above. As of January 1, 2009, there are 56 non-banking organizations in Russia, none of them with foreign investments.

In Canada, the term “bank” is not defined by the Bank Act or another statutes. The only institutions that are considered to be banks at law in Canada are banks or subsidiaries of foreign banks, which have received their letter’s patent of incorporation pursuant to the Bank Act or its predecessor legislation and listed in Schedules I and II to the Bank Act.48 “Authorized foreign banks”, listed in Schedule III, are those foreign banks authorized by Canadian regulators to establish branches in Canada.

While the banking sector has become more complex – both internally, with many new products, technologies and strategies, and externally, with new competitors domestic and foreign, new opportunities, new restrictions under the law, and uncertain and changing marketplace, but commercial banks remain preeminent participants.49

Foreign banks could establish a presence in Russia in the following organizational forms: branches, subsidiaries (joint venture banks) and representative offices.


[b] Regulatory Authorities

The legal nature of the Central Bank of the Russian Federation (Bank of Russia), like many other Central Banks around the world, is questionable.\(^{50}\) What made the Bank of Russia different from others financial regulators in the developed countries\(^{51}\) is the unprecedented concentration of power, combined with commercial activities. There is a conflict of interest when the same institution is responsible for monetary policy and prudential supervision.\(^{52}\)

The Central Bank’ legal status is questionable both from constitutional and civil laws’ point of view. Firstly, under the Constitution there are three divisions of the state power in Russia: legislative (the Federal Assembly), executive (the President and the Government) and judiciary (the Constitutional Court, the Supreme Court and the Supreme Arbitration Court). The Central Bank definitely is not a part of legislative or judiciary divisions of power. The Central Bank is not the executive power either. Firstly, the Bank of Russia is not a part of the Government and, consequently, is not a part of the executive power from the constitutional point of view. Secondly, the Bank of Russia does not comply with any organizational legal form, mentioned in the Civil Code of Russia. Under the Law On the Bank of Russia, its legal status is determined as the legal entity.\(^{53}\) Under the Civil Code of the Russian Federation, the legal entities may be either commercial (deriving profits as the main goal of their activity) or non-profit organizations. The Central Bank has been gaining an enormous profit every year, but the Law On the Bank of Russia declared that it is not the Central Bank target.


\(^{51}\) The author’s comparison is made with countries mentioned in Regulation of Foreign Banks: Banking Laws of Major Countries and the European Union, supra note 3.


\(^{53}\) The Law On the Bank of Russia, Article 1 “The Bank of Russia shall be a legal entity”.
Furthermore, the legal regime of the property of the Bank of Russia, while defined as a federal property, is uncertain. The Bank of Russia exercises its powers to own, use and manage its property, including the gold and currency (international) reserves.

Considering that political power in Russia is strong and highly monopolized, the legal status problems, listed above, are more theoretical than practical. However, in the case of a political or economical crisis, Russia could face legal problems, for example, with the Bank of Russia’ gold and currency reserves usage.

From author’s point of view, it is necessary to clarify legal status of the Bank of Russia in the constitutional and private laws. Such legal complication adds nothing for foreign investors for better understanding of Russia’s banking system.

The Bank of Russia is governed by several bodies. In 2002, in accordance with the new Law On the Bank of Russia, the management bodies were supplemented with the National Banking Board (NBB). The NBB is conceived as an instrument to enhance the transparency of the Bank’s activities. The Law On the Bank of Russia calls the NBB “a collegiate body of the Bank of Russia” (Article 12) and identifies it as a form of the Bank’s accountability to the State Duma. The NBB’ members are appointed by the State Duma (Russia’s Parliament), the Council of the Federation (Russia’s Senate), the President and the Government. The Chairman of the Bank of Russia is the NBB member by virtue of his position. The NBB examines the implementation of the main areas of state monetary and credit policy, banking regulation and banking supervision, and the execution of the currency regulation and currency control policies (Article 13).

54 The Law On the Bank of Russia, Article 2 “The authorized capital and other property of the Bank of Russia shall be in federal ownership. In pursuance of its purposes and in accordance with the procedure established by this Federal Law, the Bank of Russia shall exercise its powers to own, use and manage its property, including the gold and currency (international) reserves of the Bank of Russia. This property may not be confiscated or encumbered with obligations without Bank of Russia consent unless the federal law stipulates otherwise.

The state shall not be liable for the obligations of the Bank of Russia and the Bank of Russia shall not be liable for the obligations of the state unless they have assumed such obligations or unless federal laws stipulate otherwise.

The Bank of Russia shall cover its expenses with its own revenues.”
The Bank of Russia’s Chairman and Board of Directors are the supreme governance bodies of the Bank. In accordance with Article 83 of the Constitution and Article 14 of the Law On the Bank of Russia, the Bank’s Chairman is nominated by the President and appointed by the State Duma. In accordance with Article 20 of the Law on the Bank of Russia, the Bank’s Chairman shall:

(1) Take full responsibility for the activities of the Bank of Russia ensure that the Bank fulfils its functions in compliance with this federal law;

(2) Take decisions on all issues assigned by federal laws to the competence of the Bank, except those under the competence of the NBB or the Board of Directors;

(3) Chair the meetings of the Board of Directors; sign the Bank of Russia normative acts.

The Bank’s Board of Directors consists of the Chairman of the Bank and 12 full-time Board members. The Board of Directors has significant power in areas such as the Bank’s in-house activities, the development and implementation of a monetary and credit policy and banking supervision. Article 56 of the Law on the Bank of Russia also defines the Banking Supervision Committee as a permanent body to implement the Bank of Russia’s regulatory and supervisory functions.

The Bank of Russia’s jurisdiction covers issues of monetary and credit policy, banking regulation and supervision and even the functioning of Russia’s payment

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55 Article 35 of the Law On the Central Bank: “The principal tools and methods of the Bank of Russia monetary policy shall be as follows:
(1) Interest rates on Bank of Russia operations;
(2) Ratios of required reserves deposited with the Bank of Russia (reserve requirements);
(3) Open-market operations;
(4) Refinancing credit institutions;
(5) Currency interventions;
(6) Setting targets for money supply growth;
(7) Direct quantitative restrictions;
(8) Issue of bonds on its own behalf.”

56 Article 56 of the Law On the Central Bank: “The Bank of Russia shall be the body of banking regulation and banking supervision. The Bank of Russia shall conduct constant supervision over the observance by credit institutions and banking groups of banking legislation, Bank of Russia normative acts and the compulsory standards set by the Bank of Russia.”
system. The Bank of Russia is entitled to conduct transactions related to monetary and credit policy independently, to issue normative acts, and to license the activities of credit organizations and to ensure their compliance.

The Deposit Insurance Agency (hereinafter – Agency) was established in January 2004 by the Federal Law On the Insurance of Household Deposits in Banks of the Russian Federation 177-FZ dated on December 23, 2003. To ensure operations of the deposit insurance system the Agency shall pay out deposit compensation amounts to depositors in case of insurance event; keep register of banks-participants of deposit insurance system; monitor the formation of deposit insurance Fund, including insurance premiums of banks; manage the resources of the deposit insurance Fund.

Banks with foreign investment, taking deposits from public, must belong to the deposit insurance system.

The Agency is organized in the legal form of a state corporation (non-profit organization by the Civil Code classification). The Supreme Body of the Agency is the Board of directors, which consists of seven representatives of the Government of the Russian Federation, five representatives of the Bank of Russia and General Director of the Agency.

Currently guaranteed coverage is 700,000 RUB (around $27,000 CAD); number of banks, participated in the system is 938; number of insurance cases is 70; deposit insurance Fund balance is 80,5 billion RUB.  

The Fund consists of contributions from the state, as well as insurance premiums payable by banks involved in the deposit insurance system. Insurance premiums payable by banks are determined as the average chronological value within the accounting period (quarterly) of daily balances on accounts for recording deposits. The current rate of insurance premiums accounts for 0.15 per cent of the accounting base. The mandatory deposit fund is independent from budgetary funds as well as from funds of other persons, and the fund’s resources cannot be collected to satisfy state or Agency liabilities. If the fund lacks the resources for making payment, the

57 Available online at: http://www.asv.org.ru/
deficit could be fulfilled from federal budgetary funds or the introduction of a higher insurance premium rate.

The deposit insurance scheme intend to increase confidence in the banking system and to spread the level of household deposits away from Сберегательный Банк Российской Федерации (Sberbank, Savings Bank of the Russian Federation) to other commercial banks. With the advent of deposit insurance, Russia’s public may feel less skeptical about the security of the banking system and a lot of so-called “mattress-saving” money might be brought into the regular banking system (at the moment an estimated USD1.5 billion remains outside the system).

One of the reasons for the delay in adopting the Law On Deposit Insurance was concern that the weakness of the Russia’s banking system might lead to a collapse of the deposit insurance system, resulting in the growth of public mistrust in the banking system and the state.

Amendments to the Federal Law On Insolvency (Bankruptcy) of Credit Institutions, adopted on August 20th 2004, created an institute of Official Receiver of insolvent banks in Russia. The functions of the Receiver were delegated to the Agency. The Agency is obliged to implement bankruptcy procedures to deposit-taking banks.

The Agency, as a non-profit corporation, is not legally an authority, supervisory body, but has some “quasi-supervisory” authority within the framework of the deposit insurance system (for example, could participate in the Bank of Russia’s inspections). On the other hand, the Agency is not a commercial organization, but has some “quasi-commercial” activity within the framework of the deposit insurance system (for example, collect and sell bank’s assets within the bank insolvency procedure).

In my view, the dubious legal status and range of competence of the Agency require further clarification. Moreover, in case of the Agency activity as the Receiver, we will have deal with non-personal responsibility, what create good ground for corruption; non-market sales of banks’ assets, etc.
In comparison, the Canada Deposit Insurance Corporation (CDIC) protects deposits up to a maximum of $60,000 per person at each member institution. All licensed banks must belong to the CDIC-sponsored program. CDIC’s deposit protection program is funded by member institution premiums.

Chapter 2

Foreign Investment and Russia’s Banking System

1. The Legal Regime of Foreign Investment in Russia’s banking system

While the legal framework for foreign banks’ branches’ establishment exists, under the political decision de facto the foreign banks’ activity in this organizational

58 Canada Deposit Insurance Corporation Act, R.S.C. 1985, C-3.

59 Available online at: http://www.cdic.ca/

60 The Law On Banks, Article 2 “Banking system of the Russian Federation includes the Bank of Russia, credit organizations and also branches and representations of the foreign banks”.

Article 17 “State registration of the credit organization with foreign investments and the branch of the foreign bank and issuing them licenses for banking operations” regulates the list of additional documents, providing by the foreign legal entity for registration.

The Law On Banks, Article 18 “Additional requirements for establishment and activity of the foreign organizations with foreign investments and branches of the foreign banks” set out the definition and working mechanism of the “quota” of the foreign capital in the banking system and give the Bank of Russia the right to suspend the licensing of the foreign banks’ subsidiaries and branches when the quota is met.

The Law on the Bank of Russia, Article 52 “The Bank of Russia shall issue permits for the establishment of credit institutions with foreign investments and branches of foreign banks and accredit representative offices of credit institutions of foreign states in the Russian Federation in accordance with the procedure established by federal laws.

An increase in the authorized capital of a credit institution at non-residents’ expense shall be regulated by federal laws.”
form in Russia is prohibited. Under the Russia’s law the legal regime for wholly owned subsidiaries of foreign banks and joint venture bank are similar. Consequently, the foreign banks do not have many options to choose, they can execute the banking operations only in a form of a subsidiary or to acquire shares in existing banks.

For the first time foreign banking investors were allowed by the Decree of the President of the Russian Federation from November 17th, 1993, number 1924 On Activity of Foreign Banks and Joint Banks with Participation of Capital of Non-residents in Territory of the Russian Federation. It has been established, that foreign banks and their branches, and also joint banks, a share of non-residents in which capital exceeds 50 percent, are limited to operations with legal and physical persons - non-residents of the Russian Federation.

By the Decree of the President of the Russian Federation from June 10, 1994, No. 1184 On development of Banking System of the Russian Federation it has been established, that licensing for foreign banks and joint banks with foreign investments is carried out under the principle of reciprocity concerning the Russian banks’ activity in a correspondent country. These Decrees are still in force.

On the federal laws’ level the foreign banks’ activity is regulated by the Laws on Banks (Articles 17 and 18) and On the Central Bank (Article 52).

In my view, the main legal risk for foreign investors that definitely should cool off their intentions is that the Central Bank is granted the wide discretion towards the foreign bank regulation. In the absence of any policy document, it made the legal

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62 The Law On Banks, Article 18 “The Bank of Russia shall establish in accordance with the Federal Law On the Bank of Russia, additional requirements for the
environment for foreign investors highly unpredictable. The Central Bank regulations, in comparison with law, could be adopted immediately without any preliminary announcement.

[i] Representative Offices

On October 7, 1997, the Central Bank adopted Regulation On the Order of Opening and Activity in the Russian Federation of Representation of the Foreign Credit Organizations.63

The representation of the foreign credit organization (hereinafter - Representation) is understood as the isolated division of the foreign credit organization in Russia, which have received the Approval of the Bank of Russia on opening of Representation according to the Russian legislation and the Central Bank regulations. The Representation is not the legal entity, has no right to be engaged in banking activity on behalf of its own name and on behalf of the represented foreign bank. The Representation could not receive profit from the activity. All expenses of Representation are financed by the foreign credit organization.

[ii] Subsidiary and Joint venture banks

Special features of legal status of foreign banks’ branches, their subsidiaries and joint banks with foreign investment are constituted by additional requirements towards their establishment, state registration and activity in the Law On Banks (Article 17 and 18). These requirements are detailed in the Central Bank Provision 437 On Features of Registration of Credit Organizations with Foreign Investments and on Order of Receive the Preliminary Approval of the Bank of Russia for Increasing of Chartered Capital in Registered Credit Organizations at the Expense of the Means of Non-residents. Credit organizations with foreign investment are defined as credit organizations, which chartered capital was paid by foreign investors, unrelated to their share in capital (one share or 100%).

63 The Central Bank Order 02-437 on October 7, 1997.
As it was mentioned before, foreign banks’ branches legally are allowed in Russia; the opportunity of their participation in banking system is directly written down in the Law On Banks. However, Russia’s banking community, in fear to compete with international banks, is successfully lobbing the political decisions to ban the foreign banks’ branches penetration. The reasons for the fear are as, firstly, the cost of lending, and, secondly, amount of lending. The Bank of Russia 12% rate rocketed banks’ credit rates over 20%; small size of banks combined with credit restrictions do not allow them to finance the biggest clients. From Russian banks’ point of view is understandable, that market penetration of competitors with cheap and practically unlimited money will result in the dramatic changes in market environment and definitely not in favour of the domestic banks.

2. Foreign banks’ investment: factual background

The Central Bank official data\textsuperscript{64} demonstrates the steady increase over the last 5 years of:

(1) The total numbers of the Russia’s banks with foreign investment, including with foreign share in the banks’ capital over 50% and equal 100%;

(2) The numbers of the branches of the foreign banks’ subsidiaries.

<table>
<thead>
<tr>
<th>Year</th>
<th>2001</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total numbers of credit organizations</td>
<td>2124</td>
<td>1516</td>
<td>1409</td>
<td>1345</td>
<td>1289</td>
<td>1228</td>
</tr>
<tr>
<td>Banks</td>
<td>2084</td>
<td>1464</td>
<td>1356</td>
<td>1293</td>
<td>1243</td>
<td>1172</td>
</tr>
<tr>
<td>Nonbanks</td>
<td>40</td>
<td>52</td>
<td>53</td>
<td>52</td>
<td>53</td>
<td>56</td>
</tr>
</tbody>
</table>

\textsuperscript{64} The Central Bank official web-site does not provide the official data on credit organizations’ registration before 2001. Available online at: http://www.cbr.ru
These data also demonstrate that under the political decision the foreign banks’ branches do not operate in Russia since 2005.\textsuperscript{65}

The share of foreign investment in Russia’s banks has grown up to 28.5\% as of January 1, 2009.\textsuperscript{66} As of June 1, 2009, 226 banks with foreign investment are registered in Russia, 80 out of them with 100\% of foreign investment and 25 with share of investment, exceeding 50\%. On the separate segments of the banking market, in particular in the market of crediting of large corporate clients and the population, positions of the banks with foreign investments can appear even more strongly.

The growth of the foreign banks’ participation in the ‘after – crisis’ banking systems appeared to be a global trend. Robert Cull and Maria Soledad Martinez Peria have mentioned one important feature: foreign participation tended to increase as a result of crisis rather than prior to them. The share of assets (as a \% of total banking sector assets) held by foreign banks in Russia in 1995 was 2.0\% (in Europe and Central Asia region – 13.0\%), in 1996 – 1.4\% (13.3\%), in 1997 – 2.7\% (14.7\%), in

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|c|c|}
\hline
With foreign capital & 130 & 131 & 136 & 153 & 202 & 221 \\
\hline
100\% & 22 & 33 & 41 & 52 & 63 & 76 \\
\hline
> 50\% & 11 & 9 & 11 & 13 & 23 & 26 \\
\hline
Foreign banks' branches & 1 & 0 & 0 & 0 & 0 & 0 \\
\hline
Branches of foreign banks' subsidiaries & 7 & 16 & 29 & 90 & 169 & 242 \\
\hline
\end{tabular}
\end{table}

\textsuperscript{65} Ibid.

\textsuperscript{66} Available online at http://bankir.ru/news/newsline/1617965
1998 – 2.1% (18.2%), in 1999 – 4.5% (21.1%), in 2000 – 11.5% (28.4%), in 2001 – 13.7% (32.7%) and in 2002 – 15.6% and 35.7% respectively. Between 1995 and 2002, the average share of banking sector assets held by foreign banks in 104 developing countries rose from 18 per cent to 33 per cent.67

3. Special rules governing foreign banks entry and establishment

The bank system is the major part of the economic sovereignty of the country that causes necessity of the special order of access of the foreign capital for this sector of national economy. The special order consists in general, at a level of system, restriction of volume of foreign investments into the bank system of Russia, the allowing mechanism of access and presence of some additional requirements.

Jeffrey S. Graham and Andrew G. Harrison mentioned that the international banking community and their home country governments have continued to press Canada to bring its system of foreign bank regulation into line with international practice.68 Russia expresses the same pressure; foreign banks’ branches access remains one of the unsolved questions in the WTO-Russia’s negotiation.

Banking regulation begins at the market access stage. Although access regulation cannot guarantee that a bank will be well run after it is allowed to open, it can provide the possibility of reducing the number of unstable institutions that enter the banking system, and of keeping dishonest or inexperienced people from operating banking.

How to strike the balance between competition and domestic banking system safety is a key task for Russia in the design of foreign bank law reform.


[a] Establishment of subsidiaries

Licensing is a first step in the supervisory process. Application conditions consist of:

1. Being a financial institution;
2. Holding minimum amount of total assets;
3. Consent of home country supervisors.

The only option for foreign banks wishing to carry on a banking business in Russia is to establish a Russian-incorporated subsidiary or to acquire a share in the existing Russia’s bank.

The special rules governing the state registration of credit organization with foreign investments and branches of foreign bank are settled in the Law On Banks (Articles 17 and 18) and the Central Bank acts.

In addition to the documents specified in Article 14 of the Law On Banks, required for domestic banks’ registration, the duly formalised documents enumerated below shall be submitted by the foreign juridical person for the state registration of credit organization with foreign investment or a foreign bank branch:

1. The decision concerning the participation thereof in the creation a credit organization on the territory of the Russian Federation or opening of the branch of the bank;
2. The document confirming the registration of the juridical person and balance sheet for the three preceding years confirmed by the auditor’s opinion;
3. The written consent of the respective control agency of the country of its whereabouts to participation in the creation of a credit organization in Russia or opening of the branch of the bank in those instances when such authorisation is required according to the legislation of the country of its whereabouts.

69 The list of required documents includes a bank’ draft registration documents (charter and founder’s agreement), founders’ registration documents, business plan, state registration fee payment and standardised management resume.
A foreign natural person shall submit confirmation of a first-class (according to international practice) foreign bank of the ability of this person to pay.

Article 18 of the Law On Banks established additional requirements for creation and activity of credit organizations with foreign investments and branches of foreign banks:

(1) The amount (or quota) of participation of foreign capital in the banking system shall be established by a federal law upon the proposal of the Government agreed with the Bank of Russia. The said quota shall be calculated as the relationship of the total capital belonging to non-residents in the charter capital of credit organizations with foreign investments and the capital of branches of foreign banks to the aggregate charter capital of credit organizations registered in Russia.

The Bank of Russia shall terminate the issuance of licenses for the effectuation of banking operations to banks with foreign investments and branches of foreign banks when the established quota is reaches.

The Bank of Russia shall have the right to impose a prohibition on an increase of the charter capital of a credit organization at the expense of the means of non-residents and the alienation of stocks (or participatory shares) to the benefit of non-residents if the result of the said action is exceeding the quota of participation of foreign capital in the banking system of Russia.

(2) The Bank of Russia shall have the right by agreement with the Government to establish limitations for credit organizations with foreign investments and branches of the foreign banks on the effectuation of banking operations if limitations are applied in the respective foreign States with respect to banks with Russian investments and branches of Russian banks on their creation and activity.

(3) The Bank of Russia shall have the right to establish in accordance with the procedure established by the Law On the Central Bank additional requirements for credit organizations with foreign investments and branches of foreign banks relative to the procedure for the submission of reports, confirmation of the members of management and list of banking operations to be effectuated.
The quota propositions above are an example how the written law could be different from its implementation in Russia. The Central Bank settled the 12% quota in 1993, it existed up to 2002, since then there is no quota for foreign investment in Russia. Moreover, the Director of Department of bank regulation and supervision of the Bank of Russia Aleksey Simanovsky had declared that the bank of Russia considers inexpedient introduction of a quota on participation of the foreign capital in the Russian bank system. Nevertheless, the existence of these propositions itself decrease the level of foreign investors’ confidence in stability of Russia’s banking system and predictability of banking law.

Until 2006’ amendments, the Bank of Russia could also establish additional requirements relative to obligatory normative standards and minimum amount of charter capital.

Once it established, subsidiaries of foreign banks must maintain adequate capital and appropriate forms of liquidity in relation to their operations. The Law On Banks provides that each subsidiary of a foreign bank will begin operations with 180 million Roubles (around 6.5 million CAD in capital).

The detailed elaboration of these requirements is given in the Central Bank Position 437 On Features of Registration of the Credit Organizations with Foreign Investments and On the Order of Reception of the Preliminary Approval of the Bank of Russia on Increase in the Authorized Capital of the Registered Credit Organization due to Means of Non-residents.

Features of registration of the credit organizations with foreign investments are as following.

The bank of Russia gives out preliminary approval to creation of the credit organizations with foreign investments. The preliminary approval should be understood as the basic consent of the Bank of Russia to participation of the concrete non-resident in creation of the credit organization - the resident.

70 Available online at: http://www.prime-tass.ru/news/0/%7B28BECC6F-93EC-4BE1-86BE-3CD4D104A985%7D.uif
By consideration of a question on delivery of the approval are considered:

(i) Level of use of a quota of participation of the foreign capital in bank system of Russia;

(ii) Financial position and business reputation of founders-non-residents;

(iii) Sequence of submission of applications.

The Bank of Russia can also consider the size of foreign investments in the banking system of Russia from the states of the location of founders, and also character of mutual relations between Russia and the state of the location of each of founders. Besides the Bank of Russia can take measures of the special control over foreign investments into the bank system of Russia from founders-non-residents with a place of registration in one of the states with a preferential tax mode and absence of tariff methods of customs’ regulation or concerning investments from the resident in whom the share of such non-resident exceeds 50 % (Articles 4 and 5 of the Central Bank Position 437).

For reception of the approval founders represent to the Bank of Russia the application (petition) for delivery of the approval for creation of the credit organization with foreign investments. The application should contain the instruction on non-residents - prospective founders of the credit organization; their location; legal status; the exact size of prospective participation of each non-resident in the charter capital of the credit organization (in numerical and percentage expression). At purchase by the non-resident more than 10 % of the charter capital of the created credit organization - the resident the application should contain the information on founders of such legal person - the non-resident with the instruction of their location and the brief description of type of their activity. The application subscribes the person authorized on it by assembly of founders of the credit organization with foreign investments.

On the application on the legal person - the non-resident are applied: (i) Constituent documents;

(ii) Decision of the authorized body of the legal person on its participation in the authorized capital of the credit organization in Russia;
(iii) A copy of the document (or an extract from it), the legal person confirming registration;

(iv) Balances for three most recent years activity, confirmed by the auditor conclusion;

(v) Written approval of the corresponding control body of the country of its location to participation in the authorized capital of the credit organization in Russia or the conclusion of this body about absence of necessity of reception of such consent.

The approval is valid within one year from the date of its reception. After reception of the approval founders of the bank supposed to register it in accordance with the basic requirements settled for domestic banks in the Central Bank regulations.

Russia, unlike Canada, do not have special requirements depending on foreign bank’ home country membership in WTO. For example, foreign bank subsidiaries in Canada that are not controlled by a WTO resident may only have a head office and one branch office, unless the permission of the Minister to have more branches is obtained.71 However, it could not be considered as an argument in favour of more liberal regime towards foreign investments in Russia’s banking system. Firstly, Russia is not the WTO member; therefore, any provisions against or in favour of the WTO are not necessary. Secondly, the Central Bank’ competence allows to select the preferable countries and/or banks in accordance with the current political situation and others, non – defined in the law, factors (corrupt practice is not excluded).

[b] Acquisition of the existing banks

Participation of the non-resident in the charter capital of the bank - resident is possible only after reception of the approval of the Bank of Russia. To the credit organization - resident, registered in the form of the open joint-stock company, the sanction to sale shares to non-residents in the primary market can be given if the cumulative share of foreign investors on results of release will not exceed 1 % of its charter capital.

71 The Bank Act, 422.2
For reception of the approval the bank represents the application. The approval is valid within one year from the date of its reception. Significantly, the bank continuing from any share acquisition or amalgamation must be a Russian corporate entity.

The Central Bank of Russia also settled the requirements towards the management of the bank with foreign investments.

If the CEO of the bank is the foreign citizen or the person without citizenship, the joint executive body of the bank not less than on 50% should be generated from Russian citizens. Other proportion of the foreign and Russian citizen could be allowed only by the Bank of Russia’ permission. The CEO or CFO – foreign citizens must evaluate their qualification in the Ministry of Education and Science of the Russian Federation, applies for job permit from the Federal Migration Service, and also passed the Russian language test. Russian citizens should be not less than 75 % from total personal.

[e] Licensing of branches of foreign banks

As was mentioned above, while politically and practically foreign banks’ branches are not allowed in Russia, the legal ground for their establishment already exists (Articles 17 and 18 of the Law On Banks and the Central Bank’ Provision 437).

[d] Licensing of representative offices

The Central Bank’ approval to opening the representation in Russia could be give to the foreign banks, which:

(i) Functioning not less then five years,

(ii) Have well proved reputation in banking system of the home country,

(iii) Have a steady financial position, confirmed by the control body of the country of a residence.

At the decision-making process of opening the representation of the foreign bank from an offshore zone, presence of a bilateral agreement between the Bank of Russia and National (Central) bank of a country of origin of the bank, providing information interchange in the field of bank supervision, is considered. At decision-making on
accreditation of the representation, a character of mutual relations between the Russian Federation and a country of origin of the bank also can be considered.

The foreign bank interested in opening of the representation in Russia represents to the Bank of Russia the written application, where the purpose of opening of the representation is stated.

The application should include:

(i) Charter of the foreign bank;

(ii) Certificate on registration of the foreign bank or extract from the bank register;

(iii) Consent of the control body of the country of a residence of the foreign bank;

(iv) Power of attorney of the bank to the person, negotiating the opening of the representation;

(v) Curriculum vitae on the Head of the representation and its assistant;

(vi) Letters of recommendation from not less than two Russia’s banks;

(vii) The most recent annual report of the foreign bank;

(viii) Information on the foreign bank with the information on structure of its management bodies;

(ix) Landlord’ consent on granting of a premise under the office of the representation (the letter of guarantee or the contract of rent);

(x) Internal regulations about the representation;

(xi) Copy of the applicable fee payment for delivery of the approval.

The documents executed in foreign language are subject to translation into Russian, notary assurance and legalization by consular establishments of the Russian Federation abroad or an apostil.

In case if the representation opens not in Moscow, also there should be letters from the territorial division of the Bank of Russia and the local administration with their opinion on this question.
It is forbidden to open the representations in the territory of diplomatic establishments.

All foreign employees of the representation are obliged to pass personal accreditation in the Bank of Russia and to obtain a job permit. Candidates on a position of the Head and the assistant to the Head of the representation should have law or economic background, or working experience in the banking system more than 2 years.

The Head of the representation and its assistant is not authorized to work simultaneously in the Russian bank created with participation of the foreign bank, opened the specified representation.

The Approval specifies:

(i) Reduced and full if it is necessary, the name of the foreign bank in Russian;

(ii) Term on which the Approval stands out;

(iii) Quantity of employees of the representations - foreign citizens.

The approval stands out for the period of three years. Number of the foreign personnel of the representation, as a rule, should not exceed two persons, but could be increased upon additional approval. The approval loses force if the representation actually has not started to work within six months from the date of its delivery.

The representation must comply with the requirements of the Russia’s law and the Central bank’ regulations.

The Representation must reports about the activity to the Bank of Russia twice a year (until January and July 15th). The report should specify:

(i) Data about the structure of representation;

(ii) The brief characteristic of the basic projects, which are carried out by the foreign bank in Russia with the instruction of terms, volumes and partners;

(iii) Data on cooperation with the Central Bank and the Russia’s banks.
The Head of the representation in due time should inform the Bank of Russia on changes in staff of foreign employees, and also about the emergencies connected with activity of representation and its employees.

The Central Bank’ staff can visit the representation with the inspection once in a year.

Activity of the representation shall stops:

(i) After the term on which the approval is given out;

(ii) In case of revoking a foreign bank license;

(iii) Under the decision of the foreign bank;

(iv) In case of the representation activity contradicts the Russia’s legislation;

(v) Under the decision of the Bank of Russia (without the explanation of the reasons).

If the representation complied with all requirements and applied for the prolongation of the approval, it could be granted by the Central Bank decision.

In Canada foreign banks may establish one or more representative offices in Canada with the approval of the Superintendent, subject to any terms and conditions the Superintendent attaches to his approval.\textsuperscript{72} A foreign bank is permitted to establish a representative office regardless of whether it has also incorporated a subsidiary. The office may not be used or controlled by a Canadian corporation, and its staff must be directly or indirectly employed by the foreign bank. Representative offices may not promote services of a foreign bank subsidiary or other Canadian-incorporated affiliate of the foreign bank.\textsuperscript{73}

\begin{itemize}
\item \textsuperscript{72} The Bank Act, 522.
\item \textsuperscript{73} Foreign Bank Representative Office Regulations, S.O.R./921299 (May 21, 1992).
\end{itemize}
4. Ongoing regulations

Due to the facts that: (i) banks with foreign investments are legal entities under the Russia’s law and (ii) activities of the foreign banks branches are de facto impeded in Russia; there are no specific regulations of banking activities for banks with foreign investments (does not matter if these investments are 0,1 or 100%).

Banking regulation and supervision play an essential role to assure immutability of the financial system. Ross Cranston mentioned the following reasons for regulating banking and financial institutions: monetary policy, prudential, investor-protection, anti-crime, and consumer-protection.\(^74\) Philip R. Wood noted, that the main objectives of regulation are to protect the public from incompetence and deceit, from their own imprudence or lack of sophistication, and from insolvency of regulated institutions and debtors.\(^75\) I would like to add one more important reason for banking system regulation: the banking system’ stability protection, both against international and domestic-arise crises.

As Ross Cranston mentioned, perhaps the most characteristic feature of banking regulation these days is convergence: countries around the world are moving closer in terms of the content of prudential regulation and the techniques used.\(^76\) Legal uniformity in international banking law is needed to reduce losses from nullified transactions, to avoid unfairness and injustice and to promote international legal safety. Bank regulation, all in all, is comparatively harmonious and sensible at the international level.\(^77\) Effective cooperation between the host and home authorities is a central prerequisite for the supervision of banks’ international operations.

The Basel Committee on Banking Supervision (hereinafter – Basel Committee) is


\(^76\) Supra note 70 at 65.

\(^77\) Supra note 71 at 22.
a forum for regular cooperation on banking supervisory matters, with objects to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. The Basel Committee is best known for its international standards on capital adequacy; the Core Principles for Effective Banking Supervision; and the Concordat on cross-border banking supervision.

Russia is the Committee's member among with Australia, Belgium, Brazil, Canada, China, France, Germany, India, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States.\(^78\)

The Central Bank’ Guidelines for the State Monetary Policy in 2009 and for 2010 and 2011\(^79\) declares as one of the priorities in 2009 the complete implementation of the policies recommended by the Basel Committee document International Convergence of Capital Measurement and Capital Standards: a Revised Framework (Basel II) in regard to the simplified standardized approach for evaluating capital adequacy of banks, described in Pillar I Minimum Capital Requirements of Basel II.

The key regulation standards include: capital adequacy, credit risk (large exposures), investment in non-financial entities, deposit protection, the ownership and control of banks, and consolidated supervision.

Banks face many challenges in their daily operations. The better-known examples are unwise investments in questionable industrial projects, hazardous dealings in foreign currencies, and the investment of money received on short deposits in long-term transactions.\(^80\)

The foreign financial institutions’ activity brought more risk to the domestic markets. Besides all banking risks for the host country, we have a home

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\(^{78}\) Available online at: http://www.bis.org/bcbs/index.htm

\(^{79}\) Available online at: http://www.cbr.ru:80/eng/today/publications_reports/on_09-eng.pdf

country political and economical risk, risk of currency exchange rates, and risk of parent institution financial stability. Cross-border supervision creates challenges difficult to conquer. The legal framework is restricted to the domestic level and there exists no such system as a formal supervisor for international banking institutions. Thus it requires effective coordination and unification of regulatory and supervisory standards and flows of quality information between regulators, and the introduction of other tools like lead regulator arrangements and formal agreements between supervisors.

To maintain the stability of banking system, protect the interests of depositors and creditors the Bank of Russia sets out mandatory economic standards and requires that all banks must abide by them.

Instruction 1 of January 30, 1996, On the Procedure for Regulation the Activities of Credit Organizations81 (hereinafter – Instruction 1) was drawn up in accordance with the Federal Law On the Central Bank and established rather harsh restrictions, taking into account international banking practices. The gradual toughening of regulatory standards gave banks time to restructure their assets and liabilities. To ensure the reliability of banks, the Bank of Russia placed certain requirements on the size of authorized (regulatory) capital of newly - created banks and set a minimum level for operation banks’ own capital.

The Central Bank established the following mandatory economic standards for banks:

(i) Minimum authorized (regulatory) capital for newly created banks;
(ii) Minimum equity capital for existing banks;
(iii) Capital adequacy ratios;
(iv) Bank liquidity ratios;
(v) Maximum risk per borrower or group of related borrowers;
(vi) Maximum big credit risks;
(vii) Maximum risk per creditor (depositor);
(viii) Maximum amount of credits, guarantees and sureties granted by a bank to it

81 Вестник Банка России (The Herald of the Bank of Russia) (16 October, 1997) 66 (229).
partners (stockholders and shareholders) and insiders;

(ix) Maximum amount of personal deposits;

(x) Maximum amount of a bank’s liabilities on bills of exchange;

(xi) The ratio of banks’ equity capital used for acquiring stakes (shares) of other legal entities.

The required standards, such as the maximum amount of the non-monetary part of regulatory capital, the minimum reserves created for high-risk assets and the levels of foreign exchange, interest-rates and other risks, shall be established by others enactments of the Bank of Russia.

[a] Permissible Banking Activities

Russian legal theory adopted a legal construction of two types of the legal capacity of the legal entity.\(^\text{82}\) The legal entity generally entitled possess the civil rights and discharge the civil duties, indispensable for the performance of any kinds of activity that are not prohibited by the law; however, the certain individual kinds of activity, the list of which shall be defined by the law, can be executed only on the ground of a special permit (license).

Generally, the legal capacity of the legal entity shall arise in the moment of its establishment and shall cease in the moment, when its liquidation is completed. The rights of the legal entity to engage in an activity, for the performance of which a license shall be drawn, shall arise from the moment of its obtaining such a license, or from the time indicated in the license. These rights shall cease after the expiry of the term of its operation, unless otherwise stipulated by the law or by the other legal acts.

The general legal capacity is called *pravosposobnost’* and special legal capacity is called *spechial’naya pravosposobnost’*. Banks are legal entities of the special legal capacity.\(^\text{83}\)

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\(^{82}\) See Article 49 of the *Civil Code of the Russian Federation*, available online in English at: [http://www.russian-civil-code.com/](http://www.russian-civil-code.com/)

Under the Article 5 of the Law On Banks, banks are authorized to conduct the following banking operations:

(1) Attracting the monetary funds of natural persons and legal entities in the form of deposits (demand or fixed-term deposits);

(2) Investing those funds in its own behalf and at own expense;

(3) Opening and conducting bank accounts for natural persons and legal entities;

(4) Clearing payments ordered by natural persons and legal entities, including banks-correspondents, within their bank accounts;

(5) Collecting cash, bills, payment and settlement documents and providing cash services to natural persons and legal entities;

(6) Buying and selling foreign currencies in cash and non-cash forms;

(7) Attracting precious metals in the form of deposits and investing them;

(8) Providing bank guarantees;

(9) The money remittance without bank accounts opening (excluding postal remittance).

The banking operations above could be executed only by banks or non-bank credit organizations; organizations licensed by the Bank of Russia.

Besides the core bank’ operations banks have the right to carry out following transactions:

(1) Providing guarantees for the third parties with the execution of obligations in the monetary form;

(2) Purchase of the requirement from the third parties of execution of obligations in the monetary form;

(3) Fiduciary management of money and other property under the contract with natural and legal persons;
(4) Operations with precious metals and jewels according to the legislation of the Russian Federation;

(5) Rent of safe deposit boxes to natural and legal persons for storage of documents and values;

(6) Leasing operations;

(7) Consulting and information services.

All bank operations and other transactions are carried out in rubles, and at presence of the corresponding license of the Bank of Russia - in a foreign currency. Bank of Russia establishes rules of realization of bank operations, including rules of their material support, according to federal laws (Paragraph 5 of Article 4 of the Law On the Bank of Russia).

The difference between ‘core banking operations’ and other permissible banking operations is not clear enough that cause numerous administrative dispute, courts litigation and criminal trials.\footnote{For more detail see Trofimov, Kirill. Supra note 6 at 273-288.}

The banks have the right to carry out other transactions according to the legislation of the Russian Federation. Banks are authorized to hold, manage and otherwise deal as principal with real property. Permissible 'consulting and information services', related to banking activities, could be easily extended to the formation and management of investment, pension or mutual funds, which banks could manage through the use of subsidiary corporations.

Russia's banks are permitted to undertake a broad variety of financial service activities directly, including investment counseling, portfolio management and provision of credit card services.\footnote{On Russian banks securities market’ activity in English see \textit{e.g.:} Brown, Robert J., Jr., “Of Brokers, Banks and the Case for Regulatory Intervention in the Russian Securities Markets” (1996) 32 Stanford Journal of International Law at 185-253.} Banks may directly engage in the trading in securities on their own account, primary distribution of certain debt obligations (including the Government of Russia or local bonds, or money market securities), the primary distribution of equities issued by the bank and certain other limited types of equities issues.\footnote{See: The Law On Banks, Article 6.}
Securities' law in Russia is a subject for exclusive federal regulation.  

The types of securities' activities banks may engage in directly, as a professional securities' market participant, are prescribed in the Law On Securities Market. However, as the banks can conduct any type of securities-related activity indirectly through securities' dealer subsidiaries, the significance of these restrictions is somewhat limited. Russia's banks are permitted both to securitize their own assets and/or issue additional shares or play other roles in assets securitization – acting as an agent, for example, or providing credit support.

Russia's banks are permitted to own entities incorporated under Russia or under the laws of a non-Russia jurisdiction, whose primary activity is securities dealing. The dealer may conduct its securities brokerage and dealing activities freely, in compliance with all applicable laws.

Generally, a bank is permitted to invest in any entity, which carries on activities the bank would otherwise be permitted to conduct directly. Banks are permitted to acquire and control insurance companies as subsidiaries.

Certain basic limitations on bank's investment powers exist under the Instruction 1, including limitations on the aggregate value of a bank's investments in equities (individually – up to 10% of own capital and as a combined aggregate - up to 25% of own capital) to certain percentages of the bank's regulatory capital. The current investment regime permits bank to make substantial investments in other types of financial institutions, including insurance companies, securities dealers and other banks. This power gives banks the authority to split their business into distinct entities, such as a commercial bank and retail bank, which may or may not be held under a holding company structure.

In addition to investments in other financial institutions, banks are permitted to invest in any entity that provides a service that the bank itself would be permitted to provide.

The overall limit of all investments is capped at 25% of working capital.

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87 See: Constitution of the Russian Federation, Article 58. Otherwise, securities law in Canada falls under provincial jurisdiction (Constitution Act 1867, 92(13)).
It is reasonable to assess the power to invest in nonbank commercial and industrial enterprises as quite flexible. No special regulation for foreign banks exists. However, the Central Bank approval is required for investment in foreign financial institutions.

The Central Bank also set out following maximum liquidity ratio on operations with precious metals (standard 14): 10% of the balance as of March 1, 1997.

[b] Prohibited Activities

The industrial, trading and insurance activities are forbidden for the banks.88

Banks cannot participate in the sale of insurance products. Banks may not retail insurance policies, including those of their insurance company subsidiaries, through their branch network, and are generally prohibited from otherwise soliciting many kinds of insurance business from the customers. Nevertheless, banks have been allowed to own insurance companies and may carry out any type of insurance-related activity through insurance company subsidiaries.

There are no special regulations for foreign banks or banks with foreign capital concerning their securities, investment or other kind of permissible activities. Foreign banks in Canada are generally permitted to carry on the same businesses and undertake the same investments permitted to Canadian banks under the Bank Act.89

[c] Capital Adequacy of Banks

The Basel Committee on Banking Supervision, Core principles for effective banking supervision, revised version as of October 2006, and Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework (revised Capital Accord as of November 2005)90 consider capital adequacy requirements as part of prudential regulation and not only a component in bank entry regulation but also a central issue in the process of ongoing regulation. Capital adequacy is the minimal level of capital viewed as a necessary or desirable by the

88 The Law On Banks, Article 5.


90 Available online at: http://www.bis.org/list/bcbs/tid_25/index.htm
bank regulator for the safety and soundness of bank operations. Fundamentally, capital represents the funds that are available to absorb losses.

The role of the capital adequacy highly depends on the time of banking operations: is it normal or crisis time of business? Generally speaking, the larger amount of capital, the less likely this bank would go to insolvency during the difficult time.

Bank of Russia adopted the standards collectively quite closely conforming to the standards set by the Bank for International Settlements (BIS). Three capital adequacy standards have been established: the assets-to-capital multiple; the risk-based standard; and, for certain banking operations, the market-risk standard.

The capital adequacy standards provide an overall measure of the adequacy of a bank's capital and are applied on a consolidated basis and include all of a bank's subsidiaries. Russian banks are required to meet capital adequacy standards prescribed by the Central bank. The constituent components of Tier I and Tier II capital, and deduction from Tier I capital are established by the Central Bank. Instruction 1\textsuperscript{92} defines the capital adequacy ratio as a ratio of a bank's own funds (capital) and the total amount of the counterparty’s risk-weighted assets (calculated by dividing the bank’s total assets, including specified off-balance sheet items) by banks total capital. Five groups of standards set out to evaluate the quality of a bank's assets, depending on the extent of investment risk exposure and the risk of a partial loss of value. To determine the risk-weighted assets (the denominator of the risk-based capital ratio) the assets of a bank (and credit equivalent amounts for off-balance sheet items) are assigned to one of four broad risk categories: 0, 20, 50, 70 and 100 percent risk weight. The assignment of an asset into a particular risk category will depend on the risk associated with a particular type of asset. Amounts included in these categories are multiplied by the risk weight for the category, with the resulting weight values added together to arrive at total risk-weight assets.

The capital adequacy ratio (H1) has been set at 10% (11% for banks with capital

\textsuperscript{91} See: The Central Bank' Provision On a Technique of Definition of Own Funds (Capital) of the Credit Organizations 215-P, adopted on February 10, 2003.

\textsuperscript{92} See: Instruction 1, Article 3.
less than 5 million euro) of the balance as of January 1, 2000. The current liquidity ratio (H2) has been set at no less than 70% of the balance as of February 1, 1999. The instant liquidity ratio (H3) has been set at 20% of the balance as of February 1, 1997. The long-term liquidity ratio (H4) has been set at no more than 120%.

Canada has a quite similar regulation. Under the risk-based capital adequacy standard, a bank’s minimum capital requirement is defined as a ratio of total capital (the sum of Tier I and Tier II capital) divided by risk-weighted assets and risk-weighted off-balance sheet items. At present, the risk weighting is assigned based on an assessment of counterparty credit risk. Banks are expected to attain a risk-based Tier I capital ratio of at least 7 percent and total capital ration of at least 10 percent.93

The Central Bank also adopter the Provision On Order of Counting by the Credit Organizations the Amount at Market Risk.94 Market risk is the risk of losses in on- and off-balance sheet position arising from movements in market prices. The risks pertaining to this requirement are: for instruments in the trading book, the interest rate position risk and the equity position risk; and for the entire institution, the foreign exchange risk and the commodities risk.

[d] Restrictions and Regulations of Credit

The restrictions of credit (large exposure limits) are generally expressed in relation to bank’s capital. The Central Bank of Russia set out a group of credit risk standards.95 Maximum risk per borrower or group of related borrowers (N6) establish as a percentage of the bank’s equity capital. The maximum N6 ratio is set at 25%. Maximum big credit risk (N7) establish as a percentage of the total amount of big credit risks and the bank’s equity capital. A big credit is the total sum of the bank’s risk-weighted claims to one borrower (or a group of related borrowers) on credits, taking into account 50% of the sum of off balance claims guarantees and sureties held by the bank with regard to one borrower (or a group of related borrowers), exceeding 5% of the bank’s equity capital. The aggregate amount of big credits and loans

93 See: Regulation of Foreign Banks, supra note 3 at 332.
95 See: Instruction 1, Article 5.
extended by the bank, including related borrowers and taking into account 50 percent of off-balance claims (guarantees and sureties) may not exceed the bank’s capital more than 8 times. Maximum risk per creditor (depositor) (N8) is establish as a percentage of the deposits or credits received by the bank, guarantees and sureties and balances on the accounts of one creditor (depositor) or related creditors (depositors) in the bank’s equity capital. The maximum N8 ratio is set at 25%. Special attention has been paid to connect lending within the framework of large exposure controls. Connected lending, which means the extension of credit to the bank’s affiliates, insiders and bank shareholders, can lead to non-objective determinations of the creditworthiness of the borrower, to conflicts of interest, and in certain circumstances to dangerous leveraging within a group of companies and corruptive practices. Maximum risk per borrower-shareholder (partner) (N9) establish as the ratio of the amount of credits, guarantees and sureties issued by the bank to its partners to the bank’s equity capital. The maximum N9 ratio is set at 20%. The aggregate amount of credits and loans (N9.1), extended to the bank’s shareholders (partners), may not exceed 50% of the bank’s equity capital. The maximum amount of credits, loans, guarantees and sureties issued by the bank to its insiders (N10) may not exceed 2% of the bank’s equity capital. The aggregate amount of credits and loans extended to insiders (N10.1) may not exceed 3% of the bank’s equity capital.  

System and individual bank undercapitalization remain one of the main unsolved problems for the Central Bank. Under the Report On development of the bank sector and bank supervision in 2008, 404 banks have operation capital less than 5 million euro, consequently, taking into account the credit restriction, could provide the loans not more than 1,25 million euro.

In comparison with Russia, in Canada the aggregate exposure of a domestic bank to any entity is not permitted to exceed 25 percent of total capital. Subsidiaries of

96 Ibid. at 5-11.

97 Available online at: http://www.cbr.ru
foreign banks, however, are permitted, in certain circumstances, to lend up to 100 percent of the total capital of the subsidiary.

The Central Bank Provision 254-P from March 26, 2004 On Order of Formation by the Credit Organizations Reserves on Possible Losses Under Loans and Equal Debts provides guidance to banks in establishing investing and lending policies. The bank's board of directors or a subcommittee appointed by the board should review and approve the investment and lending policies and be advised in writing of adherence to these policies.

Foreign banks' subsidiaries are subject to the same capital restrictions as other Russia's banks.

Treatment of impaired loans is governed by the Instruction 62 from June 30, 1997, On the Order of Formation and Usage of a Reserve on Possible Losses Under Loans. Loans are generally considered to be impaired when they are contractually 180 days in arrears. Loans from regulated financial institutions or restricted loans are impaired when they are contractually 90 days in arrears. Classification of loans (4 groups) is made depending on a level of credit risk from standard to hopeless, which required reserves from 1% up to 100% respectively.

[e] Liquidity Requirements

Prudential regulation of banks’ liquidity has been traditionally a corner stone of ongoing regulation. The lack of liquidity can lead to insolvency, so the bank regulators generally seek to impose liquidity controls in the form of formal limits,

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98 These circumstances include (1) the parent is made aware of the exposure above 50% of total capital and sanctions it; (2) the parent and subsidiary are adequately supervised by regulatory authorities; (3) the parent company is in the opinion of the Superintendent a source of financial strength for the subsidiary; and (4) there are no legal, regulatory, statutory or fiscal restrictions in the parent company’s home jurisdiction to obtaining capital from the parent in the event of losses.

99 See: Shriver, R. E. and Lisson, J., “Banking Regulation in Canada” in Regulation of Foreign Banks, supra note 3 at 334-335.


guidelines and monitoring bank policies on liquidity management. Liquidity relates to a bank’s ability to meet its future cash shortage.

Russia adopts the statistical approach that refers to the ratio of liquid assets and liabilities. Liquidity is defined as the ability of a bank to meet its obligations on time. The main problem is that this approach is inherently the static one, and does not give proper weight to the dynamic character of the business of banking.

The Bank of Russia established a set of liquidity ratios: instant, current, long-term and general liquidity ratios and liquidity ratios for operations with precious metals, which are calculated as the ratio between assets and liabilities, considering the terms, amounts and types of assets and liabilities and other factors.

Canada, in a contrary, adopts no formal liquidity requirement or statutory ratios, the liquidity requirements of a particular bank are determined by the institution itself. Prudential monitor is exercised in the normal supervision process. The banks must have in place ongoing monitoring procedures that review liquid assets and funding requirements. Minimum targets for the stock of liquid assets must take into considerations the bank’s overall liquidity profile, including asset quality, stability of funding source, short-term funding requirements and, particularly for foreign bank branches and subsidiaries, the degree of integration of liquidity management with the parent bank, as well as the financial strength of the parent must be a part of a formal

\(^{102}\) See: Instruction 1, Article 4.

\(^{103}\) See: Trofimov, Kirill. (2004), supra note 6 at 118-142.

\(^{104}\) See: Instruction 1, Articles 4.1 - 4.4. “The instant liquidity ratio (minimum 20%) establish as the ratio of the sum of the banks’ liquid assets to the sum of the bank’s liabilities on demand accounts. The current liquidity ratio (minimum 70%) is establish as the ratio of the sum of the bank’s liquid assets to the sum of the bank’s liabilities on demand accounts and accounts up to 30 days. The bank long-term liquidity ratio (120%) is establish as the ratio of the entire long-term debt to the bank, including guarantees and sureties with a maturity of more than a year, to the bank’s equity capital and liabilities on deposit accounts, credits received and other debt liabilities with maturities exceeding 1 year. The general liquidity ratio (20%) establish as a percentage of liquid assets in the bank’s aggregate assets”.

\(^{105}\) See: supra note 95 at 338.
written liquidity policy. Where foreign currency represents more than 10 percent of total funding of the bank, a foreign-currency liquidity policy must be put in place.  

[f] Reserve Requirements

Reserves relate to the stability of the bank-depositor relationship as well as the ability of the government to control monetary policy (the amount and cost of credit). Depository institutions have been required to maintain reserves against their deposit and other liabilities. From the government’s perspective, to ensure safety and permit the government to control the amount of credit in circulation – increasing reserves reduces available credit. From perspective of a depository, reserves limit the ability to extend credit.  

Difference of mandatory reserve from other kinds of reserves is that this kind of reserves is created by transfer of money to the special account in the Central Bank while other reserves represent only balance sheet, accounting numbers.

Norms of reservation allow to support the certain level of money in circulation and represent the mechanism of regulation of the general liquidity of the banking system; reserve requirements are established with a view of restriction of credit opportunities of banks and maintenance at the certain level of money in circulation.

Russia's banks are obliged to carry out the specification of the mandatory reserves deposited with the Central Bank, including on terms, volumes and kinds of the involved money resources. The order of mandatory reserves is set out by the Position On mandatory Reserves of the Credit Organizations Deposited in the Central bank of the Russian Federation. Norms of mandatory reserves are differentiated, as a rule, by separate types of deposits that are caused by a various degree of liquidity of various components of banks monetary base. For example, as on September 18, 2008, the Central Bank set out the following mandatory reserve norm: (i) banks' obligations

106 Ibid. at 339.  
108 See: Trofimov, Kirill. Supra note 6 at 142-154.  
to the natural persons, nominated in RUB – 1.5%, to the foreign banks – 4.5%, and other obligations, nominated in hard currency – 2.0%.110

Under the Article 38 of the Law On the Central Bank the size of mandatory reserves in percentage terms to obligations of the credit organization and also the order of their deposition in Bank of Russia are established by Board of Directors of Bank of Russia. Specifications of mandatory reserves cannot exceed 20 percent of obligations of the credit organization. The percents on the mandatory reserves deposited by the credit organizations in the Bank of Russia are not charged.

In case of failure to meet requirements about duly and full transfer of mandatory reserves, untimely representation of Calculation of regulation of the size of mandatory reserves, unauthentic data containing in Calculation and other necessary documents; the Bank of Russia has the right: (i) to not give to such banks pawn and other credits; (ii) to not accept deposits at such credit organizations; (iii) to apply sanctions stipulated by Articles 74 and 75 Laws On the Central Bank, including revocation of banking licence.111

110 Available online at: http://www.cbr.ru/analytics/standart_system/print.asp?file=policy.html

111 The Law On the Bank of Russia, Article 74: “Should a credit institution violate federal laws or the Bank of Russia normative acts or orders issued in pursuance of these laws or fail to provide information or provide incomplete or false information, the Bank of Russia shall have the right to require the credit institution to eliminate the violations discovered, charge a penalty of 0.1 per cent of the minimum amount of authorized capital or prohibit the credit institution from conducting some banking operations for up to six months.

Should a credit institution fail to fulfill the Bank of Russia order to eliminate the violations discovered in its work or should these violations or banking operations or transactions conducted by a credit institution pose a serious threat to the interests of its creditors (depositors), the Bank of Russia shall be entitled to:

1) Charge the credit institution a fine of up to 1 per cent of its paid-up authorized capital but not more than 1 per cent of the minimum amount of authorized capital;
2) Demand that the credit institution: implement financial rehabilitation measures, including changing the structure of its assets; replace the executives included in the list of positions given in Article 60 of this Federal Law; conduct reorganization;
3) Change for a period of up to six months the compulsory standards set for the credit institution;
4) Impose a ban on the implementation of some banking operations by the credit institution under its banking license for a period of up to one year and prohibit it
In case of banks’ liquidation the mandatory reserves are used for repayment of obligations of the bank before investors and creditors.\(^{112}\)

The Supreme Court of the Russian Federation stated that: (i) the reserve fund is created basically due to the money funds involved by bank, instead of own funds of the bank; (ii) its formation is mandatory and set out by the authorized state agency from opening branches for a period of up to one year;

5) Appoint a provisional administration to manage the credit institution for a period of up to six months. The procedure for appointing a provisional administration and for its activities shall be established by federal laws and Bank of Russia normative acts issued pursuant to them;

6) Ban the reorganization of the credit institution if it may create grounds for taking anti-bankruptcy measures stipulated by the Federal Law on Insolvency (Bankruptcy) of Credit Institutions;

7) Propose that the founders (members) of the credit institution, who have the opportunity on their own or owing to an agreement between them or participation in the capital of one another or some other means of direct or indirect collaboration to influence decisions taken by management of the credit institution to take actions aimed at increasing the own funds (capital) of the credit institution to a level that would ensure its compliance with required ratios.

The Bank of Russia shall be entitled to revoke the banking license of a credit institution on the grounds established by the Federal Law on Banks and Banking Activities. The procedure for revoking a banking license shall be established by Bank of Russia normative acts.

The Bank of Russia may not prosecute a credit institution for violations listed in paragraphs 1 and 2 of this Article if five years have passed since these violations were committed.

The Bank of Russia may go to court to recover a fine from a credit institution or apply some other sanctions against it, stipulated by federal laws, no later than six months after any of the violations listed in paragraphs 1 and 2 of this Article was recorded.”

Article 75 “The Bank of Russia shall analyze the activities of credit institutions (banking groups) in order to detect situations endangering the legitimate interests of their depositors, creditors, and stability of the Russian banking system.

Should such a situation arise, the Bank of Russia shall be entitled to take measures stipulated by Article 74 of this Federal Law and implement in compliance with the decision of the Board of Directors measures to financially rehabilitate credit institutions.”

\(^{112}\) See: the Law On the Central Bank, Article 38.
(Central Bank); and, therefore, the mandatory reserves cannot be used as coverage for current banks' obligations.\textsuperscript{113}

The special requirements for offshore zones are established by the Central Bank Instruction from July 13, 1999, 606-Y On Formation of Reserve Under operations of the Credit Organizations of the Russian Federation with Residents of Offshore Zones.\textsuperscript{114}

\textbf{[g] Supervision and Reporting}

The Central Bank monitoring is implemented on the basis of the banks’ monthly balance sheets, which should have attached to them calculations of the actual values of required ratios and breakdowns of individual balance-sheet accounts, signed by the bank’s chief executive and chief accountant. Additionally, banks must keep a daily record of their transactions with customers, showing any balance owed to or by a customer. Should a bank violate any required ratios, the territorial division of the Bank of Russia shall apply sanctions against it. The territorial divisions of the Bank of Russia also have the right to inspect banks in order to make sure that they present correct and authentic information for required ratio calculations.

The examination procedure is conducted through off-site examinations of the bank's records and other annual reports or annual on-site inspections at a bank's premises to review the bank's assets, operations and procedures to the extent necessary to satisfy the Central Bank that the provisions of the banking law are being observed, particularly with respect to depositor protection and financial soundness.

The internal and external audits are mandatory for banks. The auditors are required to make a written report to the senior executives of the bank and the Central Bank regarding any transactions or conditions, which come to their attention, that are, in the auditors' opinion, likely to adversely affect the well-being of the bank and any

\textsuperscript{113} Вестник Верховного Суда (The Herald of the Supreme Court of the Russian Federation) (1997) 7.

\textsuperscript{114} Вестник Банка России (The Herald of the Bank of Russia) (1999) 42-43.
doubtful loans which in the aggregate constitute an amount greater than 1 percent of the bank's regulatory capital.\(^\text{115}\)

There are no special rules for the examination of subsidiaries of the foreign banks, which are subject to the same regulatory and examination regime as the domestic banks. All subsidiaries are required to comply with Russia's accounting practices.

The external auditors are responsible for giving an opinion on the fairness and accuracy of the financial statements and other materials presented to the shareholders. Each bank must also have independent auditors appointed by its shareholders. The auditor is required to state in the annual report, whether in the auditor's opinion the annual statement present fairly and in accordance with Russia's accountancy system the financial position of the bank as at the end of the financial year to which it relates, and the results of the operations and changes in the financial position of the bank for that financial year.\(^\text{116}\)

Banks licensed to carry out business in Russia are supervised on consolidated basis with their business, assets and liabilities – and, in most instances, those of their subsidiaries – being taken into account.\(^\text{117}\) The banking holding company group is subject to consolidated capital-adequacy requirements.

In my view, the nearest targets of banks’ supervision in Russia should be:

(i) Development and introduction of system of early reaction;

(ii) The effective, not formal control over large banks;

(iii) The prevention of bankruptcy of banks;

(iv) The consolidated supervision.


If the bank did not comply with laws and regulation, the administrative sanctions could be executed by the Central Bank. The Central Bank adopted the Instruction 59 from March 31, 1997 On Application of Sanctions to the Credit Organizations. The sanctions divided into two types: precautionary and mandatory. Precautionary sanctions are applied basically at early stage problems, when direct threats to interests of creditors and investors are not present. The reasons for mandatory sanctions are infringements (default) by the bank of requirements of federal laws or the Central Bank regulations, failure to present required information, presentation of incomplete or unreliable information and also when real threats to interests of clients and/or creditors (investors) exist. The mandatory sanctions range from fine to revocation of banking licence.

Chapter 3

Foreign Banks in Russia: essential problems

1. Policy questions

State policy, level of legislation development, law enforcement and corruption are highly interrelated. Nevertheless, each of them impedes the foreign banks’ investments and activity in Russia by different ways.

In my view, the main policy problem in Russia’s banking is the absence of the policy or, more precisely, the de facto execution the protectionism as a state policy. And banking sector is not an exception; the whole economic policy is undefined and doubtful. Once declared direction towards the market economy currently shifts into state capitalism.

Russia's historical imperial memory, political orthodoxy and reactionary bureaucracy do not support market reforms either. Mayor of Moscow Yuri Luzkov,

one of the Russian heavy-weighted politicians, blamed monetarism and considered the “state capitalism” and partial nationalization as the only options for Russia.\footnote{Available online at: http://www.rian.ru/economy/20090211/161718697.html}

With visible satisfaction the Russian President Medvedev told an international conference in Evian, France in October, 2008: "The example of the United States and other examples also demonstrate that the transition from self-regulating capitalism to what is, in fact, financial socialism takes just one step. We are witnessing the readiness to nationalize one asset after another."\footnote{Available online at http://www.cdi.org/russia/johnson/2008-183-7.cfm}

The absence of policy, either written or implicated in the legislation, is underlying cause of more than modest level of foreign investments in Russia. Even though foreign banks, attracted by several times bigger profitability of Russia’s banking sector, invested in their subsidiaries, the unpredictability and instability of Russia’s authority, keep them away from the long term or significant investments.

In my opinion, at the policy level the most important problems in banking are:

(1) Monopolistic role of the Bank of Russia and its uncertain legal status;

(2) Undefined foreign banks’ legal regime in Russia and political elimination the foreign banks’ branches.

The first political question of the top level of the Russia’s banking system is “separation of powers”, the allocation of some functions of the Bank of Russia to other agencies. What supervision model: one agency or fragmented regulatory structure is better? A decade ago, it was most common for the central banks also to be banking supervisors or several regulators, dominated by the central bank, supervised the banks. Later the growing number of countries, including Canada, have moved this function outside the central bank.\footnote{See: Wood, Philip R., supra note 71 at 25.} In my view, in order to avoid the tension between different agency it would be better to concentrate the supervision power in one hand; but monetary policy and banking supervision should be separated, like in Canada (the Bank of Canada and the OSFI).
Legal complication with the Central Bank legal status in constitutional and civil laws also adds nothing for foreign investors for better understanding of Russia’s banking system. From author’s point of view, it is necessary to clarify legal status of the Bank of Russia in constitutional and private laws.

Written banking laws and the Central Bank’ regulations do not impose significant barriers towards the foreign banks’ market penetration, except the political driven foreign banks’ branches elimination. Russia’s entrance restrictions are minimal and correspond to the international practice. By and large, in Russia practically all banks, which have potentially been interested in, are already worked. Currently, it is possible to speak about rather liberal attitude of the Central Bank towards the foreign banks’ penetration. Restrictions operating nowadays in Russia on work of foreign banks essentially do not differ from existing in the countries of the Europe and Northern America.

However, current situation with foreign banks’ branches is one of the evidences that Russia really needs strategic policy document for the banking system in order to increase predictability and transparency for foreign and domestic investors. While the activity of the Ministry of Finance and the Central Bank is not understandable for investors, Russia will have a low level of foreign investments in banking and other sectors of economy and high level of capital flight out of the country.

For me, it is hard to understand why, allowing foreign capital around 30% in banking sector and the Russian subsidiary of Germany’s Deutsche Bank enters the Top 50122, the Central Bank still ban the branches. Similarly, I do not understand, why the Bank of Russia raised its rate on 2% up to 12,5% as the anti crisis measure123, while other Central banks lower it (the Bank of Canada, for example, from 3.50% to 0.25%)124.


International practice recognized two treatment standards towards foreign banks: “national treatment” than “reciprocity”. A “national treatment standard”, first time adopted by the US in 1978, permits foreign banks (banks from the “home” country) to do business in the “host” jurisdiction on the same basis as host country banks.\textsuperscript{125}

Russia \textit{de facto}, not \textit{de jure}, executes the protectionism in the banking sector as the state policy, that causes negative effect on foreign banks' investment in Russia and Russia's banking sector development in a whole. This problem is political in nature, indeed. Russia’s banking society and government are afraid of real competition with international financial institutions. Compare two approaches: first, “Canadian regulation of international banks …does not become protectionist or rigid”\textsuperscript{126} or “in order to increased competition to happen among financial institutions it is important to encourage foreign financial institutions to operate in Canada, … it is important to ensure that these rules do not act as a barrier to foreign banks”\textsuperscript{127} and second, “Would like to confirm - the government agreed with bank community, that branches of foreign banks, their activity in the Russian Federation should be limited today; and, as a matter of fact, it should be forbidden” (President V. Putin as of December 15, 2005).\textsuperscript{128}

The Association of Russia’s Bank, non-state and non-commercial organization with over 570 credit organizations as members, probably the most influent organization, invented the program «National banking system in 2010-2020». Some

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\textsuperscript{128} Available online at: http://www.prime-tass.ru/news/show.asp?ct=articles&id=803
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of the program's propositions are quite remarkable and useful for understanding the Russia's banking community attitude towards the foreign competitors.

Expansion of the foreign capital, stated this program, can lead to gradual decrease in stability of Russia’s national bank system and reduction of volumes of active-passive operations. In more long-term prospect, especially after connection of Russia to the WTO, it can turn back for domestic banks’ losses of a leading position in a home market and loss by the state of the control over financial sphere. Therefore, it is important to define scales and forms of presence of foreign banks in a home market of Russia, which would not undermine positions of the national banking capital.

Pursuant to trans-border operations, continued the program, the real share of the market controllable by the foreign banks in Russia, noticeably exceeds the parameters describing activity of their subsidiaries. The share of foreign banks in the corporate credit market is over 50%, whereas relative share of their subsidiaries in a cumulative credit portfolio of the national bank system does not exceed 8%.

As measures to strengthen positions of the national banking capital, the Association of Russia’s banks proposed:

- Keep an interdiction on opening of branches of banks-non-residents in Russia;
- Stimulate the large Russia’s companies to increase in volumes of loans at the Russian banks. For realization of the given measure, it is necessary to establish legislatively the certain size of loan (in percentage of the sum of the planned external loan), which the Russia’s company should involve inside the country from the banks without control participation of the foreign capital.
- Suspend licensing activity of banks with participation of the foreign capital at excess of a quota of their participation in actives and the capital of the Russia’s bank system;
- Establish the minimal size of the capital of the foreign bank, intending to get or create in Russia the affiliated credit organization;
• Establish for foreign owned banks the requirement to develop and coordinate with the Bank of Russia a five years' long-term plan of development of the bank.\textsuperscript{129}

In my view, while the self-isolation and avoidance of competition are the cornerstones of real, not declared policy, the prospective of Russia’s banking system and foreign investments remain unclear. Another evidence of self-isolation policy is a fact that Russia’s banks established only 5 branches abroad (the Central Bank’ permission is required).\textsuperscript{130}

The explanation for such corporative behavior is quite simple: small size of any given Russia's bank (even state-owned Sberbank, the biggest bank in Russia) and the banking system as a whole made them uncompetitive and push the Russia's banking community to lobby restriction imposed on foreign banks' market penetration. Under the Report On development of the bank sector and bank supervision in 2008\textsuperscript{131} the total assets of the Russian banking system are 28 022,3 billion RUB (about 800,000 billion USD as an average exchange ratio 35RUB/USD as of January, 2009). $800,000 billion in assets of the whole Russia's banking system, would be placed it only on 32nd position among the biggest world banks (compare with the Royal Bank of Scotland $3,807,892 billion in assets).\textsuperscript{132}

The openness of the banking market remains one of the main unsolved problems during negtiation prosses between Russia and WTO. The first vice-chairman of the Bank of Russia Andrei Kozlov stated during a Round table «The Introduction into WTO: consequences for the Russian market of financial services» that: “Opening foreign banks’ branches in the Russian Federation contradicts strategic interests of development of Russia’s bank system”. “Russia’s bank system itself understands”, he

\textsuperscript{129} Available online at: http://www.arb.ru/site/

\textsuperscript{130} Available online at http://www.cbr.ru

\textsuperscript{131} Ibid.

\textsuperscript{132} Available online at: http://www.guardian.co.uk/news/datablog/2009/mar/25/banking-g20
added, “where to develop, and we would not be arranged under another's “caprice” in harm to own understanding of strategy of development”\textsuperscript{133}

The general policy and/or macroeconomic problems mentioned above have an unfavourable influence in Russia’s banking sector in a whole; significantly reduce the attractiveness of Russia’s market for foreign banks and foreign banks’ activity in Russia. Besides, Russia’s banking law and foreign banks regulations have more specific questions to solve, also negatively impacting on foreign banks activity. It must be admired that Russia’s bank legislation has made a significant progress with the adoption of a series of regulations and rules over the last two decades.

Absence of strategic policy, neither officially adopted nor practically executed, results in uncertainty in the future the Central Bank's steps and definitely reduced willingness to invest in Russia's banking sector. The Central Bank Guidelines for the Single State Monetary Policy in 2009 and for 2010 and 2011 is the only document with few elements of short-term strategy.

As Gennady M. Danilenko and William Burnham mentioned “…important factor which impedes the flow of foreign capital into Russia is the absence of a clear foreign investment policy. Policy uncertainty and bureaucratic obstacles and inaction stand as continuing barriers to the effective use of law.”\textsuperscript{134}

Nevertheless, it is necessary to mention that current ‘state capitalism’ and protectionism are based on pre-existed economical and political conditions.

I would like to argue that the privatization in Russia has been the primary cause, not only of the weak banking system in Russia, but also of many other economic and legal problems. Even though the mass privatization program in Russia ended almost ten years ago, it still has a negative effect on banking in Russia. To understand why privatization in Russia has such a negative impact, it is fundamental to know how it was implemented in Russia.

\textsuperscript{133} Available online at http://www.banki.ru/news/topnews/?ID=168170

The main aims of privatization in Russia were:

1) The creation of private property, which did not exist under the socialist system;

2) The creation of private owners; and

3) Transfer control over companies from the state to the private owners.

At a quick glance, these aims were achieved. However, the newest ‘state capitalism’ statements and, more important, de-privatization actions do not allow to celebrate the advent of new Russia’s capitalism.

In the banking sector, over 70% of assets are controlled by five state-owned banks. Adding the fact that over 500 privately owned banks due to their small size and credit restrictions could provide loans not exceeding $10 million, the question on real owner of Russia’s banking system appeared to be a rhetoric one.

Moreover, the privatization combined with political instability created extremely short-term oriented behavior among “new Russian” billionaires, banks owners and top executives included. Practically, it means, preference to short-term, speculative operation, not long-term strategy or projects.

The continuing fights for the control over economic and financial resources\(^\text{135}\) add nothing positive towards creating stability and predictability for both foreign and domestic investors. In this fight, all means, including criminal charges, are used. It results in poor foreign investment and disrepute abroad.

Russia made a historic leap from socialism to capitalism skipped all business evolution stages. Nowadays, the discrepancy between market forms and state-owned content resulted in protectionism and weak banking system.

However, despite the fact that privatization in Russia is marked with numerous failures, it fulfilled its main aims, namely it created the institute of private property in Russia, \(^\text{135}\) Oil company “YUKOS”, acquired by state owned “Rosneft”, and its former owner M. Khodorkovsky, sentenced in 2005 to 7 years in jail are just the most famous examples.
transferred (at least partially) ownership and control over the companies from the state to private hands and created two level banking system.

2. Legislation and law enforcement questions

The modern Russia’s legal system, similar to economy, survived the dramatic changes. New economic and political conditions demanded new standards of legal regulation. Banking law, like the banking system, was created from the very beginning, created with intensive, but sometimes blind and meaningless, borrowing of legislation from different countries, mostly from the EU and the USA. As a result, Russia have adopted, but not adapted legislation that caused lots of conflicts and problems. Nowadays, after two decades, it is a time to stress out main problems:

1) Vulnerability and complexity of banking law;

2) Lack of law enforcement.

The first problem is directly interrelated with the absence of policy. D. Ananyev, the Chairman of the Council of Federation (Senate, upper chamber of Russia’s Parliament)’ Committee of financial markets and money circulation, defined the main structural problem of Russia’s financial system as the absence of the effective legislation background. It was told in April 2009 on the annual meeting of the Association of Russia’s banks.

Banking laws vulnerability, complexity and lack of transparency create one of the biggest barriers for foreign investors. Even though Russia’s financial market is more profitable in comparison with home markets, a foreign banker will think twice before invest due to unclear «rules of game».

I would like to introduce just few examples of banking law complexity.


137 Available online at: http://www.arb.ru
The registering and licensing procedures for banks are roughly regulated by six Federal laws, the Bank of Russia’ three Instructions, five Regulations and five Ordinances, do not mention other by-law documents (e.g. telegrams).

In 2008 solely, 16 federal laws on banking were adopted.

One of the Russia’s leading legal database «Consultant» consist of 4590 (3000 of them are in force) regulations of the Central Bank adopted in more than 10 legal


140 The following Bank of Russia’ Regulations: No. 437 On the Specifics of Registration of Credit Institutions with Foreign Investments and the Procedure for Obtaining Bank of Russia Prior Permission for Increasing the Authorized Capital of a Registered Credit Institution by Non-resident Funds; No. 153-P On the Specifics of the Prudential Regulation of Non-Bank Credit Institutions Conducting Deposit and Lending Operations; No. 230-P On the Re-organization of Credit Institutions by Merger and Acquisition; No. 218-P On the Procedure and Criteria for Assessing the Financial Standing of Corporate Founders (Members) of Credit Institutions; No. 268-P On the Procedure and Criteria for Assessing the Financial Standing of Individual Founders (Members) of Credit Institutions.

141 The following Bank of Russia’ Ordinances: No. 1186-U On the Payment of the Authorized Capital of Credit Institutions from Budgets of All Levels, Government Extra-budgetary Funds, Free Funds and Other Property Owned by Federal and Local Governments; No. 513-U On the Procedure for Paying up the Authorized Capital of Credit Institutions in Foreign Currency and Making the Accounting of the Corresponding Operations; No. 1176-U On Business Plans of Credit Institutions; No. 1292-U On the Procedure for Presenting Documents by a Non-bank Credit Institution to the Bank of Russia for the Taking of the Decision by the Bank of Russia on Granting the Non-Bank Credit Institution the Status of a Bank; No. 1379-U On the Assessment of Financial Soundness of a Bank for the Purpose of Verifying its Sufficiency for Participation in the Deposit Insurance System.

142 As of June 1, 2009, available online at http://www.consultant.ru
forms. Many of them are unpublished; some (telegrams) omitted the punctuation. In this condition, the legal risk, nearly impossible for evaluation, arises.

This is an enormous shift in favour of the Central Bank’ regulations. Six different licenses for banks and 2 – for non-bank credit organization, all of them required a new application to the Bank of Russia, also do not simplify the understanding of the Russia’s banking system.

The Bank of Russia has issued Instructions (there are over 70 totally), Letters (about 50-60 per annum), Telegrams (from 300 to 600 per annum), Orders, Statutes, Extracts from protocol of a session of the Council of Directors, Decisions of the Council of Directors, Instructional directives, Communications, Joint decrees with the Government, Explanations, and others. All of them are commonly normative and enjoy limiting circulation.\textsuperscript{143}

I would like to suggest that the banking law definitely needs a simplification and, probably, codification.\textsuperscript{144} As a more particular example, the law should clearly specify the discretionary criteria for foreign investors in order to limit the licensing authority’s discretion in this regard.

Along with huge amount of acts Russia’s banking law consists of numerous loopholes. For example, the silence of the foreign banks’ regulations on the allocation of responsibility with regard to regulation and supervision creates uncertainty and legal loopholes for foreign banking investors from the very beginning (establishment of subsidiary or acquisition of ownership in existing bank) throughout banking activity regulations to bank’s insolvency. It remains unclear whether, in the event of bank insolvency, the Central Bank, together with home country authorities, will stand behind foreign owned banks as a lender of last resort and in the form of deposit insurance (under the Russia’s Civil Code the owner could be responsible for the legal entity failure).

\textsuperscript{143} See: Efimova, L.G. Банковское право [Banking Law] (Moscow: 1994) at 16.

\textsuperscript{144} On Russia’s banking law codification see e.g.: Trofimov, Kirill, (2004), supra note 6 at 323-330.
Another problematic area is international legal cooperation. The Central Bank of Russia has 29 agreements on banking supervision with different countries, primarily with former Soviet Union republics. The importance of the Central bank’s treaties between closely, by all accounts, related newly independent countries, is unquestionable. However, while foreign investment overwhelmingly came from Western Europe countries, the Bank of Russia has the treaty only with Germany (one more treaty, signed with country- member of the Basel Committee, is one with China).

Moreover, foreign banks’ discrimination in various respects (barriers to entry and operating constrain) increased the legal risk for foreign investors. In my view, the law should create a legal environment for equal competition between domestic and foreign banks. The law should clearly specify the discretionary criteria in order to limit the licensing authority’s discretion in this regard.

The classification of the legal norms in Russia’s legal theory includes so called отсылочные нормы (re-directive norms), it is norms that do not include any rules or regulations itself but re-direct to other legal norms. The vast majority of the Law On Banks’ norms are re-directive or declarative.

In contrary to law, the Central Bank’ regulations definitely have less stability and predictability, that increase the legal risk for foreign investors. In my view, a part of the banking sector’ strategy should be (i) overall reduction of the Bank of Russia’ normative acts and (ii) its upgrade up to law level. Plain, simple and publicly accessible “rules of game” will increase the attractiveness of Russia’s banking sector.

Lack of law enforcement becomes unquestionable when results of the Bank of Russia supervision are analyzed.

A corporation to engage in the banking business cannot be formed at will. Banking is perhaps more meticulously regulated than any other industry. The dual purposes of the chartering process are to regulate entry into the banking industry on the basis of

economic considerations and to assure that banks are competently and honestly operated.\textsuperscript{146}

The Central Bank is the only regulator in Russia for domestic banks, nonbank credit organizations and foreign banks' subsidiaries and representative offices. In accordance with the Central Bank Report On the Banking Sector Development and Banking Supervision in 2008\textsuperscript{147} the number of Department of banking supervision staff of managers and specialists is 4177 (over 3 supervising specialist per one bank), 96.7\% of them have university diplomas. The total Central Bank\textquotesingle s staff was around 71,200 as of January 1, 2009.\textsuperscript{148} In other words, the ratio is as following: around 60 full-time the Central Bank\textquotesingle s employees per bank. The distinctive feature of Russia's reality is that the Central Bank\textquotesingle s staff average remuneration is well above the financial industry average (including the bank's top management). The representative of the State Duma in the National Bank Council Anatoly Aksakov had informed, that the total funds for employees of Bank of Russia remuneration in 2008 had made nearby 56,6 billion rubles (over 2 billion USD).\textsuperscript{149} With all this over-packed and well over-paid personal, the results of the Central Bank supervision, measured by a number of failed banks, could not be assessed other than inefficient.

The effectiveness of the law depends crucially on fair and effective implementation. Even with all fine written regulations at hand, official data indicated that:

(i) Number of liquidated banks during historically short modern period in Russia exceeds the number of existing banks;


\textsuperscript{147} Available online at: \url{http://www.cbr.ru}

\textsuperscript{148} Available online at: \url{http://slon.ru/blogs/osadchiy/post/34082/}

\textsuperscript{149} Available online at: \url{http://www.aksakov.ru/newstext/news/id/738331.html}
(ii) Number of inactive banks, although its share is reduced over the last years, still is very high (10% in 2009, 26% in 2001).  

This data is the evidence that the Bank of Russia failed in its efforts to prevent financially weak or intentionally criminally oriented banks and/or incompetent management from access to the banking system, that has an adverse impact on banking system stability and customers confidence.

<table>
<thead>
<tr>
<th>Year</th>
<th>2001</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total numbers of credit organization</td>
<td>2124</td>
<td>1516</td>
<td>1409</td>
<td>1345</td>
<td>1289</td>
<td>1228</td>
</tr>
<tr>
<td>Banks</td>
<td>2084</td>
<td>1464</td>
<td>1356</td>
<td>1293</td>
<td>1243</td>
<td>1172</td>
</tr>
<tr>
<td>Nonbanks</td>
<td>40</td>
<td>52</td>
<td>53</td>
<td>52</td>
<td>53</td>
<td>56</td>
</tr>
<tr>
<td>Active</td>
<td>1311</td>
<td>1299</td>
<td>1253</td>
<td>1189</td>
<td>1136</td>
<td>1108</td>
</tr>
<tr>
<td>With revoked licence</td>
<td>806</td>
<td>218</td>
<td>154</td>
<td>155</td>
<td>157</td>
<td>117</td>
</tr>
<tr>
<td>Liquidated</td>
<td>869</td>
<td>1569</td>
<td>1687</td>
<td>1758</td>
<td>1819</td>
<td>1900</td>
</tr>
</tbody>
</table>

However, the law and law enforcement improvement themselves are not enough. As Joseph Norton mentioned a law-based approach to the economic regulation of the financial sector in not simply about laws and legal process: law is merely one societal means to achieving and legitimizing appropriate policy objectives. The law-based approach should also be an interdisciplinary approach, where law is the thread that

weaves together economic, political and social objectives with a transparent and fair implementation process.  

The effective banking law is impossible without a broader commercial and insolvency law reform.  

As a merit of Russia’s law I would like to underline that in case of a conflict between Russia’s internal legislation and the country's treaty obligations - the treaty obligations will prevail, given Article 15 (4) of the Constitution.

So far, the process of developing and improving banking regulation is not over yet. One of the main issues remains a contradiction between different fields of law, such as banking, civil, constitutional and securities’ regulation.

Nonetheless, eventually Russia’s banking law provides all fundamental propositions related to banking activity and foreign investments.

In conclusion, it has to be underlined that existing laws and the Central Bank regulations more or less comply with international standards, whatever this standards are; therefore, the efforts must be shifted from law or regulation making process to law enforcement. Any fine printed law is dead without effective enforcement. The effective implementation of the law depends crucially on the supervisory authorities’ independence and human resources. Although the law gives the Central Bank a fair degree of operational autonomy, de facto the Central Bank remains an institution under the ruling regime’ governance.


\footnote{Baxter, Thomas C., Jr. & Sommer, Joseph H. “Liquidity Crises” in The Reform of the International Financial Architecture, supra note 12 at 227.}
3. Corruption

As was mentioned above, corruption is highly interrelated with the absence of state policy in banking, complexity and loopholes in legislation and lack of enforcement.

Lack of law enforcement and ineffectiveness of supervision, pursuing a severe corruption, erode all sector's achievement and customers confidence, and also reduce the Russia's attractiveness for foreign banks.

Corruption is one of the most important problems of Russia’s reality, which also has a harmful effect not only in banking, but also on overall economic and political situation in Russia. Corruption has thrived over the past two decades in Russia; it has even become a Russia reality and fallen into the ordinary routine of Russian citizens. Everyone realizes that this problem exists, but a remedy for this problem has not been found yet. So, if eventually this problem can be cracked, it will not only drastically increase foreign investment, but will also allow Russia to look better in the eyes of the world community. Foreign investors openly express their deep anxiety about corruption in Russian business, which prevents it from being involved in many financially attractive business projects.

The corruption market in Russia is as large as $316-billion USD or 2.66% GDP and average bribe up to US $130,000 by some estimates.

153 On corruption in Russia see e.g.: Vorotnilov, V.V. У критической черты. Теневая триад в России: причины и последствия (Near critical edge. The shadow Triad in Russia: causes and consequences) (Moscow: RAN, 2003); Kirpichnikov, A.I. Российская коррупция (Russia’s corruption), 3rd ed. (Saint-Petersburg: Law Centre Press, 2004); Mukhin, A. A. Российская организованная преступность и власть. История взаимоотношений (Russia’s organized criminality. History of interrelations) (Moscow: CPI, 2003); Timofeev, L. M. Институциональная коррупция (Institutional corruption) (Moscow: Russian State Humanitarian University, 2000) and many others.

154 On corruption in Russia’s banking sector in English see: Johnson, Juliet A Fistful of Rubles. The Rise and Fall of the Russian Banking System at 223.

Two examples perfectly demonstrate how the provisions of the Central Bank regulations create the corruption - provocative situations. Both examples are taken from the Bank of Russia regulation On Foreign Banks’ Representations, mentioned above.

Firstly, the proposition stated: “Activity of the representation shall stops: (v) under the decision of the Bank of Russia (without the explanation of the reasons)”. Under this provision, it is highly possible that the Central Bank’ staff way of thinking could be as “you pay or you are out of business”.

Secondly, it is quite obvious, that more intercourses with corrupted authority create more opportunities (for receivers) and more “obligations” (for payers). As the Central Bank’ provision demand, in case if the representation opens not in Moscow, also there should be letters from the territorial division of the Bank of Russia and the local administration with their opinion on this question. The Chief (Начальник) of the territorial division of the Central Bank and/or the Governor could ask themselves: why do I need one more headache, what it could bring to me personally?

Both situations are not purely hypothetical. In October, 2005, for example, the deputy Head of the Department of credit organizations of the Federal Tax Agency and the Bank of Russia’ lawyer (Moscow territorial Division, Law Department) were handcuffed on the crime scene. They demanded a bribe from the Chairman of the Board of Directors of one of Moscow banks. The sum of bribe was 1 million USD.\(^{156}\)

Moreover, the numbers of liquidated banks or banks with revoked licenses, mentioned above multiply the inevitable opportunity for a ‘short arm’ selling of the bank’s assets, ‘last call’ credits and other transactions, falling under the Russia’s Criminal Code.

When measuring rule of law, control of corruption, government effectiveness, and quality of the regulatory environment provided by the state, Russia ranks far behind the most developed countries. In the Transparency International 2007 survey, Canada shares 9\(^{th}\) place with Norway while Russia shares only 143-146\(^{th}\) places out of 180 (with Gambia, Indonesia

\(^{156}\) Available online at: http://www.lenta.ru/news/2005/10/18/bribe/
and Togo) among the least corrupt countries. Moreover, Russia has a backward trend, in 2003 Russia was ranked 86th with Mozambique.

I would like to suggest the personal list of the causes of corruption, based on my own experience in banking in Russia (in a random order):

1. Political and economic instability creates the extremely short-term approach among banks’ managers and owners. If you were not certain even about the nearest future, you desperately want all and sundry.

2. Widely spread disregard for law on all levels of society.

3. Lack of the state power transparency.

It could sound well beyond the belief, but corruption in Russia has become a part of everyday life. Numerous bureaucratic procedures provide a government official with opportunities to use their authority and make themselves a fortune.

The researchers mentioned above and others suggest a wide spectrum of anti-corruption measures: to strengthen control over an official income, to create a special monitoring agency, to improve and revise existing legislation, just name a few. In my view, these kinds of measures would not work. One more controlling structure will create one more level of bribe takers. The Chairman of the Investigation Committee under the Attorney General of the Russian Federation A. Bastrykin stated that the law enforcement bodies are the most corruptive. Only formation of democratic institutions, accountability of all levels and branches of power, combined with society regard for law could change the situation. And fight with corruption must be a permanent, day-by-day activity, not a declarative program.


158 Ibid, 2003’ survey.

159 Available online at: http://www.bbc.co.uk/russian/russia/2009/07/090730_corruption_bastrykin.shtml
Threat of punishment should have a secondary role in the fight against corruption, ended. Anyway, we should not underestimate the threat of punishment, because only a combination of effective legislation and threat of punishment can be a successful tool in this fighting. However, in 2003 the Criminal Code amendments eliminated confiscation of property as an additional punishment for criminal bribe.

It is evident that suppressing corruption gives more chances to improve the Russia's reputation in the world community and the ability of the Russia’s banks to compete internationally and domestically.

Obviously, if Russia finds a good will to start the war against corruption and succeed in it, it will significantly improve all aspects of banking in Russia, and the most importantly, all aspects of foreign investments’ climate.

4. Profitability vs. instability

Analyzing foreign investment in Russia’s banking sector, the main question to answer is: what drive the investors to deal with politically unpredictable, institutionally (in sense of financial market) undeveloped, corrupt and legally vulnerable country?

Robert Cull and Maria Soledad Martinez Peria in a comprehensive survey of the existing literature on the decision by foreign banks to operate overseas discover the following reasons for foreign bank penetration:

(i) ‘follow the clients’ motive’;

(ii) host-specific factors including market opportunities and regulatory barriers;

(iii) economic and cultural ties and institutional and regulatory similarities between home and host countries.

Obviously, none of the reasons above, except market opportunity, do not work in Russia.
A majority of studies finds support for the hypothesis that banks go abroad to serve their domestic clients with overseas operations.\textsuperscript{160} Having analyzed 2,300 international bank mergers that took place between 1978 and 2000 in developed and developing countries, C. Buch and G. DeLong found that foreign banks tend to go to larger yet less developed economies, where there is the prospect for economies of scale and future growth opportunities.\textsuperscript{161}

In my view, the only reason for foreign investors in Russia is the market opportunities.

Firstly, Russia, 9\textsuperscript{th} world country by GDP,\textsuperscript{162} rich by natural resources, some kind of technologies, educated and relatively cheap work force is full of opportunities.

Secondly, with the Central Bank rate equal to 12\% as of June 1, 2009\textsuperscript{163} (compare with the Bank of Canada overnight rate 0.25\% as of June 4, 2009\textsuperscript{164}) and mortgage rates over 20\%, Russia remains among highly risky, speculative and profitable financial markets.

Thirdly, the foreign lending market oriented, natural resources companies and yet under-serviced population of 130 million people. In Canada, 99\% of the population have a bank account.\textsuperscript{165} In Russia, that figure is more like 30\%. One could insist that Russia is under-banked because the population didn’t have much money. The

\begin{flushleft}


\textsuperscript{162} Available online at: 

\textsuperscript{163} Available online at http://www.cbr.ru

\textsuperscript{164} Available online at http://www.bankofcanada.ca

\textsuperscript{165} See: \textit{Canadian Business} (15 June, 2009) at 27.
\end{flushleft}
The official level of poorness is 3,694 Rubles (less than 140 CAD) per month, but the expert evaluation of the amount of ‘mattress money’ on hand varies from several tens to several hundred billion US dollars.

Russia is really emergency and contradictitious market, indeed. There are political instability, corruption, the language barrier, currency fluctuations, a minefield of foreign ownership restrictions, random taxes, and securities issues. Nevertheless, there are also a high profit margin, under-banked customers, Gazprom and Lukoil, 22nd and 65th world biggest companies respectively and potential for growth.

Chapter 4

Proposals for Russia

Banking has become an issue of universal importance. International and domestic banks have an important role of providing financial stability and economic growth in the already financially globalized world. Thus, the President of the Russian Federation, legislators and the Bank of Russia have to realize that it is in the public interest to provide a transparent legal environment for the efficient functioning of the banking system.

I prefer to avoid the macro advices for Russia like “build the real market economy” or “democracy”. I would better suggest a few practical, specifically the banking sector oriented proposals, which are possible in the nearest future, even under the current political regime:

1) Adopt the strategy for Russia’s banking system;

2) Reinvent the upper level of Russia’s banking system;

3) Clarify, simplify and upgrade the banking law and regulations;

4) Allow the foreign banks’ branches in Russia and stimulate the Russia’s bank branching outside country;

5) Improve international cooperation on the Central Bank level.

Adoption the strategy (forms of formalizing could be different) will increase the predictability of financial authorities’ decisions and legislative development, customers’ confidence and attractiveness for foreign investors. How many and how big banks are necessary for Russia? What is the policy towards the foreign banks (market share, branches)? Is a universal bank’ model workable for Russia or investment banking business should be separated by one way or another? How large the state participation in the commercial banks must be? After two decades of fast, but unpredictable movement towards undefined targets, and financial crisis lessons to be learned, nowadays is the perfect time to choose the direction of development and define the practical steps towards it.

Re-invention of the upper level of Russia’s banking system could be done in the form of institutional separation of the monetary policy (traditional Central banks’ function) and supervision over the financial institutions. Creation of new supervision agency will allow, firstly, reduce the monopolistic power of the Bank of Russia and build a system of balances; secondly, effectively supervised not only banks, but also other financial services providers (credit cooperatives, investment funds, insurance companies and private pension funds).

Banking legislation improvement could be done in the following forms:

Firstly, upgrade the possible amount of regulations from the level of the Bank of Russia by-laws up to the level of federal laws. It will definitely improve stability and

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169 Russia is the only country among the leading economics, where monetary policy and supervision are concentrated in one hand. For the financial authorities’ structure see, e.g.: Regulation of Foreign Banks, supra note 3.
predictability of banking law (legislative process is much longer and accountable than in case of the Central Bank regulations). As a part of banking legislation improvement and anti-corruption measure, the right of the officials to decide certain issues individually without clearly defined guidelines should be highly limited.

Secondly, codify and simplify the Bank of Russia regulations:

1) Reduce the number of legal forms, using by the Central Bank;

2) Reduce the total number of legal acts, issued by the Central Bank;

3) Publish ALL normative acts online and in Бюллетень Банка России [The Herald of the Bank of Russia], nowadays less than 10% of the adopted acts were officially published;

4) Change the legal technique. For example: if the regulation was amended, it should be published as amended, not amendments itself only; exclude telegrams with omitted punctuation as a form of legal act.

This proposal will improve the banking law transparency and reduce the legal risk. Plain, simple and publicly accessible “rules of game” will increase the attractiveness of Russia’s banking sector.

A transparent banking legislation constitutes an essential condition of attracting foreign investments and maintains customers’ confidence. The strong legal system and respect for the rule of law are two interrelated prerequisites to effective law enforcement. Therefore, Russia’s banks should work according to all laws regulating their activity.

In my view, the presence of the foreign banks’ branches in Russia could bring the following positive effect:

(i) Modern banking technologies (not necessarily in a form of financial instruments’ innovations);

(ii) High reliability based on powerful financial resources, credit rating and corresponding reputation (due to the parent bank);

(iii) Opportunity to attract the parent bank clients for investment in Russia.
However, the main positive effect will be the competition: without truly international competition Russia’s banks simply do not have necessary incentives to increase capital or improve their services. The winner of the foreign banks’ branches penetration will be a general public, customer; the possible losers – few dozens of Russia’s top bankers.

Branches of the foreign banks could be a source of long-term investment in Russia’s banking system, constant provider of new technology, products and competition. It should promote functioning of the banking system in favour of economy of Russia. Unlike subsidiaries or investments into the Russia’s banks, branches of the foreign banks are lawfully dependent parts of the foreign bank. In this case, they do not need to provide the charter capital, and their structure of management can be more flexible, then in the subsidiaries. Moreover, financing of the branch is promoted by the fact that it has the same credit rating, as the parent bank, as last bears for it the full responsibility.

Indeed, the foreign banks’ branches activity will bring additional risks and supervisory problems. Regulators must recognize and begin to manage the risk inherent in international branch banking. This will require balancing the need to provide access to foreign institutions with the duty to protect domestic financial markets. Full scale, separately capitalized subsidiaries work well to protect domestic systems. However, the trend towards a global market place will continue to pressure central banks towards more flexible international branch banking systems.170

Among negative effects of the foreign banks’ branches penetration could be possible occurrence of unequal conditions of a competition for branches of foreign banks and national banks (in sense of mandatory reserves, taxation optimization scheme, differences in supervision between Russia and home country). The possible negative effect could be mitigated by imposing the certain restriction on the foreign banks’ branches activity.

For example, in Canada foreign banks must obtain the approval of both the Minister of Finance and the Superintendent of the Financial Institutions to become “authorized” to establish a Canadian branch.

The *Bank Act* permits two types of branches:

(1) full-service branches, which, except under very limited circumstances, may take deposits only in an amount greater than $150,000; and

(2) lending branches, which may not take any deposits and, which may borrow only from other financial institutions.\(^{171}\)

Foreign banks that conduct business in Canada are not permitted to operate both a lending branch and either a foreign bank subsidiary or a full-service branch. The Bank Act provides for a two-year transitional period (extendable to seven years by the Minister) during which an authorized foreign bank having received approval to establish a lending branch may maintain a substantial investment in a Canadian subsidiary of the foreign bank. In order to establish a full-service branch in Canada, a foreign bank must also comply with certain requirements\(^{172}\) and must maintain on deposit with a Superintendent-approved Canadian financial institution cash or acceptable securities having a value equal to the greater of 5 percent of branch

\(^{171}\) *The Bank Act, part XII.1 and para. 522.16.*

\(^{172}\) Be “capable of making a contribution to the Canadian financial system,” in the Minister’s view, based on submissions made by the foreign bank with regard to how it intends to serve its target market; have a minimum of $5 billion in consolidated assets, a “proven track record” in international banking and favourable financial performance over the past five years; be incorporated as a bank in its country of residency or home jurisdiction and be regulated in a manner satisfactory to OSFI; derive more than 50 percent of its gross revenues from financial services, or more than 50 percent of its assets must be related to financial services; have its shares widely held, subject to exceptions such as foreign government ownership of the applicant bank; meet the minimum risk-based capital ratios as established by the Bank for International Settlements; and if it is controlled by a non-WTO member, satisfy the Minister that treatment as favorable for Canadian banks exists or will be provided in the jurisdiction where the foreign bank principally carries on business.
liabilities or $10 million. A lending branch will be required to deposit and maintain assets in the amount of $100,000. 173

The sanction to the foreign banks on opening of branches can promote wider attraction of foreign banks in economy of Russia. I do believe, that such step will not lead to their domination above the Russia’s competitors. The Russia’s banks will always have advantage in the competition, as they have more operational experience in legal and business spheres. Such experience is priceless in Russia and could not be imported or purchased. Moreover, there is enough room for banks’ competition in Russia, due to its territory, natural resources and market potential.

Policy of protectionism, currently executed in Russia, have nothing with declared target to strengthen national banking system. In my view, only competition with international financial institutions, including their branches in Russia, can benefit banks and customers.

Stimulation of Russia’s banks foreign branching (only 5 branches in countries, other than former Soviet Union republics, in 2009), in its turn, will allow domestic bank acquire international experience and improve competitiveness. These measures could start with the ease of the Bank of Russia preliminary requirements, which are restrictively tough nowadays.

The last but not the least area of vitally importance is the international cooperation. The overwhelming majority of inter-Central Banks treaties were signed with the former Soviet republics, while foreign investments into banking sector came primarily from developed countries. Therefore, the Central Bank should be more actively deal with regulators from capital donors countries. The improvement of the Central Bank international cooperation will also decrease the risks of negative financial crisis’ consequences. The treaties between the Bank of Russia and a host country’ financial authorities could allow to solve problems of dual supervision, dispute resolution jurisdiction, participation in the deposit insurance system, insolvency, reporting, etc. Indeed, the principle of reciprocity is applicable here. International supervision cooperation could be executed in a form of partisipaiton in a different international

173 See: Regulation of Foreign Banks. Volume 2, supra note 3 at 318.
institutions, like Basel Committee, World Bank or IMF; and in a form of bilateral and multilateral treaties.

Arguably the main problem in the cross-border supervisory cooperation is a mutual confidence and information sharing. Without the access to the information from home country authorities, the host country authority is not in a position to supervise the relevant foreign banks in its jurisdiction on a stand-alone basis. However, the home supervisors can be reluctant to share information with the host supervisors for the different reasons. On the other hand, overlapping regulation could occur: both of supervisors have powers to require the bank to be compliant with their respective reporting requirements. It’s burdensome and costly, indeed. Another consequence of overlaps in supervision is a conflict of supervisory standards.

For Russia, creation of its own unique model of banking governance is not a matter of paramount necessity, this country has had lots of negative experience with its own unique way. The most recent financial crisis provides a ‘stress test’ results for different models and approaches in banking. All Russia need is to analyze these results and choose the most suitable model for Russia, borrow and adjust it. Canada’s banking system, named the soundest in the world by the World Economic Forum, could be taken as an example.

The banking sector (not natural resources’ export, indeed) has to be considered as a one of the driving forces for economic growth in Russia. It is also necessary to realize that the process of developing the sound banking system is a long one, which demands daily regulation and control, but not infrequent attempts to show the world that Russia is doing well in this sphere. Under the current conditions of economic unpredictability and political instability in Russia, it is crucial for the state to improve the investment attractiveness of the country. It can be done by institutional reforms on the upper level of the banking system and by creating more competitive and customer – oriented (foreign banks’ branches included) environment.

The emphasis should be on strategy, the Central Bank’ status, legislation, fair competition, and strong legal enforcement.

\[174\] Available online at://www.reuters.com/article/ousiv/idUSTRE4981X220081009
This paper confirms the fact that objective external criteria such as fast insider privatization in Russia, corruption, as well as the undeveloped banking system have a detrimental effect on banking in Russia. As a consequence, it leads to the protectionism as a state policy in this area. The recommendations provided in this work will definitely give positive results upon their implementation. So, it is necessary for Russia to continue the process of banking system’ strengthening as well as improving the overall economic and legal situation. This in turn would enhance efficiency of single banks as well as the banking system as a whole, thereby enhancing the economic growth and attracting foreign investment. It will also result in the financial stability and public confidence. The problems of banking in Russia that are discussed in this work will continue to have a negative impact in the near future; therefore, these topics will remain relevant until they are resolved. Whereas the study provides some recommendations, it still leaves scope for further research in this area.

Conclusion

Almost twenty years after the start of the market reforms, Russia still experienced the lack of international cooperation in banking and law enforcement, ineffectiveness of supervision. With all due respect to the progress that has been made by Russia since 1990s; democracy, economy and banking system in Russia still could be referred as a “Cargo cult democracy” and “Cargo cult banking system”.

175 Russian banks look and act like banks, but still are not banks under the traditional meaning. Protectionism as a state policy, absence of strategy, complexity and vulnerability of banking law definitely add nothing positive to the prospects of improvement.

While few foreign researches found the ground for optimistic notes, the most recent global financial crisis shown that Mr. Putin, Russian Government and the

175 Available online at: http://en.wikipedia.org/wiki/Cargo_cult

176 See e.g.: Tompson, William, “The Present and Future of Banking Reform” in Lane, David, ed. Russian Banking. Evolution, Problems and Prospects (UK, USA:
Central Bank untalented skipped the unique opportunity for structural economic reform and, as a part of it, the development of the financial sector. This unique opportunity was a sum of a practically unlimited Putin’s power and unprecedented prices of oil. The financial crisis and oil prices’ failure depleted Russia’s currency reserves (once 3rd in the world)\textsuperscript{177} and ended up the period of possibilities for reforms. As Erik Berglof \textit{et al} politely mentioned in the IMF quarterly “Finance and Development” Russia has not done enough to inoculate itself from recurring crises that stem, in large part, from sharp drop in the price of oil.\textsuperscript{178}

For me, the specific reasons for pessimism are as following:

(i) Public distrust to the banking system arose from the citizens’ distrust to the state;

(ii) Very small size of Russia’s banking system;

(iii) High market concentration with the dominant role of the state – owned banks;

(iv) Absence of strategy.

The problems and trends discussed above indicate that foreign investors are interested in Russia’s banking market’ potential but the Central Bank and the Government should not relay on this and should concentrate their effort on strengthening of the domestic banking system. This would require the facilitation of faster growth of the capital of domestic banks and further internationalization of the banking sector.

On a practical level, this paper has critically assessed certain legal norm regulated the foreign banks’ activity in Russia has argued that the currently executed

\textsuperscript{177} From maximum USD 596 billion as of August 1\textsuperscript{st}, 2008 down to USD 404 billion as of June 1\textsuperscript{st}, 2009 or 32%.

\textsuperscript{178} Available online at: http://www.imf.org/external/pubs/ft/fandd/2009/06/berglof.htm

protectionism policy is not in the best interest of the banking system and customers. The paper further advocated a necessity of simplification of the banking regulations.

Creation of its own unique model of the banking system should not be the main aim for Russia. The current financial crisis provides the complete results of a “stress test” from all major financial centres. Thus, it simply needs to borrow the best model (e.g. Canada) and adopt it to Russia’s reality. Russia has had lots of negative experience with its own unique way, which often has made this country a pariah in comparison to the rest of the world. Unfortunately, the Vice-chairman of the Central Bank Kozlov and Mayor Luzkov’ citations, mentioned above, do not give any optimism. Under the current conditions of economic unpredictability, it is crucial for the state to improve the soundness and competitiveness of the banking system. Thus, the external instruments such as efficient legislation and its strong enforcement are becoming especially relevant for Russia.

The problems of foreign banks’ activity in Russia that are discussed in this work will continue to have a negative impact in the near future. So this topic will remain relevant until they are resolved. Nonetheless, it is necessary for the Bank of Russia and Russia’s banking community to understand the importance of the competition as an engine of progress.

I would like to conclude that generally Russia has already made a visible progress in creating the modern banking system. Moreover, looking at the present economic and legal system in Russia, it is evident that this country is still in the process of developing its own banking system. However, without solving the problems, mentioned above, the forecast for Russia is rather pessimistic, then optimistic.