THE CENTRAL BANK OF THE RUSSIAN FEDERATION

Banking Supervision Report 2003

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Foreword

The release of the Banking Supervision Report, a new publication from the Bank of Russia, aroused widespread interest among bankers, government agencies, and the business community. It was highly praised by our foreign colleagues and international financial institutions. By broadening the reach of its analysis and optimising its inventory of tools, the Bank of Russia will continue to improve on the new publication by bringing its contents closer in line with advanced international practice of financial stability reporting.

In 2003, the Russian banking sector enjoyed favourable growth trends and enhanced its role in the financial intermediation system. All banking sector performance figures, without a single exception, showed a handsome growth, which was higher than it was in the preceding year. Banks eagerly increased lending to the real sector of the economy, and new segments emerged on the banking services market, primarily in consumer lending, making rapid headway through the year.

Noting improvements in the banking sector, the Bank of Russia focuses on existing problems, particularly those caused by growing complexity of risk management approaches practiced by individual lending institutions and the banking sector in general. The Bank of Russia has always attached paramount importance to banking supervision. Moreover, the role of supervision as a tool to spot problems facing the Russian banking sector continues to rise today.

In the Report for 2003, we sought to analyse the current situation in the banking sector by taking various approaches, including IMF-developed financial stability indicators, and to provide insights into Russian banks' growth problems (attributable to this country's risk-prone environment), and the goals and objectives of the Bank of Russia in promoting growth in the banking sector and elevating the quality of supervision in the next few years.

The Bank of Russia is resolved to consistently implement its policy of openness and inform the public about modern-day trends and problems in banking supervision. The Banking Supervision Report 2003 is certainly a new step in this direction.

Sergei M. Ignatyev
Chairman
Bank of Russia

I

The state of the Russian banking sector

I.1. The general economic conditions of banking sector development

I.1.1. The macroeconomic situation

The macroeconomic situation in 2003 was stable: inflation continued to fall and GDP to grow, while investment activity was stepped up and real incomes increased. There was also a strong balance of payments and a federal budget surplus.

The GDP grew by 7.3% in comparison with the previous year (2002 growth stood at 4.7%). The improvements in the Russian economy were facilitated by the world economic growth and favourable foreign trade conditions. Accelerated growth in domestic demand also stimulated economic activity.

The household sector's real expenses on final consumption in 2003 continued to increase almost as rapidly as in 2002 (7.9% as against 8.8%). One of the principal objectives of the budgetary policy in 2003 was to prevent government expenditures from growing faster than the economy and to control the level of non-interest federal budget expenditures. The public sector's expenditures on final consumption rose by 2.2% year on year as against 2.6% in 2002. Unlike the situation in the previous year, growth in fixed capital investment in 2003 was more significant than growth in the output of goods and services. Fixed capital investment increased by 12.5% last year compared with 2.8% in 2002. Unlike the situation in 2002, investment activity in 2003 rose faster than the household sector's expenses on goods and services. The fact that gross savings increased by 13.5% in 2003 (in 2002 it contracted by 2.2%) testified to a build-up of corporate investment activity and growth in gross fixed capital formation. Net exports grew by 3.0% in 2003 as against 2.2% in 2002.

Industrial output in 2003 increased by 7.0% year on year. As investment activity intensified, rapid rates of production growth were registered in investment industries such as machine-building and the building materials industry. Estimates show that the biggest contribution to industrial production growth in 2003 was made by the fuel, machine building and food industries (in 2002 these were the fuel sector, food industry and non-ferrous metallurgy sector).

Owing to the co-ordinated actions of the Bank of Russia and the Russian Government, consumer price inflation slowed down significantly in 2003 as compared with 2002. In December 2003, consumer prices rose by 12.0% year on year (in December 2002, consumer prices were up 15.1% on December 2001). At the same time, core inflation exceeded the projected target and stood at 11.2% as against 10.2% in 2002.

The number of jobs in the economy decreased, while the unemployment rate accelerated in 2003. Russia's economically active population stood at 71.7 million, of which 91.7% were employed in the economy and 8.3% were classified as unemployed in accordance with the International Labour Organisation (ILO) methodology. In 2002, the respective figures were 71.7 million, 92% and 8.0%.

Industrial production increased in 2003, while the number of jobs decreased, owing to an estimated 7.8% rise in labour productivity. This trend shows that the intensive factors of economic growth were at work.

Russia's balance of payments continued to improve in 2003.

A favourable price situation and increased export and import volumes in 2003 caused the value of exports and imports to rise to the highest levels registered since 1994. The price of oil rose by 15% year on year and petroleum product prices were up by 20% year on year. The average price of Urals crude stood at $27.3 per barrel in 2003 as against $23.7 per barrel in 2002. Exports increased by 27% year on year to $135.9 billion and imports rose by 24% to $75.4 billion. Russia's trade surplus reached record high of $60.5 billion (in 2002 it stood at $46.3 billion).

The current account surplus expanded by almost a quarter to $35.9 billion, or 8.3% of GDP, as against $29.1 billion, or 8.4% of GDP, in 2002. The capital and financial account deficit (measured without account for the changes in reserve assets) contracted to 0.5% of GDP in 2003 as against 3.3% of GDP in 2002. Net exports of capital by the private sector decreased from $8.1 billion in 2002 to $2.1 billion in 2003.

Growth in foreign exchange reserves stood at $26.4 billion, according to balance of payments data (as against $11.4 billion in 2002). Russia's international reserves grew by 1.6 times and as of January 1, 2004, stood at $76.9 billion. The expansion of international reserves contributed to financial stability. In December 2003, the real effective rate of the ruble was 4.1% up on December 2002.

The budgetary policy pursued by the Russian Government in 2003 allowed it to increase the federal budget surplus to 1.7% of GDP from 1.4% of GDP in 2002, fulfil its domestic and foreign debt obligations on time and increase the financial reserve. The budget surplus helped slow inflation, caused yields to fall on the domestic financial market, led to Russia's international ratings being raised and made the country more attractive to investors.

Russian enterprises' finances improved in 2003. The profit net of loss posted by enterprises and organisations, excluding small businesses, banks, insurance companies and budget-financed organisations, was 1,342.9 billion rubles in 2003, an increase of 42.5% on the previous year. The share of loss-making enterprises contracted by 2.1 percentage points to 41.3% of the total number. Profit growth in the economy was largely due to the export-oriented industries (the fuel and metallurgy sectors and foreign trade), whose financial performance was greatly influenced by favourable foreign trade conditions. At the same time, some industries oriented to meeting domestic demand registered a fall in profitability or a rise in losses. The improved financial standing of enterprises encouraged banks to lend more.

As economic growth continued, real money income increased in 2003. Year on year, real money income rose by 13.6% in 2003 and real disposable money income increased by 14.6%. The real imputed average monthly wage rose by 10.3% and the real imputed monthly pension went up by 4.5%.

Expenses on goods and services accounted for 69.3% of household money income in 2003 as against 73.2% in 2002, while the public saved more. Savings in the form of bank deposits and securities accounted for 5.6% of household income, an increase of 1.9 percentage points on 2002.

I.1.2. Banking sector development indicators relative to key macroindicators

In the last few years, the Russian banking sector expanded more rapidly than the country's economy as a whole. In 2003, banking sector capital grew by 1.8 times faster than GDP, banking sector assets by 1.6 times faster, banking sector credit to the non-financial sector almost twice as fast and household deposit accounts more than twice as fast. As a result, the ratio between the key banking sector indicators and GDP continued to increase. The ratio of banking sector assets to GDP grew from 38.3% to 42.1% in 2003, the ratio of loans to domestic non-financial corporate borrowers expanded from 14.7% to 17.0% and the ratio of funds attracted from corporate entities and private individuals increased from 19.6% to 21.8%.

In 2003, the banking sector enjoyed a favourable macroeconomic situation, which banks took full advantage of. Over the year, banking sector assets increased by 35.1%. More than 82% of credit institutions that were in operation at the end of 2003 registered a sustained growth. In real terms, banking sector assets grew by 28.1% in 2003, exceeding the pre-crisis level (data as of July 1, 1998) by 61.2%. The share of ruble-denominated assets continued to expand in banking sector assets: as of January 1, 2004, ruble assets accounted for 70% of total banking sector assets as against 64% a year earlier, coming close to the pre-crisis level of 73%.

The positive dynamics of major banking sector performance indicators in the past few years give grounds to believe that by 2009 Russia will be able to achieve the quantitative targets set out in the draft of the new Banking Sector Development Strategy: the ratio of banking sector assets to GDP is projected at 56%, capital to GDP at 7% and credit to the economy to GDP at 26%. It should be noted that a major condition for the attainment of these objectives is the implementation of the measures envisaged by the draft of the new Strategy to Upgrade the Banking Sector.

I.2. Institutional aspects of development

I.2.1. Quantitative characteristics

The number of operating credit institutions remained unchanged in 2003 and as of January 1, 2004, stood at 1,329.

Russian banks became increasingly universalised in 2003: the number of banks with general licences increased from 293 to 310 and the number of banks with licences to conduct operations with foreign exchange rose from 839 to 845. At the same time, the number of credit institutions with licences to take household savings on deposit declined over the year from 1,202 to 1,190.

There was only a rise in the number of credit institutions in the Central Federal District, notably, in Moscow and the Moscow Region. As of January 1, 2004, there were 679 credit institutions in Moscow and the Moscow Region (as against 663 as of January 1, 2003), that is, more than half of all operating credit institutions. In all other federal districts the number of credit institutions declined. The most significant decrease in the number of credit institutions was registered in the Southern Federal District (from 142 as of January 1, 2003, to 137 as of January 1, 2004).

Credit institutions continued to reorganise their branch networks in 2003. In the year under review, the number of branches of operating credit institutions fell from 3,326 to 3,219, that is, by 3.2% (taking into consideration the fact that there were 3,433 branches as of January 1, 2002, and 3,793 branches as of January 1, 2001, one can see that in three years the number of bank branches fell by 574, or 15.1%). The major factor of decline in the number of bank branches was the continued optimisation of the branch network of the Savings Bank (Sberbank), which closed 117 branches in 2003. As of January 1, 2004, there were 1,045 Sberbank branches in Russia.

The reduction in the number of bank branches was accompanied by a growth in the number of internal divisions of credit institutions and their branches, such as additional offices and cash points, whose total number increased by 2,584 and as of January 1, 2004, stood at 26,468 as against 23,884 as of January 1, 2003.

As of January 1, 2003, there were four federal districts (Northwestern, Volga, Siberian and Far Eastern) where the number of branches of banks based in other regions exceeded the number of local credit institutions and their branches and as of January 1, 2004, there were five such regions as the Southern Federal District joined the group.

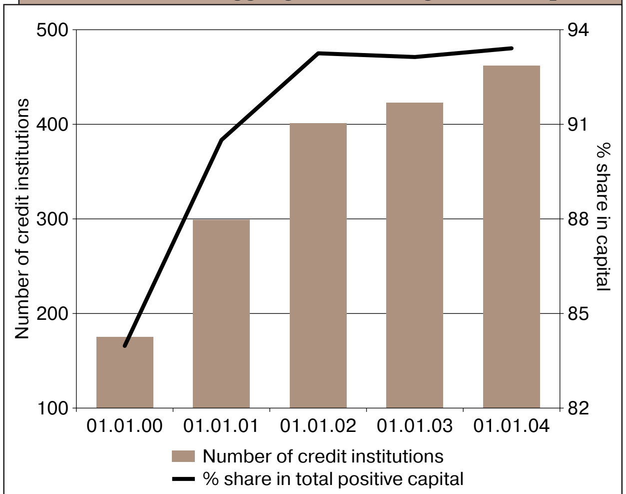
I.2.2. Concentration of banking activities

The level of banking sector assets and capital concentration slightly declined last year. At the same time, the share of the top 200 credit institutions by assets in the aggregate banking sector assets was virtually unchanged at 88.0% as of January 1, 2004, as against 88.5% as of January 1, 2003. The share of the top five banks in the banking sector assets contracted during that period from 44.2% to 42.9%, mainly due to the reduction of Sberbank's share (from 28.4% to 27.6%). As of January 1, 2004, the top 200 banks by capital accounted for 82.7% of the total banking sector capital as against 83.8% as of January 1, 2003, while the top five banks' share stood at 35% against 37%.

The number of credit institutions with a capital in excess of five million euros rose by 9.2% in 2003, while the aggregate capital of this group of banks increased by 23.4%. At the same time, the share of this group of banks in the aggregate banking sector capital was unchanged for two years at about 93% *(see Chart 1.1).*

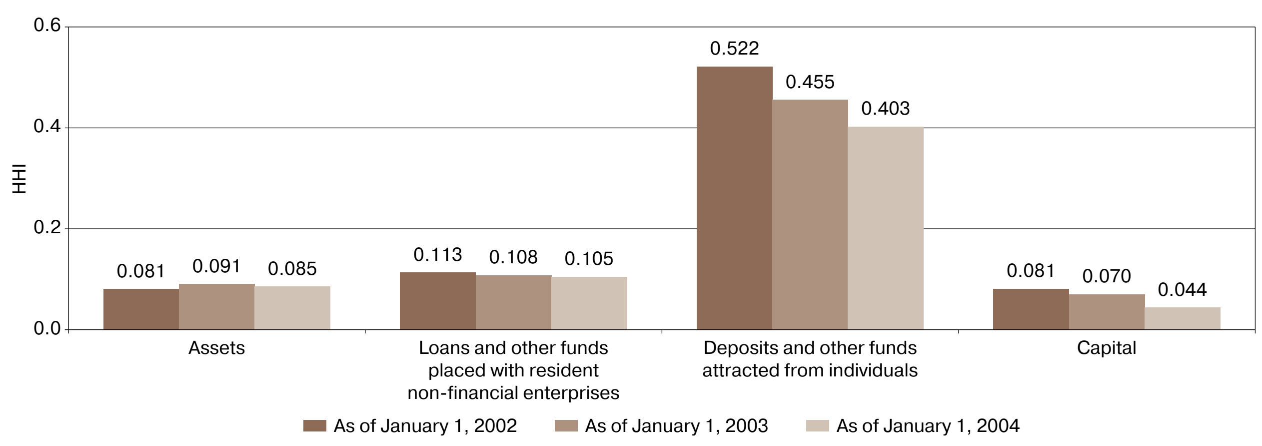
The dynamics of internationally accepted statistical indicators, notably, the Herfindahl-Hirschman Index (HHI)[1], testify to a low level of capital and asset concentration in the Russian banking sector *(see Chart 1.2).* As for loans to non-financial enterprises, the level of con-

Number of credit institutions with a capital of more than five million euros and their share in aggregate banking sector capital *CHART 1.1*

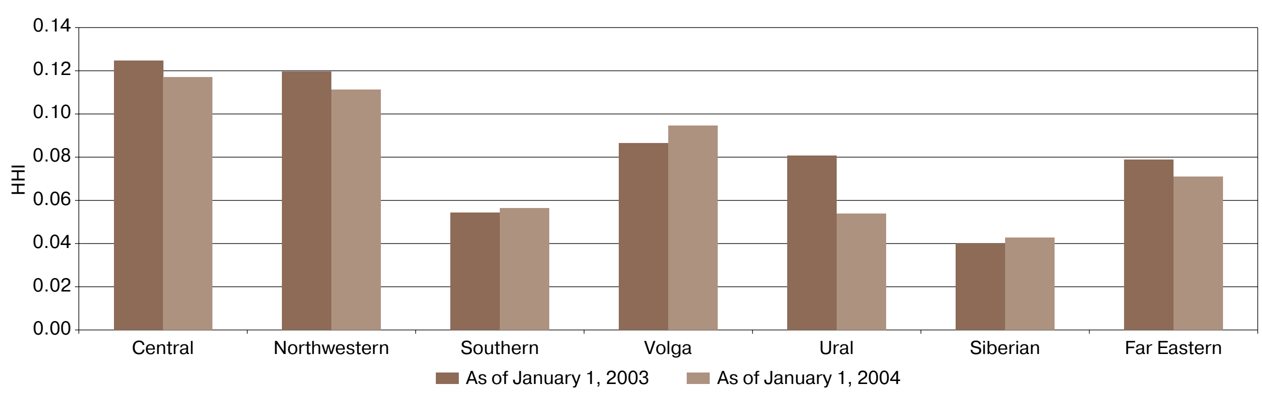


[1] The Herfindahl-Hirschman Index is recommended by the Compilation Guide on Financial Stability Indicators, which is being developed by the IMF, as a measure of concentration in the banking sector. It is calculated as a sum of squared unit weights of credit institutions' indicator in the total volume of the banking sector indicator. HHI shows the extent of the indicator's concentration on a scale of values from 0 to 1. The value 0 signifies the lowest level of concentration, less than 0.10 a low level of concentration, 0.10 to 0.18 a medium level of concentration and over 0.18 a high level of concentration.

Russian banking sector concentration indicators CHART 1.2



Banking sector asset concentration by federal district CHART 1.3



centration in this segment has also declined during the past two years and come close to low (less than 0.11).

Only the personal deposit market was characterised by a high level of concentration, despite its continuing decline. As of January 1, 2004, the HHI of this segment of the market was 0.40. The significant fall in the index in the past three years has largely been caused by the contraction of Sberbank's share in the personal deposit market and it testifies to increased competition on the retail banking market.

Concentration levels on the banking services market continued to differ significantly from region to region in 2003 *(see Chart 1.3).*

The second highest level of banking sector asset concentration after the Central Federal District was registered in the Northwestern Federal District, where the HHI stood at a medium level of 0.11. Other Federal Districts had low asset concentration levels; the lowest was registered in the Siberian Federal District.

I.2.3. Banking sector development at the regional level

The number of regional credit institutions[2] declined slightly in 2003: from 666 as of January 1, 2003, to 650 as of January 1, 2004. In 2003, the rate of growth in regional banks' assets[3] (33.7%) did not differ much from that in the aggregate banking sector assets (35.1%). As a result, the share of regional credit institutions in the aggregate banking sector assets was virtually unchanged in 2003 (35.5% as of January 1, 2004, as against 35.7% as of January 1, 2003).

The aggregate capital of regional credit institutions increased by 27.6 billion rubles, or 26.7%, in 2003, although their share in the aggregate banking sector capital contracted to 16.1% as of January 1, 2004 (as against 17.8% as of January 1, 2003).

As in the previous two years, regional credit institutions were profitable in 2003. Their total profit amounted

[2] Regional banks are the banks registered outside Moscow and the Moscow Region.
[3] Assets of the banks registered in the region, including their branch network inside the region, and assets of the branches of banks registered in other regions and located in the given region (form 107).

to 19.7 billion rubles, an increase of 19% on the previous year. The share of profit-making regional banks in the total number of operating regional banks was unchanged at 97.1% as of January 1, 2004, and their share in regional bank assets stood at 99.6%.

The best provided with banking services[4] after Moscow and the Moscow Region was the Northwestern Federal District, where the aggregate banking services index was 35% higher than the national average. At the same time, the ratio of assets and loans extended in the region to regional GDP exceeded the national average by about 50%. The ratio of individual deposits to household income and the institutional supply of the banking services (the number of credit institutions and their branches per capita) were also among the highest in the country. In the Volga Federal District, the level of provision of the banking services also slightly exceeded the national average as of January 1, 2004, while in the Siberian, Ural, Southern and Far Eastern Federal Districts it was a little below the national average. The banks located in the above federal districts accounted for 44% of the regional banks' assets as of January 1, 2004.

The Siberian Federal District was at the bottom of the banking services provision list, as the ratio of assets and loans extended in the region to regional GDP was respectively 15% and 10% smaller than the national average.

As of January 1, 2004, 13 regions and territories (the Bryansk, Kursk, Lipetsk, Orel, Tambov, Leningrad, Novgorod, Penza and Chita Regions, the Republics of Buryatiya, Marii El and Karelia and the Ingush Republic) had no more than two local credit institutions (as against 12 regions and territories as of January 1, 2003). Two territories (the Jewish Autonomous Area and Chukchee Autonomous Area) had no credit institutions as of January 1, 2004, just as in the previous years.

Thus, the provision of the Russian regions with the banking services did not change much in 2003 and the main reason why some regions are better provided with banking services than other is the different levels of their economic development.

I.2.4. State participation in the banking sector

Estimates[5] show that as of January 1, 2004, there were 20 credit institutions in which the state had a stake[6] of more than 50% (there were 23 such credit institutions as of January 1, 2003). In four of them (five as of January 1, 2003) more than 50% of the authorised capital was owned by federal-level organisations unrelated to the executive branch of power (the Bank of Russia has a controlling stake in Sberbank and the Federal Property Fund controls the Russian Development Bank, Roseximbank and Rosselkhozbank).

The group of Russian overseas banks is comprised of the Moscow Narodny Bank (London), Ost-West Handelsbank (Frankfurt am Main), Banque Commerciale pour l'Europe du Nord-Eurobank (Paris), Donau-bank (Vienna) and East-West United Bank (Luxembourg). These banks operate in compliance with their host countries' legislation and are supervised by the local supervisory authorities, while the Bank of Russia participates in managing them through its representatives on their supervisory boards.

The Bank of Russia holds a 15% stake in Donau-bank (Vienna) and East-West United Bank (Luxembourg) and owns 51.62% of the capital in Ost-West Handelsbank (Frankfurt am Main), 87.03% in Eurobank (Paris) and 88.89% in Moscow Narodny Bank (London). The overall finances of the Russian overseas banks are stable. All of them made a profit in 2003.

As of January 1, 2004, state-owned banks accounted for 28.4% of credit institutions' aggregate own funds (capital) (34.4% as of January 1, 2003), 36.0% of their assets (37.5% as of January 1, 2003), 38.2% of the bank loans to the real economy (39.2% as of January 1, 2003), 67.7% of personal deposits (72.1% as of January 1, 2003), including 63.3% of such deposits with Sberbank, and 80.0% of the investments in Russian government debt obligations, including 72% of Sberbank's investments.

State-owned banks play an important role in conducting operations with government budgetary funds and extrabudgetary funds. As of January 1, 2004, they accounted for 48.5% of the above funds deposited with operating credit institutions.

Although Sberbank's share in the aggregate banking sector assets contracted from 28.4% to 27.6% and in the aggregate banking sector capital from 20.4% to 18.3% in 2003, Sberbank continues to play a particular role on the banking services market. It continues to dominate the household deposit market: as of January 1, 2004, it accounted for 63.3% of the total value of deposits and other household funds attracted by the banking sector (67.3% as of January 1, 2003).

Sberbank is the principal player on the debt market: its share of bank investments in Russian government debt instruments expanded from 68.0% as of January 1, 2003, to 71.9% as of January 1, 2004. Sberbank continues to play a significant role in lending to the real sector, although its share of the total value of bank loans extended to nonfinancial enterprises contracted a little (from 29.8% as of January 1, 2003, to 29.3% as of January 1, 2004). Sberbank's share in interbank loans, deposit accounts and other funds placed with banks fell from 10.8% to 2.4%.

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[4] The Bank of Russia attaches great importance to the provision of the regions with banking services and constantly upgrades the methodology to evaluate it. It is currently developing a method to assess the provision of banking services using projection techniques such as the self-organising map method. We plan to deal with the results of this work in greater detail in the next issues of the Report.

[5] The Bank of Russia has to use estimates as its database has no codes allowing it to identify accurately state participation in the authorised capital of credit institutions (the tasks assigned to the Bank of Russia by the applicable legislation do not require it to use such codes).

[6] The organisations that directly represent the state include the executive bodies of power and state unitary enterprises at the federal and regional levels.

If we regard the Russian banking sector without Sberbank, we shall see that state banks play a considerably more modest role: as of January 1, 2004, they accounted for 12.4% of the own funds (capital) of operating credit institutions (17.6% as of January 1, 2003), 11.7% of the aggregate banking sector assets (12.7%), 12.6% of the loans to the non-financial enterprise sector (13.4%), 12.1% of individual deposits (14.7%) and 28.6% of bank investments in Russian government debt obligations (30.2%).

I.2.5. Foreign capital participation in the banking sector

Foreign capital increased its presence in the Russian banking system in 2003. The number of operating credit institutions with foreign interest rose from 126 to 128 over the year.

Eighty credit institutions with foreign stakes (62.5% of the total) have a general banking licence, 46 (35.9%) are licensed to conduct banking operations in rubles and foreign currency, two (1.6%) have licences to conduct banking operations in rubles alone, while 117 (91.4%) have licences to take personal deposits and 34 (26.6%) have licences to deposit and place precious metals.

Non-resident participation in the aggregate registered authorised capital of operating credit institutions increased from 15.9 billion rubles to 18.9 billion rubles, or 19%, in 2003. However, the non-resident share in the banking sector's aggregate authorised capital slightly contracted (from 5.3% to 5.2%). Foreign investment in the authorised capital of operating banks increased by three billion rubles over the year.

Fifteen wholly foreign-owned bank branches opened in Russia. Last year, the number of such bank branches increased by three: ZAO KMB-BANK opened a branch in Barnaul, ZAO AKB Michinoku Bank (Moscow) opened a branch in Khabarovsk and OOO Mezhdunarodny Bank Azerbaijana — Moskva opened a branch in St Petersburg.

The entire authorised capital of 32 banks, or 25.0% of the total, is formed with non-resident funds. The number of such banks increased by five over the year, as three new wholly foreign-owned credit institutions were registered — ZAO Standart Bank, ZAO Bank Inteza and Commercial Bank of India OOO, the Moscow branch of OOO BANK ANELIK (Armenia) was reorganised into a subsidiary, OOO KB Anelik RU, and OOO KhKF Bank became a wholly foreign-owned bank as its shareholders alienated their stakes in favour of a non-resident.

There were 41 foreign-controlled banks[7] in the Russian banking sector as of January 1, 2004, as against 37 banks as of January 1, 2003. Eight of them were among Russia's top 50 credit institutions in terms of assets.

The policy pursued by foreign-controlled banks in 2003 was designed to broaden the range of settlement services provided to customers, increase the volume of operations on international financial markets and expand operations on the retail market.

The assets of foreign-controlled banks increased by 24.2% to 415.5 billion rubles in 2003 and their own funds (capital) grew by 30.9% to 54.0 billion rubles. However, foreign capital continues to play a modest role in the Russian banking sector: as of January 1, 2004, foreign-controlled banks accounted for 7.4% of banking sector assets and 6.6% of own funds (capital) (as of January 1, 2003, the respective percentages were 8.1% and 7.1%).

Funds in customers' accounts, loans, deposit accounts and other funds raised on the interbank market remained the principal sources of funds for foreign-controlled banks: these sources accounted for almost 75% of these banks' liabilities.

The balances in customers' accounts in 2003 increased by 19.1% to 163.8 billion rubles, while their share in these banks' liabilities slightly contracted: from 41.1% as of January 1, 2003, to 39.4% as of January 1, 2004. At the same time, 44% of customers' funds were corporate customers' settlement, current and other accounts, whose balances grew by 46.1% and whose share in liabilities expanded from 14.8% as of January 1, 2003, to 17.4% as of January 1, 2004. Corporate customers' deposit accounts declined by 15.0% to 51.2 billion rubles and their share in liabilities contracted from 18.0% to 12.3%.

Foreign-controlled banks rapidly expanded their operations on the retail services market in 2003: the value of deposits and other funds taken from private individuals increased by 1.4 times (from 23.5 billion rubles to 34 billion rubles). This source accounted for 8.2% of liabilities of this group of banks as against 7% a year earlier.

However, the foreign-controlled banks' share of the retail banking market was virtually unchanged at 2.2% as of January 1, 2004, as against 2.3% as of January 1, 2003.

The balances of funds raised by foreign-controlled credit institutions on the interbank market rose by 32.2% to 146.7 billion rubles in 2003 and their share of these banks' liabilities increased from 33.2% to 35.3%. Most of the funds were attracted from non-resident banks (126.3 billion rubles, or 86%), of which 46% were attracted for a term of one year and more.

Foreign-controlled banks have come to play a more important role in redistributing resources between Russian and international financial markets. At the beginning of 2003, the funds attracted by these banks to the Russian financial market (mostly from their parent companies) exceeded the funds placed with non-residents by 22.6 billion rubles, whereas as of January 1, 2004, the excess amounted to 109.5 billion rubles. Foreign-controlled credit institutions account for 64% of the net inflow of funds brought from the international interbank market by all operating credit institutions.

Lending is a major line of business for foreign-controlled banks. Loans and other funds provided by these

[7] Credit institutions with a foreign stake in excess of 50%.

banks to the non-financial enterprise sector in 2003 increased from 117.7 billion rubles to 146.1 billion rubles, an increase of 24.2%, but their share in these banks' assets remained unchanged at 35% as of January 1, 2004. Foreign currency loans account for 79.8% of the total value of loans extended by this group of banks. The share of foreign-controlled banks in the total value of bank loans extended to the non-financial enterprise sector contracted slightly in 2003 (from 7.1% to 6.1%).

Foreign-controlled banks are noted for their high activity on the consumer credit market. The value of loans they extended to Russian consumers increased by 3.4 times (in the banking sector by 2.1 times) to 17.3 billion rubles, or 7.6% of all loans extended by these banks (as against 2.6% as of January 1, 2003). As of January 1, 2004, foreign-controlled banks accounted for 5.8% of the total value of loans extended to consumers (as against 3.7% as of January 1, 2003).

By diversifying their operations, foreign-controlled banks increased their investments in securities in 2003 by 42.5% to 55.6 billion rubles. The share of the foreign-controlled banks' investments in securities expanded from 11.7% to 13.4% of their assets. Foreign-controlled banks preferred investments in debt instruments, which grew by 43.3% and accounted for 92% of the securities acquired by this group of banks. The share of Russian government securities contracted significantly, from 67.0% to 56.1%.

The value of interbank loans, deposits and other funds placed by foreign-controlled banks decreased from 75.6 billion rubles to 57.9 billion rubles, or 23%, in 2003. A little more than half of these funds (51.7%) was provided to non-resident banks. The share of interbank loans, deposits and other placements in foreign-controlled banks' assets contracted from 23% to 14% and the share of foreign banks in the total value of banking sector interbank loans, deposits and other placements decreased from 25.9% to 22.0% in 2003.

There was a decrease in the value of funds placed by foreign banks in correspondent accounts in non-resident banks (from 44.6 billion rubles to 35.7 billion rubles, or by 20%), while their share in assets contracted from 13.3% to 8.6%. The share of foreign-controlled banks in the total value of funds in correspondent accounts with non-resident banks fell from 22.9% to 19.7%.

At the end of 2003, foreign-controlled banks had free balances of funds in the Bank of Russia that exceeded by five times their value as of January 1, 2003, and their share in the assets of this group of banks expanded significantly (from 2.2% to 9.1%).

The results of the activities of foreign-controlled banks point to their improved financial standing. Ongoing profits increased by almost 1.7 times (from 10.0 billion rubles as of January 1, 2003, to 16.5 billion rubles as of January 1, 2004). The number of profit-making banks slightly increased (from 31 to 34) and their profits grew from 10.2 billion rubles to 16.7 billion rubles. At the same time, the number of loss-making banks remained unchanged at six, and their losses increased from 144 million rubles to 218 million rubles.

Growth in profits allowed banks to improve their financial results significantly in 2003, taking into account their performance in the previous years. As of January 1, 2004, their profits amounted to 19.7 billion rubles, with account for the results of the previous years (as against 8.2 billion rubles as of January 1, 2003). Thirty-eight out of 41 foreign-controlled banks were financially sound as of January 1, 2004.

The asset profitability of foreign-controlled banks increased to 4.7% in 2003 from 3.3% in 2002, exceeding the asset profitability of the Russian banking sector as a whole.

I.3. Banking operations

I.3.1. The dynamics and structure of borrowed funds

The dynamics of major parameters in terms of the state of the banking sector in 2003 testified to the continuation of positive trends in banking sector development.

Last year not only saw an expansion of the resource base of credit institutions, but also structural changes in banking sector liabilities *(see Chart 1.4).* The increased value of personal deposits accounted for a third of the growth in banking sector liabilities. The value of personal deposit accounts in Russian banks rose by 47.1% to 1,514.4 billion rubles, while their share in banking sector liabilities expanded from 24.8% as of January 1, 2003, to 27.0% as of January 1, 2004. However, despite continued growth, the rate of the increase in personal deposits slowed a little compared to 2002, when the value of personal deposits rose by 51.9%.

For the first time in three years growth in the value of ruble individual deposit accounts exceeded growth in foreign currency individual deposit accounts *(see Chart 1.5).* As a result, the share of ruble deposit accounts in the total value of individual deposit accounts increased from 61.5% to 69.4%. This situation does not only apply to Sberbank, which is the leader of the ruble deposit market, but is even more true of other banks.

The share of individual deposit accounts with terms longer than one year continued to expand in the total value of deposits: it increased from 35.3% as of January 1, 2003, to 43.7% as of January 1, 2004, and in banking sector liabilities from 8.8% to 11.8%.

Competition increased on the retail banking market in 2003. The value of deposits taken by Sberbank rose by 38.2%, while the value of deposits taken by other credit institutions grew by 65.4%. However, Sberbank remained the leader of the individual savings market and as of January 1, 2004, it accounted for 63.3% of the total value of individual deposits (as against 67.3% as of January 1, 2003) *(see Chart 1.6).*

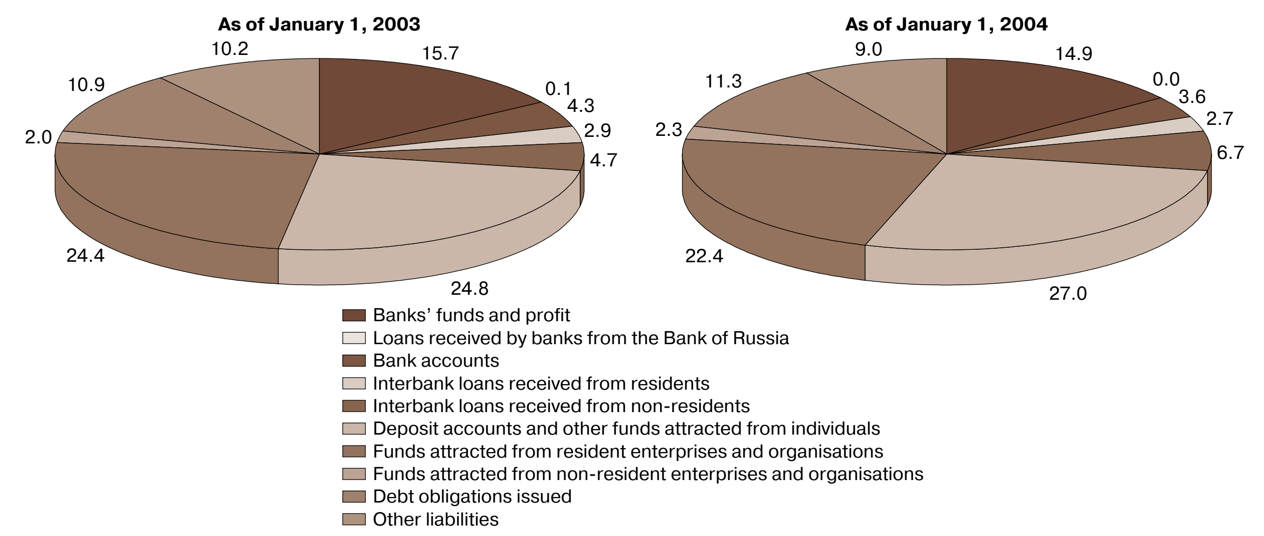
The second most important source of resources for credit institutions in 2003 was the enterprise sector's funds, the expansion of which accounted for a fifth of the growth in aggregate banking sector liabilities. Over the year, the value of corporate funds attracted by banks increased by almost 27% to 1,384.8 billion rubles, although the share of this source of funds in aggregate banking sector liabilities slightly contracted. Of the total value of funds attracted by banks from the enterprise sector, 71% came in the form of balances in settlement and current accounts.

Overall growth in corporate deposit accounts amounted to 12.9%, but their share in aggregate banking sector liabilities fell from 6.7% as of January 1, 2003, to 5.6% as of January 1, 2004.

The share of corporate demand deposits and deposit accounts with terms up to 30 days contracted by 44.8% to 10.3% in the total value of corporate deposits (as against 21.0% as of January 1, 2003), while the share of deposits with terms from 31 days to a year expanded by 39.4% and longer than a year by 11.6% (as of January 1,

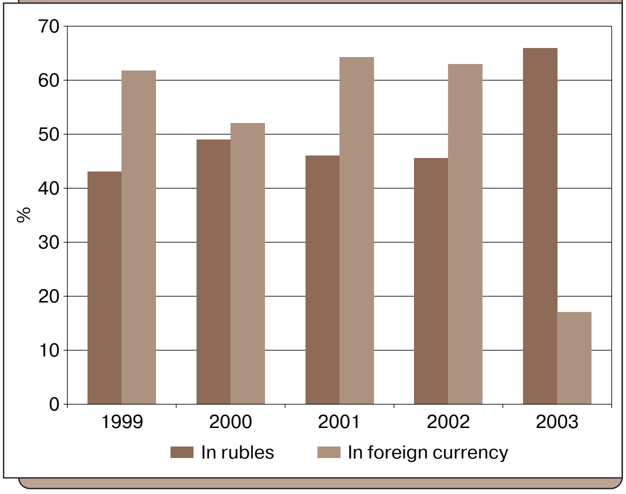
Banking sector liability structure

CHART 1.4



Rates of growth in deposits and other funds attracted from individuals

CHART 1.5



2004, these deposits accounted for 58.1% and 31.4% of the total value of deposits respectively).

The value of debt obligations issued by banks in 2003 rose by 40.8% to 634.5 billion rubles as of January 1, 2004, and they accounted for 11.3% of banking sector liabilities. The share of debt obligations issued by banks for terms longer than a year expanded by 36.8% to 32.1% in the total value of debt obligations as of the beginning of 2004.

Despite the significant contraction of their share, promissory notes continued to dominate the structure of debt obligations issued by banks (73.4% as of January 1, 2004, as against 82.6% as of January 1, 2003). The value of bank promissory notes grew by a quarter (to 466.0 billion rubles) and they accounted for 8.3% of banking sector liabilities (as against 9.0% as of January 1, 2003).

The value of bonds, certificates of deposit and savings certificates issued by banks increased by 2.2 times last year. On the whole, however, these instruments still play a small part as a source of resources for banks. Their share in banking sector liabilities stood at 2.9% as of January 1, 2004, as against 1.8% as of January 1, 2003.

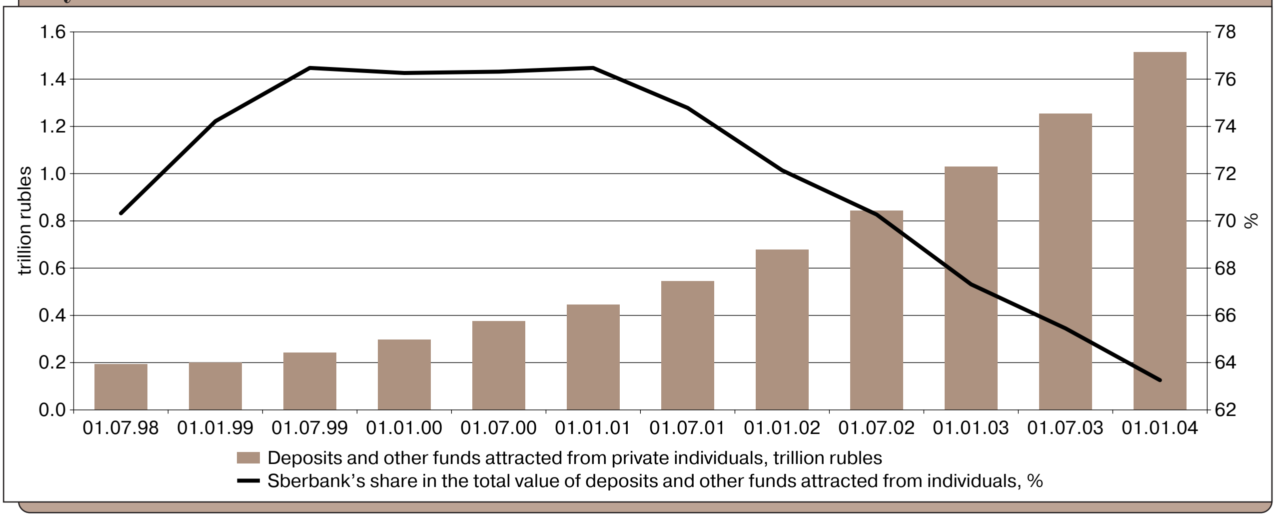
In 2003, credit institutions registered 17 bond issues with a total nominal value of 12.2 billion rubles. Most of the issuers were large Moscow-based banks. Four credit institutions accounted for 49% of the total registered bond issues with a total nominal value of 6.0 billion rubles: OAO Bank Petrokommerts, OAO AKB Rosbank, AKB BIN and ZAO Bank Russki Standart. There are no bonds of medium-sized and small banks on the financial market because potential buyers do not have enough information about these banks' finances, ownership structure and scope for development; as a result, there is little demand for their debt obligations on the open market.

Fund-raising operations on the interbank market in 2003 developed unevenly (most of the increment was registered in the latter half of the year). Full-year growth in obligations on loans, deposit accounts and other funds received from other banks stood at 66.5% and their value amounted to 525.3 billion rubles and this source accounted for 9.4% of banking sector liabilities as of January 1, 2004, as against 7.6% as of January 1, 2003 *(see Chart 1.7).*

Loans taken from non-resident banks grew at a particularly rapid rate. The average monthly[8] value of loans taken by Russian banks from non-resident banks in November and December 2003 increased by 33.1% and 57.0% year on year respectively, affecting full-year growth in their balances. Foreign currency loans accounted for 94% of the total value of loans taken from non-resident banks: their balances increased by 88.3% in 2003. As a result, the share of loans taken from non-resident banks in foreign currency expanded from 59.6% to 67.4% in the total value of interbank loans. It should be noted that as of January 1, 2004, 53% of foreign cur-

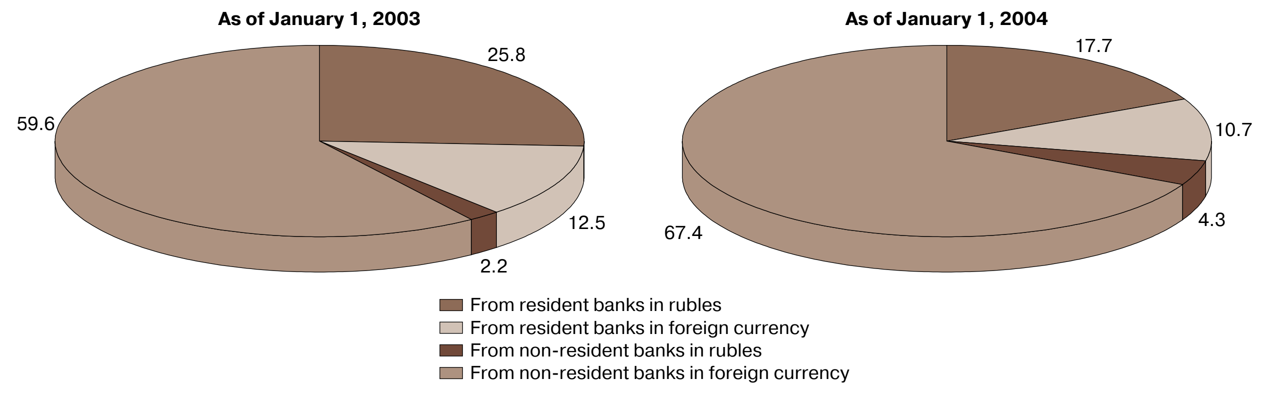
Individual deposit dynamics

CHART 1.6



[8] Here and below, average monthly values on interbank loans are calculated by the chronological average.

Loans, deposit accounts and other funds raised on interbank markets CHART 1.7



rency loans were taken from non-resident banks for a term of one year and more (about 51% as of January 1, 2003). One of the factors of growth in medium- and long-term loans taken from international financial markets was the assignment of an investment-grade rating to Russia.

Obligations on loans taken from non-resident banks in foreign currency for terms shorter than one year increased by 1.9 times in 2003 to 166 billion rubles. However, their share in banking sector liabilities was a lowly 3% as of January 1, 2004 (2.1% as of January 1, 2003).

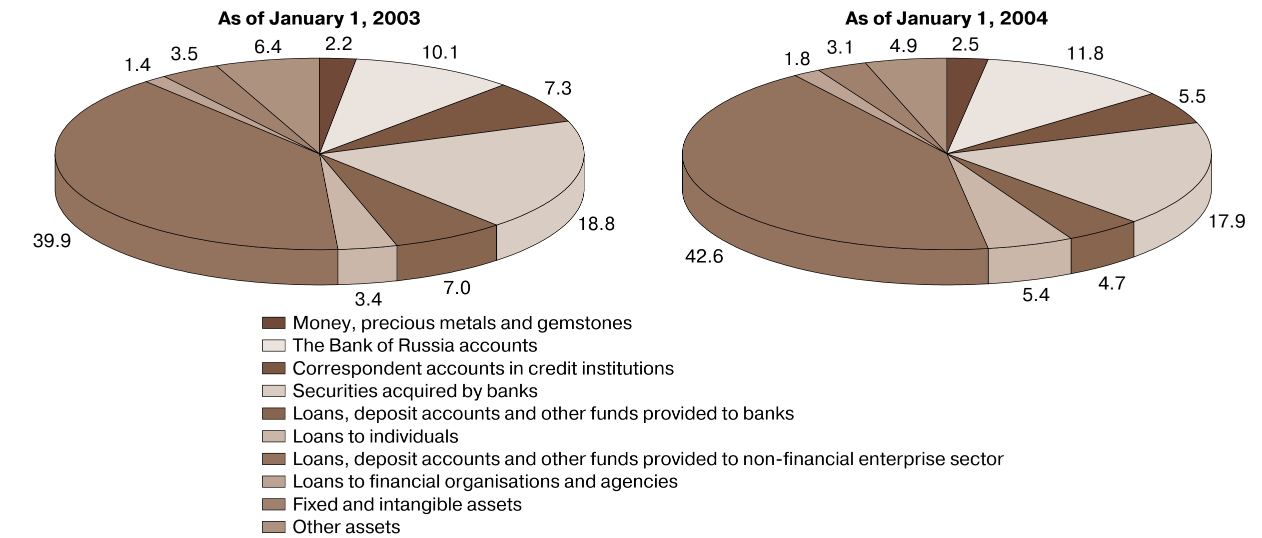
I.3.2. Asset dynamics and structure

Banking sector assets increased by 35.1% and stood at more than 5.6 trillion rubles in 2003 *(see Chart 1.8).* Ruble operations grew faster than foreign currency ones and the ruble component of banking sector assets expanded from 63.8% to 70.1%. This was due to gains made by the ruble and the increased confidence of banks, creditors and depositors in the Russian currency *(see Chart 1.9).* However, this indicator has not yet reached the July 1998 level (72.9%).

The main factor of growth in banking sector assets was the dynamic increase in lending to the real sector. Bank loans to the non-financial sector increased by 42.4% year on year (exceeding the 2002 rate of growth by 7.2 percentage points) and as of January 1, 2004, they amounted to 2,266.9 billion rubles. These loans accounted for 40.5% of aggregate banking sector assets as of January 1, 2004, as against 38.4% as of January 1, 2003 *(see Chart 1.10).*

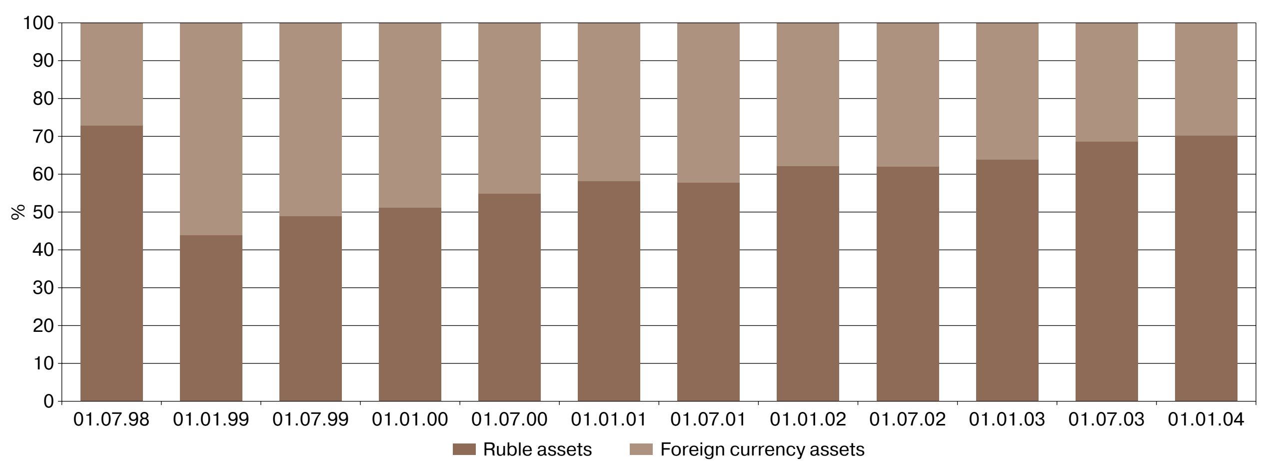
About two-thirds of the total amount of loans extended to the non-financial enterprise sector were allotted in rubles and full-year increment in the value of ruble loans exceeded 45%. As for loans extended to the Russian non-financial enterprise sector, the loans with terms longer than one year grew faster than shorter-term loans. Their full-year increment stood at 70% and they accounted for 38% of the total value of loans extended to the Russian enterprise sector (as against 32% as of the beginning of the year).

Banking sector asset structure CHART 1.8



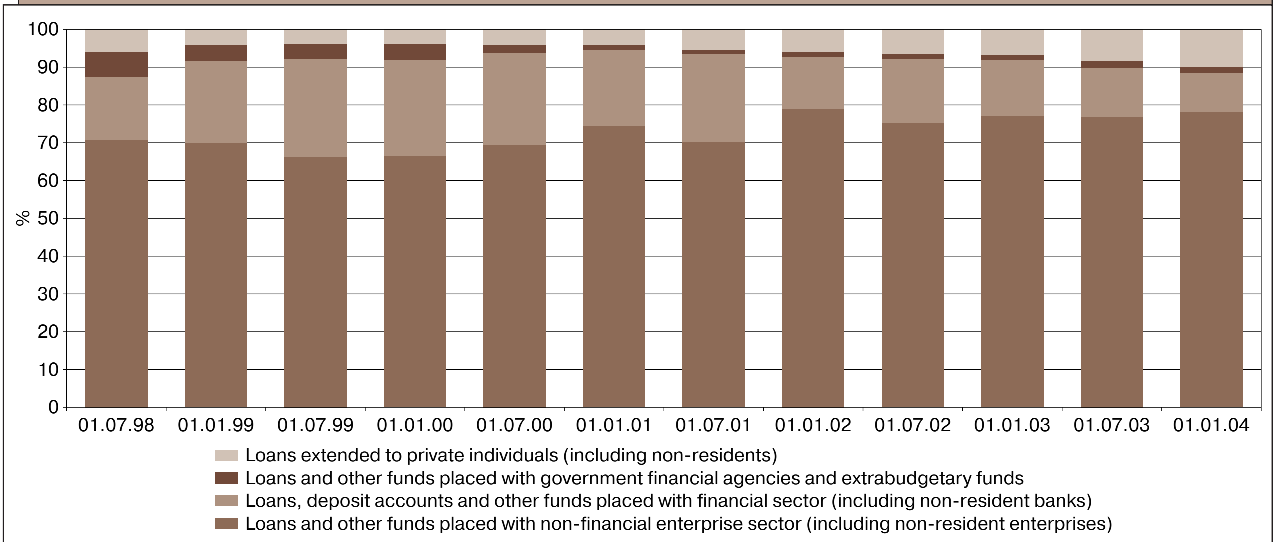
Dynamics of operating credit institutions' ruble and foreign currency assets in aggregate banking sector assets

CHART 1.9



Banking sector lending operation structure

CHART1.10



Some changes have been noted in the structure of loans[9] by sector. More rapid rates of growth (compared to 2002) were registered in 2003 in debt on loans extended to the transport and communications sector (62.8% as against 42.6%) and the construction sector (49.2% as against 45.1%). Despite a minor slowdown, growth continued at rapid rates in the debt on loans to agriculture (62.6% as against 68.3% in 2002) and trade and public catering (40.5% as against 51.8%). The debt on loans to industrial enterprises increased by 34.0% (of this, the debt on loans to chemical enterprises rose 41.6% as against 25.0% in 2002 and light industry enterprises 31.6% as against 25.7%).

Most of the loans were extended to industrial enterprises and trading and public catering establishments: the debt on loans to enterprises in these sectors accounted for 37.6% and 23.2% of the enterprise sector's total debt, respectively, as of January 1, 2004. At the same time, the share of the debt on loans to agriculture expanded from 2.4% to 2.7%, the construction sector from 4.8% to 5.0% and transport and communications from 5.0% to 5.8%.

The value of loans and other funds placed with non-resident corporate entities[10] increased by 88.8% to 118.2 billion rubles, but their share in aggregate banking sector assets was small (2.1% as of January 1, 2004).

Growth in lending to the non-financial sector of the economy was attributable to a combination of several factors: on the one hand, enterprises actively sought credit to finance growing production, especially working assets, amid less expensive bank credit; on the other hand, there was a rise in the supply of credit funds from banks due to greater resources attracted by banks on a term basis,

[9] Data by sector is based on banks' statements (form 302).
[10] Excluding loans extended to non-resident banks.

including terms longer than one year. Yet another factor was the decreased yields on the main segments of the financial market (government securities and interbank loans).

A sharp rise in banks' lending activity on the consumer credit market was a noticeable trend in lending. Last year, the value of loans extended to Russian citizens rose by 2.1 times, from 141.2 billion rubles to 298.4 billion rubles (ruble loans account for 82.5% of the total value of consumer credit). Loans to individuals accounted for 5.3% of aggregate banking sector assets as of January 1, 2004, against 3.4% as of January 1, 2003.

In 2003, credit institutions were learning to handle the relatively new banking product of mortgage lending to private individuals. According to data reported by banks, the debt on such loans rose by 2.2 times to 7.7 billion rubles (in 2002, it increased by 1.9 times).

The further development of consumer lending is constrained by the lack of appropriate legal conditions that could make collateral more effective and protect consumers' interests, and a high cost of credit, which makes it unaffordable for the majority of the population. Another restraining factor is the lack of credit bureaux, organisations that could help reduce credit institutions' risks and costs.

The expansion of operations on the securities market slowed in 2003 as compared with 2002. Most of the growth in investments in securities (by 38.6%) was registered in the first half of 2003 as government debt obligations yielded higher returns than other financial instruments. The GKO—OFZ bond yield[11] on the financial market in January 2003 stood at 13.0%, but by the middle of the year it had slipped to 7—8% (it remained at this level till the end of the year on average). Therefore, in the second half of the year the value of investments in securities fell by 7.3%. As a result, full-year increase in the banking sector's securities portfolio stood at 28.5% and as of January 1, 2004, its value amounted to 1,002.2 billion rubles. As other operations on the asset side, especially lending, grew more rapidly, the securities' share of banking sector assets contracted from 18.8% to 17.9%.

Investments in debt obligations continued to dominate in banks' securities portfolio, although their share in banking sector assets decreased from 12.1% to 11.2%. Russian government securities prevail in the structure of banking sector investments in debt obligations (71.5% as of January 1, 2004, as against 82.1% as of January 1, 2003). As has already been noted, Sberbank and other state-controlled banks accounted for the largest part of banking sector investments in securities.

As the macroeconomic situation remained relatively stable, credit institutions intensified their operations on the Russian corporate securities market: the value of the banking sector's investments in stocks and shares increased by 68.4% to 115.8 billion rubles. However, their share in banking sector assets remains small at 2.1% as of January 1, 2004 (as against 1.7% as of January 1, 2003).

The value of promissory notes discounted by credit institutions in 2003 rose by 25.3% as against 41.5% in 2002, while banks' investments in promissory notes increased by 2.2 times. Notes discounted by banks accounted for 4.7% of banking sector assets as of January 1, 2004, as against 5.0% as of January 1, 2003. Of the total value of the portfolio of promissory notes discounted by banks (261.3 billion rubles), notes issued by Russian companies accounted for 62.0%, notes issued by Russian banks 35.3% and notes issued by non-residents 2.3%.

In the banking sector as a whole, the value of claims on interbank loans declined by 9.5% in 2003 and their share in aggregate banking sector assets contracted from 7.0% to 4.7%. At the same time, the balances of loans, deposit accounts and other funds placed by banks on the domestic interbank market increased by 19.3%, whereas in foreign banks they declined by 29.6%.

[11] GKO—OFZ yields are shown according to the GKO—OFZ effective secondary trade turnover indicator (%). Data are derived from the Bank of Russia factbook Russia. Economic and Financial Situation. December 2003.

I.4. Financial condition of credit institutions

I.4.1. Financial performance

Last year saw a favourable economic situation, which allowed Russian banks to expand the scale of their activities and introduce new banking products. Growth in credit institutions' profits and improved finances was the logical result of banking sector development dynamics.

As of the beginning of 2004, there were 1,279 financially sound credit institutions (these include Group 1 banks, i.e., banks without any shortcomings in their work, and Group 2 banks, i.e., banks with few shortcomings[12]). There were 1,269 such credit institutions as of January 1, 2003. These credit institutions accounted for nearly 95% of the total number of operating credit institutions and 96% of banking sector assets. Almost all corporate funds, individual deposits, budget funds and interbank loans are held in financially sound banks. Group 3 and Group 4 banks accounted for less than 1% of the above funds.

Profitability indicators. In 2003, operating credit institutions made a profit of 128 billion rubles, an increase of 38% on the previous year (93 billion rubles) *(see Chart 1.11).* Operating credit institutions' profit, including the results of previous years, stood at 114.7 billion rubles (as against 27 billion rubles as of January 1, 2003).

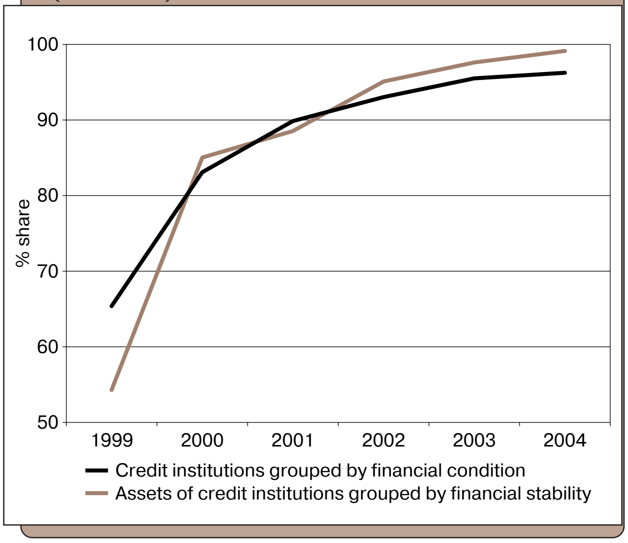
The number of profit-making banks grew for three consecutive years (from 1,279 to 1,284 in 2003), while the number of loss-making banks declined (from 46 to 41 in 2003) *(see Chart 1.13).* As a result, in 2003, credit institutions recorded a profit of 133 billion rubles, while their losses amounted to five billion rubles.

Last year saw bank profitability indicators stabilise. Credit institutions' profits grew almost at the same rate as their assets and capital[13]. As a result, banking sector asset profitability[14] in 2003 was unchanged from 2002 at 2.6%.

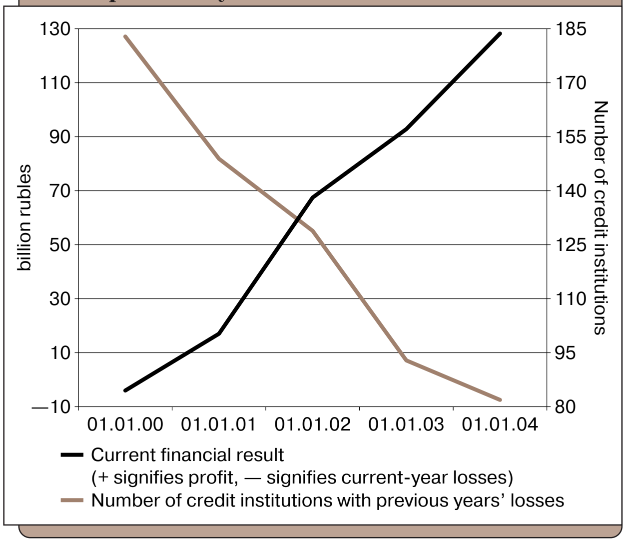
The banking sector's return on capital[15], which stood at 17.8% in 2003, was high and changed little from 2002 (18.0%).

In terms of the return on capital, the banking sector surpasses many other sectors of the Russian economy.

Dynamics of number and assets of financially sound credit institutions (% share) *CHART 1.11*

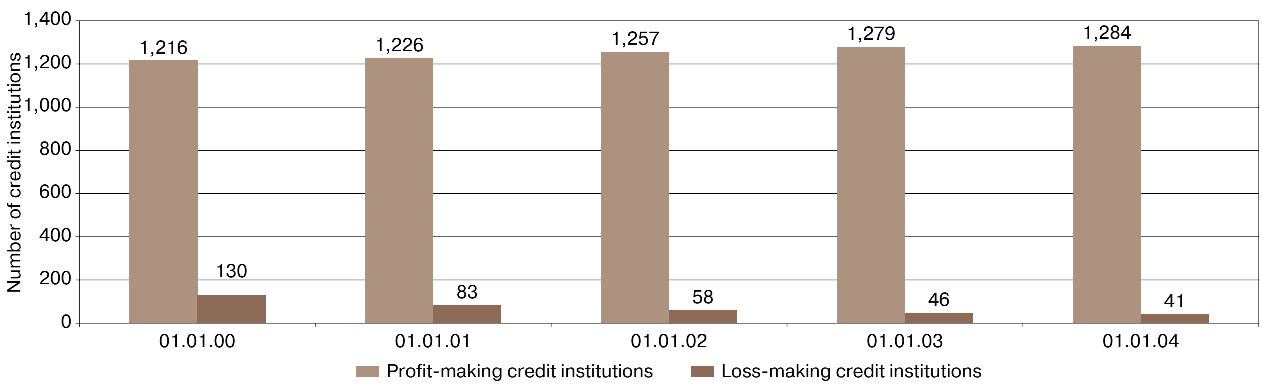


Dynamics of banking sector current financial result and number of credit institutions with previous years' losses *CHART 1.12*



[12] Credit institutions are classified in accordance with Bank of Russia Ordinance No. 766-U, dated March 31, 2000, "On the Criteria of Determining the Financial Condition of Credit Institutions".
[13] Banking sector assets grew by an average annual of 35% in 2003, capital expanded by 39% and financial result (profit) increased by 38%.
[14] Asset profitability is calculated as the ratio of profit to assets. Full-year pre-tax financial result (the balance of profits and losses) and the average annual (average chronological) value of credit institutions' assets are used for the calculation.
[15] The return on capital is calculated as the ratio of profit to capital. Full-year pre-tax financial result (profit and loss balance) and the average annual (average chronological) value of credit institutions' capital is used for the calculation. Calculated according to Goskomstat's methodology as the ratio of banking sector profit to own funds (capital) as of the end of the year, the return on capital in 2003 stood at 15.8%.

Dynamics of profit- and loss-making credit institutions CHART 1.13



According to Goskomstat data, the return on capital in the Russian economy as a whole stood at 10.8% in 2003 and in industry it was 13.2%. At the same time, some industries, both export-oriented and those oriented to rapidly expanding segments of the domestic market, demonstrated considerably higher returns on capital. The ferrous metallurgy sector and confectionary and cosmetics industries, for instance, had a return on capital higher than 30%.

In comparison: in Western Europe and the United States, financial intermediaries, including banks, consider a 15% return on capital to be high.

I.4.2. Structure of incomes and expenses

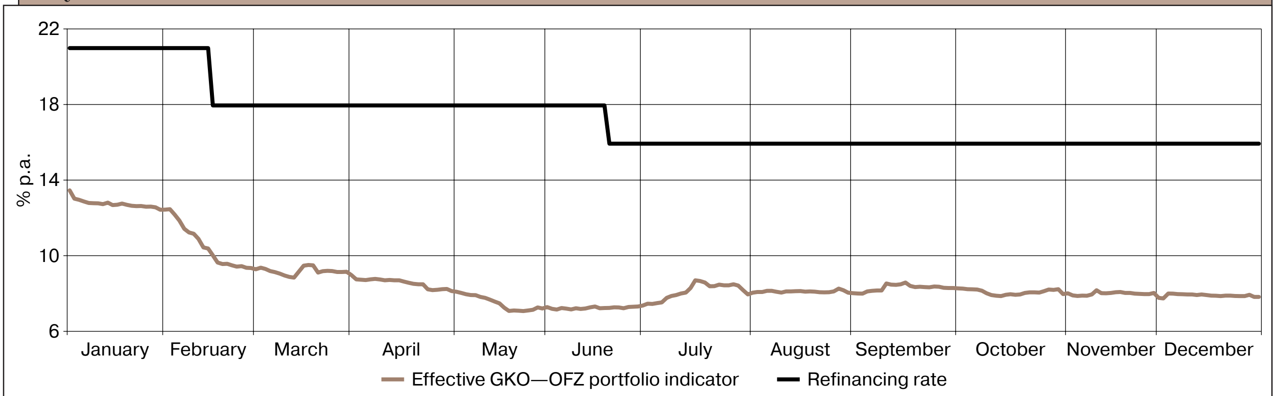
In the long-term, the financial results of Russian banks will chiefly depend on their business development strategies. It should be noted that banks' investment preferences are largely determined by interest rates in the economy and the profitability of operations in the various segments of the credit and financial markets. As interest rates decline and competition on the banking services market intensifies, banks are becoming increasingly concerned about maintaining an acceptable level of incomes, but even more about control over expenses.

The trend towards declining yields on the government and non-government securities market and on the foreign exchange and interbank markets continued in 2003 *(see Chart 1.14)*. Interest rates on loans to corporate and individual borrowers fell gradually. In 2003, the Bank of Russia cut the refinancing rate twice: by the end of the year it had fallen to 16%, prompting Sberbank and other banks to reduce interest rates on household deposits.

The structure of the banking sector's net income[16] shows that the Russian banking sector as a whole is oriented to the fulfilment of the financial intermediaries' traditional function of transforming savings into loans to the economy.

A large part of credit institutions' net income (55.6% in 2003) was net interest income, which is usually the most stable component of the financial result, formed primarily from the difference between the interest rates set by banks on the loans they extend and the funds they attract. Commission income, another traditionally stable component of banks' net income, accounted for 19.0% in 2003.

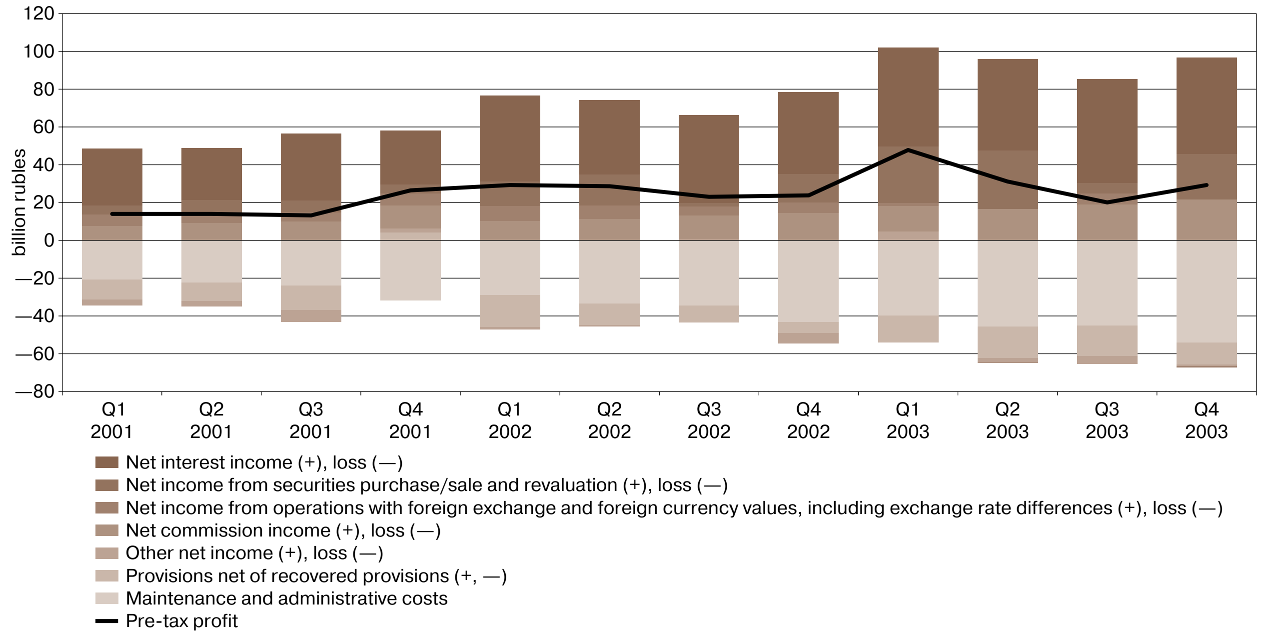
Interest rate dynamics CHART 1.14



[16] Financial result before the formation (recovery) of provisions and net of maintenance and administrative costs. Calculated in accordance with the Profit and Loss Statements of Credit Institutions (form 102).

Sources of current financial result

CHART 1.15



At the same time, the banking sector's financial result and its quarterly dynamics were largely affected by net income from the sale and purchase of securities. In 2003, net income from securities accounted for 24% of the banking sector's total net income.

As the foreign exchange market remained stable in 2003, the share of net income from operations with foreign exchange continued to contract and over the year it decreased from 8.8% to less than 1.8%.

In 2003, credit institutions successfully controlled their maintenance and administrative costs, which varied between 40 and 45 billion rubles a quarter. The share of net income used to cover the above expenses in 2003 stood at 50% (in 2001 and 2002 it also stood at about 50%).

I.5. Banking sector risks

I.5.1. Credit risk

Major characteristics of overdue debt on loans. The dynamics of the quantitative characteristics of overdue debt on loans, deposit accounts and other placements (hereinafter referred to as debt on loans) allow one to evaluate the banking sector's credit risk in 2003 as moderate. It is far too small to create conditions for a bad loan crisis[17].

Overdue debt on loans rose by 18.7% in 2003 to 48.0 billion rubles as of January 1, 2004. Against the background of dynamic growth in banks' lending operations, the share of overdue debt in total debt on loans contracted from 1.9% to 1.6%.

Overdue debt accounted for 1.6% of loans to the nonfinancial enterprise sector as of January 1, 2004, as against 1.8% as of the beginning of the year; as regards ruble loans, it was unchanged at 1.7% and in foreign currency loans it decreased from 1.9% to 1.3%. By sector, the biggest debt on ruble loans in 2003, as in 2002, was owed by agricultural enterprises (4%) and on foreign currency loans by trade and public catering enterprises (2%) *(see Chart 1.16).* On the whole, overdue debt on loans, extended in rubles or foreign currency, did not differ much between sectors.

The number of credit institutions with an overdue debt of less than 2% in their loan portfolios rose from 553 as of January 1, 2003, to 609 as of January 1, 2004, and the share of such banks in aggregate banking sector assets expanded from 76.4% to 81.5% in 2003.

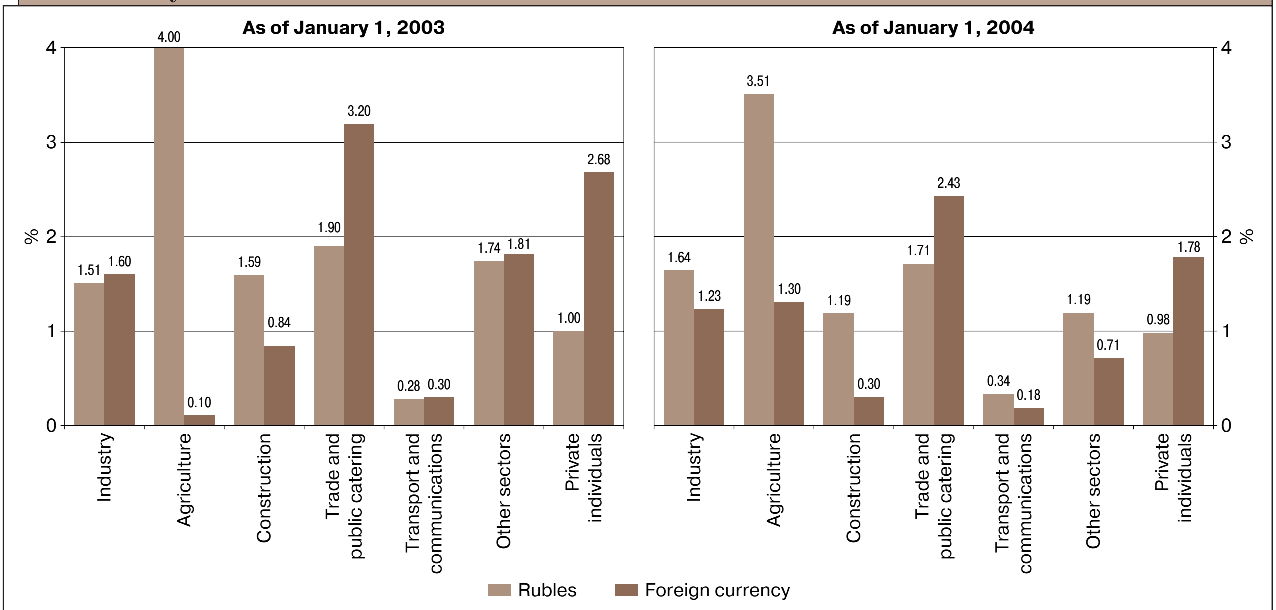
The number of credit institutions with an overdue debt in excess of 15% of their loan portfolios declined from 52 to 43 and their share in aggregate banking sector assets stood at a little over 0.5% as of January 1, 2004.

Banking sector loan portfolio quality. According to banks' data, the quality of the banking sector's loan portfolio continued to improve in 2003. Standard loans accounted for 90.7% of the total debt on loans as of January 1, 2004, as against 90.1% a year earlier; the share of impaired loans contracted from 1.8% to 1.5% and that of bad loans from 3.8% to 3.4%[18].

The number of credit institutions with more than 90% of standard loans in their loan portfolios rose from 959 to 961 in 2003 and such banks accounted for 80% of aggregate banking sector assets.

Credit risk concentration. The situation with large loan risk ratio[19] (N7) violations did not change in 2003: only one credit institution failed to meet this ratio.

Percent share of overdue debt on loans by sector *CHART 1.16*



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[17] By international standards, an overdue debt ratio of 10% indicates problems.
[18] By international banking supervision standards, bad loans exceeding 10% of the aggregate loan portfolio mean high credit risk.
[19] Bank of Russia requirements stipulate that an excess of the aggregate value of a bank's claims to a borrower or group of related borrowers on loans, deposit accounts and other placements over the bank's own funds (capital) by 5% constitutes a major credit risk.

The value of the large loan claims (credit risks) in the banking sector in 2003 increased from 1,328.9 billion rubles to 1,964.4 billion rubles, or 47.8%. As a result, the share of large loans expanded by three percentage points to 35.1% as of January 1, 2004.

The number of credit institutions that violated the N6 ratio (maximum risk per borrower or group of related borrowers) fell by more than half, from 51 as of January 1, 2003, to 24 as of January 1, 2004, and their share in aggregate banking sector assets contracted to 7% from more than 42% a year earlier.

Credit risk on operations with shareholders and insiders. The number of credit institutions that violated the maximum credit risk per shareholder (member) ratio (N9) increased from three as of January 1, 2003, to 18 as of January 1, 2004. The number of credit institutions that violated the N10 ratio (the maximum amount of loans extended and guarantees and sureties issued to insiders) decreased from three to two over the year. The share of assets of credit institutions that violated the N9 and N10 ratios was small and accounted for fractions of a percent[20].

The N9.1 ratio (maximum loans, bank guarantees and sureties provided by a credit institution/banking group to its members/shareholders) was calculated as of January 1, 2004, by 504 credit institutions as against 543 credit institutions as of January 1, 2003. As of January 1, 2004, the N9.1 ratio was violated by three credit institutions, whose share in the credit institutions that calculated this ratio stood at 0.38% (there were no violator credit institutions as of January 1, 2003).

The N10.1 ratio, which sets a limit on the aggregate amount of loans extended and guarantees and sureties issued by a credit institution to insiders by 3% of the bank's own funds (capital), was calculated by 879 credit institutions as of January 1, 2004, as against 820 credit institutions as of January 1, 2003. As of the end of 2003, three banks violated this ratio (they accounted for 0.13% of the assets of the banks that calculated this ratio), whereas at the beginning of 2003, only one credit institution failed to comply with this ratio.

Major characteristics of loan loss provision (LLP). Throughout 2003, credit institutions demonstrated good LLP performance indicators. Most banks had the required LLP by all accounting dates. As of January 1, 2004, the number of banks with LLP of at least 100% of the required amount stood at 1,238 and they accounted for 93.6% of aggregate banking sector assets (1,212 banks and 92.3% as of January 1, 2003).

It should be noted that the LLP formed as of January 1, 2004, covered 5.9% of the actual debt on loan, while impaired and bad loans accounted for 5.0% of it. Thus, the loans included by banks in Credit Risk Groups 3 and 4 were completely covered by LLP. The ratio of Credit Risk Group 3 and Group 4 LLP to the loans included in these groups stood at 83% as of January 1, 2004 (as against 81% as of January 1, 2003).

As of January 1, 2004, 53 banks, which accounted for 2.0% of banking sector assets, had LLP which covered less than 75% of the total amount of impaired and bad loans. As of the beginning of 2002, the number of such banks stood at 47 and they accounted for 1.3% of banking sector assets.

I.5.2. Market risk

The number of credit institutions that calculated credit risk in 2003 decreased from 848 to 824 and their share in banking sector assets contracted a little (from 94.7% to 93.1%).

The level of the banking sector's market risk declined by 4% in the period under review and as of January 1, 2004, it stood at 227.9 billion rubles. Market risk relative to the capital of the banks that calculated market risk also decreased, from 37.0% to 30.7%. As of January 1, 2004, market risk accounted for only 5% of the total amount of the banking sector's risks *(see Chart 1.17).*

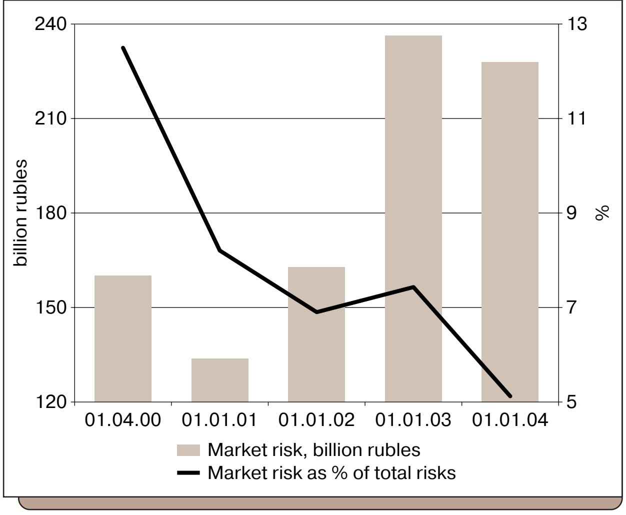
The high level of banks' activity on the stock market and the reduction of the value of open currency positions led to significant changes in the market risk structure: interest risk accounted for 32.3% of the banking sector's market risk in 2003 as against 18.6% a year earlier and stock market risk for 40.3% as against 31.6%. As a result, for the first time since the enforcement (from April 1, 2000) of Bank of Russia Regulation No. 89-P, dated September 24, 1999, "On the Market Risk Calculation Procedure for Credit Institutions", currency risk ceased to be the main component of market risk. As of the beginning of this year, it accounted for 27.4% of market risk as against 49.8% a year earlier.

As of January 1, 2004, 775 banks, which accounted for 87% of banking sector assets, took account of currency risk in calculating capital adequacy (as against 813 banks with a 93% share of banking sector assets as of January 1, 2003). In comparison: as of January 1, 2004, stock market risk was taken account of by 101 banks with a 25% share of banking sector assets and interest rate risk was taken into account by 172 banks with 30% of banking sector assets. The number of banks that played a significant role in all segments of the financial market and, consequently, had to take into account all three kinds of market risk was relatively small (70, i.e., one bank more than in 2002) and their share in banking sector assets stood at 20% as of January 1, 2004.

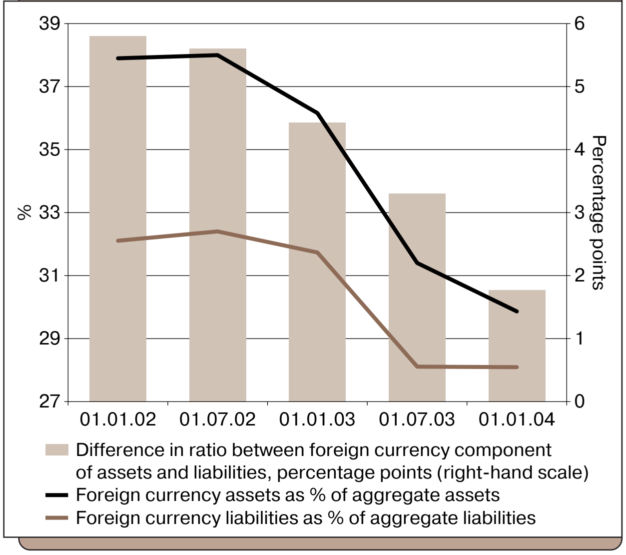
The foreign currency component of banking sector assets and liabilities continued to contract in 2003 *(see Chart 1.18).* Foreign currency assets accounted for 29.9% of aggregate banking sector assets as of January 1, 2004, and foreign currency liabilities for 28.1% of aggregate banking sector liabilities (as against 36.2% and 31.7% a year earlier respectively). As a result, the difference in the ratios between the foreign currency components of banking sector assets and liabilities de-

[20] Bank of Russia Instruction No. 110-I, dated January 16, 2004, "On Banks' Required Ratios", cancelled the N9 and N10 ratios from January 1, 2004.

Market risk as a percentage of total banking sector risks — CHART 1.17



Foreign currency assets and liabilities as a percentage of aggregate banking sector assets and liabilities — CHART 1.18



creased from 4.4 percentage points to 1.8 percentage points.

At the same time, credit institutions improved their compliance with open currency position limits. In 2003, the number of credit institutions that violated open currency position limits each quarter on average declined to 24 from 37 a year earlier. As of January 1, 2004, the share of banks that violated open currency position limits was close to nil, whereas as of January 1, 2003, it stood at 9.0%.

Credit institutions stepped up their activity on the futures markets in 2003. Foreign currency[21] remained the most important asset in forward operations. As a result, the value of off-balance-sheet claims and obligations in foreign currency increased by 1.9 times in 2003. The ratio between off-balance-sheet and balance-sheet operations conducted by credit institutions in foreign currency also increased. As of the beginning of 2003, the ratio between off-balance-sheet claims and balance-sheet assets stood at 22%, whereas by January 1, 2004, it rose to 37%. The ratio between off-balance-sheet obligations and balance-sheet liabilities demonstrated similar dynamics: in the period under review it increased from 26% to 38%.

I.5.3. Own funds (capital) adequacy to assumed risk

Banking sector capital dynamics and structure. The own funds (capital) of operating credit institutions[22] increased 40.2%[23] in 2003 and as of January 1, 2004, totalled 814.9 billion rubles.

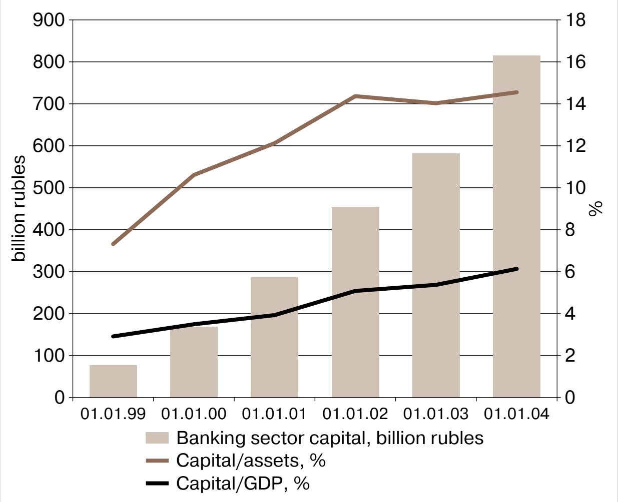
The ratio of banking sector capital to GDP increased from 5.4% to 6.1% in 2003 (before the 1998 crisis it stood at 4.8%). The ratio of banking sector capital to assets rose from 14% to 14.6% over that period *(see Chart 1.19).* This growth shows that while rapidly expanding the range and volume of their banking services, especially lending, banks just as actively broadened their capital base: 1,114 banks, or 83.8% of operating credit institutions, registered growth in own funds (capital).

The main factors of capital growth in the banking sector as a whole were increased profit and 65.1 billion rubles of funds formed from it (this source accounted for 28.1% of total increment in own funds[24]), the reduction of credit institutions' losses by 57.5 billion rubles, or 24.8%, the expansion of the paid-up authorised capital of credit institutions, included in the own funds calculation, by 47.8 billion rubles, or 20.6%, and a rise of 26.8 billion rubles, or 11.5%, in earnings from share placements.

To maintain the volume of banking operations at their current level and ensure compliance with Bank of Russia regulations, in 2003 members (shareholders) of credit institutions took steps to strengthen the capital base of their credit institutions. As of January 1, 2004, the aggregate registered authorised capital of credit institutions amounted to 362 billion rubles, an increase of 61.6 billion rubles, or 20.5% over the year. The number of operating credit institutions with an authorised capital of more than 300 million rubles rose by 38, or 22.4%, in 2003 to 208, or 15.7% of the total.

[21] The increased number of open positions on deals with foreign currency was partly caused by the introduction of a new currency market instrument in April 2003: tomorrow settlement deals in the Single Trading System (cash deals under Section D of the Chart of Accounts).
[22] Data on own funds (capital) have been calculated by 1,321 credit institutions that submitted their statements as of January 1, 2004.
[23] The revocation of AKB SBS-AGRO's licence led to a dramatic reduction in negative capital (from —81.0 billion rubles to —100 million rubles) and banking sector capital as a whole increased accordingly. AKB SBS-AGRO excluded, capital growth stood at 27.8%.
[24] Excluding the AKB SBS-AGRO factor, 37.4% of total growth.

Banking sector capital (own funds) dynamics CHART 1.19



The highest levels of share-issuing activity were registered in Moscow and St Petersburg and the Irkutsk, Nizhni Novgorod, Rostov, Samara and Saratov Regions, the Stavropol Territory and the Republics of Bashkortostan, Tatarstan and Sakha (Yakutia).

Three credit institutions, OAO UralSib, OAO Rossiiski Kredit and OAO AKB AVTOBANK-NIKOIL, issued more than a billion rubles of securities each, totalling 5.5 billion rubles in 2003, whereas in 2002 seven credit institutions issued securities with a total value of 16.2 billion rubles.

In 2003, 184 banks registered a fall in own funds (capital) to the total amount of 4.2 billion rubles and as of January 1, 2004, these banks accounted for 3.5% of banking sector assets. One bank had negative capital as of January 1, 2004 (there were two banks with negative capital as of January 1, 2003), accounting for 0.1% of banking sector assets (0.9% as of January 1, 2003).

Banks' compliance with capital adequacy requirements. The capital adequacy ratio[25] continued to decline in the banking sector in 2003 *(see Chart 1.20).* It fell from 22.2% to 19.1% mainly due to the fact that credit institutions' aggregate risk[26] increased faster than their capital. The aggregate risk of credit institutions with positive capital rose by 42.6% over the year and as of January 1, 2004, it amounted to 4,445.7 billion rubles. Capital expanded 23.0% over that period to 814.9 billion rubles.

After a major fall in 2002 (from 14 to 3) in the number of credit institutions that failed to comply with the N1 ratio, their number remained unchanged in 2003 and these three banks accounted for only 0.2% of aggregate banking sector assets (as against the three banks that had accounted for 0.9% of aggregate banking sector assets a year earlier).

The structure of banks that complied with the N1 ratio in terms of the actual value of capital adequacy changed in 2003 *(see Chart 1.22).* Although most banks have a capital adequacy ratio of more than 28%, the number of such banks declined by 91 over the year. The number of banks in all other groups, excluding the banks that failed to meet the N1 ratio, increased. Banks with a capital adequacy ratio from 12% to 14% account for the largest part of assets. As these banks have the smallest possible capital adequacy ratio, this situation causes some concern, especially taking into consideration the measures taken by the Bank of Russia to prevent capital padding.

The level of capitalisation of the largest banks is a major indicator for the banking sector's stability against systemic risks. The own funds (capital) adequacy ratio of the top 20 banks by assets stood at 15.4% as of January 1, 2004 (as against 17.9% as of January 1, 2003).

Evaluation of off-balance-sheet assets and operations. The banking sector's asset risk level, which is measured as the ratio of risk-weighted assets of credit institutions to aggregate assets, rose from 63.6% to 66.6% in 2003. The most rapid growth was registered in assets that involved maximum risk: the value of assets assigned to Risk Groups 4 and 5[27] increased by 43.9% in the period under review, while the value of assets assigned to Risk Groups 1, 2 and 3 rose by 0.4%. As a result, the share of the most risky assets (Ar 4 and Ar 5) expanded from 94.6% to 96.2% of the total value of risk-weighted banking sector assets, while Risk Group 5 assets accounted for 91.6%.

The trend towards growth (from 293.2 billion rubles to 473.4 billion rubles, or 61.5%) in credit risk on off-balance sheet instruments, except forward operations, continued in 2003, mainly due to two factors: an increase in the weighted equivalent of credit risk on guarantees (by 99.5%) and on undisbursed credit lines (by 62.4%).

The structure of the weighted equivalent of credit risk was largely unchanged in 2003: undisbursed credit lines accounted for 38.9%, guarantees 32.1%, obligations on undisbursed limits in credit overdrafts 19.1% and other off-balance sheet instruments 9.9%.

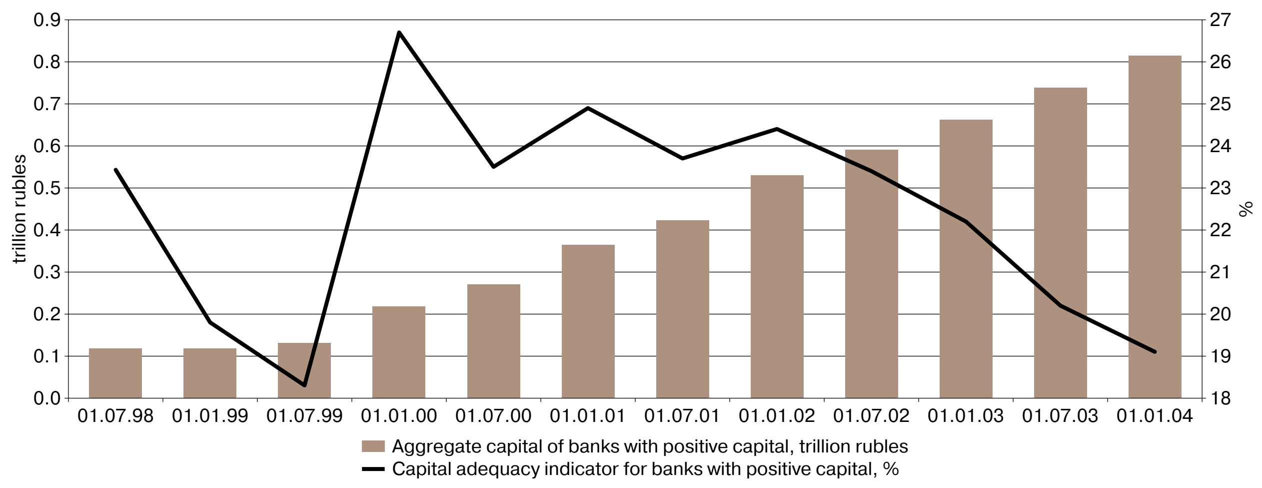
After 100% growth in 2002, credit risk on forward operations in 2003 increased by one-third (from 16.2 billion rubles to 21.6 billion rubles), but the dynamics of this indicator were rather chaotic and during the year fluctuated from 12.6 billion rubles (as of April 1, 2003) to 24.1 billion rubles (as of September 1, 2003).

As a result, the aggregate risk of operating credit institutions increased by 1,272 billion rubles, or 40.0%, in 2003. Most of the growth (86.1%) resulted from increased risk-weighted assets. Risk-weighted assets accounted for 83.8% of the total amount of operating credit institutions'

[25] Calculated for banks with positive capital.
[26] Aggregate risk is a sum total of risk-weighted assets net of provisions for securities depreciation and loan loss provisions for Risk Group 2, 3 and 4 loans.
[27] Risk Groups are given as prescribed by Bank of Russia Instruction No. 1, dated October 1, 1997, "On the Procedure for Regulating Bank Activities".

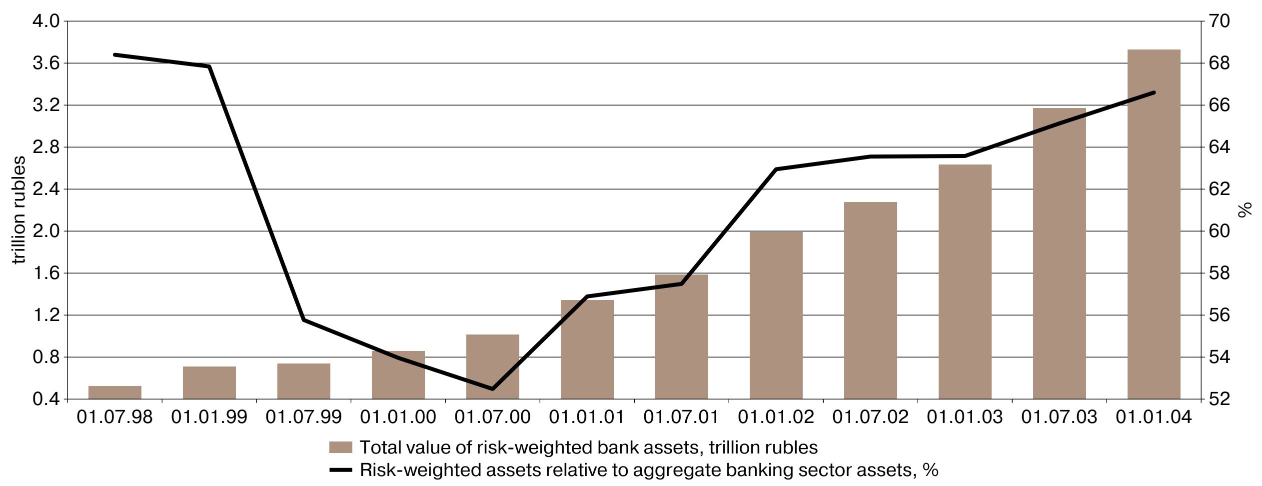
Capital adequacy indicator dynamics

CHART 1.20



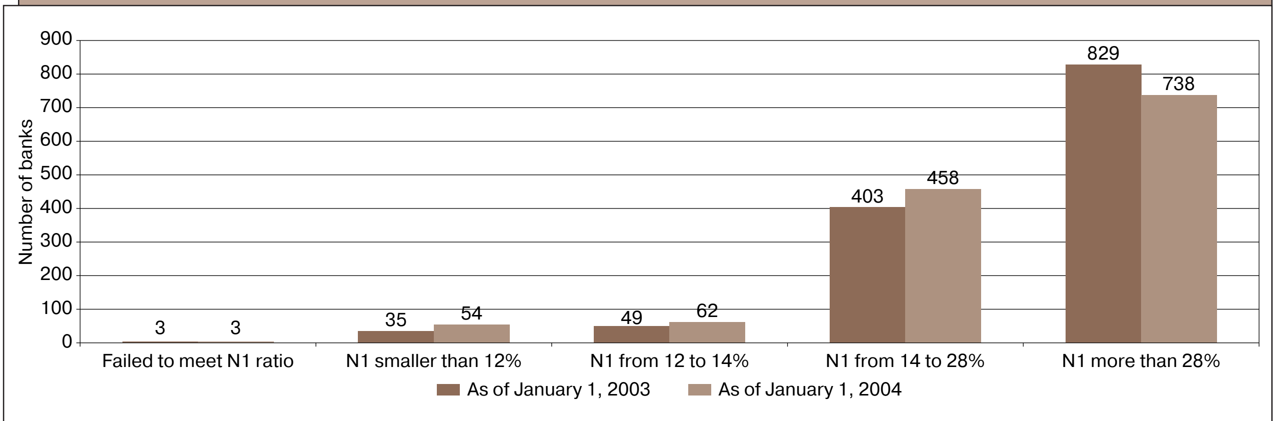
Risk-weighted bank asset dynamics

CHART 1.21



Banks grouped by N1 ratio

CHART 1.22



risks as of January 1, 2004, credit risk on off-balance sheet instruments 10.6%, market risk 5.1% and credit risk on forward operations 0.5%.

The above dynamics of off-balance and forward operations may testify to potential risk accumulation in the Russian banking sector.

I.5.4. Liquidity risk

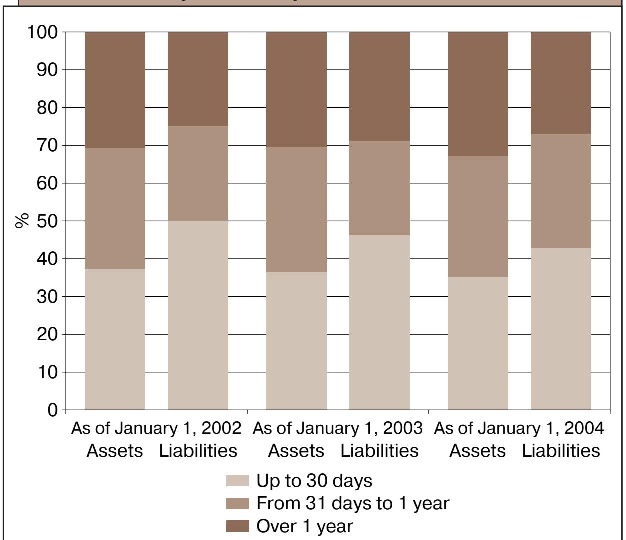
When analysing the liquidity situation in credit institutions, the Bank of Russia took into consideration the fact that the transformation of short-term liabilities into long-term assets is a major function of the banks and that a mismatch between assets and liabilities with similar maturities may only indicate some probable loss of liquidity by a credit institution. The Bank of Russia monitored such mismatches in 2003, watching their dynamics in the banking sector as a whole, in groups of banks and in individual banks.

Bank asset and liability structure by maturity. The structure of banks' assets and liabilities by maturity did not change much in the year under review. Despite the flow of long-term household deposits to the banking sector, there was no significant change in the share of long-term resources in banking sector liabilities. The mismatch between banks' long-term assets and liabilities widened from 1.7 percentage points as of January 1, 2003, to 5.8 percentage points as of January 1, 2004 *(see Chart 1.23).*

The structure of liabilities continued to reflect the specific conditions of formation of the resource base of the Russian banking sector: the value of credit institutions' call obligations[28] remained significant at 32.1% of aggregate banking sector liabilities and 74.8% of the value of liabilities with terms up to 30 days as of January 1, 2004 (as against 33.7% and 73.3% as of January 1, 2003, respectively).

Another major liquidity risk indicator is the extent to which short-term resources were transformed into long-term ones. In 2003, the structure of credit institutions grouped by the extent of the use of short-term liabilities as a source of long-term assets[29] remained unchanged on the whole. There was a large group of credit institutions which used more than 20% of their short-term liabilities as a source of long-term assets. This means that there was a significant imbalance in the structure of assets and liabilities by maturity. In 2002—2003, such banks' assets accounted for about one-third of aggregate banking sector assets.

Bank asset and liability structure by maturity *CHART 1.23*



The creation of a stable medium- and long-term resource base is one condition conducive to a qualitatively new stage in the development of banking sector operations in the real economy. As of January 1, 2003, sources with terms longer than one year accounted for 14.5% of aggregate banking sector liabilities (net of own funds). Over the year, this ratio decreased a little, to 14.2% *(see Chart 1.24).* The present state of the long-term resource base is nowhere near enough to ensure dynamic growth in long-term bank lending to the non-financial enterprise sector of the Russian economy.

Expanding the long-term resource base of credit institutions remains an urgent task for the Russian banking sector, especially taking into consideration that in 2003 the structure of banking sector assets began to demonstrate a trend towards growth in long-term lending. As of January 1, 2004, assets with terms longer than one year accounted for 32.8% of banking sector assets (as against 30.5% as of January 1, 2003).

The structure of credit institutions by liquidity coverage deficit[30] as of January 1, 2004, showed that 671 banks, or every other credit institution, had no liquidity coverage deficit.

Fulfilment of obligations. The value of banks' overdue debt obligations stood at 4.5 billion rubles as of January 1, 2004, or half the amount registered as of January 1, 2003 (10.6 billion rubles).

The number of credit institutions with overdue obligations accounted for in the corresponding balance sheet accounts declined slightly (from 107 to 101). However, their share of aggregate banking sector assets expanded from 12.0% to 13.1% as of January 1, 2004.

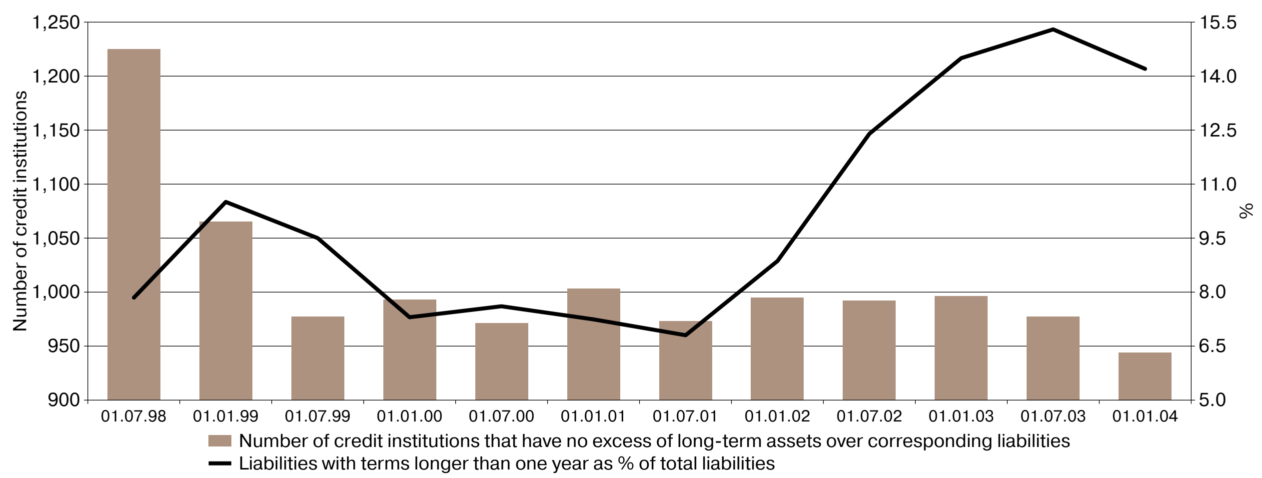
This situation contrasts sharply with that observed as of January 1, 2003, when nine banks had overdue obligations in excess of 2% and only one of them had the ratio of overdue obligations to assets at more than 25%. At the same time, banks with this indicator in excess of 2% account for a small percentage of aggregate banking sector assets (as of January 1, 2004, it stood at less than 1%).

Compliance with required liquidity ratios. The number of credit institutions that failed to comply with Bank of Russia liquidity ratios N2, N3 and N4 declined in 2003. The number of credit institutions that failed to meet the general liquidity ratio N5 slightly increased, but their share in aggregate banking sector assets contracted to 0.4%. Overall, credit institutions that failed to meet any

[28] A part of call obligations are banks' so-called average unclaimed balances which guarantee banks a certain supply of liquidity.
[29] Calculated as the ratio of the excess of long-term (one year and more) assets over corresponding liabilities to short-term liabilities (one year and less).
[30] The liquidity coverage deficit is calculated as the ratio of the excess of call obligations and obligations with terms up to 30 days over assets with the same terms to the total amount of these obligations.

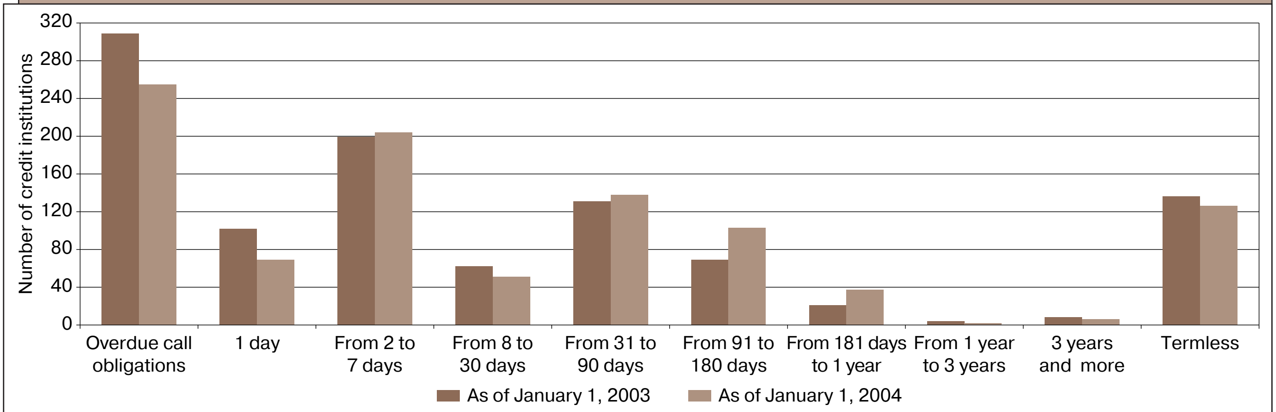
Some characteristics of credit institutions' long-term resource base

CHART 1.24



Credit institutions by maximum liquidity deficit (MLD) interval

CHART 1.25



of the above liquidity ratios did not account for more than 0.4% of aggregate banking sector assets.

It should be noted that as of January 1, 2004, none of the top 20 banks failed to meet the required liquidity ratios for the first time since the 1998 crisis.

Maximum liquidity deficit analysis. An analysis of the dynamics of the maximum liquidity deficit (MLD)[31] of Russian credit institutions produced the following results.

As of January 1, 2004, 287 credit institutions had no liquidity problems (MLD ≥ 0). In comparison: there were 240 such banks as of January 1, 2003. Such banks in 2003, as in 2002, accounted for just 3% of aggregate banking sector assets.

As of January 1, 2003, 803 credit institutions, which accounted for 77.3% of aggregate banking sector assets, had maximum liquidity deficits in the first five time intervals, which corresponded to the obligations with terms up to 90 days *(see Chart 1.25)*, whereas as of January 1, 2004, there were 717 such banks, which accounted for virtually the same part of aggregate banking sector assets (77%).

In the intervals of maximum risk from the viewpoint of a credit institution's deficit of liquidity on overdue and call obligations and obligations with one-day maturities, a liquidity deficit was registered in 411 banks as of January 1, 2003 (they accounted for 26% of aggregate banking sector assets) and in 324 banks as of January 1, 2004 (these accounted for 25.8% of aggregate banking sector assets).

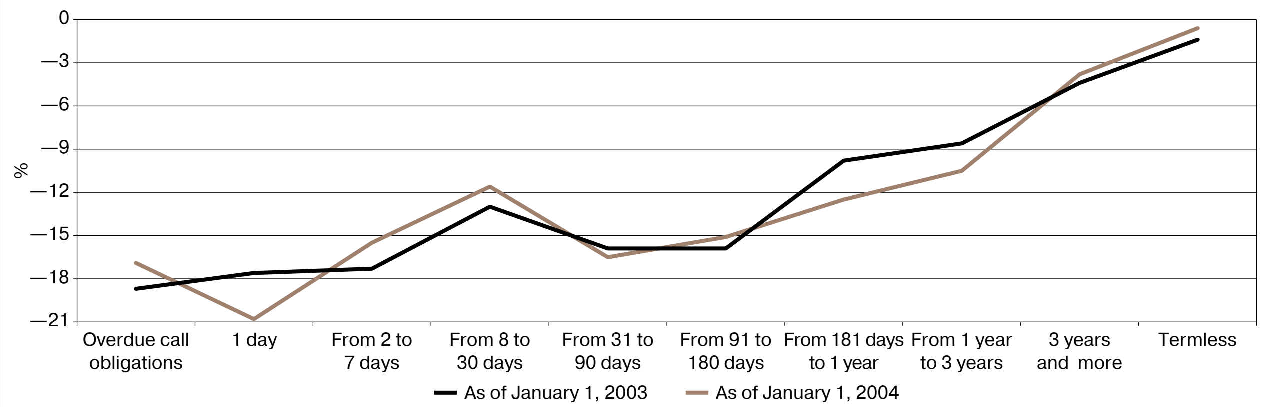
The analysis of MLD dynamics shows that there was no significant increase in banks' liquidity deficit in 2003, especially in the shorter intervals (there is no downward

[31] The idea behind the internationally accepted method of analysis using the maximum liquidity deficit ratio (MLD) is that banks should not allow significant gaps in liquidity in all time intervals of the redemption of their obligations. Consequently, a deficit is the negative difference between a credit institution's assets and liabilities at each time interval.

The purpose of this method is to establish the time interval of maximum liquidity deficit for each bank. The analysis of the results received took into account the fact that the liquidity of a bank is most susceptible to a deficit of its assets in the intervals of the shortest-term obligations.

Average MLD levels by term of redemption of bank obligations

CHART 1.26



shift of the curve) *(see Chart 1.26).* However, the excess of banks' liabilities over assets in the period under review increased in the one-day interval (by 3.2 percentage points on average), in the interval from 181 days to one year (by 2.7 percentage points) and in the interval from one year to three years (by 1.9 percentage points).

Banking regulation and supervision in Russia

II

The banking sector is a major element of the Russian financial system. Banks far surpass all other financial intermediaries in terms of their assets and capital. The present level of banking sector development in Russia has been achieved in the last five years of the banking sector reform.

At the first stage of the reform (1998—2000), the Bank of Russia sought to overcome the aftermath of the financial and economic crisis. For this purpose, in November 1998, the Russian Government and Bank of Russia adopted a key policy document, “On Measures to Restructure the Russian Banking System”, which set guidelines for the legislature, the executive branch of power and the Bank of Russia to restructure and restore the banking sector. It is clear that the implementation of the above measures saved the viable nucleus of the banking system.

At the second stage of the reform (2001—2003), the Bank of Russia made vigorous efforts to create conditions for the banking sector to develop. It was essential to restore to the full extent the banking sector’s ability to provide the basic set of financial services, increase the capital of credit institutions, raise assets’ quality, and strengthen the long-term resource base for the needs of the real economy. It was extremely important to restore banks’ credibility in the eyes of individual depositors, creditors, customers and foreign partners. These and other objectives were set in the Strategy for Development of the Banking Sector of the Russian Federation (hereinafter referred to as the Strategy), approved by the Russian Government and Bank of Russia on December 30, 2001. The measures implemented at the second stage of the reform resulted in the dynamic growth of key banking sector indicators and the functional role of the banking sector in the economy increased.

At present, the Russian banking sector is growing faster than the economy as a whole and the majority of its practices correspond to international standards, especially the recommendations of the Basel Committee on Banking Supervision. The Russian banking sector will fully conform to these standards when the third stage of its reform (2004—2008) has been completed and the tasks set in the new version of the Strategy for Development of the Banking Sector of the Russian Federation (hereinafter referred to as the new version of the Strategy), which is currently being drafted, have been accomplished.

II.1. General characteristics of banking regulation and supervision

II.1.1. Tasks and objectives of the Bank of Russia in banking regulation and banking supervision

As it is the body of banking regulation and banking supervision under Federal Law No. 86-FZ, dated July 10, 2002, "On the Central Bank of the Russian Federation (Bank of Russia)", the Bank of Russia maintains the stability of the Russian banking system and protects the interests of creditors and depositors.

The new version of the Strategy stipulates that the principal objective of the banking system at the third stage of its reform is to build up potential for development and enhance the role of the banking sector as a factor of economic growth and the implementation of key social and economic development programmes. In tackling this problem, the Bank of Russia will increase the competitiveness and capitalisation of the banking sector and improve the banking supervision system. The banking sector reform should help attain the goals set in Russia's Medium-term Social and Economic Development Programme, particularly ending the Russian economy's overdependence on raw materials by accelerating the diversification and realisation of its competitive advantages.

The principal objectives of the banking sector's development are as follows:

— to enhance the general economic effectiveness of the banking sector's functions to accumulate household and corporate funds and transform them into loans and investments;

— to increase the functional role of Russian credit institutions in the economy and make them more competitive than foreign financial organisations on the domestic market;

— to make the banking sector more stable and protect the interests of depositors and other bank creditors more effectively;

— to prevent credit institutions from being used in dishonest commercial practices and for unlawful purposes, particularly money laundering and terrorist financing;

— to encourage the development of a competitive environment, boost market discipline and make credit institutions more transparent;

— to increase the confidence of investors, creditors and depositors, especially the population, in the Russian banking sector.

When carrying out measures to meet the targets set in the new version of the Strategy, the Russian Government and Bank of Russia take into account the recommendations made by an international mission in 2002—2003 on the results of the implementation of the Russian Financial Sector Assessment Programme (FSAP).

II.1.2. The organisational structure of Bank of Russia banking supervision

The supervisory structure of the Bank of Russia central office now comprises the Banking Regulation and Supervision Department, Credit Institutions Licensing and Financial Rehabilitation Department, Foreign Exchange Regulation and Control Department and Main Inspectorate of Credit Institutions. The principal objectives of these structures are to provide methodological and organisational support for the implementation by the Bank of Russia of its legislatively established functions in banking regulation and supervision from the moment a credit institution enters the banking services market until control over liquidation procedures is established.

The Bank of Russia supervisory divisions are subordinated to the Bank of Russia Banking Supervision Committee, which is headed by the First Deputy Chairman of the Bank of Russia. The Committee is responsible for drafting decisions on the implementation of banking regulation and supervision policy.

The Bank of Russia implements its banking regulation and supervision policy through its regional branches (main divisions and national banks) in constituent entities of the Russian Federation. As of January 1, 2004, the Bank of Russia system included 59 main divisions and 19 national banks.

II.1.3. Bank of Russia supervisory staff

The Bank of Russia supervisory divisions have a total staff of more than 4,200, of whom 88.6% are employees of Bank of Russia regional branches and 11.4% work in the central office. Most of the supervisory staff (94.4%) are university-educated specialists and 22.8% have worked in the banking system for 15 years and more (see Table 1 of the Appendix).

In implementing the Strategy, in 2003, the Bank of Russia retrained its supervisors in co-operation with some of the country's leading higher education establishments, such as the Higher School of Economics and the Russian Government Financial Academy and the Academy of the National Economy.

To create a qualitatively new cadre of specialists capable of modernising the banking system, the Bank of Russia provided training for 123 employees from 50 regional branches and central office divisions in the following specialised fields: commercial bank curator/bank manager and commercial bank inspector/bank manager.

In addition to providing vocational training, the Bank of Russia is carrying out a programme designed to improve the socially-oriented interpersonal skills of curators and inspectors by teaching them communication and presentation skills, ways to persuade partners and win their confidence, and approaches to co-operation.

As the Russian banking sector adopted international financial reporting standards on January 1, 2004, in 2003—2004 the Bank of Russia implemented a large-scale training programme for its managers and specialists, as well as managers and specialists from commercial banks, in the theoretical and practical aspects of International Financial Reporting Standards (IFRS). In 2003, it conducted 22 seminars for bank supervisors, which involved 406 employees of the Bank of Russia central office and regional branches, and more than 20 training sessions, which involved over 1,200 bank managers, chief accountants and internal auditors. This programme is continuing in 2004.

In 2003, the Bank of Russia trained specialists at its regional branches as the heads of provisional administrations of credit institutions. Four seminars, which involved 107 employees from 69 Bank of Russia regional branches, were held at the Bank of Russia Moscow Banking School in 2003. Today, every Bank of Russia regional branch has specialists who can work in the provisional administrations of credit institutions.

To train employees from its regional branches and credit institutions in methods to combat money laundering and terrorists' financing, the Bank of Russia held 11 seminars, involving 525 people, and organised training courses for managers of Bank of Russia regional branches.

When co-operating with foreign central banks and international financial organisations in training bank personnel, in 2003 the Bank of Russia held a number of seminars featuring Western experts to study foreign expertise in key areas of banking supervision, including the evaluation of credit institutions' finances, risk-focused supervision, online banking and inspection methodologies.

II.2. Upgrading the legislative and regulatory framework of banking regulation and supervision in accordance with internationally accepted standards

In 2003, the Bank of Russia continued to take steps to bring the national banking regulation system into compliance with internationally accepted standards, especially the Core Principles for Effective Banking Supervision and other documents of the Basel Committee on Banking Supervision.

Last year, the Russian Government and Bank of Russia continued to carry out measures set out in the Strategy and Guidelines for the Single State Monetary Policy in 2003. A number of new laws and regulations on banking have created additional opportunities for the Bank of Russia to fulfil effectively its functions in the field of banking regulation and supervision.

This particularly applies to the adoption of Federal Law No. 177-FZ, dated December 23, 2003, "On Individual Bank Deposit Insurance in the Russian Federation", which aims to protect the rights and legitimate interests of bank deposit holders, increase confidence in the banking system and encourage the flow of household savings to the banking sector. The law set out the legal, financial and organisational principles of the mandatory deposit insurance system and established the competence and procedure for creating and operating the organisation responsible for compulsory deposit insurance and the procedure for compensation payments on deposits. The law established the following principles of operation for the deposit insurance system:

— banks that take personal savings on deposit must participate in the deposit insurance system;
— the risk of unfavourable consequences for depositors in the event of the bank's failure to fulfil its obligations must be reduced;
— the deposit insurance system must be transparent;
— the mandatory deposit insurance fund must accumulate compulsory insurance contributions made by banks participating in the deposit insurance system.

Federal Law No. 173-FZ, dated December 10, 2003, "On Foreign Exchange Regulation and Foreign Exchange Control" which came into force on June 18, 2004, brought Russian legislation into conformity with international requirements on the free movement of capital. The law aims to liberalise the Russian economy further and improve the investment climate in the country. The implementation of its provisions will facilitate economic development and help broaden international economic co-operation. The Bank of Russia plans to issue a dozen regulations in pursuance of this law.

Federal Law No. 131-FZ, dated October 30, 2002, "On Amending the Federal Law 'On Countering the Legalisation (Laundering) of Criminally Obtained Incomes,'" which came into force on January 3, 2003, extended the legal and organisational anti-laundering mechanisms to combat the financing of terrorism. It also granted credit institutions additional powers to prevent criminally obtained proceeds from entering the banking system and it being used for money laundering and the financing of terrorism.

In 2003, Russia passed the Federal Law "On Mortgage Securities", which regulates relations that arise in the issue, transfer and circulation of mortgage securities, except pawns, and fulfilling obligations on mortgage securities. Article 7 of the law gives the Bank of Russia the right to establish special own funds (capital) adequacy calculation procedures and ratios, liquidity ratios and interest and currency risk levels for credit institutions that issue bonds secured by mortgage. It also allows the Bank of Russia to require that such credit institutions disclose information on their activities in addition to that required by other federal laws. Should a credit institution violate the above ratios or fail to meet other requirements, the Bank of Russia may apply measures against it as stipulated by Article 74 of the Federal Law "On the Central Bank of the Russian Federation (Bank of Russia)".

The Bank of Russia paid great attention to upgrading its documents regulating the activities of credit institutions. It conducted this work taking into consideration the amendments made to the applicable banking legislation on banking supervision, the registration of credit institutions and licensing of banking activities, insolvency (bankruptcy) prevention and optimising bank liquidation procedures.

Quality of capital. One of the most important decisions taken by the Bank of Russia was the issue of regulations[32] designed to improve the quality of credit institutions' capital. Should the Bank of Russia discover that the fixed and/or additional capital of a credit institution (or a part thereof) has been formed by investors using inappropriate assets[33], it may demand that the credit institution exclude these assets from the own funds (capital) calculation. The Bank of Russia also required credit insti-

[32] Bank of Russia Regulation No. 215-P, dated February 10, 2003, "On the Methodology of Determining Own Funds (Capital) of Credit Institutions" and Bank of Russia Ordinance No. 1246-U, dated February 10, 2003, "On Actions to be Taken upon the Discovery of the Evidence (Signs) of the Formation of Own Funds (Capital) or a Part Thereof, Using Inappropriate Assets".

[33] Inappropriate assets for the purpose of determining the amount of own funds (capital) of credit institutions signify the property provided to an investor by the credit institution itself (directly or through a third party) and the property provided by other persons if a credit institution has assumed the risk of incurring losses resulting from the provision of the said property.

tutions to use in the calculation of required ratios the own funds (capital) as they were evaluated by the Bank of Russia and stipulated that credit institutions and banking groups should account for the corrected amount of their own funds in their reports.

The Bank of Russia established the procedure for requiring a credit institution to correct its capital and the sequence of actions to be taken by Bank of Russia divisions upon discovering evidence or signs of the use of inappropriate assets by investors in forming own funds (capital) or a part thereof.

Recognising banks as complying with requirements for participation in the deposit insurance system. To implement the Federal Deposit Insurance Law, in 2003 the Bank of Russia drafted Ordinance No. 1379-U "On the Assessment of the Financial Stability of a Bank for the Purpose of Recognising it Sufficient for Participation in the Deposit Insurance System", which established the set of indicators and the methodologies for calculating them and establishing the summary result on them for the purpose of recognising a bank financially sound enough to participate in the deposit insurance system. In addition, the Ordinance implemented the principle of evaluating banks' performance on the basis of a comprehensive assessment of banks' activities. Unlike the assessment methodology used now, the new document provides for the evaluation of a bank's performance not only on the basis of its finances, but also by taking into account the transparency of its ownership structure and the quality of its management. These principles are implemented in the draft new Bank of Russia regulation "On the Evaluation of the Performance of Credit Institutions".

Bank of Russia Regulation No. 248-P "On the Procedure for Considering by the Bank of Russia a Bank's Request for a Bank of Russia Resolution on the Bank's Compliance with the Requirements for Participation in the Deposit Insurance System" and Bank of Russia Regulation No. 247-P "On the Procedure for Considering by the Bank of Russia an Appeal against the Bank of Russia Negative Decision on a Bank's Repeat Request for the Bank's Compliance with the Requirements for Participation in the Deposit Insurance System"[34] regulate the procedures for considering banks' requests.

Loan loss provisioning. The Bank of Russia carried out measures to introduce internationally accepted principles of loan loss provisioning in its regulations. Regulation No. 232-P, dated July 9, 2003, "On Loan Loss Provisioning by Credit Institutions", which came into effect on March 1, 2004, provides for making further use of professional judgement in evaluating the quality of assets, taking account of highly liquid security when making provisions, and introducing the criterion of materiality, allowing a credit institution to create a provision for a portfolio of similar claims (obligations) immaterial from the viewpoint of transaction volumes without making a professional judgement on each particular element.

The draft Regulation "On the Procedure for Making Loan Loss Provisions and Provisions for Debts on Loans and Similar Debts"[35], prepared by the Bank of Russia in 2003, provides for the further development of the principle of professional judgement in evaluating credit risk and introduces some changes, such as five risk classification groups, "bracket" provisioning rates, the use of the materiality criterion and a modified interpretation of the role of the security factor in loan loss provisioning.

In connection with the changes made in Bank of Russia foreign exchange regulation and foreign exchange control rules, which provide for the division of offshore zones into three groups, depending on the level of security and compatibility of the banking regulation and control system of each country with international standards, the Bank of Russia required credit institutions to make provisions for operations with residents of offshore zones.

Upgrading banking regulation. To control credit institutions' liquidity levels and ensure that risks banks assume are assessed appropriately, in 2003, the Bank of Russia issued a number of operating ordinances establishing a special procedure for using supervisory measures with regard to the observance of required ratios, such as the general liquidity ratio (N5), the ratio of risk in own promissory note obligations (N13) and some other ratios (N8, N9, N11, N.11.1. and N.14). Later in the year the Bank of Russia took into account the provisions of the above ordinances when working on the Instruction "On the Required Ratios for Banks"[36], which was drafted in pursuance of the Federal Law "On the Central Bank of the Russian Federation (Bank of Russia)" and took into account national and international banking supervision practices.

The Instruction cancelled some required ratios, reduced the lowest permissible instant and current liquidity ratios, changed the procedure for calculating liquidity ratios, specified the methodology of calculating risk regulating ratios and granted Bank of Russia regional branches the right to establish control levels for the required ratios. It stipulated that credit institutions must observe the required ratios on a daily basis.

Consolidated supervision. To make consolidated supervision more effective, the Bank of Russia continued to upgrade the legislative framework of supervision last year:

— it revised the list of required ratios established for banking/consolidated groups, specified the procedure for calculating own funds (net assets) of a group and the indicators for non-credit institution group members used in calculating the required ratios, and drew up a model list of group members' reports necessary for compiling consolidated statements (Bank

[34] Bank of Russia Ordinance No. 1379-U, Bank of Russia Regulation No. 247-P and Bank of Russia Regulation No. 248-P were adopted on January 16, 2004.
[35] Regulation No. 254-P passed by the Bank of Russia on March 26, 2004.
[36] Instruction No. 110-I passed by the Bank of Russia on January 16, 2004.

of Russia Regulation No. 246-P, dated January 5, 2004, “On the Procedure for Compiling Consolidated Statements by the Parent Bank of a Banking/Consolidated Group”);

— to implement the principles of compiling consolidated statements, set out in the above Regulation, the Bank of Russia issued Operating Ordinance No. 1-T, dated January 5, 2004, “On Methodological Recommendations for Compiling Consolidated Statements”.

In addition, Bank of Russia Ordinance No. 1270-U, dated April 14, 2003, “On the Statements Published by Credit Institutions and Banking/Consolidated Groups” specified some requirements for the publication of reports by credit institutions and parent banks of banking/consolidated groups, such as publication deadlines and the requirement for a consolidated group to publish its annual report.

Related party lending. Taking into account the results of an IMF/World Bank mission’s consideration of the compatibility of Bank of Russia regulations with the Basel Committee’s Core Principles for Effective Banking Supervision (Principle 10), conducted under the Financial Sector Assessment Programme for Russia, the Bank of Russia issued Operating Ordinance No. 68-T, dated May 5, 2003, “On Related Lending”, which contained recommendations for banks on additional control over risks involved in lending to persons related to a bank. Specifically, the regulation requires the board of directors of a credit institution to approve such transactions if they exceed the internal lending limits set by the credit institution. It also prohibits concessional lending to related persons.

Report optimisation. In 2003, the Bank of Russia continued to upgrade and optimise credit institutions’ prudential reporting practices and the results of this work were used in drafting proposals for Bank of Russia Ordinance No. 1376-U, dated January 16, 2004, “On the List and Forms of Credit Institutions’ Reports and the Procedure for Compiling and Submitting Them to the Bank of Russia”. The implementation of these proposals allowed the Bank of Russia to match the makeup and content of prudential reports with the task of supervising credit institutions’ risk controls and detecting problems in credit institutions at the early stages.

In addition, in 2003, the Bank of Russia issued Operating Ordinance No. 109-T, dated July 16, 2003, “On Forms of Controlling Credit Institutions’ Reports”, which drew the attention of Bank of Russia regional branches to the need to use a uniform procedure for accepting reports from credit institutions.

Internal control. An analysis of the use of effective regulations on internal control in credit institutions conducted by the Bank of Russia in 2003 showed that the requirements they contained were not comprehensive enough by today’s standards. Therefore, credit institutions considered internal control as a mere formality rather than a system covering all activities and levels of management and as a rule they made do with organising an internal control service. On the other hand, it was difficult for Bank of Russia branches to supervise the quality of internal control in credit institutions. In addition, the effective internal control regulations did not take into account the Basel Committee’s new recommendations on internal control in banks that were adopted in 1998—2002.

Bank of Russia Regulation No. 242-P, dated December 16, 2003, “On Organising Internal Control in Credit Institutions and Banking Groups” eliminated these shortcomings.

Online banking. Taking into consideration the constantly growing role of information technology in banking, including the Internet, and the increase in related banking risks, the Bank of Russia drafted an Ordinance, “On the Procedure for Reporting the Use of Internet Technologies by Credit Institutions to the Central Bank of the Russian Federation”, which came into force on July 1, 2004. The testing of the accounting form established by the draft Ordinance with the participation of banking associations helped optimise the set of data that must be reported and avoid the duplication of the same data in various reports.

Evaluating the financial condition of founders (members) of credit institutions. Bank of Russia Regulation No. 218-P, dated March 19, 2003, “On the Procedure for and the Criteria of Evaluating the Financial Condition of Corporate Founders (Members) of Credit Institutions”, introduced a methodology of evaluating the financial condition of corporate founders (members) of credit institutions through the use of a set of standard indicators. The Regulation stipulates that the evaluation of the financial condition on the basis of the analysis of the acquirer’s absolute and relative performance indicators should be conducted taking into account the nature and scale of the acquirer’s activities and his sectoral affiliation and location. The requirements set in the Regulation are designed to increase the capitalisation of the banking system due to real, not fictitious investments and make the shareholder (stakeholder) structure of credit institutions more transparent.

Bank of Russia Operating Ordinance No. 134-T, dated September 16, 2003, “On the Application by Bank of Russia Regional Branches of Bank of Russia Regulation No. 218-P, Dated March 19, 2003, ‘On the Procedure for and the Criteria of Evaluating the Financial Condition of Corporate Founders (Members) of Credit Institutions’” contains recommendations for detecting the use of inappropriate assets in forming the authorised capital of credit institutions. The Bank of Russia instructed its regional branches to focus on the need to analyse how the risk of possible losses was evaluated and to detect inappropriate assets while establishing how correctly a credit institution formed its authorised capital.

Information on credit institutions’ affiliated persons. Bank of Russia Regulation No. 227-P, dated May 14, 2003, “On the Procedure for Making the Accounting for and Providing Information on the Affiliated Persons of a Credit Institution” is designed to ensure control over the credit institutions’ shareholder (stakeholder) structure and identify any group capable of directly or indirectly influencing the decision-making by the management of a credit institution. The document established the procedure for compiling and keeping lists of affiliated persons by credit institutions and presenting reports to the Bank of Russia containing information on affiliated persons and groups of persons who own the credit institution and on its participation in financial-industrial groups.

In connection with the development of the legislation regulating relations of affiliation, the Bank of Russia upgraded the procedure in accordance with which credit institutions should inform it about their affiliated persons. To evaluate risks appropriately and to identify banking groups and bank holding companies on the basis of the analysis of information contained in credit institutions' reports, the Bank of Russia establishes the ownership structure of a credit institution and identifies the corporate entities and private individuals capable of directly or indirectly exerting significant influence on the decisions taken by the credit institution's management.

Simplifying bank reorganisation procedures. Bank of Russia Regulation No. 230-P, dated June 4, 2003, "On the Reorganisation of Credit Institutions by Merger and Acquisition" contains a list of data and documents necessary for the state registration of a credit institution established as a result of a merger and the state registration of the changes made to the founding documents of a credit institution in connection with its reorganisation in the form of acquisition and establishes the procedure for submitting these data and documents to the Bank of Russia and for the Bank of Russia's consideration. The Regulation sets out the specific conditions of licensing the activities of credit institutions reorganised by merger or acquisition and simplifies the merger and acquisition procedures, reduces the time needed for the Bank of Russia to examine the documents connected with reorganisation and optimises the route and duration of the movement of documents between the Bank of Russia regional branches and central office, the Ministry of Taxes and Duties and credit institutions involved in the reorganisation. Specifically,

- the Bank of Russia cancelled the requirement for representatives of its regional branch (branches) to hold a working meeting with representatives of reorganised credit institutions and to compile a consolidated balance sheet and approve it at a joint general meeting of members of the reorganised credit institutions;
- members of the reorganised credit institutions were granted the right to take an independent decision on appointing an audit firm (an auditor) to confirm the fairness of financial statements and the compliance of the reorganisation procedures conducted by credit institutions with the applicable legislation;
- the Bank of Russia optimised the routes and duration of the movement of documents between credit institutions and the Bank of Russia regional branches and central office. It reduced the time it took to consider documents in case of a merger from six to four months and in case of acquisition from six to three months.

Upgrading the procedure for issuing and registering securities. Bank of Russia Ordinance No. 1288-U, dated June 3, 2003, "On Introducing Amendments and Addenda to Bank of Russia Instruction No. 102-I, Dated July 22, 2002, "On Rules of Issue and Registration of Securities by Credit Institutions in Russia" was drafted in connection with the amendments made to the Federal Law "On the Securities Market". It was designed to ensure equal opportunities for investment decision-making with regard to credit institutions' publicly traded securities and securities of other issuers by establishing on the basis of the applicable law a single amount of information that must be disclosed. The Ordinance also permitted the issue of options, which are defined and regulated in Federal Law No. 185-FZ, dated December 28, 2002, "On Introducing Amendments and Addenda to the Federal Law "On the Securities Market' and Amending the Federal Law "On Non-profit Organisations", which gave credit institutions broader opportunities for issuing securities. The document also changed the stages by which credit institutions should issue securities, the procedure for approving the documents submitted to the registering authority for the registration of securities issues and the content of information included in security prospectuses.

The procedure for transforming non-bank credit institutions into banks. Bank of Russia Ordinance No. 1292-U, dated June 19, 2003, "On the Procedure for Submitting Documents by a Non-Bank Credit Institution to the Bank of Russia to Obtain the Status of a Bank" established the procedure in line with which the Bank of Russia should grant a non-bank credit institution the status of a bank. The requirements set in the Ordinance are in accordance with the new procedure for the state registration of changes to credit institutions' founding documents, established by the Federal Law "On the State Registration of Corporate Entities and Individual Entrepreneurs" and the Federal Law "On Bringing Laws into Compliance with the Federal Law "On the State Registration of Corporate Entities".

The procedure for establishing a minimum authorised capital of newly established credit institutions. Bank of Russia Ordinance No. 1346-U, dated December 1, 2003, "On the Minimum Authorised Capital of Newly Established Credit Institutions, the Amount of Own Funds (Capital) for Operating Credit Institutions as the Condition for Opening Subsidiaries and/or Branches in a Foreign State and the Amount of Own Funds (Capital) for Non-Bank Credit Institutions Applying for the Status of a Bank", was issued in connection with the amendments made to the Federal Law "On the Central Bank of the Russian Federation (Bank of Russia)". It brought the names of the previously set ratios into conformity with Articles 62 and 63 of the Federal Law "On the Central Bank of the Russian Federation (Bank of Russia)" without changing their quantitative values (taking into account the above Articles, the Bank of Russia established the following ratio: "the minimum authorised capital for newly established banks, regardless of the foreign stake in them") and excluded the term "subsidiary non-bank credit institution of a foreign bank," as there is no such term in Russian legislation.

Upgrading the procedure for disclosing information on credit institutions' owners. Bank of Russia Operating Ordinance No. 107-T, dated July 11, 2003, "On the Conditions of Classifying Corporate Entities and/or Private Individuals as a Group of Entities and/or Individuals Connected by an Agreement", issued in pursuance of paragraph 8 of Article 11 of the Federal Law "On Banks and Banking Activities" and Article 61 of the Federal Law "On the Central Bank of the Russian Federation (Bank of Russia)", is designed to ensure the transparency of the shareholder (stakeholder) structure of credit institutions and explains the term "a group of corporate entities and/or private individuals connected by an agreement".

Upgrading the legal basis for provisional administrations. Bank of Russia Regulation No. 241-P, dated November 26, 2003, "On the Provisional Administration of a Credit Institution" is designed to make provisional administrations more effective, improve the supervision of operating credit institutions and credit institutions after the revocation of their banking licences. It establishes the procedure for approving transactions by a provisional administration and making expenditures by a provisional administration connected with the functioning of a credit institution and sets the deadlines and procedure for the stock-taking of a credit institution. The Regulation takes into account the provisions of the Code of Administrative Offences of the Russian Federation and Federal Law "On the State Registration of Corporate Entities and Individual Entrepreneurs".

Tightening controls over bank liquidation procedures. Bank of Russia Ordinance No. 1241-U, dated January 21, 2003, "On the List of Data and Documents Necessary for the State Registration of a Credit Institution in Connection with Its Liquidation", aims to establish Bank of Russia control over the compliance of liquidation procedures with the applicable legislation at all stages of the bankruptcy (liquidation) proceedings, ensure the complete settlement of creditors' claims and the appropriate use of bankruptcy assets and reduce the time needed to process the documents for making the decision on the state registration of a credit institution in connection with its liquidation.

The ratio between a credit institution's own funds (capital) and authorised capital. Bank of Russia Ordinance No. 1260-U, dated March 24, 2003, "On the Procedure for Matching the Authorised Capital of a Credit Institution with Its Own Funds (Capital)", set the procedure for reducing the authorised capital of a credit institution to an amount that will not exceed its own funds (capital) and making the corresponding changes to its founding documents within 45 days after the receipt of the Bank of Russia order to match authorised capital with own funds (capital). The Ordinance cancelled additional adjustments to the calculation of own funds (capital) made for the purpose of comparing them with authorised capital when monitoring credit institutions' compliance with the standards set by the Federal Law "On the Central Bank of the Russian Federation (Bank of Russia)", the Federal Law "On Banks and Banking Activities" and the Federal Law "On the Insolvency (Bankruptcy) of Credit Institutions". The document also stipulates that should the Bank of Russia be required to revoke a banking licence, it can do so without making the corresponding demand to the credit institution and revoke the licence in compliance with the law.

Upgrading the banking licence revocation procedure. Bank of Russia Ordinance No. 1311-U, dated July 25, 2003, "On the Procedure for Revoking a Banking Licence from a Credit Institution for Significant Distortions in Reported Data", defined "significant distortions of reported data" and clarified what distortions in reporting may provide sufficient grounds for the revocation of a banking licence pursuant to point 3 of paragraph 1 of Article 20 of the Federal Law "On Banks and Banking Activities".

Upgrading the regulation of inspections. Guided by internationally accepted principles, the Bank of Russia took into account the prospects for Russian banking sector development when elaborating the concept of inspection. Specifically, it took into consideration the shift of emphasis in inspecting credit institutions from detecting shortcomings, violations and false reporting to a qualitative assessment based on informed judgement about a credit institution's risk management and internal control systems, its financial condition and prospects for the future.

In implementing its new inspection concept and supervisory standards, the Bank of Russia elaborated new policies on the inspection of credit institutions and their branches. Pursuant to Article 73 of the Federal Law "On the Central Bank of the Russian Federation (Bank of Russia)" and in seeking to upgrade the legal regulation of inspection practices, the Bank of Russia drafted and issued an instruction[37] that established the procedure for inspecting credit institutions and their branches by Bank of Russia authorised representatives.

The principal objectives of this document are as follows: to develop an integrated system of co-operation between credit institutions and Bank of Russia authorised representatives in conducting inspections of credit institutions and their branches; to broaden the powers of Bank of Russia authorised representatives, particularly in gaining access to the documents (information) necessary for conducting an inspection, and, at the same time, making them responsible for the confidentiality of this information; to make more stringent requirements on the quality of inspection results and the documents in which they are included; and to upgrade inspection techniques in accordance with international best

[37] Bank of Russia Instruction No. 105-I, dated August 25, 2003, "On the Procedure for Conducting Inspections of Credit Institutions (and Their Branches) by Authorised Representatives of the Central Bank of the Russian Federation".

practice and the recommendations of the Basel Committee on Banking Supervision.

Significant changes were also made to the internal procedure for organising Bank of Russia inspections, notably, the procedure for co-operation between the various divisions of the Bank of Russia central office and regional branches in organising and conducting inspections of credit institutions and their branches[38], the powers of the Bank of Russia divisions and inspectors-general of the Main Inspectorate of Credit Institutions and Bank of Russia executives and the procedure for their co-operation in conducting Bank of Russia inspections.

The issue of the above Bank of Russia regulations helped create an effective mechanism for organising and conducting inspections of credit institutions and their branches to ensure the financial stability of credit institutions and the banking sector as a whole.

[38] Bank of Russia Instruction No. 108-I, dated December 1, 2003, “On Organising Inspections by the Central Bank of the Russian Federation (Bank of Russia)”.

II.3. Regulating access to the banking services market

Guided by the Federal Law “On the Central Bank of the Russian Federation (Bank of Russia)” and the Federal Law “On Banks and Banking Activities” and the tasks set in the Russian Banking Sector Development Strategy for 2003, the Bank of Russia, in making decisions on access to the banking services market and on the state registration of credit institutions and licensing their banking operations, monitored compliance with the following requirements set by the banking legislation and Bank of Russia regulations:

— the minimum authorised capital of a newly established credit institution;
— the formation of the authorised capital of a credit institution with investors’ own funds;
— compliance with the limit set on the amount of authorised capital paid in in non-pecuniary form, such as property (buildings and offices);
— the transparency of the ownership structure of credit institutions;
— the finances of the founders (members) of a credit institution;
— the compliance of candidates for the position of a member of the board of directors (supervisory board), chief executive officer, deputy chief executive officer, member of a collegiate executive body, chief accountant and deputy chief accountant of a credit institution with the qualification and business reputation requirements established by the Bank of Russia.

The Bank of Russia controlled the acquisition of large blocks of shares (stakes) (more than 20%) in credit institutions.

The trend of the past few years towards fewer registered credit institutions continued in 2003. Over the year, the total number of credit institutions registered by the Bank of Russia declined from 1,826 to 1,666. The number of operating credit institutions licensed to conduct banking operations was unchanged at 1,329.

Sixteen new credit institutions (14 banks and two non-bank credit institutions) were registered in the year under review.

The reorganisation of credit institutions continued:

— seven credit institutions merged with other credit institutions in 2003;
— nine credit institutions changed their legal status after transforming from limited liability companies into joint-stock companies;
— one credit institution changed its legal status as a result of transforming from a limited liability company into a complementary liability company (the first reorganisation of this kind).

There were no reorganisations of non-bank credit institutions into banks or of banks into non-bank credit institutions (in the previous two years, one non-bank credit institution was turned into a bank each year).

Sixty-five credit institutions, or 4.9% of the total number of operating credit institutions, broadened the range of their activities by obtaining additional licences in 2003. In 2003, the Bank of Russia issued:

— 22 general banking licences;
— 24 licences to conduct banking operations with foreign currency;
— 10 licences to take deposits and place precious metals (the same indicator as in 2002);
— six licences to take household savings on deposit.

Two banks had their licences changed in 2003 as the Bank of Russia lifted restrictions it had imposed on them earlier on establishing correspondent relations with foreign banks.

The Bank of Russia issued a licence to open and keep corporate accounts and effect settlements on them to one credit institution, which previously had the licence of a settlement centre of the organised securities market.

The Bank of Russia refused to grant permission to 12 credit institutions to expand the range of their activities. Of these, three credit institutions were denied permission because their ownership structure was not transparent enough, while the other nine had violated the following laws and Bank of Russia regulations:

— authorised capital formation;
— financial soundness;
— compliance with Bank of Russia requirements on the amount of own funds (capital);
— management formation procedures.

II.4. Off-site supervision

In 2003, the Bank of Russia carried out a series of measures to accomplish the tasks set in the Russian Banking Sector Development Strategy and banking legislation. The principal objectives of the Bank of Russia policy on off-site supervision were, as before, to maintain banking sector stability, protect legitimate interests of creditors and depositors and adopt sound decisions in the field of banking regulation and supervision.

The steps taken by the Bank of Russia in the field of off-site supervision aimed to implement the proactive function of banking supervision. They included upgrading the early warning system based on off-site analysis data, using supervision techniques based on the principle of consolidation, developing advanced methods to evaluate risk and the financial stability of credit institutions, and optimising the banking supervision regime. In carrying out this work, the Bank of Russia increasingly attached importance to the use of the principle of informed (professional) judgement.

Ongoing supervision. When developing the methodology of and organising ongoing supervision, the Bank of Russia continued to bring the banking regulation system into conformity with internationally accepted practices, especially the Core Principles for Effective Banking Supervision. It continued to change supervisory practices, shifting the emphasis from the evaluation of nominal compliance with requirements by credit institutions to the assessment of their stability (risk-oriented or substantive supervision).

When the draft Federal Law on Deposit Insurance was being discussed, the Bank of Russia and its regional branches carried out measures to prepare credit institutions for their participation in the deposit insurance system.

Particular attention was accorded to improving the qualitative parameters of banking sector capital and preventing the use of fictitious capitalisation schemes. In 2003, the Bank of Russia inspected 562 credit institutions, or 42% of the total, to find evidence (signs) of own funds (capital) formation with inappropriate assets; signs of fictitious capital were discovered in 118 credit institutions, or almost in one-fifth of the inspected credit institutions. Thirteen credit institutions made capital corrections on the orders of Bank of Russia regional branches and ten credit institutions did so independently. The total amount of capital corrections stood at 483.9 million rubles. After the Bank of Russia Banking Supervision Committee considered the materials submitted on the issue by Bank of Russia regional branches, two credit institutions were ordered to correct their capital to the total amount of 3,494.2 million rubles and one credit institution, which used inappropriate assets to increase its authorised capital, had its banking licence revoked.

The Bank of Russia took steps to upgrade the organisation of ongoing supervision in its regional branches, carrying out measures to improve co-ordination (co-operation) between their supervisory units. At meetings and seminars held at the interregional level, the participants discussed ways to improve banking regulation and supervision, heard recommendations on how to improve co-ordination between supervisory units and detect problems in credit institutions at the early stages of ongoing supervision.

There were fewer violations of effective regulations last year and sanctions applied against credit institutions reflected this trend. At the same time, the Bank of Russia continued to move away from compulsory measures towards prevention. Appropriate supervisory action was ensured by the sound evaluation of any given situation in a credit institution, taking into account the most probable prospects for its future, and by the most effective use by the supervisory body of possibilities and powers granted to it by the applicable legislation.

As for preventive measures, as a result of an analysis of credit institutions' reports, the Bank of Russia notified in writing the management and/or board of directors (supervisory board) of 1,188 credit institutions about shortcomings found in their work and held meetings with managers of 367 banks.

As regards compulsory measures, the Bank of Russia imposed restrictions and bans on 75 banks from taking household savings on deposits (123 banks in 2002), while 51 banks were prohibited from opening branches (83 banks in 2002). The Bank of Russia fined 342 banks for violating prudential standards (473 banks in 2002) and 149 banks (150 in 2002) were ordered to comply with the required ratios.

When fulfilling the functions assigned to it, the Bank of Russia supervised the annual audits of statements of credit institutions and banking groups and analysed the quality of audits.

Early warning system (EWS). In 2003, the Bank of Russia continued to develop a system to detect problems in banks at the early stages (the early warning system) and while conducting this work, it studied various models of early warning systems used in world supervisory practice. The base model it has chosen is the own funds (capital) adequacy (N1) projection model. To implement it in practice, the Bank of Russia has developed software that makes it possible to forecast the own funds (capital) adequacy ratio (N1) for a six-month period and evaluate on a preliminary basis the authenticity of credit institutions' statements, using a method designed to detect cases of nominal compliance with prudential standards involving the manipulation of accounting data (so-called regulation schemes).

Micro-, meso- and macro-analysis. *Analysing the finances of banks.* The Bank of Russia carried out measures to upgrade the methodology of analysing the activities of credit institutions and develop on its basis the software system "Analysis of the Financial Condition of a Bank." It includes an analysis of banks that have branches (including an analysis of branch reports) and an analysis of consolidated statements, which allows areas of increased risk in the activities of banking/consolidated groups to be identified and analysis results to be taken into account when evaluating the financial stability of credit institutions within banking/consolidated groups.

In 2003, the Bank of Russia on the whole completed the development of the *System of Analysis of Aggregate Bank and Banking Services Indicators in a Region.* The Bank of Russia regional branches have been supplied with corresponding software systems to help them carry out the tasks set in the Recommendations for the Analysis of Credit Institutions' Activities and Banking Services Development in a Region.

Stress testing the banking sector. Continuing the work begun under the Russian Financial Sector Assessment Programme, the Bank of Russia conducted the stress testing of the Russian banking sector.

The stress test showed that the Russian banking sector on the whole had become more vulnerable to stress situations than in 2002. The reasons were the expansion of bank lending operations in absolute and relative terms and the changed structure of borrowed funds in favour of household deposits in the absence of a deposit insurance system.

After studying foreign experience, the Bank of Russia elaborated the Principles of Conducting Stress Testing in Credit Institutions, a document dealing with current problems of this method of analysis, which is widely used in foreign banking practice in evaluating the risk of probable losses in adverse economic development scenarios. In December 2003, the Bank of Russia placed this document on its Web site to enable its regional branches and credit institutions to use it in their analysis.

Curatorship. The Bank of Russia continued to phase in curatorship in the practice of supervising credit institutions. Experience has shown that curatorship serves to develop the substantive aspect of supervision. The curator of a credit institution, as he is constantly in touch with its management and staff and has all the available information on its activities, can accurately assess the current state and potential of the credit institution, identify high-risk areas in its activities and propose supervisory responses and banking supervision regimes.

The Bank of Russia issued the recommendations "On the Experiment to Introduce Curatorship in the Practice of Supervising Credit Institutions" (No. 04-15-3/371, dated January 31, 2003). The experiment was conducted in ten Bank of Russia regional branches and its results were summed up in June 2003 at a meeting with the heads of the Bank of Russia regional branches involved in the experiment. The Bank of Russia drafted a Regulation, "On the Curator of a Credit Institution."

Disclosure of information. In an effort to make the activities of the Bank of Russia and the banking sector as a whole more transparent and bolster market discipline, the Bank of Russia took steps towards disclosure of information, placing monthly data on the state of the banking sector on its Web site.

To make credit institutions more transparent, the Bank of Russia issued (on April 16, 2003) a factsheet on the disclosure of information by credit institutions on the Bank of Russia Web site and Operating Ordinance No. 55-T, dated April 15, 2003, "On the Disclosure of Information by Credit Institutions."

As a result of the work carried out in 2003, the number of credit institutions that disclosed information on their activities increased by 3.5 times, from 198 to 687.

In 2003, the Bank of Russia issued its first Banking Supervision Report, which contained wide-ranging information on the Russian banking regulation and supervision system in 2002, evaluated its compatibility with internationally accepted practices and described the main activities of the Bank of Russia supervisory divisions.

To inform the public and banking community on the decisions taken in litigations between the Bank of Russia and credit institutions, the Bank of Russia drafted an Order, "On Work to Make Court Decisions Public in Cases Involving the Bank of Russia and Credit Institutions".

II.5. Inspection of credit institutions

To be able to adopt well-founded decisions in banking regulation and banking supervision, the Bank of Russia conducted on-site inspections of credit institutions. The aim of Bank of Russia inspections was to evaluate credit institutions' finances and prospects for the future on the basis of a risk-oriented approach to existing and potential problems. Particular attention was paid to the evaluation of own funds (capital) levels and adequacy, quality of assets and the efficacy of risk management and internal control systems.

Inspections of credit institutions and their branches were planned taking into consideration the purposes of banking supervision. Ordinary inspections must be held at least once a year and, as recommended by the Bank of Russia, comprehensive inspections must be conducted at least once in two years[39].

A total of 1,341 inspections were to be conducted in 2003 in accordance with the General Plan of Comprehensive and Selective Inspections of Credit Institutions and Their Branches. In reality, 2,180 inspections were conducted, 60% more than planned (of these, 986 inspections were conducted in credit institutions and 1,194 in branches of credit institutions).

Comprehensive inspections were conducted in 2003 in credit institutions which accounted for 16.6% of aggregate banking sector assets (Sberbank excluded) as against 11% in 2002. The credit institutions inspected last year accounted for 39.4—79.1% of their respective federal districts' aggregate banking sector assets, as against 39.6—66.7% in 2002 (in Moscow and the Moscow Region the respective percentages were 11% and 6.5%).

There were 1,305 selective inspections of credit institutions and their branches. Comprehensive inspections, to which the Bank of Russia attached priority, accounted for 40.1% of the total number of inspections as against 18.3% a year earlier. In some regions the percentage of comprehensive inspections more than trebled: in Moscow and the Moscow Region, for example, it increased from 18.4% to 61.4% and in the Ural Federal District from 21.9% to 67.7%.

The inspection divisions of the Bank of Russia regional branches conducted 839 unscheduled inspections of credit institutions and their branches. Unscheduled inspections were conducted when a threat to the interests of creditors and depositors of credit institutions was detected.

Inspections of credit institutions and their branches revealed 25,427 violations of Russian laws and Bank of Russia regulations, of which 3,447 violations (13.5%) had a negative effect on the finances of credit institutions and their branches. An analysis of the violations detected in 2003 showed that most of them were committed in conducting lending and deposit operations, accounting and meeting the requirements of foreign exchange legislation. Other typical violations that affected the finances of credit institutions were non-compliance with the required ratios and false reporting, which included distortions in the accounting of incomes and expenses.

The Bank of Russia conducted 279 inspections to verify the correctness of own funds (capital) formation by credit institutions and detect the use of inappropriate assets by investors in forming credit institutions' own funds (capital).

The Bank of Russia continued to monitor how credit institutions observed the requirements of the Federal Law "On Countering the Legalisation (Laundering) of Criminally Obtained Incomes and the Financing of Terrorism". In conducting this work, it co-operated with law enforcement, tax and other controlling agencies. In 2003, it conducted 1,699 inspections of credit institutions and branches of credit institutions for this purpose. Credit institutions' compliance with the anti-laundering and anti-terrorist financing legislation and Bank of Russia regulations was verified by scheduled and unscheduled comprehensive and selective inspections, some of which were conducted at the request of the law enforcement agencies and the Financial Monitoring Committee of the Russian Federation.

The most frequent violations (80% of the total) discovered in this field were:

— the failure to report operations subject to mandatory control to the authorised body within the time period established by the Federal Law;

— the failure to pass information on operations subject to mandatory control to the authorised body.

In 2003, the Bank of Russia conducted 134 inspections of credit institutions at the request of the federal bodies of power and in 21 cases (16%) information contained in the requests could not be confirmed.

[39] The Russian Federation President's Decree No. 1184, dated June 10, 1994, "On Improving the Performance of the Banking System of the Russian Federation" (as amended by the Russian Federation President's Decree No. 419, dated July 27, 1995).

II.6. Financial rehabilitation and restructuring of credit institutions

As the situation in the banking sector improved, the number of credit institutions that could be subjected to bankruptcy-prevention measures under Article 4 of the Federal Law “On the Insolvency (Bankruptcy) of Credit Institutions” continued to decline in 2003: from 26 as of January 1, 2003, to 20 as of January 1, 2004, (this accounts for 1.5% of the total number of operating credit institutions).

In 2003, 18 credit institutions managed to eliminate reasons to be subjected to bankruptcy-prevention measures independently without any instructions from the Bank of Russia.

In the year under review, the Bank of Russia controlled the implementation of the financial rehabilitation plans by 30 credit institutions, of which 16 (53%) restored their financial condition and were taken off the watch list.

One of the principal areas of activity of the Bank of Russia was working with credit institutions that had allowed their own funds (capital) to become smaller than their authorised capital as stated in their founding documents at the end of the accounting month. In the year under review, the Bank of Russia regional branches ordered 29 credit institutions to match their authorised capital with their own funds (capital). Two credit institutions had their banking licences revoked for failing to comply with this requirement by the established deadline. The number of credit institutions that permitted the reduction of their own funds (capital) to lower levels than their authorised capital fell to seven as of January 1, 2004, from nine as of January 1, 2003.

The appointment of provisional administrations to credit institutions is a major instrument used by the Bank of Russia to protect the legitimate interests of creditors and depositors of problem credit institutions and credit institutions which have had their licences revoked.

In 2003, the Bank of Russia supervised 29 provisional administrations of credit institutions, of which 14 were appointed in the period under review. Nine of these 14 provisional administrations were appointed to credit institutions after their banking licences had been recalled and five were appointed to operating credit institutions (later, the functions, powers and terms of office of these five provisional administrations were changed as the credit institutions they managed had their banking licences revoked).

Twenty-three provisional administrations were dissolved in 2003 after the credit institutions they managed were declared insolvent (bankrupt) by the court of arbitration or were liquidated.

The Bank of Russia continued to co-operate with the government Agency for the Restructuring of Credit Organisations (ARCO) in accordance with procedures established by the Federal Law “On the Restructuring of Credit Institutions.”

In the year under review, the Bank of Russia supervised the restructuring of three credit institutions controlled by ARCO. Pursuant to the Federal Law “On the Restructuring of Credit Institutions”, as of January 1, 2004, ARCO had liquidated the joint-stock bank AKB SBS-AGRO.

II.7. The liquidation of credit institutions

Guided by Article 74 of the Federal Law "On the Central Bank of the Russian Federation (Bank of Russia)" and Articles 20 and 23 of the Federal Law "On Banks and Banking Activities", in 2003 the Bank of Russia ordered the revocation (cancellation) of 16 credit institutions' banking licences. Eleven credit institutions had their licences revoked in compliance with the requirements set in paragraph 2 of Article 20 of the Federal Law "On Banks and Banking Activities", while nine had their licences revoked for failing to meet their obligations to creditors on time.

As of January 1, 2004, 336 credit institutions were slated for liquidation, of which 330 were to be liquidated in accordance with an arbitration court ruling by their founders (members) (such decisions were taken in 2003 on 57 of these credit institutions). The time period between the beginning of the liquidation proceedings and the revocation of a licence was reduced as the implementation of the Federal Law "On Insolvency (Bankruptcy)" and Federal Law "On the Insolvency (Bankruptcy) of Credit Institutions" improved. Receivers and liquidators were appointed to and liquidation commissions were set up in 307 credit institutions, in 76 of these in 2003.

The Bank of Russia registered the liquidation of 166 credit institutions, of which 151 were liquidated on arbitration court ruling to end bankruptcy proceedings; two were liquidated voluntarily by their members; seven were liquidated through bankruptcy proceedings by the decision of their members and creditors; and six were liquidated forcibly by court rulings.

The average percentage of creditors' satisfied claims in the credit institutions whose liquidation was registered in 2003 was 4.5%, of which 1st priority group stood at 68.4%, 2nd priority group 81.1%, 3rd priority group 34.2%, 4th priority group 2.2% (debt on payments to the budget) and 5th priority group 1.2%.

In implementing the provisions of Article 6 of the Federal Law "On the Insolvency (Bankruptcy) of Credit Institutions", the Bank of Russia appointed its employees as receivers to 32 credit institutions declared bankrupt by arbitration courts as absent debtors and in five of them bankruptcy proceedings were completed in 2003.

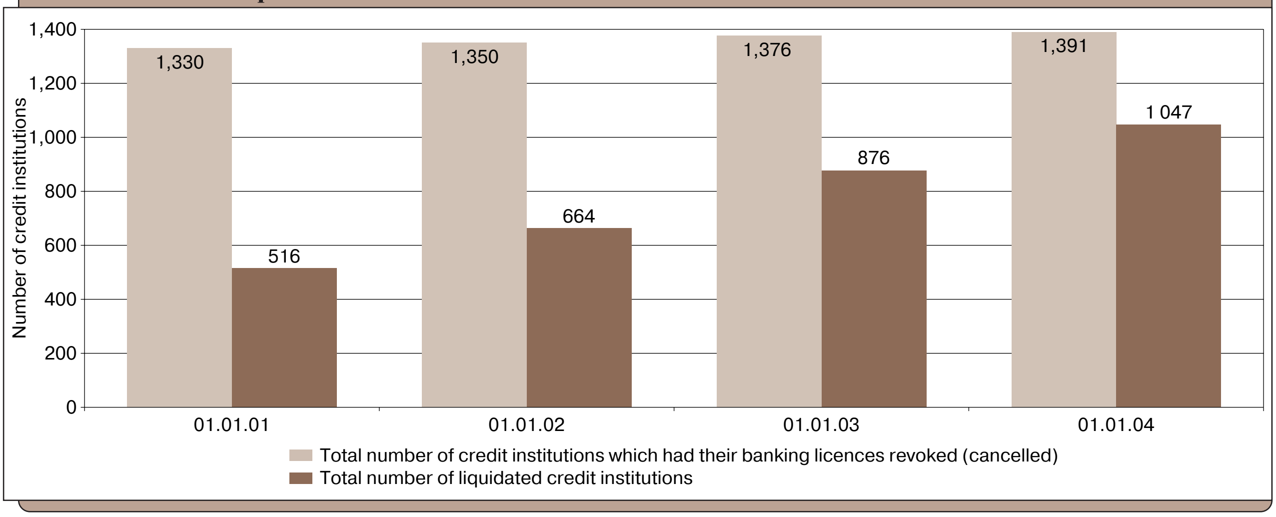
To control the activities of receivers (liquidators) of credit institutions, the Bank of Russia conducted 36 inspections in 2003, after which it ordered receivers (liquidators) to rectify the faults discovered in their work.

Taking into consideration the provisions of Article 6 of the Federal Law "On the Insolvency (Bankruptcy) of Credit Institutions" and Article 20 of the Federal Law "On Insolvency (Bankruptcy)", the Bank of Russia issued 111 receivers' certificates, extended 394 receivers' certificates and cancelled nine receivers' certificates. It refused to grant receivers' certificates to 71 applicants, of which ten requested the extension of the term of their certificates.

To maintain a constant exchange of information on issues relating to control over receivers and co-operation in training receivers, the Bank of Russia signed an agreement with the Ministry of Justice of the Russian Federation (No. 01-33-5/4860, No. 28, dated December 30, 2003).

Number of credit institutions (on accrual basis) whose licences were revoked by the Bank of Russia and number of liquidated credit institutions

CHART 2.1



II.8. Countering the legalisation (laundering) of criminally obtained incomes and terrorist financing

In 2003, the Bank of Russia continued to tackle the tasks and fulfil the functions assigned to it by the Federal Law “On Countering the Legalisation (Laundering) of Criminally Obtained Incomes and the Financing of Terrorism” (hereinafter referred to as the Law) and to make the banking sector’s efforts in this sphere more effective. The principal objectives pursued by the Bank of Russia were as follows:

— to provide the banking system with regulations and methodologies to counter the legalisation (laundering) of criminally obtained incomes and terrorist financing;
— to monitor credit institutions’ compliance with the provisions of the Law and Bank of Russia regulations issued in pursuance of the Law and the implementation of Bank of Russia recommendations;
— to train specialists for the banking sector;
— to approve the internal control rules established by credit institutions to counter the legalisation (laundering) of criminally obtained incomes and terrorist financing;
— to participate in Russia’s co-operation with international organisations set up to counter money laundering and terrorist financing.

To harmonise Bank of Russia regulations with Federal Law No. 131-FZ, dated October 30, 2002, “On Introducing Amendments and Addenda to the Federal Law “On Countering the Legalisation (Laundering) of Criminally Obtained Incomes and the Financing of Terrorism” and to make credit institutions’ efforts in this area more effective the Bank of Russia issued a number of documents to regulate the construction and modernisation of credit institutions’ internal control systems to counter money laundering and terrorist financing (these include recommendations on the identification of credit institutions’ customers; recommendations on the implementation of programmes establishing the procedure for refusing to conclude a bank account agreement and conduct operations at customers’ requests and suspending operations of persons involved in terrorist activities; recommendations on the establishment of correspondent relations with credit institutions of some countries and territories; and recommendations on ways to tighten control over money transfers made without opening a bank account and operations conducted using prepaid financial products).

To prevent the use of the banking system for terrorist financing, the Bank of Russia informed credit institutions about the Financial Monitoring Committee’s lists of persons suspected of being involved in extremist and terrorist activities. In 2003, credit institutions received five lists containing information on 111 corporate entities and 754 private individuals.

In addition, the Bank of Russia continued to make efforts to keep the Russian banking community better informed about international developments, providing credit institutions with information about new international initiatives against money laundering and terrorist financing (notably, the text of the new version of the Global Anti-Laundering Guidelines for Private Banking, known as the Wolfsberg Principles) and some newssheets released by the Financial Action Task Force (FATF).

To supervise banking sector practices against money laundering and terrorist financing, the Bank of Russia conducted 1,699 inspections of credit institutions and branches of credit institutions. They showed that most credit institutions fulfilled the functions assigned to them by the Law. At the same time, 689 inspections, or almost 40% of their total number, revealed violations of the applicable legislation and Bank of Russia regulations against money laundering and terrorist financing. There are four groups of typical violations: a failure to pass information to the Financial Monitoring Committee due to erroneously classifying operations as not subject to mandatory control; mistakes committed in compiling and sending operations data to the authorised body (a failure to fill in a report form or filling it in incorrectly); a failure to comply with the customer identification and scrutiny programme approved by a credit institution; a failure to comply with the established procedure for keeping documents and information.

The main reasons for the violations detected by inspectors were inadequate control exercised by credit institutions’ managers over their structural divisions, poor quality inspections conducted by banks’ internal control services and a failure to understand the provisions of applicable laws and regulations correctly. Some violations were technical and they were remedied during the inspections.

The following preventive measures were used against the inspected credit institutions for violations: in 353 cases inspectors informed the management of the inspected credit institutions about the shortcomings they had discovered in their work. The sanctions applied were as follows: 135 credit institutions were ordered to eliminate the violations discovered in their work; five credit institutions were prohibited from conducting some banking operations; two credit institutions were not allowed to open branches; 81 credit institutions were fined; and one credit institution had its licence revoked.

Throughout the year, Bank of Russia regional branches received methodological assistance on issues related to money laundering and the financing of terrorism. In response to requests, the Bank of Russia wrote and sent its divisions and branches more than 100 clarifications and having analysed and summarised them, it issued three memos on the application of the anti-laundering and terrorist financing legislation.

To implement Russian Government Resolution No. 6, dated January 8, 2003, “On the Procedure for Approving Internal Control Rules in Organisations Conducting Operations with Money and Other Property”, the Bank of Russia organised the approval of credit institutions’ anti-laundering internal control rules. Its regional branches had completed the approval of the rules by the end of the third quarter of 2003.

II.9. Co-operation with the Russian banking community

Co-operation between the Bank of Russia and the banking community improved and expanded significantly in 2003. The work on the new version of the Strategy showed that the banking community, which accumulates information on the real problems that face credit institutions, is capable of putting forward specific proposals on how to tackle them. The Bank of Russia intends to continue to promote co-operation with the banking community to achieve the common strategic goal of developing and strengthening the Russian banking sector.

To encourage constructive dialogue with the banking community and make its decisions more effective, in April 2003, the Bank of Russia began to place drafts of its most important regulatory documents on its official Web site for public discussion, such as the Procedure for Making Loan Loss Provisions and Provisions for Debt on Loans and Similar Debts, the Procedure for Organising Internal Control in Credit Institutions and Banking Groups, the Instruction on the Required Ratios for Banks, and the new version of Instruction No. 41, dated May 22, 1996, “On Setting Limits on the Open Currency Position and Monitoring Their Observance by the Authorised Banks of the Russian Federation.”

Credit institutions, banking associations, audit firms and independent experts actively participated in the discussion of Bank of Russia draft regulations and the Bank of Russia took account of their proposals when drawing up the final versions of its regulations. The Bank of Russia considered the practice of holding public discussion of its draft regulations successful and decided to continue it.

At the final stage of the discussion of the drafts of the Bank of Russia Regulation “On the Procedure for Making Loan Loss Provisions and Provisions for Debt on Loans and Similar Debts” and Bank of Russia Instruction “On the Required Ratios for Banks”, Bank of Russia executives met managers of the banks who represented the Association of Regional Banks and Association of Russian Banks and the results of the discussion they held were taken into account in the final drafts of the documents.

To study the development dynamics of online banking and conduct detailed surveys of credit institutions in this field, the Bank of Russia polled credit institutions in six regions (Niznhi Novgorod, Saratov, Sverdlovsk, Tyumen, and Chelyabinsk Regions and St Petersburg).

In 2003, the Bank of Russia co-operated with the Ministry of Finance in auditing credit institutions. Its representatives took part in the work of the Finance Ministry’s Audit Council, the Commission on Audit Practices and working groups (on standards, quality control, methodology and mandatory audit), the Commission on the Development and Updating of Auditor Qualification Examination Programmes and working group on the development of programmes for auditing credit institutions, banking groups and bank holding companies (banking audit). This work included a discussion of draft laws and regulations on audit and draft Federal Audit Rules (Standards).

In March 2003, the Bank of Russia organised in St Petersburg with the participation of representatives of the Finance Ministry, banking associations, credit institutions and audit firms the Ninth National Banking Audit Day on the following subject: “Auditing Credit Institutions in the New Conditions of Audit Regulation.” The discussion centred on issues related to the state and prospects for the development of banking audit in Russia.

II.10. Co-operation with international organisations and foreign central banks and regulatory authorities in the field of banking supervision

II.10.1. Financial Sector Assessment Programme (FSAP) for Russia

In 2003, the Bank of Russia participated in the implementation of the Financial Sector Assessment Programme for Russia[40].

After the completion of the Programme, the Bank of Russia considered the final reports of the International Monetary Fund "Russian Federation: Financial System Stability Assessment" and "Russian Federation: 2003 Article IV Consultation" and the World Bank "Russia — Financial Sector Assessment" and prepared comments on them. In October 2003, the Bank of Russia placed the World Bank report on its Web site.

The main assessments and conclusions with regard to the FSAP for Russia indicate that in many respects the Russian system of banking regulation and supervision meets the requirements of the Basel Committee's Core Principles for Effective Banking Supervision (hereinafter referred to as CP). At the same time, World Bank experts gave a number of specific recommendations on some principles, such as corporate governance and licensing (CP 3 and 4), capital adequacy (CP 6), lending policy, provisioning and credit risk (CP 7, 8, 9 and 10), internal control (CP 14), money laundering (CP 15), accounting standards (CP 21), compulsory measures (CP 22) and the exchange of supervisory information (CP 25).

The Bank of Russia took their opinion into account in working out measures to upgrade banking regulation and supervision.

II.10.2. Participation in international projects

In 2003, the Bank of Russia co-operated with international financial organisations such as the International Monetary Fund and the World Bank on a wide range of issues, including the upgrading of the banking supervision system, building internal control systems in banks, developing early warning systems to detect problems in credit institutions at the early stages and creating credit bureaux.

In 2003, the Bank of Russia continued to co-operate with the World Bank in looking for new applications of the World Bank loan, granted to finance the Financial Sector Development Project, and extending the term of this loan. The Bank of Russia and World Bank also discussed issues relating to the development of a project designed to encourage regional Russian banks to extend loans to small and medium-sized business in the regions.

The Bank of Russia in 2003 co-operated with the European Commission for the TACIS programme in implementing the following projects:

— Banking Supervision and Reporting, a project designed to make banking supervision more effective and develop a system of prudential reporting compatible with the IFRS and international supervisory best practice (the project is to be completed in 2005);

— Training Bank of Russia Personnel. Stage III, a project designed to train Bank of Russia specialists in evaluating and managing risks in credit institutions (the project is to be completed in 2005).

Co-operating with the Financial Services Volunteer Corps (FSVC), USA, the Bank of Russia drafted and submitted to the FSVC proposals on the provision of technical assistance in key areas of banking regulation and supervision.

Assisted by the FSVC mission in Russia, the Bank of Russia organised a seminar in October 2003 on "Strategic Planning for Bank Inspectors", which discussed capitalisation, banking risks and their management and the introduction of international financial reporting standards and a deposit insurance system.

The Bank of Russia continued to co-operate with the Toronto Leadership Centre for Financial Sector Supervision on issues relating to assistance to the Bank of Russia in banking regulation and supervision. The Bank of Russia helped organise a visit by Toronto Centre experts, who arrived in Russia to identify what technical assistance the Bank of Russia needed in the field of banking regulation and supervision. After the visit, the Toronto Centre submitted a report to the Bank of Russia on the latter's needs in banking supervision training.

II.10.3. International co-operation in banking supervision

Co-operation with international financial organisations. The Bank of Russia took part in compiling data

[40] The Financial Sector Assessment Programme is a joint IMF-World Bank international programme designed to make the efforts to upgrade the national financial systems of the participating countries more effective. The FSAP has been implemented since 1999 by the concerted efforts of representatives of international financial organisations and national supervisory authorities for the purpose of identifying strengths and weaknesses of the financial systems of the participating countries, evaluate systemic risks and determine macroeconomic policy priorities. The FSAP is now being carried out or has been completed in more than 60 countries, including industrialised and developing nations and emerging markets. The FSAP for Russia has been implemented with the participation of representatives of the Bank of England, Bundesbank, Bank of Finland, Financial Supervision Agency of South Africa and the Financial Supervision Agency of Hungary.

for the World Bank Survey of Prudential Regulations and Supervision of Commercial Banks and the IMF Global Financial Stability Report, which were published on the Web sites of the two organisations.

Bank of Russia representatives participated in implementing the Global Bank Insolvency Initiative of the IMF, World Bank and Financial Stability Institute, which drafted the Main Report “Legal, Institutional and Regulatory Framework to Deal with Insolvent Banks”. The final version of the report is to be published in March 2005.

The Bank of Russia participated in exchanging information and in meetings held within the framework of the World Bank Russia Banking Sector Corporate Governance Project and in the presentation of the report. It also took part in the Euroforum conference “Securitisation in Russia and Kazakhstan”.

Co-operation with the Basel Committee on Banking Supervision and its regional groups. Bank of Russia representatives took part in the activities and meetings of the Basel Committee’s Core Principles Liaison Group and its Working Group on Capital (February, April, August and December) and in the chief supervisors’ meeting on corporate governance, supervision and credit risk, held in May 2003. The Bank of Russia organised for the Russian side the Liaison Group meeting in St Petersburg on August 26—28, 2003.

The discussion at the above meetings focused on issues such as the draft of the New Capital Accord, practical aspects of independence, accountability and legal security of the banking supervisory authorities; the accountability, transparency and stability of banking systems in accordance with the principles laid down in the New Capital Accord; the implementation of the Basel Core Principles for Effective Banking Supervision, prevention of systemic banking crises, supervision of credit and operational risks, corporate governance, Standards 32 and 39 of the International Financial Reporting Standards and co-ordination of actions (interrelations) between the Basel Committee and regional groups.

To keep the banking community informed, the Bank of Russia participated in the international conference “Basel Accord II. Transition Problems for European Countries. Deadlines Set”, which was held in St Petersburg in April 2003. The conference was organised by the Russian Chamber of Commerce and Industry and the Belgian Banking Academy with the support of the Basel Committee on Banking Supervision and European Commission.

To evaluate the possible influence of the New Capital Accord (Basel II) on bank performance indicators, the Bank of Russia took part in the international Quantitative Impact Study 3 (QIS3) project (the results of the study were published on May 5, 2003). Six Russian banks were involved in the study at the request of the Bank of Russia (365 banks from 43 countries participated in the project).

Bank of Russia representatives took part in a new two-year project launched by the Financial Stability Institute and Bank for International Settlements to develop and support online training programmes and Web resources for supervisors (FSI Connect). The project aims to co-ordinate global efforts and elaborate further strategies for supervisory authorities on various financial markets.

Bank of Russia representatives attended the 16th Conference of the Regional Group, entitled “The Impact of European Union Enlargement on Banking Supervision in Central and Eastern European Countries”, held in Tallinn in May, and the 13th Conference of the Regional Group on Banking Supervision of Transcaucasian and Central Asian States and Russia, held in Dushanbe, Tajikistan, in October 2003, on the following subjects: “Consolidated Supervision”, “Corporate Governance in Credit Institutions: Practice and Specifics”, “Supervision and Detection of Operations Connected with Money Laundering and Terrorist Financing” and “Establishing a Single Financial Market Supervising Authority”.

Co-operation with the Financial Action Task Force (FATF). The Bank of Russia programme for international co-operation in 2003 included active participation in preparations for Russia’s membership of the FATF. To acquaint FATF experts with the practical steps taken by Russia against money laundering and the financing of terrorism, the Bank of Russia presented materials containing information on the measures taken by the Russian banking system in this area. In addition, Bank of Russia executives and specialists, including executives and specialists of the Bank of Russia regional branches, met FATF experts. The latter also had the opportunity to evaluate anti-laundering and anti-terrorist financing systems used by credit institutions in Moscow and some other cities. A major factor in the FATF’s decision to admit Russia to this international organisation (in Berlin, Germany, in June 2003) was the international community’s appreciation of the efforts made by the Bank of Russia to improve the anti-laundering and anti-terrorist financing system in the Russian banking sector.

When implementing a Russian presidential decree, the Bank of Russia participated in the elaboration of the Concept of the National Strategy for Countering Money Laundering and Terrorist Financing and it also took part in the work to upgrade Russian legislation to bring it into conformity with the new version of the FATF Forty Recommendations and FATF experts’ requirements.

Improving conditions for co-operation with foreign supervisory authorities. To create better conditions for co-operation with foreign supervisory authorities and sharing supervisory information, the Bank of Russia continued to conclude agreements on co-operation (memoranda of understanding) in the field of banking supervision. It signed a new agreement on co-operation in banking supervision with the Central Bank of Armenia.

The Bank of Russia continued to work on the wording of agreements (memoranda) on co-operation in banking supervision with the Banking Supervision Commission of Poland, the National Bank of Serbia, the National Bank of Slovakia, the Regulation and Supervision Agency of Turkey, the National Bank of Ukraine, the Swiss Federal Banking Commission and the Financial Inspectorate of Estonia.

The Bank of Russia also invited the Bundesbank and Banking Supervision Agency of Germany and the Financial Supervision Agency of Finland to sign a memorandum of understanding.

In 2003, the Bank of Russia continued to work on new agreements (memoranda) with the following banking supervision authorities: the National Bank of the Kyrgyz Republic, the Bank of Lithuania and the Central Bank of Mongolia.

The activities of the sub-group Banks/Financial Services of the Russian-German Working Group on Strategic and Financial Co-operation. A series of meetings were held within the framework of the sub-group Banks/Financial Services of the Russian-German Working Group on Strategic and Financial Co-operation to discuss the most urgent issues relating to various segments of the financial market in Russia. The following meetings were held with the participation of representatives of the Russian President's Office, the State Duma of the Federal Assembly of the Russian Federation, federal ministries, banking and financial institutions, academic circles and foreign organisations:

— a two-day conference and seminar was held on March 20 and 21, 2003, on the following subjects: "Mortgage Banks", "Financing Housing Construction. Building Savings Banks" and "Credit and Savings Co-operatives". The participants discussed the problem of creating a legislative framework for the activities of credit institutions involved in the financing of housing construction and credit co-operatives and assessed prospects for the development of the mortgage business in Russia. They devoted considerable attention to risk regulation and supervision of credit institutions and the problem of ensuring more effective protection of the rights of creditors and investors in Russia;

— on August 12, 2003, the sub-group held a working meeting on "Credit Security", which discussed various aspects of credit security, including legislation, law application practices, banking supervision, credit security instruments used in Russia and in Germany, credit security in specialised credit institutions, credit security in financing housing construction, investment portfolio formation in Russian banks and pension funds, and mortgage legislation development in Russia in the context of the Strategy for Development of the Banking Sector of the Russian Federation.

II.10.4. Organising and holding international conferences

The Bank of Russia participated in organising and holding the 12th International Banking Congress (IBC) "Banking Sector and Sustained Economic Growth", which took place in St Petersburg in June 2003. Representatives of Russian and foreign business circles, international organisations, central (national) banks and supervisory authorities of foreign countries, as well as the banking community, discussed co-operation between the banking sector and the economy in Russia, and the functioning of the banking sector in terms of international competition, taking into consideration the easing of foreign exchange regulation in Russia. They also focused on the development of new banking services, such as retail banking, mortgage services, lending to small businesses and online banking, the strengthening of banking sector stability, optimisation of supervision, conversion of credit institutions to international accounting and financial reporting standards, and making the banking business more transparent.

II.11. Prospects for the development of the banking regulation and supervision system

The present Russian system of banking regulation and supervision is in need of improvement and the principal objective of its development remains the transition to substantive, risk-oriented supervision. In this context, efforts will continue to be made to evaluate the performance of credit institutions mainly from the viewpoint of the substance of their activities, the nature and profile of the risks assumed and their possible impact on the stability of credit institutions. Professional judgement based on up-to-date methodologies, the knowledge of advanced banking techniques and the nature and conditions of banking risks and accumulated experience will play an increasingly important role in banking supervision. These principles will be put into practice in upgrading recommendations on the analysis of banks' performance and condition for the purposes of banking supervision and establishing basic supervision regimes.

Registration and licensing. To upgrade the decision-making procedure used by the Bank of Russia with regard to the state registration of credit institutions and licensing banking activities, the Bank of Russia will use the entire range of instruments described in its Instruction No. 109-I "On the Decision-Making Procedure Used by the Bank of Russia with Regard to the State Registration of Credit Institutions and the Issue of Banking Licences" (drafted in 2003, issued on January 14, 2004).

In accordance with this Instruction, the Bank of Russia regional branches will conduct on-site inspections of credit institutions to determine the sources of funds paid to acquire their shares (stakes) and investigate the finances of the purchasers to make sure that they have enough own capital (net assets) to pay for the shares (stakes) they acquire if a credit institution's authorised capital increases by more than 20% of the previously registered amount and in case there is reason to believe, as the relevant federal laws and Bank of Russia regulations stipulate, that the credit institution's shares (stakes) were paid for in violation of the established requirements. At the same time, to increase the transparency of the shareholder (stakeholder) ownership structure of a credit institution and broaden opportunities for obtaining information for the evaluation of its finances, the Bank of Russia and its regional branches received the right to request any information from the founders of a credit institution being set up on the financial standing and activities of persons that could directly or indirectly influence the decisions taken by the founders of the credit institution and to demand that a credit institution requesting permission to expand the range of its operations by obtaining the corresponding banking licence provide information on its members and their groups.

To give credit institutions broader opportunities for managing their liquidity, the Bank of Russia restored the limit for the maximum contribution to the authorised capital of a credit institution made with property rather than money to the pre-crisis level of 20% of the authorised capital.

In addition, the Bank of Russia provided a more detailed description of the procedure for expanding the range of activities of banks requesting licences to take household savings on deposit. It stipulated that in addition to complying with general standards, a bank must meet the requirements set in the Federal Law on Deposit Insurance. A corresponding inspection should be conducted in the bank to confirm its compliance with this law.

The Bank of Russia implemented a series of measures to simplify the procedure for providing banking services, lifted a number of administrative controls on banking and simplified and made more transparent the procedures for supervising the observance of federal legislation when making decisions on the state registration of credit institutions and issuing banking licences.

Specifically, the requirements a bank branch must meet to begin conducting banking operations have been reduced to the need to obtain approval for the appointment of the CEO, deputy CEO, chief accountant and deputy chief accountant and have an office for conducting operations with valuables that conforms to established standards.

At the same time, credit institutions received the opportunity to open a new kind of internal division, the cash credit office, which now has the right to extend loans to small business and individuals and provide cash services to corporate entities and private individuals. The cash credit office will allow credit institutions to broaden the range of banking services and bring them closer to the end user and improve the quality of banking services, especially those provided to small businesses and private individuals. All this will help diversify banking services, make them more profitable, stimulate investment activity and create a more favourable climate in the business community.

To improve the legislative basis of banking supervision, the Bank of Russia drafted and issued regulations in 2003 that are designed to raise the level of corporate governance in credit institutions.

It drafted a regulation aimed at clarifying the provisions of laws and Bank of Russia regulations on the assessment of the compliance of persons elected (appointed) to executive positions in credit institutions and elected to the boards of directors (supervisory boards) with the established business reputation and qualification requirements. According to the draft regulation, the business reputation of the above persons will be evaluated from the viewpoint of its compliance with the provisions of the tax and labour laws, the Federal Law “On Countering the Legalisation (Laundering) of Criminally Obtained Incomes and the Financing of Terrorism”, the fulfilment in good faith of civil and common law obligations as a private individual or a manager of a corporate entity and the observance of ethical standards accepted in a credit institution and the banking community in general.

A major task is to simplify bank merger and acquisition procedures. To stimulate the development of the banking services market, the Bank of Russia will create more favourable conditions for the reorganisation of credit institutions by merger and acquisition. Laws and regulations are to be adopted to this end, which will considerably accelerate and reduce the cost of the reorganisation of credit institutions in the form of mergers and acquisitions. Specifically, amendments are to be made to the Federal Law “On Banks and Banking Activities”, which will stipulate that the right to demand an early fulfilment of pecuniary obligations will only be granted to individual creditors, if the obligations to them arose before the date on which the credit institutions announced their reorganisation. Corporate creditors may demand that credit institutions fulfil their obligations to them before they are due if this right is included in the agreement between a bank and its corporate creditor. This procedure is designed to help the acquiring credit institutions and credit institutions created by merger or reorganisation to remain liquid and solvent.

The Bank of Russia will continue to draft recommendations on the evaluation of credit institutions’ business plans. This evaluation must be based on an analysis of a credit institution’s ability to ensure financial stability, including the fulfilment of prudential standards and reserve requirements, observe legislation on the protection of creditors’ and depositors’ interests, and enable a credit institution to operate for a long time as a profit-making enterprise with an effective risk management system.

In addition, the Bank of Russia is to implement measures to ensure the identification and disclosure of information about the real owners of credit institutions and control over their finances and to tighten requirements for credit institutions’ executives and their business reputation.

To implement the new version of the Strategy, in 2004 the Bank of Russia will continue to work on amendments to the applicable federal legislation to increase the transparency of the ownership structure of credit institutions, establish more stringent control over the decision-making procedure in credit institutions and tighten requirements for the founders (members) and real owners of credit institutions. Specifically, the following measures are planned:

— to reduce the threshold values of acquisitions of shares (stakes) in credit institutions controlled by the Bank of Russia (the purchase of more than 1% of shares (stakes) in a credit institution will require notification and the purchase of more than 10% of shares (stakes) will require permission);
— to introduce a definition and criteria for the real owners of credit institutions, establish requirements for the disclosure of information on the real owners and other persons who make up the ownership structure of credit institutions;
— to grant the Bank of Russia the right to establish criteria for the business reputation of the founder (member) of a credit institution and its real owner and evaluate the latter’s finances;
— to grant the Bank of Russia the right to refuse to give prior permission for the purchase of more than 10% of shares (stakes) in a credit institution, should it find out that the financial position of the purchaser and/or real owner or their business reputation does not meet the established requirements or that they have violated anti-trust rules;
— to improve the quality of the management of credit institutions, specify the requirements for a credit institution’s managers and members of the board of directors (supervisory board) and grant the Bank of Russia the right to establish business reputation criteria for them;
— to make a credit institution’s affiliated persons accountable for the quality of the information they provide;
— to make the requirement that the board of directors (supervisory board) of a credit institution plays a greater role and bears more responsibility, establish its exclusive competences and require credit institutions to indicate in their charters the size and make-up of their boards of directors and include independent members in them.

The problem of transparency of the ownership structure of credit institutions and the identification of their real owners is also linked with the implementation of measures to counter money laundering and terrorist financing. The Bank of Russia and the Financial Monitoring Service are currently working on amendments to the Federal Law “On Banks and Banking Activities” and the Federal Law “On the Central Bank of the Russian Federation (Bank of Russia)”, designed to prevent persons suspected of being involved with criminal or terrorist groups from participating in credit institutions or managing them. One possible amendment grants the Bank of Russia the right to refuse to register a credit institution or issue to it a banking licence, if any of its founders (members), real owners or candidates of the position of members of the board of directors (supervisory board), chief executive officer, chief accountant or deputy chief accountant has been convicted of committing a crime motivated by gain or by contract, an economic crime or some other criminal offences stipulated by the Criminal Code of the Russian Federation.

There are also plans to broaden the range of criteria in accordance with which the Bank of Russia may refuse to give permission for a transaction to acquire more than 10% of shares (stakes) in a credit institution, if any of the purchasers and/or real owners has been convicted for any of the above crimes. At the same time, the Bank of Russia will have the power to deny the founders (members) and real owners of credit institutions who have committed such crimes the right to participate in managing credit institutions, which they are entitled to as shareholders (stakeholders).

Off-site supervision. The overall objective of the Bank of Russia in the field of banking regulation and supervision is to promote the development of substantive (risk-oriented) banking supervision. This means that the supervision regime and supervisory response will depend, above all, on the nature of the risks assumed by a credit institution and the way it manages these risks.

When building a deposit insurance system in pursuance of the Federal Law on Deposit Insurance, the Bank of Russia will take additional measures with regard to the comprehensive evaluation of the financial soundness of credit institutions based on internationally accepted practices, including the quality of bank assets and capital, the level of liquidity and profitability and the state of the control systems, especially its strategic aspects and internal control.

The Bank of Russia will continue to develop various components of the early warning system and complete the development of a situation model for a bank as well as introduce this model in supervisory practice.

To improve the supervisory practice which would ensure the use of a supervisory regime depending on the condition of a credit institution, including the level of risks it has assumed, the quality of risk management and transparency of the ownership structure, the Bank of Russia will draft a corresponding methodological document.

Plans are in place to continue introducing curatorship in the practice of supervising credit institutions. The conducted experiment has shown that the implementation of this principle generally meets the task of developing the substantive component of supervision. International experience also indicates that curatorship makes risk-oriented banking supervision more effective, provided that curators have a high professional level and their activities are kept under control. The Bank of Russia plans to issue a Regulation “On the Curator of a Credit Institution” and draft recommendations on organising the curator’s activities.

The Bank of Russia will continue to take steps to improve the qualitative parameters of banking sector capital, to correct capital formed using fictitious capitalisation schemes and prevent the use of such schemes. Building upon the experience gained in this field, the Bank of Russia will draft recommendations for specialists on the corresponding range of issues.

The Bank of Russia intends to further upgrade consolidated supervision, including the analysis of risks assumed by credit institutions when dealing with private individuals and corporate entities, including non-credit institution members of banking groups and bank holding companies. This work requires the appropriate legal basis, including amendments to the applicable legislation. The Bank of Russia also plans to reconsider its tactics with regard to the consolidated reporting by banking/consolidated groups and the procedure for calculating the risks they assume, taking into account the recommendations of the Basel Committee on Banking Supervision and international expertise.

Special efforts will be made to ensure the effective management of risks that arise in bank lending to related persons and prevent the extension of soft loans to related persons. Amendments should be made to the applicable legislation for this purpose.

Efforts will continue to be made to upgrade prudential reporting, including the implementation of measures within the framework of the European Union’s TACIS Project “Banking Supervision and Reporting” (2003—2005). By the time the Project is completed, the Bank of Russia will have worked out reporting standards based on internationally accepted principles and the best international supervisory practice.

The Bank of Russia intends to amend some of its regulations, such as Regulation No. 232-P, dated July 9, 2003, “On the Procedure for Making Loan Loss Provisions by Credit Institutions”, Instruction No. 41, dated May 22, 1996, “On Setting Limits on Open Currency Positions and Monitoring Their Observance by Authorised Banks of the Russian Federation”, Regulation No. 516, dated September 8, 1997, “On the Prudential Regulation of Non-Bank Credit Institutions Conducting Settlement Operations and Collection Organisations”. The Bank of Russia issued a clarification on the procedure of using Instruction No. 63, dated July 2, 1997, “On the Procedure for Conducting Trust Management Operations and Accounting for These Operations by Credit Institutions”. The amendments will help assess banking risks more accurately, establish and specify the requirements for reducing them, determine a permissible mix of operations and drawing up a list of prudential standards.

The Bank of Russia will continue to upgrade the methodology of calculating banks’ required ratios, such as liquidity ratios and maximum risk per borrower or group of related borrowers (N6). It also plans to issue a clarification on the methods used by banks to observe required ratios on a daily basis.

In implementing the Russian Banking Sector Development Strategy for 2003, the Bank of Russia continued to work on a draft of proposals to amend federal legislation with provisions that would allow the Bank of Russia to establish mandatory corporate governance rules for credit institutions. The Bank of Russia Committee on Banking Supervision drafted and discussed conceptual proposals on amending the Federal Law “On Banks and Banking Activities” and the Federal Law “On the Central Bank of the Russian Federation (Bank of Russia)” and began to work on draft recommendations on corporate governance in credit institutions. The regulations being drafted give the interests of a credit institution, its creditors and depositors precedence over the interests of individual founders (members) and managers of the credit institution, provides for measures to prevent a conflict of interests in the management of a credit institution and sets requirements for managerial decision-making. If approved, these documents will boost the role of the board of directors (supervisory board) in credit institutions and provide general guidelines for the banking community in organising and assessing the state of corporate governance.

The Bank of Russia has begun to work on draft recommendations for managing legal risk and the risk of a loss of business reputation for credit institutions and banking groups, which set out the principles by which credit institutions should be guided in establishing the procedure for detecting, evaluating, monitoring, and minimising the above risks.

The Bank of Russia intends to send credit institutions its recommendations on managing operational and other risks.

To improve the evaluation and monitoring of the banking sector's strengths and weaknesses, the Bank of Russia will continue to calculate and analyse the IMF-developed financial stability indicators (FSI) for the banking sector.

It will also continue to evaluate the banking sector's financial resilience in economic crises, using stress testing and taking into account the impact of various risk factors. The Bank of Russia will continue to improve its methodology by using IMF recommendations and international experience in this area. It will evaluate the effects of a crisis on various segments of the financial market, especially the stock market, as well as the real estate market.

The Bank of Russia will continue to survey credit institutions from the viewpoint of online banking. The survey aims to uncover the most complete possible information on how credit institutions use online banking and on related sources and factors of banking risks.

Inspection of credit institutions. In the near future, Bank of Russia inspections will be aimed, in addition to fulfilling their traditional function of banking supervision, at organising inspections of credit institutions for the purpose of creating a well-functioning deposit insurance system in compliance with the Federal Law on Deposit Insurance.

In conducting inspections, the Bank of Russia focuses on the need to evaluate the current and future financial soundness of credit institutions and the efficacy of their risk management and internal control systems. It will seek to improve the quality of inspections by developing the substantive method of evaluating credit institutions' performance, especially the nature of risk and the quality of risk management, and using informed judgement as the basis for the evaluation of the qualitative aspects of activity, financial standing and prospects for the future of credit institutions and their branches.

The Bank of Russia will continue to upgrade inspection methodologies by amending its own regulations and drafting amendments to the applicable legislation. Additional efforts will be made to improve information and analysis support for inspections, including through the introduction of the software system "Inspection Division Automated System".

The financial rehabilitation and liquidation of credit institutions. To improve the methods of preventing insolvency (bankruptcy) of credit institutions and upgrade the procedure for revoking banking licences and liquidating credit institutions, the Bank of Russia, implementing measures envisaged by the Russian Banking Sector Development Strategy, will participate in considering the following amendments to be made to Russian legislation:

— to exclude the property transferred by the borrower as collateral against a loan from bankruptcy assets in the event of the borrower's bankruptcy and simplify and standardise the procedure for registering the recovery against the property used as collateral;
— to raise the capital adequacy requirement and the capital requirement whose non-fulfilment must be penalised by the revocation of a credit institution's banking licence;
— to streamline and accelerate credit institution bankruptcy procedures, ensure better protection of the rights of creditors and depositors, establish special standards in the Federal Law "On the Insolvency (Bankruptcy) of Credit Institutions" as compared with the Federal Law "On Insolvency (Bankruptcy)" with regard to the financial rehabilitation and liquidation of credit institutions, and introduce the institute of a corporate liquidator;
— to ensure a more effective protection of the interests of creditors and depositors of credit institutions which have financial problems but are not subject to the initiation of insolvency (bankruptcy) proceedings against them. Additional amendments may be made to the applicable legislation for this purpose, which would establish the powers of the banking supervisory authorities as recommended by the Basel Committee on Banking Supervision in its Supervisory Guidance on Dealing with Weak Banks and accepted in the international practice;
— to ensure the implementation of cross-border bank insolvency procedures by concluding interstate agreements setting the procedure for liquidating commercial and non-commercial representative offices of Russian banks abroad and foreign banks in Russia.

The Bank of Russia continues to participate in the State Duma's second reading of the draft law "On Amending the Federal Law "On the Insolvency (Bankruptcy) of Credit Institutions", which is designed to improve the protection of the interests of credit institutions' lenders and depositors during bankruptcy proceedings in order to satisfy their claims. The idea is to change in principle the attitude to bankruptcy proceedings in credit institutions. This sphere of activities is almost entirely transferred from the realm of private enterprise to the sphere of public law. It is proposed that the main liquidator of credit institutions that have had their licences revoked should be the Deposit Insurance Agency, a non-profit corporation. A corporate liquidator will be able to maintain a balance between the interests of all groups of creditors, reduce the time taken by bankruptcy proceedings and make them more transparent. The implementation of the concept of the draft law fully accords with international bankruptcy regulation practices, which have proven beyond doubt that the bankruptcy process of credit institutions requires specific procedures.

Bankruptcy proceedings will be made easier for depositors from the viewpoint of presenting their claims, as they will save them money and time they now spend on court hearings establishing the level of their claims.

Additional measures are to be taken to ensure control and security of the property of a credit institution and its documents (the activities of the provisional administration, the receiver's reports and matching the interim liquidation balance sheet with the liquidation balance sheet). It will be necessary, therefore, to create a special system to control the course of the bankruptcy proceedings on the basis of reporting and Bank of Russia inspections.

A provision may be made in legislation that a bank may resume its operations within a specified period of time after the court confirms that it has settled all its obligations, if the bank has fulfilled all Bank of Russia requirements for a newly created bank and the Bank of Russia has agreed to issue a licence.

Statistical appendix

III

TABLE 1

Quantitative and qualitative characteristics of the supervisory staff at the Bank of Russia's central office and regional branches as of January 1, 2004

Division title	Nominal number of jobs as of January 1, 2004	Total number of employees as of January 1, 2004 (excluding part-timers)	Of whom							
			age			education		length of work in the banking sector		women
			under 30 (born 1974 and later)	over 50 (born 1953 and earlier)	of whom women over 55 and men over 60	higher	vocational secondary	3 years and less	15 years and more	
Central Office										
Banking Regulation and Supervision Department	166	160	30	46	11	155	4	18	47	113
Credit Institutions Licensing and Financial Rehabilitation Department	135	131	36	22	7	122	8	13	24	95
Foreign Exchange Regulation and Control Department	120	104	38	19	5	97		15	29	63
Main Inspectorate of Credit Institutions	158	92	28	17	3	88	3	23	5	44
Central Office Total	**579**	**487**	**132**	**104**	**26**	**462**	**15**	**69**	**105**	**315**
Regional Branches										
Credit Institution Supervision Department (Division)	1,470	1,451	249	238	60	1,378	65	82	460	1,201
Credit Institution Inspection Department (Division)	1,069	1,045	165	200	45	1,008	32	56	200	581
Foreign Operations and Foreign Exchange Regulation and Control Department (Division)	681	666	143	71	18	648	15	49	134	443
Sectors of the Moscow Branch	631	617	226	92	28	531	69	90	73	431
Regional Branches Total	**3,851**	**3,779**	**783**	**601**	**151**	**3,565**	**181**	**277**	**867**	**2,656**
Bank of Russia Total	**4,430**	**4,266**	**915**	**705**	**177**	**4,027**	**196**	**346**	**972**	**2,971**

Number of inspections of credit institutions and branches conducted by the Bank of Russia in 2003

TABLE 2

No.	Federal District	Number of planned inspections	Actual number of inspections				Comprehensive inspections	Selective inspections
			total	credit institutions	branches of credit institutions based in the region	branches of credit institutions based in other regions		
1	Central Federal District (excluding Moscow and Moscow Region)	181	329	87	40	202	107	222
2	Northwestern Federal District	145	317	117	19	181	81	236
3	Southern Federal District	228	350	153	46	151	136	214
4	Volga Federal District	180	295	123	25	147	121	174
5	Ural Federal District	94	99	37	36	26	67	32
6	Siberian Federal District	153	255	79	23	153	77	178
7	Far Eastern Federal District	92	152	46	16	90	51	101
8	Moscow and Moscow Region	268	383	344	10	29	235	148
	TOTAL	**1,341**	**2,180**	**986**	**215**	**979**	**875**	**1,305**

Dynamics of the the key macroeconomic indicators in 2001—2003

TABLE 3

	2001	2002	2003
Gross Domestic Product, billion rubles	8,943.6	10,834.2	13,285.2
Real GDP growth rates (as % of previous year)	105.1	104.7	107.3
GDP deflator index, %	116.5	115.7	114.3
Federal budget surplus, % of GDP	3.0	1.4	1.7
Industrial output (as % of previous year)	104.9	103.7	107.0
Agricultural output (as % of previous year)	107.5	101.5	101.5
Retail trade turnover (as % of previous year)	111.0	109.3	108.4
Fixed capital investment (as % of previous year)	110.0	102.8	112.5
Labour productivity (as % of previous year)	104.7	102.3	107.8
Real disposable money income (as % of previous year)	108.7	111.0	114.6
Unemployment rate as % of economically active population, calculated by ILO methodology (average for period)	9.0	8.0	8.3
Consumer price index (December to December), %	118.6	115.1	112.0
Ruble/US dollar nominal rate, average for period	29.17	31.35	30.68

Quantitative characteristics of Russian credit institutions (numbers)

TABLE 4

Indicator	01.01.03	01.04.03	01.07.03	01.10.03	01.01.04
Credit institutions registered by the Bank of Russia and other authorities	1,828	1,806	1,764	1,699	1,668
Operating credit institutions (credit institutions with banking licences)	1,329	1,335	1,332	1,330	1,329
Bank of Russia-registered credit institutions that have not yet paid in authorised capital and have not received licences (within time period set by law)	8	2	3	4	4
Credit institutions whose banking licences have been revoked (cancelled)	491	469	429	365	335
Credit institutions with licences to conduct operations in foreign currency	839	843	846	843	845
Credit institutions with general licences	293	298	300	304	310

Provision of Russian regions with banking services as of January 1, 2004

TABLE 5

Region	No. of credit institutions	No. of branches	Assets (net), million rubles	Loans and other placements with non-financial enterprises and organisations, million rubles	Deposit accounts and other funds taken from private individuals, million rubles	Gross Regional Product for 2003, billion rubles (estimate)	Population as of 01.01.04, thou (estimate)	Per capita income (monthly average for 2003 Q4), rubles	Institutional saturation with banking services (by population)	Financial saturation with banking services (by assets)	Financial saturation with banking services (by lending volume)	Savings business development index (per capita deposits to incomes)	Composite index of region's provision with banking services*
1	2	3	4	5	6	7	8	9	10	11	12	13	14
Central Federal District (excluding Moscow and Moscow Region)	**73**	**417**	**235,346**	**110,123**	**132,818**	**1,022**	**20,775**	**3,694**	**0.83**	**0.98**	**1.08**	**1.13**	**1.00**
Belgorod Region	6	29	19,242	12,766	11,293	80	1,512	4,029	0.82	1.03	1.60	1.21	1.13
Bryansk Region	2	20	10,015	3,204	6,183	48	1,365	3,622	0.57	0.90	0.67	0.82	0.73
Vladimir Region	3	31	15,839	9,424	9,795	67	1,508	3,247	0.80	1.01	1.41	1.31	1.10
Voronezh Region	4	34	40,586	17,096	18,218	94	2,357	3,759	0.57	1.84	1.82	1.34	1.26
Ivanovo Region	5	18	8,903	2,222	5,342	33	1,134	2,432	0.72	1.15	0.68	1.27	0.92
Kaluga Region	6	30	12,088	4,667	7,159	51	1,030	3,620	1.23	1.02	0.92	1.25	1.10
Kostroma Region	5	17	6,569	2,169	4,043	35	729	3,279	1.07	0.79	0.62	1.10	0.87
Kursk Region	2	18	10,803	6,090	6,501	57	1,219	3,760	0.58	0.81	1.07	0.93	0.83
Lipetsk Region	2	17	14,417	7,899	7,776	76	1,202	4,249	0.56	0.81	1.04	0.99	0.83
Orel Region	2	22	7,698	2,993	4,548	46	852	3,703	0.99	0.72	0.66	0.94	0.81
Ryazan Region	5	23	12,367	4,564	8,052	65	1,212	3,604	0.82	0.80	0.70	1.20	0.86
Smolensk Region	4	29	12,657	6,334	6,532	57	1,036	4,016	1.12	0.94	1.10	1.03	1.05
Tambov Region	2	20	8,616	4,769	5,641	50	1,163	3,991	0.67	0.74	0.96	0.79	0.78
Tver Region	8	36	11,582	3,056	7,247	76	1,451	3,045	1.07	0.65	0.40	1.07	0.74
Tula Region	6	39	17,594	10,748	11,819	82	1,651	3,732	0.96	0.91	1.30	1.25	1.09
Yaroslavl Region	11	34	26,370	12,122	12,668	106	1,354	4,786	1.17	1.06	1.15	1.28	1.16
Northwestern Federal District	**86**	**373**	**402,740**	**169,899**	**155,569**	**1,123**	**13,865**	**6,015**	**1.17**	**1.53**	**1.51**	**1.22**	**1.35**
Republic of Karelia	1	24	7,812	5,396	4,467	51	710	5,295	1.24	0.66	1.06	0.78	0.91
Komi Republic	6	40	18,266	4,666	12,276	132	1,008	7,885	1.61	0.59	0.35	1.01	0.76
Arkhangelsk Region	4	27	15,126	8,827	8,900	101	1,321	5,068	0.83	0.64	0.87	0.87	0.79
Vologda Region	8	31	25,498	9,944	11,083	104	1,259	5,041	1.09	1.04	0.96	1.14	1.06
Kaliningrad Region	12	32	18,028	6,487	9,042	47	950	4,223	1.63	1.65	1.39	1.47	1.53
Leningrad Region	2	42	13,778	4,246	9,675	120	1,663	3,528	0.93	0.49	0.35	1.08	0.65
Murmansk Region	4	28	18,421	6,770	12,237	88	883	7,161	1.28	0.89	0.77	1.26	1.03
Novgorod Region	2	19	6,024	2,257	3,663	41	685	4,002	1.08	0.62	0.54	0.87	0.75
Pskov Region	4	13	5,535	1,688	3,353	31	750	3,530	0.80	0.77	0.55	0.83	0.73
St Petersburg	43	117	274,252	119,618	80,874	410	4,636	7,993	1.22	2.85	2.92	1.43	1.95

CONT.

1	2	3	4	5	6	7	8	9	10	11	12	13	14
Southern Federal District	**137**	**466**	**209,161**	**88,525**	**111,950**	**904**	**21,761**	**4,068**	**0.98**	**0.98**	**0.98**	**0.83**	**0.94**
Republic of Adygeya	5	6	2,478	455	1,689	10	445	2,872	0.87	1.04	0.45	0.86	0.77
Republic of Daghestan	38	75	5,058	804	1,395	47	2,604	2,833	1.53	0.46	0.17	0.12	0.35
Republic of Ingushetia	2	5	523	98	135	7	476	1,693	0.52	0.30	0.13	0.11	0.22
Kabardino-Balkar Republic	7	9	3,577	1,456	2,000	32	899	3,717	0.63	0.48	0.46	0.39	0.48
Republic of Kalmykia — Khalmg Tangch	3	4	1,153	360	439	18	291	2,521	0.85	0.28	0.20	0.39	0.37
Karachai-Circassian Republic	6	5	1,438	845	845	11	438	3,126	0.89	0.56	0.77	0.40	0.63
Republic of North Ossetia	6	17	5,113	1,279	2,730	22	707	4,015	1.15	1.00	0.58	0.63	0.81
Krasnodar Territory	23	101	63,698	31,463	38,426	274	5,109	4,398	0.86	0.99	1.15	1.12	1.02
Stavropol Territory	11	54	30,684	11,875	18,123	108	2,722	3,737	0.84	1.21	1.09	1.16	1.07
Astrakhan Region	4	28	10,369	2,511	6,278	54	1,003	4,386	1.13	0.81	0.46	0.93	0.79
Volgograd Region	6	58	28,040	11,308	15,767	135	2,681	4,320	0.84	0.89	0.84	0.89	0.86
Rostov Region	26	103	56,357	26,005	24,096	186	4,375	5,068	1.04	1.29	1.40	0.71	1.07
Volga Federal District	**154**	**631**	**528,794**	**241,973**	**220,026**	**2,088**	**30,946**	**4,493**	**0.90**	**1.08**	**1.16**	**1.03**	**1.04**
Republic of Bashkortostan	13	44	81,281	24,354	23,691	277	4,091	4,969	0.49	1.25	0.88	0.76	0.80
Republic of Marii El	1	25	3,645	1,397	2,306	23	723	2,503	1.27	0.67	0.61	0.83	0.81
Republic of Mordovia	5	17	7,442	3,142	3,452	36	879	3,221	0.88	0.88	0.87	0.80	0.86
Republic of Tatarstan	26	98	90,618	46,608	31,758	325	3,773	4,975	1.16	1.19	1.43	1.11	1.22
Udmurt Republic	10	28	22,416	13,378	8,631	102	1,563	3,476	0.86	0.93	1.31	1.04	1.02
Chuvash Republic	5	20	9,627	5,658	5,687	50	1,307	3,089	0.67	0.82	1.13	0.92	0.87
Kirov Region	3	26	12,354	5,307	7,455	65	1,484	3,395	0.69	0.81	0.81	0.97	0.81
Nizhni Novgorod Region	19	83	72,911	33,714	32,844	249	3,487	4,545	1.03	1.24	1.35	1.35	1.24
Orenburg Region	11	39	23,509	8,312	11,884	134	2,163	3,650	0.82	0.75	0.62	0.98	0.78
Penza Region	2	28	12,162	3,318	7,469	51	1,439	3,153	0.74	1.01	0.64	1.08	0.85
Perm Region	11	52	55,223	26,146	23,341	276	2,801	5,856	0.79	0.85	0.94	0.93	0.88
Samara Region	24	77	93,161	50,618	36,941	304	3,221	6,625	1.11	1.31	1.67	1.13	1.28
Saratov Region	18	67	33,117	14,269	17,157	134	2,648	3,878	1.13	1.05	1.06	1.09	1.08
Ulyanovsk Region	6	27	11,327	5,751	7,411	61	1,367	3,292	0.85	0.80	0.95	1.08	0.91
Ural Federal District	**76**	**417**	**320,986**	**109,595**	**133,189**	**1,800**	**12,328**	**7,063**	**1.41**	**0.76**	**0.61**	**1.00**	**0.90**
Kurgan Region	6	24	5,494	2,067	3,089	37	1,007	3,504	1.05	0.62	0.55	0.57	0.67
Sverdlovsk Region	30	128	109,675	54,731	43,429	320	4,459	6,074	1.25	1.46	1.71	1.05	1.35
Tyumen Region	27	166	152,747	29,575	62,336	1,217	3,281	12,377	2.08	0.53	0.24	1.00	0.72
Chelyabinsk Region	13	99	53,069	23,222	24,334	225	3,581	4,428	1.10	1.00	1.03	1.00	1.03

END

1	2	3	4	5	6	7	8	9	10	11	12	13	14
Siberian Federal District	**80**	**417**	**261,830**	**118,899**	**126,430**	**1,314**	**19,929**	**4,842**	**0.88**	**0.85**	**0.90**	**0.86**	**0.87**
Republic of Altai	5	2	1,220	431	521	8	203	3,681	1.22	0.62	0.51	0.46	0.65
Republic of Buryatia	2	27	8,073	2,073	3,532	46	976	4,201	1.05	0.75	0.45	0.56	0.67
Republic of Tyva	3	4	876	184	483	7	307	3,483	0.80	0.50	0.24	0.29	0.41
Republic of Khakassia	3	11	3,470	486	2,112	30	543	4,026	0.91	0.50	0.16	0.63	0.47
Altai Territory	9	54	26,643	14,194	11,852	95	2,587	3,657	0.86	1.19	1.49	0.82	1.06
Krasnoyarsk Territory	9	76	44,627	15,064	24,253	354	2,945	6,261	1.02	0.54	0.43	0.86	0.67
Irkutsk Region	10	61	33,047	15,057	18,093	189	2,565	4,811	0.98	0.74	0.79	0.96	0.86
Kemerovo Region	11	34	31,947	17,512	18,374	173	2,878	5,457	0.55	0.79	1.01	0.76	0.76
Novosibirsk Region	14	44	55,458	26,690	18,975	159	2,676	4,180	0.77	1.49	1.68	1.11	1.21
Omsk Region	8	44	30,098	16,705	13,809	103	2,061	5,233	0.89	1.24	1.61	0.84	1.10
Tomsk Region	4	29	17,641	9,434	9,989	95	1,041	5,877	1.12	0.79	0.99	1.07	0.98
Chita Region	2	31	8,731	1,069	4,438	54	1,147	3,797	1.02	0.68	0.20	0.67	0.55
Far Eastern Federal District	**44**	**206**	**116,859**	**45,609**	**60,498**	**586**	**6,640**	**6,478**	**1.33**	**0.85**	**0.78**	**0.92**	**0.95**
Republic of Sakha (Yakutia)	6	53	17,088	5,878	9,342	149	948	10,113	2.20	0.49	0.39	0.64	0.72
Primorskiy (Maritime) Territory	10	40	28,077	11,602	14,377	110	2,052	4,800	0.86	1.09	1.06	0.95	0.99
Khabarovsk Territory	6	27	30,219	13,908	15,677	122	1,428	6,746	0.82	1.06	1.14	1.06	1.01
Amur Region	5	18	8,413	3,319	4,426	58	896	4,499	0.91	0.62	0.57	0.72	0.69
Kamchatka Region	8	16	8,217	3,180	4,875	34	356	7,546	2.38	1.02	0.93	1.19	1.28
Magadan Region	3	18	9,075	3,569	3,085	23	179	8,402	4.13	1.67	1.54	1.34	1.94
Sakhalin Region	6	21	12,455	3,167	6,616	72	539	8,096	1.77	0.74	0.44	0.99	0.87
Jewish Autonomous Region	0	6	1,154	339	768	7	190	4,438	1.11	0.69	0.48	0.59	0.68
Chukchee Autonomous Area	0	7	2,163	648	1,332	12	52	9,876	4.73	0.80	0.56	1.69	1.37
Total (excluding Moscow and Moscow Region)	**650**	**2,927**	**2,075,715**	**884,624**	**940,480**	**8,837**	**126,245**	**4,866**	**1.00**	**1.00**	**1.00**	**1.00**	**1.00**

** Calculated according to the methodology of the Bank of Russia Banking Regulation and Supervision Department.*

TABLE 6

Some performance indicators of credit institutions with foreign interest relative to indicators of operating credit institutions (%)

	01.07.98	01.01.01	01.01.02	01.01.03	01.07.03	01.01.04
Credit institutions with a 50%-plus foreign stake						
Assets	6.7	9.5	8.8	8.1	7.2	7.4
Own funds	5.0	9.4	7.7	7.1	6.7	6.6
Correspondent accounts in non-resident banks	6.4	15.6	20.0	22.9	21.4	19.7
Loans and other placements with non-financial enterprises and organisations, including non-resident corporate entities	8.8	7.1	7.2	7.1	6.6	6.1
Loans, deposits and other placements with banks	14.6	33.0	31.3	25.9	22.1	22.0
Funds in household accounts	0.7	1.8	2.2	2.2	2.1	2.2
including deposit accounts and other funds	0.7	1.7	2.3	2.3	2.2	2.2
Enterprise sector funds*	7.2	14.0	11.7	10.4	9.5	9.3
of which wholly-foreign owned credit institutions						
Assets	4.7	5.1	5.2	5.6	5.2	5.6
Own funds	3.4	6.2	5.2	5.4	5.3	5.4
Correspondent accounts in non-resident banks	3.2	9.0	10.5	19.2	17.2	16.8
Loans and other placements with non-financial enterprises and organisations, including non-resident corporate entities	6.9	5.5	5.2	5.5	5.1	4.6
Loans, deposits and other placements with banks	8.4	13.2	20.4	16.3	15.7	17.0
Funds in household accounts	0.2	1.0	1.4	1.5	1.4	1.5
including deposit accounts and other funds	0.2	1.0	1.5	1.5	1.4	1.5
Enterprise sector funds*	3.4	5.5	5.3	5.5	5.4	5.7

** These include deposit accounts, government extrabudgetary funds, funds of the Finance Ministry, financial agencies and clients in factoring and forfeiting operations, float, and funds written down from clients' accounts which have not passed through a credit institution's correspondent account.*

Structure of banking sector liabilities by source of funds (billion rubles)

TABLE 7

	Liabilities	01.01.03	01.04.03	01.07.03	01.10.03	01.01.04
1	Bank funds and profits, total	652.5	755.7	741.4	775.5	834.3
	of which					
1.1	Bank funds	625.0	629.1	672.6	688.8	719.6
1.2	Profit (loss), including financial results of previous years	27.4	126.6	68.8	86.7	114.7
	of which					
1.2.1	Reporting year's profit (loss)	93.0	47.8	78.6	99.1	128.4
2	Loans, deposits and other funds received by credit institutions from the Bank of Russia	6.2	5.3	3.6	3.6	0.1
3	Bank accounts, total	176.5	171.4	184.3	180.5	202.3
	of which					
3.1	Correspondent credit institutions' correspondent accounts	111.0	114.5	117.4	107.9	118.4
3.2	Non-resident banks' correspondent accounts	63.7	53.8	62.6	68.6	78.6
4	Loans, deposits and other funds received from other banks, total	315.4	321.4	368.6	397.0	525.3
	of which					
4.1	Overdue debt	17.6	3.5	3.4	3.5	3.1
5	Customers' funds, total	2,194.5	2,404.0	2,621.9	2,876.7	2,999.6
	of which					
5.1	Budget funds in settlement and current accounts	42.3	62.6	73.8	90.1	56.3
5.2	Government extrabudgetary funds in settlement and current accounts	27.0	18.9	22.4	22.7	22.3
5.3	Corporate funds in settlement, current and other accounts	735.0	788.7	881.7	948.0	978.5
5.4	Customer float	11.8	50.9	53.1	58.7	22.9
5.5	Corporate deposit accounts	276.7	278.4	258.6	305.3	312.5
5.6	Personal accounts	1,060.7	1,171.8	1,287.8	1,406.2	1,558.5
	of which					
5.6.1	Deposits and other funds taken from private individuals	1,029.6	1,140.3	1,253.7	1,368.4	1,514.4
5.7	Other borrowed funds	39.7	32.2	43.9	45.1	48.4
5.8	Customers' funds in factoring and forfeiting operations	0.2	0.1	0.1	0.1	0.3
5.9	Funds debited from customers' accounts which have not been entered over a credit institution's correspondent account	0.9	0.4	0.5	0.4	0.0
6	Debt instruments issued by banks, total	450.6	498.2	552.7	577.4	634.5
	of which					
6.1	Bonds	7.4	10.6	13.7	13.9	13.8
6.2	Certificates of deposit	66.6	76.2	90.8	104.4	148.2
6.3	Savings certificates	1.1	1.3	1.4	1.4	1.7
6.4	Promissory notes and bank acceptances	372.4	405.6	440.9	452.7	466.0
7	Other liabilities, total	349.6	358.5	395.7	417.5	404.5
	of which					
7.1	Reserves	168.3	179.0	195.0	207.9	216.6
7.2	Float	110.8	118.9	130.5	128.3	118.1
7.3	Creditors	8.1	8.6	14.8	22.9	8.2
7.4	Fixed and intangible asset depreciation	27.2	18.6	20.1	21.9	23.9
7.5	Deferred income	27.3	26.5	28.0	28.1	30.1
Total liabilities		**4,145.3**	**4,514.6**	**4,868.2**	**5,228.2**	**5,600.7**

Structure of banking sector assets by form of investment (billion rubles)

TABLE 8

	Assets	01.01.03	01.04.03	01.07.03	01.10.03	01.01.04
1	Money, precious metals and gemstones, total	91.2	94.6	102.6	104.0	137.9
1.1	of which money	88.1	92.2	97.6	97.0	133.5
2	Accounts in the Bank of Russia, total	416.8	415.4	484.2	413.1	658.6
	of which					
2.1	Credit institutions' correspondent accounts in the Bank of Russia	164.5	128.8	155.3	142.6	296.1
2.2	Credit institutions' required reserves transferred to the Bank of Russia	200.7	218.8	238.6	254.6	267.4
2.3	Deposit accounts with the Bank of Russia	47.4	61.4	80.4	5.1	87.3
3	Correspondent accounts in credit institutions, total	300.9	281.9	267.4	350.3	305.6
	of which					
3.1	Correspondent accounts in correspondent credit institutions	106.7	104.7	116.6	113.7	123.8
3.2	Correspondent accounts in non-resident banks	194.2	177.2	150.8	236.6	181.8
4	Securities acquired by banks, total*	779.9	980.4	1,080.7	1,053.1	1,002.2
	of which					
4.1	Debt obligations	502.6	666.4	710.9	660.5	625.1
	of which					
4.1.1	Debt obligations of the Russian Federation	412.8	478.2	541.4	491.7	447.0
4.2	Stocks and shares	68.7	78.2	101.6	127.8	115.8
	of which					
4.2.1	Controlling shareholdings	17.4	18.3	20.0	15.9	17.4
4.3	Discounted promissory notes	208.5	235.8	268.2	264.8	261.3
5	Other participation in authorised capital	4.7	4.2	4.6	4.6	4.2
6	Loan debt, total	2,148.8	2,298.4	2,502.2	2,861.2	3,048.0
	of which					
6.1	Loans, deposits and other placements	2,146.2	2,297.3	2,501.3	2,860.6	3,047.4
	including overdue debt	40.5	44.2	46.6	43.3	48.0
	of which					
6.1.1	Loans and other placements with non-financial enterprises and organisations	1,654.0	1,768.5	1,919.4	2,179.4	2,385.0
	including overdue debt	29.0	32.7	35.9	32.1	37.2
6.1.2	Loans, deposits and other placements with banks	291.4	304.4	283.4	333.1	263.7
	including overdue debt	9.0	8.8	7.5	7.8	6.9
6.2	Financing of government programmes and capital investment on a repayable basis	2.7	1.1	0.9	0.6	0.6
7	Fixed assets, intangible assets and inventories	157.2	152.4	160.2	167.6	179.0
8	Disposition of profit	55.1	58.9	12.6	17.8	25.3
9	Other assets, total	190.7	228.3	253.7	256.5	239.9
	of which					
9.1	Float	100.8	121.2	137.5	138.5	120.8
9.2	Debtors	21.7	22.2	24.0	24.2	22.9
9.3	Overdue interest on loans	3.4	3.2	3.2	3.0	3.7
9.4	Deferred expenses	51.5	68.8	74.8	76.9	77.1
Total assets		**4,145.3**	**4,514.6**	**4,868.2**	**5,228.2**	**5,600.7**

** Including controlling shareholdings.*

Main characteristics of banking sector lending operations (billion rubles)

TABLE 9

		Rubles					Foreign currency					Total				
		01.01.03	01.04.03	01.07.03	01.10.03	01.01.04	01.01.03	01.04.03	01.07.03	01.10.03	01.01.04	01.01.03	01.04.03	01.07.03	01.10.03	01.01.04
1.	Loans, deposits and other placements, total	1,319.7	1,413.5	1,620.1	1,802.4	1,987.6	826.5	883.8	881.1	1,058.3	1,059.8	2,146.2	2,297.3	2,501.3	2,860.6	3,047.4
	of which overdue debt	24.9	29.6	29.7	29.0	32.4	15.6	14.6	16.8	14.3	15.6	40.5	44.2	46.6	43.3	48.0
1.1.	Loans and other placements with resident non-financial enterprises and organisations	1,044.2	1,107.1	1,249.2	1,379.6	1,516.9	547.2	595.4	599.6	717.7	749.9	1,591.4	1,702.5	1,848.8	2,097.4	2,266.9
	of which overdue debt	18.0	22.3	23.5	22.6	25.8	10.5	9.9	11.6	8.8	10.1	28.4	32.2	35.1	31.4	35.8
1.2.	Loans and other placements with non-resident corporate entities, except banks	3.4	3.0	2.9	6.4	27.1	59.2	63.0	67.6	75.6	91.0	62.6	66.0	70.6	82.0	118.2
	of which overdue debt	0.24	0.24	0.24	0.25	0.25	0.33	0.27	0.52	0.49	1.08	0.58	0.51	0.76	0.74	1.33
1.3.	Loans, deposits and other placements with financial sector	103.5	117.1	129.7	136.5	129.9	45.0	52.6	56.9	61.3	61.2	148.4	169.7	186.6	197.8	191.1
	of which overdue debt	5.2	5.4	4.1	4.0	3.9	0.4	0.1	0.2	0.1	0.1	5.6	5.4	4.3	4.1	3.9
1.3.1.	Loans, deposits and other placements with resident credit institutions	85.1	99.0	101.1	105.4	95.5	34.7	43.0	43.3	47.6	47.5	119.9	141.9	144.5	152.9	143.0
	of which overdue debt	5.2	5.3	4.1	4.0	3.8	0.3	0.0	0.2	0.0	0.0	5.6	5.3	4.2	4.0	3.8
1.3.2.	Loans, deposits and other placements with resident financial organisations of different forms of ownership	18.3	18.1	28.6	31.1	34.5	10.2	9.6	13.6	13.7	13.6	28.6	27.7	42.1	44.8	48.1
	of which overdue debt	0.01	0.05	0.02	0.03	0.02	0.05	0.05	0.05	0.05	0.06	0.06	0.10	0.07	0.07	0.08
1.4.	Loans, deposits and other placements with non-resident banks	25.0	22.1	21.0	23.9	20.3	146.6	140.3	117.9	156.3	100.5	171.5	162.4	138.9	180.2	120.7
	of which overdue debt	0.01	0.01	0.01	0.01	0.01	3.45	3.45	3.30	3.77	3.09	3.46	3.46	3.31	3.78	3.10
1.5.	Loans and other funds provided to government financial agencies and extrabudgetary funds	27.8	35.7	43.3	46.7	46.8	2.1	2.4	2.5	2.3	3.4	29.9	38.1	45.8	48.9	50.1
	of which overdue debt	0.28	0.25	0.20	0.13	0.17	0.02	0.02	0.15	0.11	0.10	0.30	0.27	0.36	0.24	0.27
1.6.	Loans extended to resident individuals	115.8	128.4	173.8	209.0	246.1	25.3	28.8	35.2	43.5	52.2	141.2	157.1	208.9	252.5	298.4
	of which overdue debt	1.2	1.4	1.7	2.0	2.4	0.7	0.7	0.8	0.9	1.0	1.9	2.1	2.5	2.8	3.4
1.7.	Loans extended to non-resident individuals	0.1	0.0	0.1	0.0	0.1	0.9	1.1	1.0	1.2	1.3	1.0	1.1	1.1	1.2	1.3
	of which overdue debt	0.00	0.00	0.00	0.00	0.00	0.21	0.22	0.21	0.22	0.21	0.21	0.22	0.21	0.22	0.21
	For the record:															
	Overdue interest on loans, deposits and other placements with residents	1.8	1.8	1.7	1.3	1.5	1.6	1.5	1.5	1.6	2.2	3.4	3.2	3.2	3.0	3.7
	Overdue interest on loans, deposits and other placements with non-residents	0.00	0.00	0.00	0.00	0.00	0.01	0.00	0.00	0.00	0.00	0.01	0.00	0.00	0.00	0.00
	Credit institutions' investments in residents' promissory notes	187.9	212.5	243.4	238.2	237.9	9.8	11.3	16.6	18.4	17.5	197.6	223.8	260.1	256.6	255.4
	Credit institutions' investments in non-residents' promissory notes	1.4	2.2	2.2	3.4	1.2	9.5	9.8	6.0	4.8	4.7	10.9	12.1	8.1	8.2	5.9

Return on capital in key sectors of the Russian economy in 2003

TABLE 10

Sector	Return on capital*, %
Electric-power industry	2.0
Fuel sector	17.5
Trade and public catering	14.8
Communications	34.5
Transport	6.0
Ferrous metallurgy	32.4
Non-ferrous metallurgy	21.3
Food industry	19.3
Woodworking and pulp-and-paper industry	7.5
Building materials industry	15.8
Construction	10.4
Machine-building and metalworking	8.5
Chemical and petrochemical industry	9.9
Light industry	—5.8
Economy as a whole	**10.8**
Banking sector**	15.8

Source: data on sectors of the economy have been compiled by Goskomstat and on banking sector by the Bank of Russia.

** The return on capital is calculated as the ratio of profit net of loss to capital and reserves. Capital and reserves comprise authorised capital, additional capital, reserve capital, social security fund, targeted allocations and receipts, retained profit and uncovered loss of previous years and accounting period.*

*** Calculated by the Bank of Russia according to Goskomstat methodology. The return on capital is calculated as the ratio of banking sector profit to own funds (capital) as of the end of 2003.*

Credit institutions grouped by liquidity coverage deficit*

TABLE 11

Indicator	No. of credit institutions					% share in aggregate banking sector assets				
	01.01.03	01.04.03	01.07.03	01.10.03	01.01.04	01.01.03	01.04.03	01.07.03	01.10.03	01.01.04
Less than 0%	659	638	601	618	671	24.0	21.1	18.4	17.0	31.2
From 0 to 20%	422	402	440	434	420	22.0	30.5	24.3	21.7	21.0
More than 20%	244	291	286	273	234	54.1	48.5	57.3	61.3	47.9
Data unavailable	4	4	5	5	4	0.0	0.0	0.0	0.0	0.0
TOTAL	**1,329**	**1,335**	**1,332**	**1,330**	**1,329**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Calculated as prescribed by Form No. 125 "Information on Assets and Liabilities by Call Date and Term of Payment" (Annex No. 17 to Bank of Russia Instruction No. 17, dated October 1, 1997, "On Compiling Financial Statements").

** The liquidity coverage deficit is the ratio of the excess of demand liabilities and liabilities with maturity up to 30 days over assets with the same terms to the total value of the above liabilities.*

Financial rehabilitation and liquidation of credit institutions

TABLE 12

Indicator	As of 01.01.03	As of 01.01.04
1. Number of credit institutions liable to insolvency (bankruptcy) prevention measures under Article 4 of the Federal Law "On the Insolvency (Bankruptcy) of Credit Institutions"	26	20
2. Number of credit institutions carrying out financial rehabilitation measures	18	10
3. Number of credit institutions which allowed their own funds (capital) to become smaller than authorised capital	9	7
4. Number of provisional administrations of credit institutions	15	5
5. Number of credit institutions controlled by ARCO	3	1
6. Number of credit institutions slated for liquidations, of which:	491	336
— Number of credit institutions whose liquidation has been completed but not yet registered	147	92
— Number of credit institutions on which no liquidation decision has yet been taken	23	6
7. Number of bank receivers' (liquidators') certificates issued/extended in 2003	111/394	

THE CENTRAL BANK
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Banking Supervision Report 2003