ANALYSIS

Russian Investment Regulation: Lessons of Bank Deposit Insurance Reform

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Abstract

Russia's bank deposit insurance program demonstrates that, contrary to widespread belief, the federal government is capable of effective financial industry regulation. This mandatory program, instituted in 2004, may in its broad outline prefigure how investment industry regulation will unfold in Russia, possibly in the not-too-distant future.

One Successful Reform

Russia's poor performance on every aspect of investment regulation—shareholder rights, enforceability of contracts, insider trading, corporate transparency and disclosure, etc.—is well documented and analyzed. At times, the prospects for reform seem hopeless, buried by centuries of centralized control, pervasive corruption, and a culture of "legal nihilism."

There is, however, an area of financial regulation that has been successful in Russia during the Putin era—the bank deposit insurance program. Little attention has been paid to this program, perhaps because the security of small retail depositors is not a terribly exciting subject. The deposit insurance program provides a window, however, into how effective Russian regulation can be when the political will exists to support it. While the program is significant in itself, it may also prefigure how meaningful investment reform may come about.

Bank Deposit Insurance: The Basics

Under the bank insurance program, deposits of private citizens are insured up to 700,000 rubles at almost 1,000 banks. Similar to the US Federal Deposit Insurance Corporation (FDIC) in design and implementation, the program is meant to mobilize domestic savings that traditionally have remained hidden (most often in hard currency) under the mattress. The insurance is covered by premiums paid by member banks. Membership in the system is mandatory.

The Agency for Bank Insurance (Agenstvo po strakhovaniyu vkladov, www.asv.org.ru), created in 2004, is a joint venture of the Russian Ministry of Finance and the Central Bank. The Agency, as administrator of the insurance fund, has the authority to put banks into bankruptcy for failing to meet Agency criteria. To date, the Agency has closed 176 banks since 2005, and has placed 111 banks in the process of liquidation. Another 15 banks are either in the process of being "sanitized," or have recently completed the process. Assets of the liquidated banks are sold under a bankruptcy procedure.

The Agency's Chairman is the Minister of Finance. Funding for support of bank stability is reported to be 300 billion rubles ($11 billion), a small sum in most banking systems. Russian banks are, however, much smaller in general than Western banks: the ten largest banks in Russia have combined assets of $525 billion equivalent, slightly larger than the reported assets of the 49th largest world bank, Toronto Dominion Bank. (http://www.bankersalmanac.com/addcon/infobank/bank-rankings.aspx)

Deposit Insurance: National Patterns

Russian banking remains, twenty five years after the start of perestroika, heavily centralized in Moscow and the Moscow region. Nearly half of the insured banks—476—are based in Moscow or Moscow Oblast (see Table 1). After Moscow, the next nine regions with the highest number of insured banks have between them 24% of the total, leaving 26% of the nation's deposit-taking banks scattered across the remaining 72 administrative units.

Table 1: Russian Deposit-Taking Banks: Eleven Largest Regions

Moscow and Moscow Oblast	476
Petersburg	36
Dagestan	27
Tatarstan	24
Sverdlovsk	20
Samara	20
Rostov	18
Nizhny Novgorod	17
Tyumen	16
Krasnodar	15

Source: asv.org.ru

The dominant bank in the Russian system, Sberbank, is present in every jurisdiction. As both the largest savings institution in the country (its role in the Soviet era), and the largest corporate lender, Sberbank dwarfs the other institutions. Its assets are roughly $270 billion, nearly 50 percent of the total assets for the ten largest banks in Russia (see Table 2). Combined with state-owned VTB (the prior Vneshtorgbank, or Bank for External Trade), with assets of $95 billion, of which $27 billion roll up under the retail subsidiary VTB 24, these two banks control two thirds of the total bank assets for the ten largest banks. Excluding the two foreign-owned banks in the top ten—Unicredito and Raiffeisen—removes $30 billion of the top ten assets, leaving the banking system even more heavily skewed (70 percent) to the two giant state institutions, Sberbank and VTB.

The areas with the highest concentration of banks include major industrial regions—Sverdlovsk, Samara, Rostov—and regions oriented toward resources, notably oil—Tyumen and Krasnodar. Dagestan is both a resource region and has an active economic relationship with Central Asia and the Caucasus.

Several resource-rich or industrial regions are not represented in the top ten, a possible indication of the regional elites' relative political weakness. None of the Siberian or Far East regions figure in the top ten for number of banks.

The Accredited Banks

Among the banking insurance program members, the Agency for Bank Insurance has appointed 59 banks as agents of the insurance program (see Table 3). These banks have a privileged status. When the Agency decides that a bank has failed to perform adequately under the insurance program, these accredited banks are responsible for carrying out the liquidation of the assets. Banks compete in a tender process to act as liquidator, a role that allows the bank to see the failed bank's holdings and quite possibly to acquire assets or deposits in the liquidation. Agent status also reflects confidence at the Central Bank that these banks will conform to the requirements of the regulatory system, and carry out orderly liquidations without creating scandal or in other ways discrediting the system. In that sense, these banks—representing just six percent of the registered banks—are the "A" list of Russian retail banking. See http://www.asv.org.ru/accreditation/org_agent/bank/

These agent banks and the way in which they are spread across Russia's regions provides a window into the banking system and a perspective on financial regulation more broadly. In some respects, the agent bank pattern mirrors the pattern of bank registrations across the regions—that is, the banks accredited under the deposit insurance regime are heavily concentrated in the most heavily banked regions. 39 of 59 accredited banks, or 66 percent, are located in the ten regions with the most banks (see Table 4). And again Moscow is disproportionately represented—29 agent banks or half of the total are based in Moscow. As in the case of bank distribution, the ten largest regions for accredited agents have about 75% of the total, leaving 25% to be distributed thinly across the remaining jurisdictions.

Some of the larger regions by number of banks—Tyumen, Dagestan, and Rostov—have no accredited agent bank. This suggests that the agency is able to monitor the system effectively from Moscow (or through the local Sberbank resources) in even relatively large regions. It also suggests that there are no local banks that are considered strong enough to exercise fiduciary responsibility for the Central Bank in some of the major regions. And although there are no Far East regions in the top ten list by number of banks, three Far East regions—Amur, Kamchatka, and Sakha/Yakutia—each have two agent banks (as do Chelyabinsk and Saratov). Fiduciary responsibility is therefore somewhat more widely distributed than the purely quantitative distribution of banks would suggest.

Why Did Banking Insurance Succeed?

Bank deposit insurance has enjoyed significant success in Russia for a number of reasons. First, the most rudimentary functioning of the post-Communist era economy required a reliable system for processing transactions. Domestic payments, import trade transactions, clearing and settling securities trades all required stable and reliable processing capability. Second, mobilization of the savings of the population required confidence in the banking system. The 1998 market collapse left many citizens with a deep distrust of their own banks, as many of the banks closed and confiscated their deposits.

These two issues—the need for a stable transaction processing system and the desire to attract savings into bank accounts—set the stage for launching bank deposit insurance and with it, the first serious enforcement of bank regulation in Russia. Even though the need for a stable banking system was obvious, it was not a foregone conclusion that strong regulation should be implemented. Banks, especially those with hard currency licenses, were critical of the capital flight and asset stripping that prevailed in the Yeltsin years and had enriched many individuals. For much of the country, the lack of strong bank regulation and the opacity of most bank activity was essential to their continued self-enrichment.

It was dangerous to propose bank deposit insurance in the early 2000's—Andrei Kozlov, a first deputy Chairman of the Central Bank and a pioneer of deposit insurance, was fatally shot outside a Moscow stadium in September 2006 by gunmen allegedly hired by a disgruntled bank owner. Kozlov understood that bank deposit insurance required the ability to oversee banking activity, and he was known for withdrawing bank licenses when he found money laundering or other illicit activity.

But perhaps the strongest single reason for the success of bank deposit insurance is the political vulnerability that continued bank failures would ignite. Once a deposit insurance system is initiated, it must succeed or it creates unacceptable levels of risk for the political rulers. Thus, the bank deposit program was created as a mandatory program, with strong enforcement capability.

This decisive regulatory move suggests that Russia's ruling groups reached a consensus in the early 2000's that the days of using the banking system for personal enrichment were, if not over, at least fading fast. The banking system was simply too vital to the personal enrichment of the elite to allow continued abuse. There are of course no minutes of meetings that record how or when this consensus was reached, but it seems clear that Russia's informal system of overlapping and competing clans and interest groups reached agreement to regulate banks—or perhaps to accept the imposition of banking regulation—during the early Putin years.

Outlook for Investment Reform

If deposit insurance and bank regulation can be viewed as a major regulatory accomplishment, what will it take to convince Russia's elite that it is absolutely essential to their collective survival (and coincidentally, the nation's economic survival) that major investment market reforms be enacted and rigorously enforced?

The political consensus to reform the banking system coalesced in the wake of a major disaster. The 1998 default led to the wholesale incineration of the banks, staggering losses for foreign banks operating in the country, and the ostracism of Russian banks from operations in most of the world's major banking centers. Russia's historic lack of civil institutions makes the country vulnerable to moments of major crisis: change does not take place until the existing political infrastructure and the country is on the verge of disintegration.

To reach a reform consensus for the investment industry may take a collapse equally as devastating as the 1998 default. The 2008–2009 global crisis triggered major declines in the Russian securities market—stock prices dropped 75%, and several oligarchs found themselves unable to sustain their debt load given the decline in the underlying collateral. Bank liquidity dried up, and lending to corporations all but disappeared. But resurgent oil prices helped ameliorate the worst effects, and no serious reform ensued. One wing of the ruling elite, gathered around Medvedev, saw the implications but was powerless to force the situation to a genuine policy shift.

Further, investment reform lacks the immediacy for the general public that bank reform had. The public is less likely to take the leadership to task for investment abuse. Investment in public equities by the citizenry is still at a very low level, so losses in that market do not have the same resonance as a loss of savings does. The risk of widespread scandal resulting from corrupt practices in the equities markets therefore is still relatively low. The alleged theft of $230 million from Hermitage Capital's operating accounts and the subsequent death of Sergei Magnitsky in prison was a boldfaced example of how crude corrupt practices can be carried out without risk of widespread public outrage or governmental action (at least to this point).

As long as the population does not hold the leadership liable for the continued theft of resources, there is little risk that the political stability of the country will be adversely affected by the lack of reform. Sentencing an occasional corrupt individual for his/her crimes (the Luzhkovs come to mind) is sufficient to maintain the appearance of progress. Only if the top leadership were tied directly to an incidence of corruption that is simple enough for a large part of the population to understand is there significant risk of public anger and a need for fundamental reform.[1]

Increasingly, however, the old corrupt methods are bumping up against the grim reality of economic stagnation. Russia has fallen behind its peers in the emerging markets in terms of growth: market analysts argue regularly that the "BRIC" countries (Brazil, Russia, India China) should really be the "BIC" countries. Despite record oil prices and high commodity prices, economic growth remains in the four percent range; foreign direct investment remains at extremely low levels, and is focused largely on resource industries. Declining population, decrepit infrastructure, and an undeveloped technology sector all make Russia vulnerable to economic decline when so many of its neighbors in Asia and Europe are making solid progress.

Implementing Reform: The Broad Outlines

If a major scandal caught the public attention and mass demonstrations were to occur, it could precipitate a government decision to undertake a major reform. In that

1 Just prior to publication, Russian banking authorities authorized a massive bailout ($14 billion) to the Bank of Moscow, the country's fifth largest bank. The announcement has all the earmarks of a major power play in Moscow, rather than a failure of bank supervision. The bank was closely aligned with Mayor Luzhkov and his wife, and was the target of a hostile takeover by VTB Bank, a state-owned institution and the second largest bank in the country. The Bank of Moscow CEO fled to London immediately after the VTB attack was launched. Sixty billion rubles (over $2 billion) in loan proceeds have reportedly been sent offshore, and all loans to Luzhkov-linked entities are being treated as worthless. The Deposit Insurance Agency will be lent $10 billion equivalent by the Treasury. After "saving" the bank, VTB will control 75% of the former Bank of Moscow.

event, it is likely that the lessons of the bank deposit program would provide the blueprint for moving forward. First, the Ministry of Finance would put in place an organization like the insurance agency—a joint venture of the government with a securities regulator capable of liquidating the assets of companies that violated basic securities law. As in the case of deposit insurance, it is certain to be a heavily Moscow-oriented system in its earliest incarnation.

Second, the focus of reform in the initial phase will likely be state institutions—in the first instance, the state bureaucracy, followed closely by the state corporations (See Table 5). Medvedev's decision to remove members of the state hierarchy from the top management of state corporations is a step in this direction. Given the dominance of state institutions in Russia's economic life, the focus makes good sense. Sberbank and VTB dominate the banking system, and gave the Ministry of Finance a firm foundation for putting in place a mandatory deposit insurance program—roughly two thirds of all banking assets are in state-controlled banks. If the state apparatus can be "cleansed" in terms of the worst forms of corruption, and state-controlled corporations are forced to follow that model (interestingly, state ownership of the largest Russian corporations is roughly the same as the percent of bank assets under state control), the reform movement would have significant momentum for attacking the issues of corruption, transparency, and shareholder rights in the private sector.

Third, it is likely that regulatory reform would institute the same kind of mutual liability system that underlies the bank deposit program. Part of the success of banking reform lies in this "shared responsibility" aspect of the program—that is, all banks pay an insurance premium to cover the costs of failed banks. Bank managers have to worry that the sins of their neighbors will be visited upon them in the form of heightened insurance premiums. A similar kind of self-regulatory incentive would be needed in the securities industry in order to assure compliance.

None of this would come easily, and investment reform would be far more complex than the banking reform that allowed deposit insurance to succeed. For enforcement of investment laws, the government would need to change the compensation for judges. Only if the judges at all levels are given the possibility of living a life free from improper payments can one expect the justices to refuse the temptation of bribery. Justices would at that point have an incentive to protect the integrity of their profession, and a self-regulating environment would be cultivated.

To pay for an independent judiciary may require new taxes, just as the insurance system relies on insurance premiums from member banks. A tax on corporate profits or securities houses may inspire new capital flight, but it is likely that many of the more pragmatic businesspeople in Russia will realize that the benefits of instituting a vigorous anti-corruption regime will far outweigh the cost of funding independent justices at all levels.

Russia's government has proven it can act very effectively on regulation of financial services companies when the political will to do so exists. The alternative to action, as Russian history has shown on numerous occasions, is a full scale collapse of the political order in the face of mass political unrest. Russia's leaders know that pattern well, and are likely to see the introduction of a strong investment regulatory regime as the lesser of two evils. As the backwardness of Russia's economy presses ever more strongly on the political class, the choice will become that much more stark.

About the Author:
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Additional Reading

- Bank Insurance Law: www.asv.org.ru/en/legislation/law_1/law_dia.doc
- List of Accredited Banks: http://www.asv.org.ru/accreditation/org_agent/bank/
- World Experience with Deposit Insurance: http://www.asv.org.ru/insurance/experience/
  Deposit insurance currently exists in 106 countries. Over the last decade, the mandatory deposit insurance system was introduced in most post-socialist states, including all countries included in the European Community, as well as in Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan , Ukraine and Uzbekistan.
- Carsten Sprenger, "State-Owned Enterprises in Russia," Presentation at the OECD Roundtable on Corporate Governance of State-Owned Enterprises, Moscow, October 27, 2008, http://www.oecd.org/dataoecd/23/31/42576825.pdf

Table 2: Russian Banks: Top Ten by Assets (Stated in Billions of USD)

	Bank	City	Ruble Assets	USD Assets	State Controlled
1	Sberbank Rossii*	Moscow	7,492,012,807	$ 263,256,362	Yes
2	Bank VTB	St. Petersburg	2,646,496,899	$ 92,993,320	Yes
3	Gazprombank	Moscow	1,602,359,183	$ 56,304,128	Yes
4	Rossel'khozbank*	Moscow	981,582,663	$ 34,491,116	Yes
5	Bank Moskvy AKB*	Moscow	821,746,715	$ 28,874,757	Yes
6	VTB 24*	Moscow	750,417,278	$ 26,368,364	Yes
7	Al'fa-Bank*	Moscow	630,295,339	$ 22,147,487	No
8	YuniKredit Bank	Moscow	537,197,806	$ 18,876,201	Foreign
9	Rajffajzenbank	Moscow	481,217,452	$ 16,909,148	Foreign
10	Bank Uralsib*	Moscow	438,250,650	$ 15,399,369	No
Total assets:			*16,381,576,792*	*$ 549,251,889*	

**Accredited Bank for Insurance Agency*
VTB 24 capital is included in Bank VTB and is deducted from the grand total.
Source: Interfax

Table 3: Accredited Banks by Region and Rank, Agency for Insurance of Deposits, 2010

Bank	Region	Asset Rank	Capital Rank	Retained Profits Rank
Vostochnyi KB	Amur Oblast	48	55	34
Aziatsko-Tikhookeansk-Bank	Amur Oblast	91	90	53
VKABank	Astrakhan Oblast	467	280	293
InvestKapitalBank	Bashkortostan	176	308	215
Chelindbank AKB	Chelyabinsk Oblast	102	79	136
Chelyabinvestbank AKB	Chelyabinsk Oblast	112	114	96
Bank Verkhnelenskii	Irkutsk Oblast	632	680	533
Kamchatprofitbank AKB	Kamchatka Krai	303	410	323
Solid Bank	Kamchatka Krai	382	453	519
Kuban' Kredit KB	Krasnodar Krai	110	101	55
Kraiinvestbank	Krasnodar Krai	122	117	200
Lipetskkombank	Lipetsk Oblast	135	205	78
Sberbank Rossii	Moscow	1	1	1
Rossel'khozbank	Moscow	4	4	28
Bank Moskvy AKB	Moscow	5	5	7
VTB 24	Moscow	6	6	3
Al'fa-Bank	Moscow	7	7	13
Bank Uralsib	Moscow	10	11	11
Promsvyaz'bank	Moscow	11	13	971
Rosbank AKB	Moscow	12	17	945
TransKreditBank	Moscow	14	25	14

Continued overleaf

Table 3: Accredited Banks by Region and Rank Agency for Insurance of Deposits, 2010 (continued)

Bank	Region	Asset Rank	Capital Rank	Retained Profits Rank
NOMOS-BANK	Moscow	15	15	22
Bank Zenit	Moscow	22	30	36
MBRR AKB	Moscow	25	40	969
Svyaz'-Bank AKB	Moscow	32	33	15
Absolyut Bank	Moscow	34	50	970
MInB AKB	Moscow	39	45	50
OTP Bank	Moscow	40	41	80
Rus'-Bank	Moscow	41	69	112
BINBANK	Moscow	43	81	963
Yuniastrum Bank	Moscow	46	52	69
Probiznesbank AKB	Moscow	52	66	102
Investtorgbank AKB	Moscow	57	49	58
Vneshprombank	Moscow	61	100	90
Rosevrobank AKB	Moscow	64	63	65
Severnyi Morskoi Put' KB	Moscow	70	76	79
VserossBRR	Moscow	73	119	62
Moi Bank	Moscow	127	183	153
Agropromkredit KB	Moscow	134	158	931
Russlavbank KB	Moscow	156	257	916
Evrotrast KB	Moscow	183	229	934
Sarovbiznesbank AKB	Nizhny Novgorod Oblast	115	132	116
MDM Bank	Novosibirsk Oblast	13	10	974
Orenburg KB	Orenburg Oblast	212	215	240
Ural'skii FinansDom KB	Perm Krai	146	157	897
Bank Sankt-Peterburg	St. Petersburg	16	20	63
BaltInvestBank	St. Petersburg	79	121	194
PrimSotsBank SKB	Primorsky Krai	151	208	117
Pervobank	Samara Oblast	90	92	961
Gazbank KB	Samara Oblast	113	109	195
Ekspress-Volga KB	Saratov Oblast	128	263	125
Ekonombank AKB	Saratov Oblast	230	278	260
SKB-Bank	Sverdlov Oblast	53	68	93
Ak Bars AKB	Tatarstan	18	14	75
Tatfondbank AIKB	Tatarstan	62	56	165
BystroBank	Udmurtia	187	232	424
Khanty-Mansiiskii Bank	Khantii-Mansii Autonomous Okrug	21	26	45
Almazergienbank AKB	Yakutia-Sakha	199	288	940
Taatta AB	Yakutia-Sakha	567	582	758

Source: www.asv.org.ru

Table 4: Accredited Banks: Federal Dsitribution. Agency for Insurance of Deposits, 2010

Region	Number of Accredited Banks	% Total Accredited
Amur Oblast	2	3%
Astrahan Oblast	1	2%
Bashkortostan	1	2%
Irkutsk Oblast	1	2%
Kamchatka Oblast	2	3%
Krasnodar Krai	3	5%
Lipetsk Oblast	1	2%
Moscow	29	48%
Nizhny Novgorod Oblast	1	2%
Novosibirsk Oblast	1	2%
Orenburg Oblast	1	2%
Perm Krai	1	2%
St. Petersburg	2	3%
Primorsky Krai	1	2%
Samara Oblast	2	3%
Saratov Oblast	2	3%
Sverdlovsk Oblast	1	2%
Tatarstan	2	3%
Udmurtia	1	2%
Khantii-Mansii Autonomous Okrug	1	2%
Chelyabinsk Oblast	2	3%
Yakutia-Sakha	2	3%

Source: www.asv.org.ru

Table 5: State Participation in Industrial Ownership. Ten Largest Entities, 2008

Rank	Company Name	Mln US Dollars	Share (%)	State Share
1	Gazprom	236,187	50.1	118,330
2	Rosneft	92,968	84.6	78,651
4	Sberbank	51,058	60.6	30,941
9	Gazprom Neft	22,787	73.7	16,794
12	Vneshtorgbank (VTB)	18,823	77.5	14,588
15	RusHydro	16,738	60.4	10,110
22	Rostelekom	8,349	50.7	4,233
23	Unified National Electric Grid (FGC UES)	6,377	77.7	4,955
26	Bank of Moscow	5,531	44	2,434
32	Mosenergo	4,043	60.5	2,446
	Total Capitalization	*462,861*	*61.25*	*283,481*

Note: Bank of Moscow was absorbed by VTB in 2011

Source: OECD