Perspectives

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The Russian Banking Sector and the leading Role of Sberbank

WORLD SAVINGS BANKS INSTITUTE

EUROPEAN SAVINGS BANKS GROUP

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Introduction

Russia's banks have moved away from the 1998 crisis. Growing demand for banking services from both retail and corporate clients has enabled them to expand their business and discover new products. The share of the banking sector in Russia's GDP is expected to increase from 38.2% (2002) to 40.1% in 2004 and reach 44-45% by 2007.

The stabilisation of Russia's economy and the improvement of the macroeconomic conditions have produced growth, lower inflation and an increase in real disposable income. The banking sector is seen as the crucial element in stimulating internal investment in Russia, a prerequisite for sustainable growth. For this reason, the Russian banking sector will have to meet a number of challenges in the coming years, including improving regulatory measures, insuring retail deposits of commercial banks and fostering corporate governance.

This issue of **Perspectives**, *released on the occasion of the 23rd Meeting of the WSBI Board of Administration in Moscow on 14 November 2003, explores the development of the Russian banking system from its origins in the 18th century to the financial crisis of 1998. Further, it analyses the latest trends and the background against which the country's banks are currently working to enlarge their business.*

Sberbank, the host of the WSBI Board Meeting, is Russia's leading bank with a 67.4 % share of the household savings market. The bank covers the entire territory of the country with 1,162 branches and 18,980 subbranches. At its General Shareholders Meeting in 2000, Sberbank developed a vision that implies a radical improvement of its customer service and the strengthening of its market position.This publication also examines the measures the bank has been implementing to reach these goals.

The figures in the text are given in accordance with the Russian Accounting Standards, the official national standard for accounting and reporting. Since 1996, in line with the general policy of introducing IAS reporting, Sberbank has been publishing its audited financial statements under IFRS.

1. Background and current status of the Russian banking sector

1.1 Origins of the Russian banking system

The origins of the Russian banking system can be traced back to the middle of the 18th century. The first Russian banks, The Gentry Credit Bank and The Merchants Bank, opened in 1754 in St. Petersburg and Moscow respectively. These institutions acted in support of the Russian Government, actively lending to land-owners and the treasury.

The savings business began some 100 years later. Emperor Nicolas I signed the first Charter of the Savings Offices in 1841 and the first institutions of that kind opened in Moscow and St. Petersburg in the following year.

From 1842 to 1860, 45 additional savings offices opened in major Russian cities to provide low income groups with access to an organised savings system. However, Russia with its serfdom regime did not have many potential depositors and had no real tools to promote the concept of savings with rural residents making up the bulk of its population. The abolition of serfdom in 1861 brought about radical change, which gave a boost to the savings business.

Savings offices began to open at banks, post offices, railway stations, schools etc. At that time they came under supervision of the State Bank, established in 1860.

Russian savings offices were originally designed as state-owned bodies. State ownership was a very important factor in promoting public trust in these new institutions, since the state assumed liability for all individual funds deposited with the savings offices.

1.2 Banking business in Russia after the abolition of serfdom

The early 1860s signalled a period of business revival, also thanks to the construction of railways and rapid development of trade. The abolition of serfdom brought about a change in land-ownership relations. By that time, Russia had accumulated large sums of capital, which could be used efficiently with the assistance of state-owned as well as private joint-stock banks. It was in this period that the first private banks emerged in the country and their success led to a boom in the banking sector. Between 1881 and 1883, new procedures for the opening and winding-up of commercial banks were established in law.

The period of the late 19th and early 20th century witnessed a rapid development of capitalism in Russia with the growth of its banking system. The emergence of new banks and competition in the banking sector were accompanied by a concentration of capital. In late 19th century, Russia had 39 commercial joint-stock banks with 242 branches. The number of savings offices at that time amounted to around 4,000.

By the turn of the century, Russia had based its monetary circulation on the gold coinage standard, a well-developed credit system and a network of 5,415 savings offices with 3.6 million accounts. These offices were the most accessible credit institutions in Russia in terms of customers: peasants made up over one third of all depositors, and many customers were lower-income urban residents. Deposits with savings offices were guaranteed by the state. The State Bank of Russia used the deposits to support the Russian Government's programmes by investing the funds in state securities.

The industrial boom of 1909–1914, characterised by the expansion and consolidation of enterprises, required new capital and the lack of domestic funds stimulated the influx of foreign capital into Russia.

Before World War I, Russia ranked fifth in the world in terms of industrial output (absolute volume). The country was developing and operating a successful finance and credit system, with the number of banks amounting to 3,575 by 1914. The State Bank of Russia was at the head of the system, controlling monetary policy and also engaging in business operations.

During this period, savings offices were transformed into universal lending institutions. In addition to collecting deposits , they provided capital, income and life insurance. By 1916, Russia's savings offices had a network of 9,855 institutions with RUB 3,133 million in deposits.

1.3 Russian banking system during the civil war and revolution

World War I and the inflation stemming from it resulted in dramatic changes in the banking environment. Russia's economy and banking system were facing new problems related to the war, with military actions being financed mainly through new issues. Practically all funds raised by the savings offices from individuals were used to cover war expenses. By November 1917, the price index grew tenfold compared with 1913, bringing down the purchasing power of one rouble to ten pre-war kopecks.

On 27 December 1917, the Soviet Government adopted a decree to nationalise all commercial banks and establish a state monopoly of banking.

World War I hyperinflation and the revolution contributed to devalue retail savings and paralysed the savings business in the country.

Between 1918 and 1921, Soviet Russia practically ceased industrial production and liquidated the banking system it had inherited. Although the savings offices survived, they were not operational during this period.

1.4 Revival of the banking system under the New Economic Policy (NEP)

To tackle the crisis and revive the national economy, the Soviet Government launched its so-called New Economic Policy (NEP). The long-felt need to create a credit centre and regulate the circulation of money resulted in the establishment of the State Bank of the Russian Federation in October 1921.

In deciding to readopt the traditional system, the country wanted credit institutions that could serve the needs of the economy. The Government and the State Bank established several joint-stock banks to lend to trade and industry, revived the system of community and agricultural banks, established a credit system servicing cooperatives and introduced mutual loan societies.

The standard of living increased with the growth of the economy and normalisation of monetary circulation. The system of savings offices started operating again and soon reached pre-war levels.

Four years of NEP helped to restore the economy and reach pre-war production levels in most areas. The revival strategy was then followed by a new industrialisation policy to replace NEP.

In December 1929, the Government approved the first five-year plan that would conclude NEP and introduce a changeover to a controlled economic environment.

1.5 Russian banking system in a controlled economy

The development of the savings business during this period became an issue of national importance. The savings offices, which came under Government authority in 1929, were collecting individual deposits and offering Government bonds.

The lending reform implemented during the centralised planning period helped to stabilise the banking system. By 1940, deposits with savings offices totalled RUB 7.3 billion.

By the outbreak of the Great Patriotic War of 1941-1945, the USSR had an efficient banking system plus a functioning system of monetary circulation and currency relations. During the War, the savings offices raised funds from individuals to cover the expenses of the military effort. They sold Government bonds, placing the funds and valuables contributed by the people into a defence fund.

After the war, in 1946, the Government developed plans to restore the country within five years, assigning a leading role to the banking system. The savings offices network, which had shrunk by half during the war and occupation, recovered and reached its pre-war level by 1952.

The banking system did not change in the 60s–70s and early 80s. The savings offices, formerly under the authority of the USSR Finance Ministry, came under the supervision of the USSR State Bank in 1963.

1.6 Russian banking system at the beginning of the reforms

In the early 1980s, the USSR had a stable banking system in place, with the USSR State Bank holding the monopoly of the credit sector. Its total subordination to the Government turned it into a tool for State management and control. The State Bank accumulated all available funds on its accounts and allocated them under a special Government-approved plan.

In the late 80s, Russia's economy entered a new period of change, moving from the old Soviet controlled economy to a new market-driven system.

Changes in the banking sector started in 1987 with a reform resulting in the re-organisation of the existing banks into new specialised state-controlled lending institutions dedicated to specific economic sectors. The five new banks were: USSR Promstroybank (industrial sector), USSR Agroprombank (agro-industrial sector), USSR Zhilsotzbank (housing and social infrastructure), USSR Vnesheconombank (foreign trade) and USSR Savings Bank (Sberbank).

The latter offered savings and lending products, building on the well-developed network of savings offices. It was also involved in other corporate services and the redemption of government bonds. Sberbank introduced advanced methods of settlement and retail lending and focused on radically improving retail banking services.

1.7 Creating a two-tier commercial banking system

A new stage in the development of the banking system began in 1990 with the adoption of the "Law on Banks and Banking". This new law introduced a two-tier banking system, with the upper level represented by the Central Bank of Russia (CBR) and the second layer by commercial banks, other lending institutions and the representative offices of foreign banks. During this period, the CBR was granted the exclusive right to issue money with its main function being the support of the rouble: a constitutional function, which it performed independently of other state authorities.

In the early 90's, the specialised state-controlled banks (Promstroybank, Zhilsotzbank, Agroprombank, Sberbank) were re-organised into universal joint-stock commercial banks offering services to all kinds of customers independently of their sector.

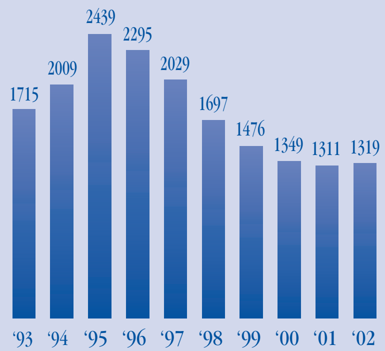
The banking system was now operating in a challenging environment with the country moving from a controlled to a market-driven economy. The political and economic changes triggered rapid growth of the new commercial banks with various ownership structures.

The mushrooming of commercial banks was spurred by hyperinflation resulting from a prolonged economic downturn and unbalanced budget on the one hand and by easy registration procedures on the other. Inflation soared to 2,510% in 1992, before falling to 220% in 1994 and eventually 120% as late as 1995. Soaring inflation and liberalisation of operations with currency valuables created a favourable environment for the proliferation of commercial banks because their assets - mostly denominated in foreign currency - were growing rapidly whereas the funds they raised were losing value at the same pace. As a result, the number of new commercial banks, including the privatised units of the former specialised banks, rose to 1,181 by 01.05.1991. By 1994, this figure was 2,009, reaching a peak of 2,583 in July 1996.

New banks appeared alongside the liquidation of bankrupt banks. In 1991-1995, 301 banks lost their licence.

The year 1995 saw a turning point in the development of the national banking system,

Number of credit institutions entitled to conduct banking business (as of year opening)



Source: Central Bank of Russia (CBR)

brought about by the stabilisation of the rouble, falling inflation and more stringent CBR supervision requirements for commercial banks. The number of operating banks started to fall and the establishment of new banks slowed down (see chart).

The number of banks in operation stabilised over the following years. However, this did not mean that Russia's banking system was entering a stage of maturity; it was simply approaching a quality stage.

1.8 The financial crisis of 1998 and the restructuring of the banking system

Before 1998, commercial banks were engaged in speculative operations. The most developed market of that period, in addition to foreign exchange operations, was that of state securities. The rate of investment in securities was much higher than that for lending. Between January 1996 and January 1998, the growth rate of bank investments in state securities was 171%, whereas investments in lending only increased by 33%. The reason lay in the status of the domestic economy and finance: a prolonged downturn set in throughout the real economy sector, with the exception of some export-oriented sectors, and the country with its ill-balanced budget was compelled to finance itself through bond issues.

Russia was in great need of borrowings, and this made them highly profitable. A good market infrastructure for Government loans and high liquidity rendered such borrowings highly attractive - not only as an object of short-term investment but also as source of liquidity. The attractiveness of this market was enhanced by the fact that it was controlled by the Russian Finance Ministry and the CBR.

Eventually, the country's poorly balanced financial and foreign exchange systems collapsed in 1998, resulting in a grave systemic crisis. After failing to service its domestic debts and support the current rate of the rouble for commercial banks to continue servicing their debts to foreign counter-parties, the Government announced a default on its domestic debt and a moratorium on the payment of foreign debts.

The Government's refusal to redeem its rouble-denominated state securities (GKO/ OFZ) and the restructuring announcement made on 17 August 1998 are generally regarded as the starting-point of the crisis. The failure to service the domestic debt had an immediate impact on the liquidity of the banking system. State securities had accounted for a major share of Russian banks' assets before August 1998. The loss of liquidity generated a succession of payment defaults, creating panic among customers and resulting in a mass withdrawal of deposits, which paralysed the banking system.

Panic-stricken depositors, who expected their foreign currency deposits to be frozen and their rouble savings devalued, withdrew not only their roubles but also currency deposits. In August 1998 alone, retail deposits in roubles shrank by 19.5% (RUB 6.5 billion) and foreign currency deposits by 24% (US$ 0.9 billion).

The moratorium on foreign debt repayment, intended to grant the banks a deferral of their external obligations, was of no avail because the Russian banking system failed to stabilise over the three months and actually got worse.

The measures taken by the CBR at that time were aimed at restoring the system's liquidity and complying with the demands of retail depositors. To raise liquidity, the CBR bought Government bonds from major banks and provided them with direct loans. To tackle the depositors' problems, it was decided to transfer deposits and some portions of the commercial banks' assets to Sberbank. At that time, Sberbank was among the few banks that had succeeded in avoiding a default on their obligations to depositors, customers and foreign counterparts.

In late 1998, the Government set to work on a plan to help the banking system overcome the crisis. External managers were appointed to large banks for re-organisation purposes. Tasks were assigned to them by the Agency for the Restructuring of Credit Organisations (ARCO), staffed by Government and CBR representatives. ARCO managed problem banks, regulating their relations with lenders and depositors. By the year 2000, this objective had been reached, enabling the Russian banking system to recover and move on to a new phase.

The 1998 crisis forced commercial banks to review their priorities and risks and to assess a new environment. Instrumental in these processes were the improved public finances and changes in foreign exchange control which left very limited opportunities for speculative operations. Steady GDP growth and the positive development of major economic indices made lending to the real sector more attractive than to other fields of the economy. The major growth factors in post-crisis Russia are set out below:

- enhanced competitiveness of domestic products with devaluation of the rouble and development of import substitution;
- growth of export revenues in a favourable foreign trade environment on major commodity markets;
- price controls on the products of natural monopolies, resulting in domestic production growth.

Services to the real sector have become the staple of commercial banks' business over the past five years. However, traditional banking operations can only develop if the key problems facing the system and national economy are resolved. Accordingly, the development of Russia's banking system after the crisis was aimed at supporting the economic and banking reforms.

A strategy for the development of the national banking sector was eventually agreed over the past three years. Taking account of the views expressed by the banking community, the CBR gradually lifted a number of critical restrictions that had been hampering the sector's development. In 2001, the Government and the CBR adopted "The Russian Banking Sector Development Strategy" to promote reforms.

The most critical priorities of the Russian banking system are:

- improvement of central bank supervision over commercial banks;
- enhancement of corporate governance and transparency of commercial banks;
- perfection of internal techniques to control major risks;
- insurance of commercial banks' retail deposits;
- establishment of credit bureaux.

Although some problems still have to be resolved, the sector is gaining strength in general and the banks are playing a more important role in the country's economy. The CBR and the Government are making joint efforts to reform the banking sector and create a stable, competitive system.

2.
Development trends in the Russian banking sector [1]

The rapid growth of major indices of the Russian banking system over recent years is due to the positive changes in the country's economy. Critical factors for the banking sector have been the stabilisation of the economy and the improvement of the macroeconomic environment, resulting in general growth (including the production sector), lower inflation, growth in retail turnover and a rise in real disposable income. In addition, there is evidence of betterment of the framework for business operations, including legal, fiscal, budgetary and structural changes.

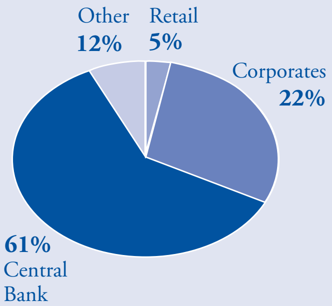
The aggregate effect of these factors is a rapidly growing demand for banking services among both retail and corporate customers. On the other hand, the banks now have the opportunity to expand their business and offer new products.

Accumulated banking assets in Russia amount to almost RUB 4,000 billion (US$ 126 billion), of which over 62% is held by the top 20 Russian banks and Sberbank, whose share of the national aggregate banking assets exceeds 27%. These figures illustrate the high concentration of Russian banking capital.

Notwithstanding the fact that many Russian banks are keen to develop their network, the total number of bank branches in Russia has shrunk over the past two years, falling by 2.8% in 2001 and 1.6% in 2002. Commercial banks trying to expand their networks have 2,164 branches in total, of which 1,162 are branches of Sberbank. In addition to the branches, the latter has 18,980 sub-branches throughout the country.

Sberbank is the only publicly traded joint-stock bank among the commercial banks in Russia. It has over 200,000 shareholders, and its major shareholder is the CBR.

Sberbank's shareholding structure as of 01.01.2003



[1] Based on Sberbank's data

2.1 Liabilities

	Percentage			Change	
	01.01.2001	01.01.2002	01.01.2003	2001	2002
Liabilities	**100%**	**100%**	**100%**	**37.5%**	**33.6%**
Corporate funds	**41.92%**	**39.27%**	**38.40%**	**28.8%**	**30.6%**
Roubles				34.4%	36.0%
Foreign currency				19.0%	20.2%
Retail deposits	**20.27%**	**22.73%**	**26.01%**	**54.2%**	**52.8%**
Roubles				46.0%	46.0%
Foreign currency				71.6%	65.2%
Shareholders' equity	**16.95%**	**17.36%**	**16.12%**	**40.8%**	**24.0%**
Roubles				41.8%	24.5%
Foreign currency				-54.5%	-104.5%
Other	**20.86%**	**20.64%**	**19.48%**	**36.0%**	**26.1%**

2.1.1 Retail deposits

Supported by a rapid growth in income and the stabilisation of the economy, the market for retail deposits has been developing more dynamically than that for corporate funds. The share of deposits in the banking system's liabilities grew from 20.27% to 26.01% over the period 2001–2002. However, corporate funds continue to constitute the greatest share of Russian banks' liabilities.

Aggregate retail deposits total RUB 1,050 billion (US$ 34 billion), with Sberbank and the other large banks accounting for 80% in 2002. Smaller banks are not in a position to compete with Sberbank and the large banks in this sector.

The rate of growth in retail deposits was 52.8% in 2002, more or less twice the rate of growth in corporate funds. The highest rates are recorded for deposits in foreign currencies (71.6% and 65.2% in 2001 and 2002 respectively).

Large banks are fairly well-positioned. By 01.01.2003, retail funds raised by the 20 largest commercial banks accounted 14.6% (as against Sberbank's share of approx. 67.4%).

Sberbank is the leader on the household savings market. Since early 1998, retail deposits

Retail deposit products offered by Russian banks and Sberbank, by deposit term (as of 01.04.2003)

Term	Share in Total Deposits			
	Large banks	Medium banks[2]	Small banks[3]	Sberbank
Call deposits	23.6%	22.20%	21.9%	12.8%
Up to 1 month	0.5%	0.29%	0.3%	0%
1 – 3 months	4.3%	5.37%	6.3%	2.6%
3 – 6 months	14.6%	21.38%	19.9%	22.3%
6 months – 1 year	43.1%	30.15%	30.9%	11.3%
1 year – 3 years	13.6%	15.32%	15.7%	49.1%
Over 3 years	0.2%	1.49%	2.8%	1.9%
Bank card accounts	0.2%	3.80%	2.3%	0.1%

have grown 550%, totalling RUB 700 billion (US$ 22 billion) by 2003. A distinctive feature of Sberbank's policy on retail deposits is the focus on rouble deposits, which account for around three quarters of the total. Sberbank's share of the rouble market is 79.3%, compared with 48.4% of the foreign currency deposit market.

Unlike Sberbank, foreign banks prefer to raise deposits in foreign currency (95% of their total deposits) by virtue of the priority they give to providing services to non-residents. Large banks, on the other hand, like to take deposits in roughly equal amounts of roubles and foreign currency. 65% of deposits are in foreign currency, compared with 35% in roubles. The share of larger banks amounts to 25.4% for foreign currency deposits and 8.1% in roubles.

In terms of deposit duration, banks differ widely from each other. Deposits are taken for six months up to one year, in addition to "call" deposits.

Sberbank is actively developing long-term retail products, relying on the favourable macroeconomic factors and well-developed retail servicing technologies. In 2002, deposits of over twelve months accounted for more than 50% of the total deposits taken by the bank. Sberbank's share in this market segment is 87.1%, with long-term deposits in both roubles and foreign currency.

(1) The category of medium-sized banks includes 460 Russian banks following the top 20 banks and Sberbank in terms of assets.
(2) The small banks category covers all Russian banks outside the large and medium-size category.

The gradual revival of general interest in commercial banks is stimulating the retail business and, hence, competition in this area. Evidence of this development is given by the 220% increase in the number of bank cards issued in Russia over the past two years to 16.7 million. Card-based operations have more than tripled to RUB 215.1 billion.

2.1.2 Corporate funds

Russian banks are developing services in the area of corporate funds. Their share in the banks' liabilities accounts for 38.4%, representing a drop over the past two years. In absolute terms, the funds raised from corporates total RUB 1,500 billion (over US$ 48 billion).

A critical competitive factor on this market is the ability to offer full service to corporate customers. The share of large banks in this segment is 41.4%, compared with 29.9% for the medium-sized banks and 15.7% for Sberbank.

The majority of corporate funds raised by the banking system have been in local currency (69%), with funds raised in foreign currency amounting to 31%. For Sberbank and the medium-sized banks, corporate funds in roubles account for around 3/4 of the total, compared with a figure of 55% for the big banks.

2.2 Assets

	Structure			Growth rate	
	01.01.2001	01.01.2002	01.01.2003	2001	2002
Assets	**100%**	**100%**	**100%**	**37.46%**	**33.59%**
Loans to legal entities	**40.43%**	**45.92%**	**47.03%**	**56.14%**	**36.84%**
Roubles				59.78%	31.04%
Hard currency				48.38%	50.13%
Loans to individuals	**1.60%**	**2.49%**	**2.80%**	**114.41%**	**50.07%**
Roubles				133.12%	44.61%
Hard currency				57.80%	74.46%
Investments in securities	**16.50%**	**13.56%**	**14.25%**	**12.96%**	**40.42%**
Roubles				26.14%	64.31%
Hard currency				5.23%	23.63%
Other	**41.47%**	**38.03%**	**35.91%**	**26.05%**	**26.17%**

2.2.1 *Lending to legal entities*

There have been significant changes in the structure of the banking system's assets since 1998. While in the pre-crisis period, banks were mainly investing in Government securities (around 23% of assets), starting from the beginning of 2003 they have been granting loans to legal entities (47%), which amount to RUB 1,860 billion (US$ 58.5 billion). Over the past two years, these assets have grown constantly, i.e. by 56.1% in 2001 and 36.8% in 2002. This trend is also linked to the positive changes taking place in the country's economy. Due to improved profitability and corporate management, the major part of corporate profits are destined to the upgrading of production facilities, thus increasing the demand for loans. The share of corporate loans in Sberbank's assets is 45%, compared with over 50% for the other large banks.

Against the backdrop of growth rates in lending, Sberbank's share of the corporate client lending market remains constantly high, amounting to 27% at the beginning of 2003. The share of Sberbank's lending in roubles exceeded 32.5%, as against 16% in hard currency.

Since the beginning of 1998, the bank's loans to corporate clients have increased more than 16-fold, reaching RUB 500 billion (US$ 16 billion.). The growth rate over the past two years exceeds 30%. The closest competitor on this market is Alfa Bank, with a loan portfolio five times smaller than Sberbank's.

The main indicator of the banks' position on this market is the achievements in lending to first-rate borrowers. Large Russian and international banks compete with Sberbank in this segment.

The large banks have a strong and stable position. As of 01.01.2003, the share of loans extended by the 20 largest commercial banks to legal entities was 36.5%.

A distinctive feature of the lending policy pursued by the large banks is the preferential development of lending in foreign currency, while Sberbank mainly lends in roubles (around 80% of all outstanding loans at the beginning of 2003). This preference arises from large banks' participation in different investment-banking groups that control cash flows from export-import transactions. The funds of large banks are actively used to finance foreign trade transactions.

Foreign banks also prefer to develop hard currency lending due to their focus on non-residents. At the beginning of 2003, foreign banks accounted for 12.2% of corporate loans in hard currency and 1.2% in roubles.

The rather insignificant share of foreign banks in the corporate lending market does not reflect the real volume of Russian enterprises' borrowing from international credit institutions. Cross-border lending to Russian corporations has been quite extensive over the past few years, reaching some US$ 14 billion in 2002, i.e. approximately 30% of total corporate lending by Russian banks.

It should be noted that corporate lending in roubles developed at its highest rate in 2001 (annual growth rate of around 62.0%), while foreign currency loans prevailed in 2002 with an annual growth rate of approx. 50%.

The position of the largest banks on the lending market shows that they are serious competitors to Sberbank in virtually all term segments and are also quite strong in "call" lending (22.6%), a service that Sberbank does not provide.

Corporate loan portfolio structure by maturity - Large Russian banks and Sberbank

Term	Share of aggregate corporate loans	
	Large banks	Sberbank
Overdraft credits	1.1%	2.8%
Call deposits	13.1%	0.0%
Up to 1 month	4.8%	0.8%
From 1 to 3 months	8.3%	3.1%
From 3 to 6 months	12.9%	18.7%
From 6 months to 1 year	24.2%	33.8%
From 1 to 3 years	23.9%	27.6%
Over 3 years	11.6%	13.2%

Loans of 12 months and longer make up 44.8% of the hard currency loan portfolio of foreign banks. Loans in roubles are mainly provided by foreign banks over the short term to finance the current operations of enterprises, with loans of up to 90 days accounting for 55.3% of their portfolios.

Sberbank's position on the rouble corporate lending market is especially strong for the segment of 3-to-12-month loans (about 48%) and over one year (49%). The bank also operates successfully on the rouble overdraft credit market, with a share of around 37%.
On the hard-currency lending market, Sberbank is especially well positioned in the 1-to-3-year loan segment (23.3%) and terms over three years (about 31%).

2.2.2 *Lending to individuals*

One of the market segments that have been developing most dynamically is lending to individuals. This development has been boosted by a general improvement of the macroeconomic indicators and the growth of real disposable income, in particular. Although lending to individuals does not account for a significant proportion of the banking system assets (2.8% in January 2003), the total volume of retail loans has increased 3.2-fold to RUB 111 billion (US$ 3.5 billion) over the past two years.

As from 2001, the growth rate for retail lending was higher than that of corporate lending, increasing by 114.4% in 2001 and a further 50.1% in 2002.

Since the beginning of 1998, Sberbank's outstanding loans to individuals increased more than 13-fold, totalling RUB 65 billion (US$ 2 billion). The vast majority of these loans (97%) are in the national currency, with foreign currency loans accounting for around 3% of the portfolio. Sberbank acts as market maker for household loans with a generally quite stable share, i.e. 42.2% per 01.01.2001 and around 47.5% at the beginning of 2003.

Despite growing competition, Sberbank has a strong position in this segment and is actively developing its operations, addressing a wide customer base and offering a large range of credit products and services. The competitors are large Russian banks and banks actively pursuing advanced household lending strategies.

The share of the 20 largest Russian banks on the household lending market has developed in an erratic manner in the past two years, from 12.1% on 01.01.2001 to 25.2% on 01.01.2002 and back to 11.8% at the beginning of 2003. These changes in the share and volume of loans are explained by the fact that some large banks still continue to use credit-deposit schemes for investment-banking groups interested in optimising taxation on income paid to their employees. This resulted in the share of large banks on the retail deposit market being more than halved from 25.5% to 9.7% in 2002. However, the fall in the large banks' share of the retail deposit market in hard currency in 2002 was insignificant, i.e. from 23.9% to 20.0%.

Innovations are used by Russian commercial banks to penetrate the retail lending market and to increase their share by attracting new customers and low-income citizens. Competitiveness of services is achieved by cost cutting along with increasing the volume of transactions. To this end, innovative banks use lending methods like express lending and lending schemes designed for specific client groups. The high risk of these schemes is combined with aggressive promotion and the building-up of transaction volumes.

2.2.3 Securities

The growth rate of banks' investments in securities was much higher in 2002 than in 2001, rising to 40.4% from 13%. Most investments were in Government securities (74%), with Sberbank remaining the main player with an 82% rise. At the beginning of 2003, Sberbank's share in this segment was 19.5%, with a roughly equal share divided among the 20 largest Russian banks and about 9% for the medium-sized banks.

An active development of the Russian equity and corporate bonds market is driving banks' investment in non-Government securities. The volume of investments in this kind of assets more than doubled in 2002.

Large banks are the most active players in the market for corporate securities (both equities and bonds), holding a combined share of 63.2% per 01.01.2003. They virtually dominate the market for non-Government securities denominated in hard currency, with their investments totalling 98% at the beginning of 2003. Against the background of depressed interest rates for deposits, large banks are taking over as underwriters for the placement of clients' securities. At the same time, the unavailability of their own long-term funds and the growing numbers of private and corporate investors interested in acquiring stable securities are driving large banks to play the role of arrangers of bond issues.

2.3 Forecast for key development indices for the banking system and retail banking

The strategy for the development of the banking sector elaborated by the CBR and the Finance Ministry expects the share of banking assets in GDP to increase to 40.1% in early 2004 (from 38.2% as of the end of 2002), capital from 5.4% to 5.6%, and loans to the real sector from 14.8% to 16.4%[4]. By 2007, assets are expected to reach 44-45% of GDP, while loans to the real sector to 19-20%.

The measures scheduled for 2003-2005 to improve the banking environment in the Russian Federation are aimed at cutting banks' administrative costs, increasing their competitiveness, improving protection of their interests and those of the creditors, as well as further enhancing the effectiveness and efficiency of supervision.

An improvement in the banking environment should lead to higher indices and a betterment of the banking industry as a whole, first and foremost in relation to corporate governance and internal control, the structure of assets and liabilities, acceptable exposure and transparency.

2.3.1 Banking concentration

The analysis of banking groups according to their assets shows that there is no evident trend regarding the concentration of assets in the banking sector: from the beginning of 1998, the share of the top 50 banks in aggregate assets hardly changed at all, declining slightly from 74.0% to 73.5%.

Table 1: Banks according to their assets

Banks	Share in aggregate assets, %			
	01.01.1996	01.01.1998	01.01.2002	01.01.2003
First 20	51.3	60.2	62.7	62.6
From 21 to 50	11.6	13.8	11.8	10.9
From 51 to 200	18.1	14.5	14.4	15.0
From 201 to 1000	16.4	10.6	10.7	11.2
From 1001	2.6	0.9	0.3	0.3
Total	100	100	100	100

(4) Loans to enterprises and companies.

2.3.2 Profitability and capitalization of banks

Table 2: Performance of Russian credit institutions

	Profit (+)/loss (-) volume - RUB million		
	01.01.2001	01.01.2002	01.01.2003
Total	17,184	67,607.4	92,952.9
Profitable banks	48,565	70,709 .6	104,993.0
Loss-making banks	-31,381	-3,102.2	-12,040.1

The high growth rate for banking assets and improved quality have resulted in an even higher rate of growth in the banks' profit. According to the results for 2002, the aggregate income of the banks was RUB 93 billion, i.e. 1.4 times higher than in the previous year and 5.4 times higher than in 2000.

The positive development of banking profits has helped to solve banks' most crucial problem of the post-crisis period, namely undercapitalisation. It has contributed to a sustainable growth in banks' capitalization (aggregate banking capital reached RUB 780.3 billion at the beginning of 2003, compared with a growth rate of 27.5% in 2002 and 39.9% in 2001). A number of measures, including M&As, were also taken by the Government and the CBR to further capitalize the banks.

2.3.3 Number of banks

Growing competition and an increase in M&As have reduced the number of credit institutions in Russia to 1,826 (1,773 banks) at the beginning of 2003, corresponding to a fall of 14.9% compared with 2001.

Table 3: Credit institutions registered by CBR or by an authorized registration body

	01.01.2001	01.01.2002	01.01.2003	Change over 2 years
Total	2,124	2,001	1,826	-14.0%
Banks	2,084	1,953	1,773	-14.9%

2.3.4 Development trends

It was possible to identify the following trends in the course of the past two years:

- aggregate capitalization growth;
- development of extensive retail operations, especially for deposits;
- stronger increase in lending to corporates and individuals;
- gradual growth of equity market activities.

The banking system in Russia thus seems to be performing its principal role to an ever-greater extent, namely transforming retail deposits into investments to ensure economic growth.

2.4 Development parameters of the Russian banking system compared to other countries

At present, the recovery of the Russian banking system after the severe financial crisis of 1998 has been completed in general terms. As of June 1, 2003 the aggregate assets of the Russian banks totalled US$ 156.8 billion, compared with US$ 122.1 billion on June 1, 1998. In 2002, the ratio of aggregate banking assets to GDP was 38.2%, practically equal to the 1998 maximum for post-Soviet Russia (38.5%) and considerably exceeding the level of the crisis year 1999 (33.2%).

Today, the Russian banking system faces new challenges, primarily that of ensuring the necessary conditions for sustainable economic growth. At the same time, it must be remembered that the banking sector can not be better than the economy, and the quality of its development will depend directly on the rates and quality of development of the general economic system.

In the pre-crisis period, the Russian banks were the vanguard of market relations and their development breakthrough was in sharp contrast to the crisis state of the real sector of economy. Today, the Russian banking system is entering a new development phase linked to its need to be fundamentally modernised in

Main development parameters of the Russian banking system (as % of GDP)(5)

As of the end of the year	1997	1998	1999	2000	2001	2002	2003(6)
Banking system assets	27.0	38.5	33.2	32.3	34.9	38.2	40.1
Claims to the non-financial private sector and population(7)	9.4	12.8	10.9	11.9	15.4	17.2	19.0

(5) Calculated according to CBR methodology.
(6) Forecast.
(7) Calculated according to IMF methodology.

terms of economic growth and increased competitiveness. Whereas in the mid 90s, Russian banks mainly dealt in Government debt securities and converted hard currency liabilities (funds of non-residents) into hard-currency, its main function today is to transform savings into investment and short-term loans to businesses, and capital flows from raw materials to processing industries.

After the severe crisis of 1998, the Russian banking system became more focused on the lending business. In 1999-2000, Russian banks grew due to the growth of liquidity created by servicing the capital outflow. For the next two years, the main driver for growth were loans to the private sector, which increased from 9.4% of GDP at the end of 1994 to 17.2% at the end of 2002. In many developing countries, the ratio exceeds 40% of GDP and is in developed countries even bigger, e.g. 78.1% in the USA, 88.3% in France, 118.6% in Germany and 142.6% in Great Britain[8].

As the macroeconomic situation improved and real income grew (average annual growth of 8.8% in 2000-2002 as against an 18.1% drop in 1998), the rate of inflation decreased (84.4% in 1998, 15.1% in 2002) and the banking system was able to significantly raise the volume of retail lending (Table 4).

Table 4: Development of corporate and retail loans

	1997	1998	1999	2000	2001	2002
Corporate and retail loans, US$ bn.	**43.0**	**17.3**	**18.8**	**30.3**	**44.4**	**57.2**
Annual growth, US$ bn.	-	-25.7	1.5	11.5	14.1	12.8
Annual growth, %	-	-59.8	8.6	61.2	46.5	28.8
Ratio of market volume to GDP annual volume, %	9.4	11.7	9.9	11.1	14.2	16.2
Including: Corporate loans, US$ bn.	**40.3**	**16.4**	**17.7**	**28.7**	**41.2**	**52.7**
Annual growth, US$ bn.	-	-23.9	1.3	11.0	12.5	11.5
Annual growth, %		-59.3	7.9	62.1	43.6	27.9
As % of GDP	8.8	10.9	9.3	10.5	13.2	14.8
Retail loans, US$ bn.	**2.7**	**1.0**	**1.04**	**1.6**	**3.2**	**4.5**
Annual growth, US$ bn.	-	-1.7	0.04	0.56	1.6	1.3
Annual growth, %	-	-63.0	4.0	53.8	200.0	40.6
As % of GDP	0.61	0.74	0.58	0.61	1.05	1.31

Source: CBR

[8] according to IMF: International Financial Statistics, Yearbook, 2002.

Today, the state of the Russian banking sector reflects the level of structural changes in the economy, financial markets, budget and tax systems and legal regulation. Based on certain parameters, the Russian banking system has virtually caught up with the countries in transition (Table 5). However, the Russian banking system will hardly be up to the level of the banking systems in the G-7 countries in the very near future. This can be concluded, to take just one example, from the level of monetisation of the Russian economy, which remains extremely low at 19.5% of GDP in 2002, while in the leading economies this figure exceeds 50%.

Table 5: Banking systems in comparison *

Country	Aggregate assets to GDP, % 1995	Aggregate assets to GDP, % 2002	Loans to private sector as % of GDP 1995	Loans to private sector as % of GDP 2002
Leading economies				
USA	76.7%	91.1%	63.9%	78.1%
Great Britain	122.4%	145.4%	115.3%	142.6%
Japan	147.8%	153.4%	112.5%	102.0%
Germany	134.6%	167.5%	103.1%	118.6%
France	108.2%	133.6%	87.0%	88.3%
Canada	90.3%	93.5%	75.7%	79.8%
Italy	94.4%	99.6%	57.6%	82.3%
Emerging economies				
Russia	**22.2%**	**34.8%**	**8.7%**	**17.2%**
Brazil	46.7%	66.6%	35.0%	35.4%
Mexico	43.8%	37.3%	29.2%	12.6%
South Korea	68.3%	133.6%	53.2%	114.0%
China[9]	102.0%	173.4%	88.3%	124.6%
Turkey[10]	33.5%	70.4%	18.5%	20.9%
Poland	42.3%	50.8%	18.5%	28.8%
Czech Republic	103.5%	93.7%	58.1%	35.6%
India	39.2%	50.0%	22.8%	28.9%

* Calculated in accordance with IMF methodology.
Source: International Financial Statistics, Yearbook, 2002.

[9] 2000 data.
[10] 2001 data.

At the same time, the current Russian banking system cannot cope with the ambitious tasks of qualitative growth. As before, it is strongly dependant on public funds, while accumulated excessive liquidity does not provide sufficient a level of financing (investment loans, in particular). Corporate lending ensues by way of financial and industrial groups rather than on a market competition basis.

In the period of extensive privatization in 1996-1997, banking capital merged with industrial enterprises, something quite untypical for emerging economies. Large monopolists in the real sector established so-called "pocket" banks to serve various enterprises, concerns and industries. In turn, the large commercial banks invested considerable amounts of money in Russian companies (for the purpose of ensuring financial flows rather than purchasing assets). During that period, the purchase of controlling stakes took on a massive scale.

Over the past few years, Russian companies have tended to tap world capital markets directly. In 2002, funds raised by Russian companies on euro bond markets approached US$ 3.13 billion, compared with almost US$ 3.6 billion in just the first half of 2003[11]. The Russian banking system does not have the capacity to meet the demand due to low competitiveness (impossibility of raising long-term and cheap funding). It can be said that bank loans are used to improve the financial standing of companies (decreasing accounts payable, liquidity replenishment and increase of financial investments) rather then for producing growth and investment accumulation.

If the banking system fails to increase its contribution to investment financing, a lack of internal investments will inevitably hinder economic development and push the authorities to undertake periodical micro-devaluations as the only means of supporting non-competitive industry.

(11) CBR data.

3. Framework for the development of the Russian banking sector

3.1 Improvements to the institutional and legal base necessary to secure radical growth of the banking system

A new qualitative approach is needed to maintain a sustainable rate of growth. This can be secured by increasing the volume of real investments. A solution should be sought by creating the necessary conditions to channel substantial "unorganised" savings in the real sector of the economy, as well as by making changes in the legal system and financial market structure and by supervising the market adequately in order to reduce risks.

The key condition for increasing financial investment in the real sector is the availability of long-term resources and a reduction of their cost. Retail savings can be considered the main source of long-term funds, which can be accumulated by both the banking sector and institutional investors like pension funds and insurance companies. In this regard, Russia is moving closer to the countries that started economic reforms earlier.

Whereas during the period 1995-1996, the main sources of funds for the banking sector were corporate account balances (70%) and retail savings accounted for no more then 30%, to day these are more or less evenly balanced. Retail deposits are increasing at a higher rate, boosted by income growth. The ratio of corporate funds to retail deposits could change to 30/70 over the next five to seven years, as it is happening in the banking systems of Central Europe

The following analysis provides some insight into the Russian savings market potential: retail savings with banks as a ratio to GDP exceed 50% in Western Europe, 40% in the USA, 29.8% in Poland and 42.5% in the Czech Republic, while in Russia this figure is no more than 10.6%. According to estimates made by experts, non-organized "mattress" savings amount to at least US$ 25-30 billion.

Another key issue is the cost of long-term funding, which is firstly determined by the inflation rate and economic stability of a country. From a macro-economic perspective, Russia has achieved an impressive success: whereas inflation was running at 84% during the crisis of 1998, it has not exceeded 20% for the past three years (the forecast for 2003 is 12-13%) and in 2004 it is expected to fall to a single-digit rate for the first time. The fall in inflation coincides with a monetary expansion complicating the general picture.

Another aspect crucial for the transformation of retail funds into investment is people's trust in the national financial system. Although such confidence was extremely low during the crisis of 1998, by the end of 2001 the volume of deposits was in excess of the pre-crisis level. The high level of confidence of the population in Sberbank reflects not only the unconditional fulfilment of its obligations even during the crises; it should also be taken into account in planning the further development of the country's banking system. Sberbank and other savings banks view the sustainable development of the national economy together with that of the world economy as a pledge of their success.

Other conditions are an increase in the standard of living and the provision of banking services that contribute to mobilise savings and to stimulate demand for loans that in turn increase purchasing power and consumption on credit. Savings banks frequently cope with these tasks better then newly created financial institutions, even in a highly competitive environment. This clearly shows the advantages of traditional approaches in such a sensitive area as household savings over academic textbook knowledge of the market economy.

Experience of the development of banking systems in other countries shows that a deposit insurance scheme can help to build confidence. This instrument is extremely effective in transitional economies. The situation in Russia evolved as follows. At the very beginning of market reforms, the federal law "On banks and banking activities" stipulated that retail deposits "in banks that belong to the state and banks where 50% of voting shares (interest) belong to the state are guaranteed by the state". Since there are a number of large banks (in addition to Sberbank) with state participation exceeding the quoted share, a deposit insurance system is in place in Russia, and speculations concerning the advantages enjoyed by Sberbank are not justified. However, it should be noted that there is no mechanism established by law for implementing this guarantee.

The latest version of the law "On insurance of retail deposits" is presently under discussion in the Russian parliament. The deposit insurance fund is to be pooled by a one-off contribution by the state and quarterly payments by the banks. In contrast to the existing system, the guarantee will cover all the banks meeting the requirements to be admitted to the scheme. Banks failing to comply with these requirements will be stripped of the right to offer services to individual customers. A shortcoming of this law is the small amount of repayment guaranteed: 100% is guaranteed only for the equivalent of US$ 700 and the total amount of compensation will not exceed US$ 3,000. Furthermore, there are a number of important shortfalls that can negatively affect the development of the banking system:

- immediate increase in costs for banks due to insurance contributions and more rigorous supervision requirements that could slow down the development of the banking system;
- some banks will withdraw from the deposit market despite the undersupply of banking services, especially in the regions;
- the very process of the deposit insurance system going live is creating some local tensions in the banking system;

- "moral hazard" is made possible if depositors do not care for secure deposits, lured by the rate of interest alone;
- the system to be introduced harms the position of depositors of those banks, including Sberbank, whose deposits are already under guarantee before the law comes into force.

The provision concerning Sberbank's entry to the deposit insurance scheme on the same terms as other banks is causing a certain amount of concern. Considering Sberbank's current share of the deposit market, its contribution to the insurance fund will become a "socially unfair" burden, since in the case of bankruptcy of some private banks their clients will receive compensation at the expense of Sberbank depositors.

Although the introduction of a deposit insurance scheme is not a universal remedy capable of instantly strengthening confidence among depositors and investors, it is a move in the right direction, provided that all banks are placed in an equal position in terms of market operations and not through administratively imposed limits.

The importance of banks' capital and its effectiveness in financing growth could increase provided simultaneous improvements are made to the legislative, judicial, legal, regulatory, infrastructural, managerial and organizational environment determining the development of non-financial institutions and the Russian economy as a whole.

At present, the issues of excessive liquidity in the banking sector and of the development of lending are associated with controlling and reducing credit risks. The adverse effects of a possible increase in credit risks can be minimised through structural changes. Developing and implementing these is a priority within the competence of Government authorities. Today, the main obstacles for progress in the banking system are more of a behavioural and structural rather than of a quantitative nature.

A shortage of transparent would-be borrowers is seen by the majority of credit managers as the main factor inhibiting lending. A lack of information prevents them from assessing risks adequately, resulting in loan applications being turned down in the majority of cases. In international banking practice, the problem with retail lending is resolved through credit bureaus, which do not yet exist in Russia. Setting up and legalizing credit bureaus and their operations is an issue for Russia's legislators. Establishing credit bureaus as efficient market institutions will require radical changes to current legislation.

In terms of improving the institutional and legislative base, the Russian banking system is progressing in the wake of the banking systems of the world's leading economies. There are immediate plans to amend and improve legislation to further reinforce legal protection of the rights of creditors whose claims are secured by a pledge.

Accelerated charging of pledged assets, reduced periods and simplified procedures for disposal of pledged property including bankruptcy procedures are also under consideration. In the very near future, the law should cover issues such as the pledging of accounts and recourse to funds in pledged accounts, including the establishment of a pledge registration system.

The following measures are bound to influence positively both the quality and volume of banking activities:

- amendment of the Federal Law on Insolvency (Bankruptcy), providing for non-inclusion of pledged property in the bankrupt's estate,
- greater responsibility for improper and fraudulent actions in the system of custody accounting of corporate equity and debt securities,
- enforceability of pledge agreements covering goods in trade and real estate to activate SME lending,
- development of an adequate legislative and regulatory base to expand the list of pledgable property as accepted by international practice,
- transparency of the disposal of pledged assets,
- reduction of notarisation fee for pledge registration.

Some legislation issues have a negative impact on the development of mortgage lending. At present, there is no single state (public) pledge record system in Russia; the current judicial and enforcement system is not always efficient and the enforcement laws abound in ambiguous interpretations.

Practically everywhere in the world, housing is viewed as an expensive asset with a long life, which generally cannot be purchased without long-term mortgage loans. The following issues must be addressed to promote mortgage lending:

- amending and extending the Housing Code of the Russian Federation, taking into account the need to form a legal mechanism to provide temporary housing to the borrower and family members in the case of recourse to pledged property. This task may be resolved by creating a dwelling pool for evicted tenants or a temporary residence pool for borrowers and their family members to be used while the pledged property is being disposed of and the relationship with the lender is being settled;
- the Federal Law on Mortgage (pledge of property) should envisage a more straight-forward procedure for interaction between the trustees, the lender and the borrower;
- changing the procedure for mortgage loan provisioning (long-term housing loans), because the existing procedure was developed for assessing short-term exposures.

Federal law on mortgage-backed securities must also be adopted. Credit institutions which comply with the requirements protecting investors' rights must also be allowed to issue such securities. Allowing credit institutions to manage assets of various funds (such as investment and pension funds) may boost mortgage lending. There is a need to amend the Federal Law on Licensing Specific Types of Activity and on Investment Funds. In more general terms, the development of the lending market and the expansion of credit institutions' funds will facilitate the securitization of assets, which is a standard form of increasing liquidity of banking assets. Development of securitization in the Russian financial market will first require a proper legal basis.

High costs are also an obstacle to the expansion of lending in the Russian banking sector. It should be noted that a number of positive changes in this direction are already taking place. Nonetheless, the following steps would be advisable:

- revision of regulatory (physical security) requirements for banking premises in accordance with actual operational risks,
- simplification of the procedure for opening branches and other facilities for providing banking services;
- acceleration of transition to full-format electronic data interchange and adoption of relevant laws on the use of digital electronic signatures.

Furthermore, Russian banking experts point out the oversized and overloaded forms banks have to submit for reporting purposes to controlling and supervisory bodies as well as to numerous federal agencies. Experts estimate that the completion of such forms takes up as much as 10-15% of the working time of a bank. Self-regulatory banking organizations should become an important link between supervisory authorities and market participants, playing a more significant role in improving control.

It is necessary to simplify the method of providing banking and statistical reports via:

- an optimisation of reporting items,
- a decrease in the number of forms eliminating duplication,
- a reduction in the number of federal bodies requiring reporting statements from banks.

Short-term plans should provide for a reduction of costs, simplify and streamline the procedures required to enter the banking market, to obtain a banking licence and to open branches as well as internal divisions of credit organizations.

Another issue worth mentioning is the low transparency of shareholding structures in the majority of Russian banks. Sberbank is the only bank whose shares are freely floated on the stock market and included among Russia's blue chips. This can be explained, to a significant extent, by the recent history of the Russian financial system whose banks were created as treasuries of major corporations.

However, the transformation of such "captive" banks into real credit institutions is currently gaining strength and the appearance of listed shares (including IPOs) in three to five other banks is quite likely over the next few years. This process is being driven not only by market forces but also by the efforts of the CBR and the Federal Securities Commission, which have been calling for the development of credit institutions subscribing to good corporate governance and to transparency standards recognized by the international community.

3.2 Problem of expanding investment lending in Russia and possible measures to limit cross-border operations of foreign banks

The phase of reconstruction of the economy characterised by low investment is over in Russia. Further growth in production requires the modernization and creation of new facilities and substantial investments. The reconstructed banking system should provide for investment growth. Although this is driven primarily by the decisions of managers, shareholders and bank owners, the Government must also develop and implement an active investment policy. At the same time, relations between the state and the banking system must be based on a strategic partnership, with the state interested in an efficient business sector fostering economic growth and the business community in an efficient Government that addresses its concerns.

Such investment policy should be directed at resolving issues that hinder investment growth, i.e. primarily at a set of macroeconomic conditions. The most important macroeconomic factor is sustainable low inflation, which brings down the nominal cost of funds, thus increasing the number of attractive projects and reducing pay-back periods and risks.

Another significant factor is the stability or predictability of the environment for institutional investment. It is crucial for the authorities when amending tax legislation, regulated prices and tariffs to consider the potential impact on the solvency of the real sector in the short and long-term and on its ability to meet credit obligations.

There has recently been a discussion on reducing the tax burden on the real sector of the Russian economy. To what extent is such tax reform justified in economic terms? On the one hand, reducing tax entails decreased budget allocations and lower Government spending, including investment. In addition, aggregate consumption, which is another factor of growth, is negatively affected by virtue of being reduced in the public sector. On the other hand, a liberalised fiscal environment stimulates production and increases the competitiveness of producers in attracting investments. To be fair, the tax burden in Russia (approx. 33.5% of GDP in 2001 and with an estimated maximum of 31% in 2003) is lower than in other countries of Eastern Europe (approximately 40-41% of GDP) and the OECD countries (averaging 36.1% of GDP).

The existence of a non-market sector presents a much more serious problem for Russia's economy. The focus for the majority of enterprises today is the reduction of "informal taxes", i.e. less Government involvement in economic processes. In this respect, it is important not only to amend current legislation (which determines the structure of economy) but also to reform the administrative system, to make relationships between investors and investment recipients more straightforward and effective.

The attractiveness of the investment market can be assessed by its size. However, this market in present-day Russia is relatively small. The Russian Federation has ample natural resources, real estate and other assets which are virtually unrepresented on the capital markets and thus cannot be used even as a pledge to reduce investment risk. The value of the marketable assets is therefore also significantly decreased. For example, non-existence of ownership rights to the land an industrial property is located on significantly reduces the value of the enterprise. Thus, involving these assets in market relations at market value would increase growth prospects for the economy and the banking sector, thus providing access to financing.

Interest rates on borrowed funds are presently quite high in Russia, compared with western capital markets. The situation concerning investment loans is aggravated by the abolition of the profit tax benefit on interest expenditure. As a result, many enterprises finance their investment programs from their own funds, detracting from capital turnover and financing working capital shortfall with less expensive and more accessible commercial loans. This method of financing is inherently more risky both for the enterprises and the banks. The role of the banking system lies mainly in re-directing enterprises towards bank loans for the purpose of modernising production rather than financing their working capital.

In expanding investment funding and reducing the cost of investment loans, the Government's policy must be aimed at decreasing the risks faced by commercial banks, increasing their capitalization and defining priorities in developing the economy by:

- subsidizing interest rates, providing guarantees and using other incentives for key and priority production projects in underfinanced industries (processing industries);
- exempting income retained for capitalization purposes from tax, including all expenses on provisions created in accordance with the requirements of the CBR in relation to the cost of banking;
- creating a mechanism for providing state guarantees for financial and credit organizations as security for issued loans, possibly in the form of a national credit guarantee agency for investments and export loans.

Furthermore, necessary amendments to the tax and currency legislation should be one of the Government's most urgent tasks. These should provide for an actual mechanism of pledging export and other proceeds of an enterprise in line with internationally approved practice.

The banking regulations also require significant change. However, this is not an easy task, as it necessitates liberalising supervisory requirements in order to avoid restraining economic growth while, at the same time, preventing the increase and concentration of risk.

The existing system of allocations (7-10% of liabilities) to the Obligatory Reserve Fund

(FOR) cannot be regarded as adequate in view of the current macroeconomic situation. Long-term borrowings of the banks could easily be exempted from the obligatory reserve requirement. The reserve requirement for long-term funding increases costs for banks and limits the possibility of placement in investment credits. Many countries do without an FOR requirement, and their economies still develop quite successfully. In Europe, the reserve amounts to around € 130 billion (financing provided by the European Central Bank ranges between € 190 and 200 billion). It should be noted that, in the European system, deposits and securities with maturity in excess of two years and financing through REPO transactions are not included in the FOR calculation.

A revision of FOR may therefore become an additional instrument for increasing the funds of Russian banks through:

- reduction of the FOR rate,
- introduction of a differentiated FOR rate depending on term of maturity,
- providing access to FOR for maintaining current liquidity (for a short-term period),
- permission to use state securities for FOR purposes by depositing Government securities with the CBR.

A combination of world markets interest rates falling to an historical low and the increased attractiveness and reliability of lending to Russian corporations has led to the Russian banking sector being confronted with a dramatic increase in competition from foreign banks. Today, the Russian banking system is – in *de facto* terms - reaping the fruits of financial globalization and increased transparency. With regard to lending to the real sector - taken as a US dollar equivalent - loans granted directly by head offices of foreign banks to Russian borrowers account for around 25%, and this figure is rising.

Due to the fact that foreign and Russian banks exist under different legal and taxation systems subject to different regulatory and supervisory requirements, Russian banks are initially at a disadvantage on the domestic market. We can presently talk of "loan dumping", where interest rates are established by foreign banks at a very low level, which is undeniably out of line with both the existing market and the investment risk.

Cheap financing is beneficial to an enterprise. However, there are investments and investments. Direct investment in production helps to boost output, raise employment and increase tax revenues. However, relatively short-term loans guaranteed by export proceeds may - under unfavourable conditions (rising interest rates, negative events) - bear significant risks both for the borrower and the economy in general.

The introduction of certain amendments to and changes in the current regulations on residents borrowing from non-residents in hard currency would be in the interest of developing and strengthening the banking system and further reducing the flight of capital. These changes should be directed at creating level conditions for cross-border lending by non-

resident banks to residents. Furthermore, this activity should be supervised by the monetary authorities in order to protect the still relatively weak Russian banking system from the risk of a significant capital outflow in the process of the country's growing involvement in the global markets. At the same time, however, such changes should not affect the credit operations of Russian banks in relation to the market share of non-residents banks since these operate under the same terms.

3.3 Prospects of Russia joining the world financial community by accessing the WTO

The banking community is interested in having a clear and strong official position regarding the terms for Russia's entry in the WTO. It is not so much the accession to the WTO that is the cause of concern today, but rather the absence of a clear state policy in relation to foreign capital and the national banking system. In joining the WTO, the main challenge is to retaining control in the hands of the national banking authorities.

We assume that accession to the WTO would require a transition period of seven to ten years. A complete opening up of the national financial market is only possible once a national banking system is in place and operating effectively. Otherwise, Russia risks following the route of several other Eastern European countries that have experienced a denationalisation of their banking sectors. For example, when the IMF and EBRD were evaluating the stability of the financial sector in Poland and Lithuania, they commented on excessive bank liquidity and an outflow of funds to other countries. At the same time, major Lithuanian and Polish corporations tend to borrow directly from abroad and not from local banks. It should be pointed out that 110 of the 140 WTO member countries currently retain various constraints on access to foreign capital.

The following adverse effects of uncontrolled movement of capital and foreign banking services to the Russian national market can be cited:

- no guarantee that foreign banking assets will be used to finance the real economy sector and not be limited to the securities market;
- foreign banks will first of all consider their own national interests and their national banking regulations;
- in controlling the flows of major producers, including predominantly export flows, foreign banks will be able to gain control over the financial flows and solvency of the major Russian economic entities in both export and domestic payments. In this case, there is a likelihood that financial flows will be channelled abroad.

When establishing Russia's positions during the WTO negotiations, special attention should be devoted to protecting those segments of the financial market that are currently less well developed and which may be dominated by foreign banks.

The national business is least of all prepared for competition or it is simply not present in segments such as derivatives, stock exchange trading, mortgage lending and non-Government pension funds. Thus, the appearance of foreign pension funds would completely deprive domestic credit institutions of any competitive advantages. The lack of adequate regulatory norms on derivatives, mortgage-lending and mortgage-backed securities limits the scope of activity of Russian banks and makes the position of foreign banking institutions more stable from the outset.

At the same time, foreign banking capital can undoubtedly enrich the Russian market through the contribution of modern technologies, new financial products and considerable experience in corporate governance. There is no doubt that a well-measured access to foreign banking capital should be encouraged as a means to promote competition and enable the mobilisation of funds from that segment of the population that prefers to bank with foreign credit institutions due to their stability and standing.

Today, there are two main ways of increasing competition in banking: through the liberalization of conditions to enter the market and the creation of conditions for establishing markets and institutes within the country, in areas such as insurance and pension funds, which could compete with foreign and domestic banks for the management of savings. If such institutions develop properly and assume a role that is at least partially comparable with that of their counterparts in the world's leading economies, their presence will significantly increase the stability and reliability of Russia's financial system. When the country joins the WTO, special attention should be devoted to protective measures and conditions favourable for developing competition in the finance sector.

3.4 Transition of the Russian banking sector to International Financial Reporting Standards (IFRS)

The transition of Russia's economy and banking sector to International Financial Reporting Standards (IFRS) is an important factor in demonstrating the increasing degree of Russia's integration into the global economic process.

The main objective of switching to IFRS is to increase stability through the greater transparency of credit organizations. The introduction of IFRS creates pre-conditions for accelerated growth of domestic and foreign investments in the banking system, which, in turn, should result in increased capitalization and enhanced development of the Russian banks.

A new stage in the development of business relations in Russia requires the improvement of the country's accounting system. Several factors call for such reform:

- a mutating economic environment for businesses, including more extensive relationships with international entities,
- new business opportunities,
- changes in the legal framework for businesses.

In general, the process of implementing unified financial reporting and accounting standards is of a global nature. In recent years, European countries and the US have made significant progress in unifying and reciprocally accepting IFRS and GAAP. Nevertheless, as of today, international standards as such do not exist in any European country. Each set of national standards differs in its own way from the international ones.

However, switching to new accounting and reporting standards is more complex in Russia than in other European countries, because the latter apply standards that do not differ as much as Russia's from the international ones. For this reason, Russia has more banks subject to the rigorous IFRS transition schedule than the EU. While European banks are scheduled to switch to international financial reporting standards from 2005, this process should start as early as 2004 in Russia.

Many Russian banks have already been preparing accounting statements according to IFRS, guided by the principle of maximum transparency. Sberbank was one of the first in Russia to voluntary compile annual accounts certified by audit companies according to IFRS (in 1996). Sberbank's IFRS financial statements are published on its web site as well as in the annual reports.

In 2002, Sberbank prepared interim IFRS statements within the framework of a special pilot project. In December 2002, Sberbank established a separate functional unit responsible for preparing financial statements according to IFRS. Based on this experience and on its team of experts, Sberbank considers the introduction of IFRS in the Russian banking sector primarily a factor for ensuring greater trust on the part of share-holders, investors and clients.

3.4.1 Preparations for the implementation of IFRS in Russia

The CBR has been working on the transition of Russian banks to IFRS for a long time. Three stages can be singled out in this process. From 1993 to 1997, appropriate changes were gradually introduced into normative CBR documents, regulating procedures for preparing financial statements by commercial banks and making them more compatible with IFRS principles ("Instruction on Preparing General Financial Statements by Commercial Banks").

In 1997, a new Accounts Charter for credit institutions was launched, ensuring the possibility of preparing financial statements in accordance with IFRS.

In 2002, a pilot project on the preparation of financial statements according to IFRS was carried out in a number of banks.

The CBR set up the Committee for IFRS Implementation with the participation of representatives from some of its departments, the Ministry of Finance and legislative bodies. The Committee is in charge of developing a methodology for transition to IFRS and is also entrusted with the amendment of both the Law on Accounting and the TAX Code for their adaptation to IFRS introduction.

The CBR has already prepared guidelines for Russian banks' transition to IFRS and has sent them to the EU for expert consideration. Obtaining the approval of international organizations is a matter of primary importance for the CBR. In the future, such approval will save the CBR from claims of discrepancies between the new Russian standards and IFRS. It is deemed necessary to ensure the integrity of the conceptual framework in preparing reporting in accordance with IFRS.

The CBR has decided to use the period January-June 2004 for a transformation test. The first financial statements in accordance with IFRS will be prepared for a period of nine months in the year 2004. The annual financial statements for this year should be confirmed by an independant auditor. During 2005, reports prepared according to IFRS and those following Russian Accounting Standards will have to be presented simultaneously. It is assumed that, during the period in question, banks that have shown drawbacks in the structure of their balance sheet will have the possibility of mend this.

In 2004-2006, preparation of financial statements in accordance with IFRS and their use for the purpose of banking supervision according to the Basle Principles will become one of the most important directions in the work under consideration.

3.4.2 Readiness of the Russian banking sector for the implementation of IFRS

Principles of transition to IFRS were adopted by way of a resolution of the CBR Board and approved by the Russian Government. Despite the rigorous schedule for the transition of credit institutions to IFRS as of 01.01.2004 (whereas in the real sector of the economy, only companies whose shares are quoted on the open market – 100 in all – will prepare their financial reports according to IFRS) and the existing difficulties, realisation appears quite feasible because the assets of the banks already doing IFRS reporting are considerable.

At present, about 120 banks in Russia prepare their reports according to IFRS, accounting for around 70% of the entire assets and capital of the sector. Many of them have been preparing their financial statements according to IFRS and having them audited by foreign audit companies for quite a long time. Such cooperation is extremely useful for the banks because, based on the financial statements prepared according to IFRS and audited by international auditors, these banks can, for instance, see their undercapitalization or "bad" assets.

In addition, much has already been done in the Russian accounting system to bring it into line with international accounting principles. Decisions on introducing changes in the accounting system over the last three years have been agreed with competent audit companies. Within the framework of transition to IFRS, the CBR has developed a series of guidelines, which, in the opinion of the European experts who analysed them, fully correspond to current international standards.

3.4.3 Major problems related to the implementation of IFRS in Russia

We should distinguish between keeping accounts according to IFRS and compiling reports according to IFRS. As of 01.01.2004, an IFRS financial statement may be prepared by transformation-based adjustments related to specific algorithms, professional judgements, and indirect calculations based on other financial information. At the same time, a large number of problems need to be solved in the accounting process that forms the basis for subsequent statements so that the principles of accounting conform to international standards.

This may take years because many standards are based on the accounting of some deals that are interpreted differently under Russian and international law. Unification will require changes to the Russian Civil Code, as well as the laws governing securities market, mortgages, banks and banking. This implies changes to an entire set of laws in order to bring the concepts of transactions and deals (and, respectively, accounting) closer to international interpretation. Such work should proceed simultaneously in the banking sector and the real sector of the economy.

The CBR considers changes in legislation as one of the most important issues in the changeover to IFRS. The concern is that the IFRS are presently of no legal consequence. Work is under way to prepare a draft law stipulating that statements compiled by transformation, including consolidated statements conforming to IFRS, are relevant in law.

Another very important issue related to IFRS implementation is that some owners are unwilling to disclose all the information about their companies and themselves. Accordingly, the IFRS, which are intended to increase transparency, will fail to serve that purpose because "substantiated judgements" and "fair estimates", allow for differing interpretations, and the unwilling owners will make use of the ambiguity. If the IFRS are to be fully implemented, the owners' attitude and behaviour need to change drastically, and this will take time.

A substantial problem is the training of accountants and auditors. There are very few audit firms in Russia that could give a qualified opinion on financial statements according to IFRS. In fact, Russia has to tackle two major issues: the introduction of International Audit Standards and IFRS. The training problem has to be resolved in the very near future, otherwise there will be nobody to audit the reports compiled under the new requirements.

There are also problems with the software in that it should also migrate from Russian

Accounting Standards to IFRS. The software will be modified on a step-by-step basis, like the accounting.

The results of a pilot project to implement new accounting rules in credit institutions demonstrate that the banks' management, planning, and forecasting systems must be restructured. The CBR has already prepared and submitted the appropriate instructions for international expertise.

Notwithstanding the efforts already made, the Ministry of Finance and enterprises will not have enough time to synchronise with the banking sector's changeover by 01.01.2004, though most of the companies listed in Russia have already been compiling their financial statements according to IFRS for some time.

The CBR is convinced that banks and companies must switch to IFRS at the same time, by virtue of the need to change both reporting forms and reporting principles, and the CBR will not tolerate lenders and borrowers reflecting one and the same transaction differently in their balance sheets. If this issue is not settled by 01.01.2004, a compromise or interim solution will be required, and the Committee for IFRS Implementation is currently elaborating such an option.

The new accounting law for the IFRS change-over will be introduced in the coming years. In the meantime the Russian banks will keep their accounts according to Russian Accounting Standards, using translation factors to compile their IFRS statements.

It is generally felt that all the obstacles will be eliminated sooner or later because IFRS implementation is a critical factor for the development of the Russian economy and its integration in the world economy.

Enhancing the transparency of the national banking sector is essential for strengthening public trust, the stability of the sector and for eliminating uncertainties in the market.

4. Main directions of Sberbank's development

The major directions of Sberbank's development are presented in the Sberbank Development Concept to 2005.

According to the concept approved by the General Shareholders Meeting in 2000, the main strategic goal of Sberbank is to radically improve its customer service quality and retain its position as the largest modern, first-rate, competitive bank in Eastern Europe. This requires a system resistant to potential economic shocks (both in Russia and abroad), with the best possible distribution of efforts in servicing three major customer groups: retail, corporate, and public.

To achieve this strategic goal, Sberbank will have to:

- Introduce a new customer servicing philosophy, combining standard technologies with a customised approach; implement efficient customer servicing techniques and improve the quality of services.
- Work more with corporate clients; attract and retain as many first-rate customers as possible over a long-term perspective; increase the share of corporates in borrowed funds to 25% and the share of their loans and liabilities in net assets to 45%.
- Render maximum assistance to the Government in the implementation of federal investment programmes and export support programmes.
- Rely on its powerful customer base, ensure a good balance of assets and liabilities and introduce modern techniques of assets and liabilities management; diversify the bank's financial resources, including external funding.
- Raise the share of non-interest income by developing customer services; ensure that the share of fee income in the net operation income is not less than 15%.
- Increase capital to expand investments in the Russian economy; ensure that ROE is not less than 20%.
- Implement a full-scale risk management system.
- Create a flexible management system based on economic incentives and optimum distribution of powers; enhance controllability of the bank by giving more powers to regional head offices and improving decision-making procedures.
- Streamline the branch network with due regard for economic and social factors.

4.1 Raising funds

Political stabilisation and positive trends in the national economy attract investments in the real sector and require faster growth of funding. The main sources of funding for the bank are:

- retail savings, the major and the most reliable investment source,
- corporate funds, the most rapidly growing constituent of the bank's liabilities,
- funds raised from international financial markets, a long-term liability to enhance the financing of investment projects.

Major goals for fund raising up to 2005:

- Retain leadership in the raising of retail funds, stimulate the savings and investment activity by giving depositors an opportunity to choose from the most effective forms of savings, meet customer requirements for liquidity, profitability and reliability, ensuring the growth of funds deposited with the bank; maintain the most favourable deposit rates for socially exposed depositors.
- Preserve and, if possible, increase the current share of the corporate banking market, creating long-term customer preferences for Sberbank services.
- Foster foreign investments in the Russian economy; diversify its funding base by all available means, including foreign borrowings.

In order to support asset operations, invest in the real sector and reduce the interest risk, the bank has set itself the following priorities: longer terms of borrowing, reduction of the total funding cost, optimisation of the structure for raising funds according to the "price–term–revaluation or early withdrawal risk" criterion.

4.2 Placement of funds

To achieve its main strategic goals, the bank will maintain an optimum balance of efforts in the three main areas of funds placement:

- retail lending, a promising segment;
- lending, project financing and investment in corporate securities, the main area of funds placement promoting the national economy, supporting domestic manufacturers and service providers;
- investment in corporate securities, lending and participation in federal and regional target projects, the basic means for supporting federal programmes.

The main objectives in funds placement for the period up to 2005 are:

- expand retail consumer lending, helping to resolve housing and social problems;
- enlarge investments in the real sector, mainly through high rates of growth in corporate lending in Russian roubles and other currencies;
- perform ongoing work to optimise the structure of the Government securities portfolio, increase profitability, liquidity, reduce exchange and market risks.

The bank will work to maintain a sufficient level of liquidity, a balance of assets and liabilities by term and currency, ensure the optimum level of diversification by region, economy sector, customer and size of investment. The bank will develop its asset operations with regard to the efficiency of specific market segments.

4.3 Retail banking

Historically, retail savings have represented the core of funds raised by the bank. Sberbank regards stable and mutually beneficial relations with retail customers as the basis for its successful performance.

At present, Russia offers favourable conditions for retail banking development. Improvement of the macroeconomic situation, economic growth, falling inflation, growth in retail turnover, increased real disposable income, positive changes in the banking laws, fiscal and budget policy, structural reforms and a stable socioeconomic environment promote the development of retail banking in Russia.

Over the past two years, these changes have resulted in stable growth of demand for retail banking services. Retail deposits with Sberbank have been growing twice as fast as the balances of corporate funds. However, despite the rapid growth observed over the past few years, retail banking in Russia is still underdeveloped compared to other emerging markets. Consumer lending has also been growing faster than corporate lending.

In general, the development of financial services and retail banking in Russia is hampered by a variety of factors, including:

- Low individual income: the gross national income per capita in Russia is less than half of that of the largest Central and Eastern European (CEE) countries. Low income affects consumer behaviour, individual demand for banking services, and, indirectly, the profitability of retail banking on a national scale. It is the per-capita income that is bound to have the most significant impact on retail market development and can serve as the most reliable indicative parameter for market players.
- Low density of population and vast territory of the country: compared with other European countries, the density of population in Russia is less in terms of order of magnitude. Even in the most densely populated Central Federal District, the density (56.1 individuals per square kilometre) is much lower than in a typical European country, whereas eastwards of the Urals it does not exceed 2.5 people per square kilometre. The distance between cities in the Russian Federation varies from 45 to 75 km, as compared to 8-20 km in Europe. Only 30% of the Russian population is concentrated in the capitals of federal regions, and the capitals are, on the average, six times as large as the second biggest cities in the respective regions[12]. Only two cities in Russia can boast a population in excess of two million (cf. twenty-two in the USA, though the total population of these cities is only twice as large). These examples testify to the fact that the development of retail banking in Russia is hampered by high organisational costs (higher than in CEE countries), local infrastructure, personnel problems and low efficiency of economies of scale.

With regard to developing the branch network, the bank has to tackle the complex problem of combining economic interests with reasonable pricing of services for the majority of individuals.

[12] Data from the Demography and Human Ecology Center of the Institute of Economic Forecasts, Russian Academy of Sciences.

To streamline the provision of retail banking services between 1999 and 2000, Sberbank reorganised its branch network to consolidate its regional units and improve the management of its regional head offices, branches and client services. Seventy-one regional banks (branches) of Sberbank were transformed into seventeen regional head offices, while other units became their branches.

Consolidation allowed Sberbank to implement new banking technologies, reduce costs and realise economies of scale by offering technology solutions in all the regional units.

With competition becoming fiercer, the maintenance of leadership in this market segment depends primarily on the nature of the services offered. In addition to raising retail funds and developing retail lending, the bank considers cashier and settlement services as one of its principal business areas. A good branch network and banking infrastructure allow the bank to offer its customers unique cashier and settlement services. In addition to card operations (via national and international payment systems), the bank offers settlement of virtually all types of retail payments.

The development of such operations is aimed to make banking transactions less complicated (both for the bank and for its customers), implement a flexible policy concerning charges and fees and increase the volume of settlement operations carried out. To increase the volume of payments and reduce related costs, Sberbank will be developing services enabling clients to do payments to retail sales companies, enterprises and various organisations, in addition to utilities. Sberbank will work to raise non-cash credits and debits on customers' instructions.

4.4 Corporate banking

Improving the quality of banking services to corporate customers is one of the most important tasks facing Sberbank today. This will enable the bank to optimise the structure of funding and offer competitive prices on investments in the real economy sector. Increasing balances of corporate current and settlement accounts to 25% or more of the bank's total borrowed funds will ensure a lower interest rate risk and increase non-interest income.

This goal can be achieved through long-term customer relations and mutually beneficial cooperation with customers. The bank plans to develop and roll out a standard portfolio of banking products for individual entrepreneurs and small businesses in all regions of Russia.

Sberbank is developing a comprehensive range of services for medium-sized and large companies that fulfils customers' requirements and provides them with access to all the products and services accepted in the international banking practice. Services to this category of customers should be rendered on the basis on flexible technologies, envisaging maximum possible adaptation of the bank's capabilities to the requirements of its customers. For large customers, the bank will set up a personal manager service. In rendering various services to its clients, the bank will place special emphasis on the quality

of service, decreasing execution time and developing a "Client Bank" culture. Regional features will be taken into account in developing the product range as well as the bank's policy on interest rates and fees.

In its relations with budget organizations of different levels, the bank adheres to the principles of offering a whole range of high-quality banking products and services at the lowest possible price.

The development of long-term relations with customers and the provision of comprehensive services will decrease the risk of corporate balance fluctuations and make such risks more predictable.

Rendering cash and settlement services to the bank's customers will serve the aim of preserving and increasing the bank's share of the corporate payments market by improving the quality of such services.

Reduced payment execution time (both in Russian roubles and foreign currency) will be achieved by improving the bank's own technologies, developing its telecommunications infrastructure and optimizing payment flows. A ramified network of the bank's NOSTRO correspondent accounts, backed-up by the established system of country risks and limits on the correspondent banks, will ensure the possibility of quick and safe execution of payments to any region of the world. Optimization of the NOSTRO correspondent accounts network will be aimed at decreasing the cost of settlements, rendering additional services and providing direct contacts with the banks servicing the financial flows of their foreign partners. Special attention will be paid to establishing long-term relations with correspondent banks and providing mutually beneficial account servicing and payment execution. Services for opening and maintaining LORO accounts of credit institutions of good standing will be developed further, as well as the execution of settlement agent functions and exchange sites.

The bank will pursue its centralized policy of opening and maintaining NOSTRO correspondent accounts with foreign banks, providing a single standard of payment execution time and settlement quality at all Sberbank's regional head offices and branches.

The further development of relations with large enterprises and institutions of federal importance, which bank regularly with Sberbank, will be top-priority in corporate lending.

Efficiency of the borrower's business, cost-effectiveness of the project to be financed, as well as regular cash flow on the accounts with Sberbank will remain determining factors in decision-making on corporate lending.

In addition, overdraft lending and lending through promissory notes will be further developed to suit customers' cash flows and their demand for optimization of settlements with counterparties, as well as for decreasing debt-servicing costs.

Extending short-term credits (up to one year) to corporate customers (both in Russian roubles and in foreign currency) will aim to meet customers' demands with regard to working capital. Target groups for this type of corporate lending include enterprises in the light industry and the food sector, communal services and amenities, trading companies and trade intermediates. The amounts of funds to be extended will be determined by the solvency of the borrower, cash flow on the accounts, plus the industry-related and regional specifics of its business. Credit risk will be decreased through loan portfolio diversification, enhanced lending to efficient SMEs and improving the quality of sureties.

Intense financing of export and import operations will provide the required volumes of short-term lending in foreign currency. Pre-export lending will be widely used and provided mainly for medium-sized and large corporate customers and their Russian partners. Such operations will be developed with due regard for the situation on the financial and raw material markets and possible increase in the sovereign rating of Russia. This will considerably extend the bank's possibilities to use non-credit instruments, such as forfeiting, documentary operations and guarantees. Rendering services to the parties of foreign trade contracts (exporters and importers) and enterprises demonstrating consistent performance on the national market will become a priority for the execution of the bank's guarantee operations. With the Russian economy stabilising and the country's international rating improving, payment guarantees, contract performance guarantees as well as tender and customs guarantees account to the most promising types of banking transactions.

The bank will develop products, taking account of the specifics of different industries. The pre-financing of the production of precious metals against future deliveries will be further developed as an additional guarantee of loan repayment, on top of standard forms of loan securitization. The procedure for rendering additional services to borrowers in the form of the purchase of precious metals from gold mining enterprises (both for future resale and formation of the bank's investment portfolio in precious metals) will be improved.

The number of Sberbank branches participating in the EBRD Program of Lending to Micro- and Small Business Enterprises will be increased. Making use of the experience gained in the cooperation with EBRD, Sberbank will develop its own lending programs for micro- and small business, using its own funds.

Investment lending will become one of the main instruments for expanding the most attractive market segment: Russia's largest solvent customers. This will form the bank's customer base, which will serve as an additional "accelerator" for the development of all types of lending operations and rendering concomitant services to customers. A larger number of long-term lending products, investment lending and project financing will be necessitated by the strict observance of liquidity standards set by the CBR, as well as by the needs of the real sector of the economy.

5. Position of the state on the development of the Russian banking system

An effective and highly developed banking system, enjoying the confidence of the economy is an important condition for stable growth. Different measures were taken to create such system at different stages of the country's economic development. At the initial stage of market reforms, it was necessary to eliminate the state monopoly and liberalize banking. Later, however, when the reforms contributed to "deteriorate" the quality of the banking system, giving rise to higher risks and bankruptcies, state regulation concentrated on improving the reliability of the system. This proved difficult to do under the unstable macroeconomic conditions, as demonstrated by the financial crisis of 1998.

The present-day situation offers a unique opportunity: the Russian banking system has gained considerable experience in operating in a market economy and overcoming crises. It is now matter of improving the quality of regulation and supervision, while at the same time liberalising banking and the financial markets.

With regard to regulation, the task is to remove the restrictions imposed during the crisis, which became a hindrance once conditions started to stabilise. This applies to ratio requirements for different categories of assets and liabilities, as well as to regulatory measures directly affecting the profitability of the banks. This is the case of the Obligatory Reserve Funds. The obligation to compile financial statements must be revised to avoid duplication and eliminate redundant reports no longer used by state statistical offices. Responsibilities imposed by the state on the banking system should also be revised, primarily to exclude control functions that are not inherent to banking. However, this does not mean that the measures aimed at preventing money laundering and terrorism financing should be relaxed.

In addition, the growing involvement of Russia in the globalization process necessitates an awareness of world trends. At present, the CBR is making efforts to improve the quality of banking supervision by substituting the control of formal parameters and the observance of instructions with supervision rules that analyse not only the current state but also the dynamics of the banking sphere. This is a highly complicated task because, quoting a well-known saying, it could be argued that "the supervisory system is always getting ready for the crisis that has just ended".

One of the most important steps, in addition to the introduction of IFRS, is preparing for the transition to Basel II. At the same time, it is becoming increasingly clear that neglecting national specificities in a process of reform could damage more than help a banking system. This holds particularly true in respect to the difference between investment banks conducting international M&A business and savings institutions. A differentiated approach must be studied, also taking into account the experience of other parts of the world and that of the World Savings Banks Institute. Another aspect of the implementation of Basel II in Russian banks is the availability and collection of information. Today, risks are measured on the basis of the criteria elaborated by the CBR. According to the new capital rules, risks should be estimated by applying mathematical formulas, which foreign banks have been using for quite some time. Russian banks have not yet accumulated historical databases of sufficient length for these methods to be applied. The situation is compounded by the fact that the Russian banking system still lacks institutions necessary to guarantee its smooth functioning. Therefore, one of the state's priorities in the sphere of banking is the creation of a proper infrastructure.

For this purpose, laws are currently being drafted on individual deposit insurance, credit bureaus, mortgage securities, derivatives, requirements for credit agencies, etc. Although these draft laws still contain many unresolved issues, they help to regulate areas of the banking business that would otherwise remain outside the legal framework.

The Russian banking system resembles that of continental Europe with banks acting as main lenders to the real economy and with corporations holding shares. At the same time, the Anglo-Saxon model was selected for the stock market, with the real economy being financed by public offerings of shares to minority shareholders and banks playing an auxiliary role. This problem continues to exist, hampering banks' activities on the stock market.

The state's efforts to improve regulation and supervision are coupled with the creation of conditions favourable to the liberalisation of financial markets, which is to be regulated by the Draft Amendments to the Law on Currency Regulation and Currency Control. However, the results of such amendments are not self-evident. On the one hand, the corporate sector will gain access to relatively cheap funds available on international capital markets and competition in the banking sector will grow. On the other, conditions may facilitate the capital flow in amounts that could threaten the national economy and banking system. It is worthwhile emphasizing once again that, judging by the global experience, liberalization of the financial markets should not run ahead of liberalisation of trade operations. In any case, care should be taken and a rational approach pursued, i.e. establishing conditions favourable to the inflow of foreign investments to the banking sector and having the subsidiaries of foreign banks operating in the same environment (from the viewpoint of competition) as Russian banks.

The main issue in the relations between the state and Russian banks is the development of a strategy that enables the banking sector to grow according to the country's national interest. Russia is also faced with the necessity of elaborating a vision for its future social and political structures, determining the mechanisms that would ensure sustainable development is a complex and rapidly changing world. Under such conditions, the role of the state is reduced to that of a coordinator, harmonising the rules in individual segments of the market with its interests. Thus, to ensure the development and reliable functioning of the Russian banking system, the role of the state should not be too paternalistic. This role should become increasingly important, especially at the stage of the introduction of banking sector reforms.

Annex

Sberbank
Balance Sheet as at 31 December 2002 in accordance with IFRStandards
(thousands of Russian Roubles - purchasing power as at 31 December 2002)

			Pro-forma Restated	
	2002	2001	2002	2001
Assets				
Cash and cash equivalents	67 608 513	40 070 873	67 608 513	40 070 873
Mandatory cash balances with the Central Bank of the Russian Federation	74 808 687	61 600 025	74 808 687	61 600 025
Trading securities	125 854 436	78 264 745	125 854 436	78 264 745
Due from banks	40 024 779	1 067 793	40 024 779	1 067 793
Securities available for sale	93 025 286	93 012 939	93 025 286	93 012 939
Loans and advances to customers	516 671 183	441 348 823	516 671 183	441 348 823
Securities acquired at original issuance	102 027 415	108 018 415	102 027 415	108 018 415
Tax asset	217 330	-	217 330	2 150 228
Premises and equipment	61 675 642	58 490 679	61 675 642	58 490 679
Other assets	5 100 097	6 395 724	5 100 097	6 395 724
Total assets	**1 087 013 368**	**888 270 016**	**1 087 013 368**	**890 420 244**
Liabilities				
Due to banks	4 053 218	17 816 971	4 053 218	17 816 971
Deposits from individuals	708 015 138	577 809 139	708 015 138	577 809 139
Customer accounts	187 745 057	150 232 658	187 745 057	150 232 658
Own securities issued	54 160 970	33 082 136	54 160 970	33 082 136
Other borrowed funds	1 467 509	1 792 291	1 467 509	1 792 291
Tax liability	-	8 112 809	-	-
Other liabilities	8 451 980	5 718 648	8 451 980	5 718 648
Total liabilities	**963 893 872**	**794 564 652**	**963 893 872**	**786 451 843**

			Pro-forma Restated	
	2002	2001	2002	2001
Shareholders' equity				
Share capital	20 980 583	20 980 583	20 980 583	20 980 583
Share premium	10 016 190	10 016 190	10 016 190	10 016 190
Treasury shares	(411)	(1 211)	(411)	(1 211)
Revaluation reserve for premises	497 605	521 300	497 605	521 300
Accumulated retained earnings and other reserves	91 625 529	62 188 502	91 625 529	72 451 539
Total shareholders' equity	**123 119 496**	**93 705 364**	**123 119 496**	**103 968 401**
Total liabilities and shareholders' equity	**1 087 013 368**	**888 270 016**	**1 087 013 368**	**890 420 244**
Interest income on loans	94 794 887	77 355 423	94 794 887	77 355 423
Interest income on securities	36 785 503	38 108 603	36 785 503	38 108 603
Interest expense	(58 729 018)	(53 012 628)	(58 729 018)	(53 012 628)
Net interest income	**72 851 372**	**62 451 398**	**72 851 372**	**62 451 398**
Impairment of interest earning assets	(13 651 554)	(10 375 136)	(13 651 554)	(10 375 136)
Net interest income after impairment for interest earning assets	**59 199 818**	**52 076 262**	**59 199 818**	**52 076 262**
Gains less losses arising from securities and derivatives	19 344 898	26 704 625	19 344 898	26 704 625
Gains less losses arising from dealing in foreign currencies	2 886 561	3 005 166	2 886 561	3 005 166
Foreign exchange translation gains less losses	3 579 901	7 150 314	3 579 901	7 150 314
Fee and commission income	16 929 637	14 319 373	16 929 637	14 319 373
Fee and commission expense	(480 229)	(580 831)	(480 229)	(580 831)
Other operating income	2 220 310	2 316 569	2 220 310	2 316 569
Net operating income	**103 680 896**	**104 991 478**	**103 680 896**	**104 991 478**
Payroll and other staff costs	(43 462 154)	(40 731 105)	(43 462 154)	(40 731 105)
Operating expenses	(24 380 268)	(21 964 587)	(24 380 268)	(21 964 587)
Reversal of allowance for impairment of securities	-	4 960 304	-	4 960 304
(Additional charge)/reversal of provisions for credit related commitments	(16 659)	47 286	(16 659)	47 286
Monetary loss	(7 922 164)	(3 400 889)	(7 922 164)	(3 400 889)
Profit before taxation	**27 899 651**	**43 902 487**	**27 899 651**	**43 902 487**
Income tax benefit/(expense)	2 621 664	(12 305 611)	(7 641 373)	(2 042 574)

	2002	2001	Pro-forma Restated 2002	Pro-forma Restated 2001
Net profit	**30 521 315**	**31 596 876**	**20 258 278**	**41 859 913**
Earnings per share (expressed in Russian Roubles per share)	**1 603**	**1 820**	**1 063**	**2 412**

	2002	2001
Cash flows from operating activities		
Interest received on loans	94 743 781	75 188 543
Interest received on securities	32 767 528	35 136 418
Interest paid	(56 817 683)	(48 236 572)
Income received from dealing in securities and derivatives	11 713 336	6 252 553
Income received from dealing in foreign currencies	2 886 561	3 088 085
Fees and commissions received	16 929 637	14 319 373
Fees and commissions paid	(480 229)	(580 831)
Other operating income received	2 190 166	2 488 099
Staff costs paid	(40 731 100)	(38 434 989)
Operating expenses	(24 000 002)	(15 366 883)
Income tax paid	(6 267 197)	(4 744 266)
Operating profits before changes in operating assets and liabilities	**32 934 798**	**29 109 530**
Cash flows from operating assets and liabilities		
Net (increase)/decrease in:		
Mandatory cash balances with the Central Bank of the Russian Federation	(22 852 002)	(15 130 986)
Trading securities	(55 783 548)	(37 009 926)
Due from banks	(41 378 278)	25 990 294
Loans and advances to customers	(153 640 094)	(174 695 101)
Securities available for sale	(8 141 134)	(7 120 202)
Securities acquired at original issuance	4 985 996	(1 091 418)
Other assets	1 584 261	(2 070 845)

	2002	2001
Net increase/(decrease) in:		
Due to banks	(12 367 011)	13 232 351
Deposits from individuals	212 790 671	173 199 097
Customer accounts	60 015 812	16 553 896
Own securities issued	26 469 692	(7 804 122)
Other liabilities	1 007 387	1 191 205
Net cash from operating activities	**45 626 550**	**14 353 773**
Cash flows from investing activities		
Purchase of premises and equipment	(9 661 646)	(5 345 239)
Proceeds from sale of premises and equipment	448 660	387 246
Sales of other investments	-	130 135
Dividend income received	30 144	15 139
Net cash used in investing activities	**(9 182 842)**	**(4 812 719)**
Cash flows from financing activities		
Issue of ordinary shares	-	6 210 999
Sale of treasury shares	800	837
Other borrowed funds (repaid)/received	(95 897)	1 063 595
Dividends paid	(1 115 484)	(925 617)
Net cash (used in) provided by financing activities	**(1 210 581)**	**6 349 814**
Effect of exchange rate changes on cash and cash equivalents	**370 723**	**608 673**
Effect of inflation on cash and cash equivalents	**(8 066 210)**	**(7 890 076)**
Net increase in cash and cash equivalents	**27 537 640**	**8 609 465**
Cash and cash equivalents at beginning of the year	40 070 873	31 461 408
Cash and cash equivalents at the end of the year	**67 608 513**	**40 070 873**

	Share capital	Treasury shares	Share premium	Revaluation reserve for premises	Retained earnings and other reserves	Total shareholders' equity
Balance at 1 January 2001	**20 670 033**	**(2 048)**	**4 115 741**	**409 593**	**31 482 013**	**56 675 332**
Net profit	-	-	-	-	31 596 876	31 596 876
Share issue						
- Nominal value	310 550	-	-	-	-	310 550
- Share premium	-	-	5 900 449	-	-	5 900 449
Sale of treasury shares, net	-	837	-	-	-	837
Reduction of deferred tax in respect of revaluation of premises	-	-	-	144 370	-	144 370
Reclassification of depreciation charged in respect of revaluation reserve for premises	-	-	-	(32 663)	32 663	-
Dividends declared						
- Ordinary shares	-	-	-	-	(874 031)	(874 031)
- Preference shares	-	-	-	-	(49 019)	(49 019)
Balance at 31 December 2001	**20 980 583**	**(1 211)**	**10 016 190**	**521 300**	**62 188 502**	**93 705 364**
Net profit	-	-	-	-	30 521 315	30 521 315
Sale of treasury shares, net	-	800	-	-	-	800
Reduction of deferred tax in respect of revaluation of premises	-	-	-	7 483	-	7 483
Reclassification of depreciation charged in respect of premises revaluation	-	-	-	(31 178)	31 178	-
Dividends declared						
- Ordinary shares	-	-	-	-	(1 055 688)	(1 055 688)
- Preference shares	-	-	-	-	(59 778)	(59 778)
Balance at 31 December 2002	**20 980 583**	**(411)**	**10 016 190**	**497 605**	**91 625 529**	**123 119 496**

Pro-forma (Restated)

	Share capital	Treasury shares	Share premium	Revaluation reserve for premises	Retained earnings and other reserves	Total shareholders' equity
Balance at 1 January 2001	**20 670 033**	**(2 048)**	**4 115 741**	**409 593**	**31 482 013**	**56 675 332**
Net profit	-	-	-	-	31 596 876	31 596 876
Share issue						
- Nominal value	310 550	-	-	-	-	310 550
- Share premium	-	-	5 900 449	-	-	5 900 449
Sale of treasury shares, net	-	837	-	-	-	837
Reduction of deferred tax in respect of revaluation of premises	-	-	-	144 370	-	144 370
Reclassification of depreciation charged in respect of premises revaluation	-	-	-	(32 663)	32 663	-
Dividends declared						
- Ordinary shares	-	-	-	-	(874 031)	(874 031)
- Preference shares	-	-	-	-	(49 019)	(49 019)
Balance at 31 December 2001 as previously reported	**20 980 583**	**(1 211)**	**10 016 190**	**521 300**	**62 188 502**	**93 705 364**
Restatement of deferred tax liability	-	-	-	-	10 263 037	10 263 037
Balance at 31 December 2001 as restated	**20 980 583**	**(1 211)**	**10 016 190**	**521 300**	**72 451 539**	**103 968 401**

	Share capital	Treasury shares	Share premium	Revaluation reserve for premises	Retained earnings and other reserves	Total shareholders' equity
Net profit	-	-	-	-	20 258 278	20 258 278
Sale of treasury shares, net	-	800	-	-	-	800
Reduction of deferred tax in respect of revaluation of premises	-	-	-	7 483	-	7 483
Reclassification of depreciation charged in respect of premises revaluation	-	-	-	(31 178)	31 178	-
Dividends declared						
- Ordinary shares	-	-	-	-	(1 055 688)	(1 055 688)
- Preference shares	-	-	-	-	(59 778)	(59 778)
Balance at 31 December 2002	**20 980 583**	**(411)**	**10 016 190**	**497 605**	**91 625 529**	**123 119 496**

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