Masterarbeit zur Erlangung des Grades eines Master of Arts
(M.A.) in International Business Administration
an der Universität Hamburg

"Bank Regulations and Bank Supervision: EU Experience and Russian Practice"

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Eingereicht am:	Hamburg, den 18. Februar 2011

Spätester Termin für die Erstellung des Gutachtens durch den Erstprüfer:

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List of Abbreviations

AMA	Advanced Measurement Approach
BCBS	Basel Committee on Banking Supervision
BCIBS	Basel Committee on International Banking Supervision
BIA	Basic Indicator Approach
BSC	Banking Supervision Committee
BIS	Bank for International Settlements
CEBS	Committee of European Banking Supervisors
CBR	Central Bank of Russia
CBRF	Central Bank of Russian Federation
CEO	Chief Executive Officer
CIS	Commonwealth of Independent States
CO	Credit Organization
ECB	European Central Bank
ERM	Enterprise Risk Management
ERP	Enterprise Resource Planning
ESCB	European System of Central Banks
ESF	Expected Shortfall
ESFSA	European System of Financial Supervisory Authorities
EU	European Union
FD	Federal District
FL	Federal Law
FSIS	Federal Service for Insurance Supervision
FSP	Financial Service Provider
GDP	Gross Domestic Product
IAIS	International Association of Insurance Supervisors
IASC	International Accounting Standards Committee
IFRS	International Financial Reporting Standards

IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IRB	International Ratings Based (Approach)
IT	Information Technology
IPO	Initial Public Offering
OECD	Organization for Economic Cooperation and Development
P&L	Profit & Loss
RF	Russian Federation
RSFSR	Russian Soviet Federative Socialist Republic
Rosstat	Russian Federal Service of State Statistics
Rub.	Russian Ruble (Currency)
TEU	Treaty on European Union
UK	United Kingdom
US	United States
USSR	United Soviet Socialistic Republic
VaE	Value at Earning
VaR	Value at Risk
WTO	World Trade Organization
e.g.	“for example”
et al.	*lat.* “and others”
etc.	*lat.* et cetera: “and so forth”
i.e.	*lat.* id est: “that is; in other words”

Introduction

Contemporary financial institutions had faced the plethora of the challenging factors (globalization, liberalization of the market, development of the information technologies, etc.) that determined the impetus for the changes in the regulations of and the supervision of the processes and potential risks occurring in the financial institutions.

The Basel Committee on Banking Supervision (thereafter – BCBS) points out that the activities of the financial institutions determine the economy of the country and influences the global economy[1]. Therefore, the stability of the banks is one of the rudimentary tenants for the sustainable economic development. Consequently, effective supervision and regulation of the financial institutions potentially increase the credibility of the financial system and protection of the investors and credit businesses, and ensure the stability of the financial systems and global economy.

The recent examples of the economic and financial downturn (Russian crisis in 1999, "TMT bubble" ("dotcom bubble") in 2000, Icelandic crisis in 2008-2009, Irish crisis in 2008-2010, etc[2].) demonstrate the necessity of the certain regulations and supervision models that would ensure the high level of financial system protection from the potential threats of the financial systems[3]. Moreover, the stable and developing economy is determined by the efficient risk management since the breakdown of one national financial system would have a chain reaction and lead to the financial crisis on the national and global scale.

Global crisis of 2007-2009 brought into the spotlight the importance of financial services regulation and supervision. "In late 2008, governments stepped in to rescue banks that were teetering on the edge of bankruptcy. Pressure groups have decided that if banks are an arm of the state, they should be subject to the same scrutiny as the government."[4] In the multi-level governance of financial services, the EU level is paramount because EU rules, unlike international regulatory agreements, are legally binding and national financial legislation in the member states is shaped by, or at the very least incorporates, EU legislation.

The global recession of 2007-2008 has highlighted that financial markets are inherently unstable and market failures and fluctuations result in huge

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[1] BCBS (2006):"Principes fondamentaux pour un contrôle bancaire efficace". pp. 1-2.
[2] Paul (2004), pp. 303-333.
[3] BCBS (2006):"Principes fondamentaux pour un contrôle bancaire efficace". pp. 1-2.
[4] Lynn (2010), p.26.

economic and social costs. There is no country in the world which has not been affected by contagious effects of the crisis through financial or trade channels. Banks have increasingly recognized that traditional methods of risk management have become obsolete and that new measures are needed to assess the risks of the financial instruments.[5]

Academic research (Perotti, 2002; Barth et al., 2004; Wilson, 2004; Fries and Taci, 2005; Alexander et al., 2006; Beck et al., 2006; Berger et al., 2008, Cornford, 2008, Pritchard, 2008; Grigorian and Manole, 2006; Helmreich. and Jäger, 2008; Pasiouras et al., 2009; Gleeson; 2010; etc.) provides variety of the works that examines and evaluates the impact of bank regulation and supervision on bank's actual performance and stability. However, majority of the researches are localized and limited to a particular country, focusing on financial ratios or non-parametric frontier approach, etc. As for bank regulation and supervision in Russian Federation, there are only few academic researches (Poltavcev, 2005; Helmreich and Jäger, 2008; Andrievskaya, et al., 2010; Rozanova, 2010; Moiseyev, 2010; Solanko and Fungáčová, 2010, etc.) discussing the necessity of developing bank regulation and supervision in Russian Federation associated with Basel II.

This paper contributes to the research of banking regulation and supervision in the EU and Russian Federation. Despite of the fact that banking supervision practice in Russia recently has been largely consistent with the one of the EU member states, it still has a lot of points for improvement. The following are the insufficient and incomplete areas, the measures taken for the development of risk-management supervision, which is aimed at improving the accuracy of assessing the financial stability of credit institutions; the application of adequate supervisory response measures, and the implementation of procedures to monitor compliance of banks' requirements of the deposit insurance system. The computer software, which enables monitoring the status of the bank in real time mode is not used to full capacity.

Furthermore, OECD report states that there are two main areas in the banking sector that need to be enhanced substantially. The significant prudential supervision in Russian Federation and world's best practices and international policies and practices did not affected macro-prudential considerations and under-emhasizes liquidity to capital[6].

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[5] Ferran/Goodhart (2001), p.276.
[6] OECD(2010): OECD/Economic surveys/Russian Federation page.

Therefore, Russian Federation needs improvement in: regulatory documents for the implementation of supervisory functions – in the authorities' definition of the Bank of Russia on the use of professional (reasoned) opinion in the course of bank inspection and implementation of e-bank supervision; interaction of different types of banking supervision and control; contemplating measures of administrative and other responsibilities for managers and workers of credit institution for submission to the bank supervisor and the publication of false information about credit institution.

The methodology and policies applied by the Institute of Supervisory Control are insufficient; it is designed to enlighten and diagnose the problems of off-site supervision, on-site inspection, control of foreign exchange, control of emission and investment activities, the operations on the securities market, the formation of mandatory reserves, licensing in terms of expanding the activities of credit institution, internal control of banks. Approaches to assessing the financial stability of credit institutions require specification.

The relevance and lack of full scientifically valid, credible and comprehensive research hinders the growth and improvement of the banking sector efficiency in the current tough post-recession economic conditions of the Russian market. This reason has determined the choice of the thesis theme, as well as purpose and objectives of this paper.

The purpose of this paper is to develop a theoretical and methodological framework for banking supervision, development and feasibility study and create recommendations for its improvement and development in Russia.

To ensure the purpose fulfillment, the following tasks were determined:

- to investigate factors causing the need of banking supervision in Russia;
- to clarify the definition of banking supervision;
- to investigate development trends of banking supervision in European Union;
- to identify the ways to improve the efficiency of using different types of banking supervision;
- to investigate the organization and to identify the key areas for monitoring the financial soundness of the banking sector.

The subject of the paper corresponds to economic relations, developing in the process of realization of banking supervision.

The object of the paper represents activity of the Central Bank of Russian Federation (thereafter – CBR) in the process of banking supervision to ensure the soundness and stability of the banking system.

Theoretical part of the paper composes the works of Russian and foreign economists, devoted to the development of banks and banking supervision; practice of regulatory authorities of the Bank of Russia and practice in assessing the financial situation and degree of the problems in commercial banks; information on the results of inspections and measures taken effect on banks; materials of the conferences on the subject.

Methodological part of the paper constitutes the dialectical method of investigating the theoretical aspects of the theme, by means of which revealed the possibilities to study the issues of improving banking supervision in dynamic, relationship and interdependence.

The current paper is an attempt to provide the overview of the bank regulations and bank supervision in the EU and its practice in the Russian Federation. It's not intended to show how to perform risk capital calculations or any specific legal content of the EU/Russian Federation legislation, which would be an interesting topic on its own right. The international level is mentioned only whenever this is directly relevant to explain developments in the EU or Russian Federation.

The timeframe of the paper spans from 1990s to provide an overview of financial market integration, regulation and supervision in the EU over the past four decades and to the March of 2010. Lately the bank regulation was changing rapidly, but mentioned in the paper fundamental conceptual material should remain intact.

The thesis is organized as follows. Chapter I indicates the banking system as part of the financial system and describes characteristics of the Russian banking system and the role of banking supervision. Chapter II examines the statement of the Basel Committee as to the Core Principles for effective banking supervision.
Chapter III elucidates the concept and nature, forms and types of surveillance and enforcement activities in the banking system of the Russian Federation.
Chapter IV organizes problems of banking supervision in Russia, determines areas for improving the bank supervision and gives some recommendations.

Finally, conclusions are drawn for the bank regulations and supervision within the EU and its practice in the Russian Federation.

Chapter I

The Banking System as an object of Bank Regulations and Bank Supervision

1.1. The Banking System as Part of Financial System

The financial system functions to transfer financial assets between savers and borrowers. It comprises of diverse financial institutions, markets, services, etc. that are interconnected between each other[7]. Figure 1 demonstrates the simplified overview of the financial system. The lenders (households, firms, central banks, etc.) supply the funds to the borrowers (firm, government, households, etc.) through the financial markets (money markets, bond markets and equity markets) or via financial intermediaries (money market funds, mutual funds, insurance companies and pension funds).

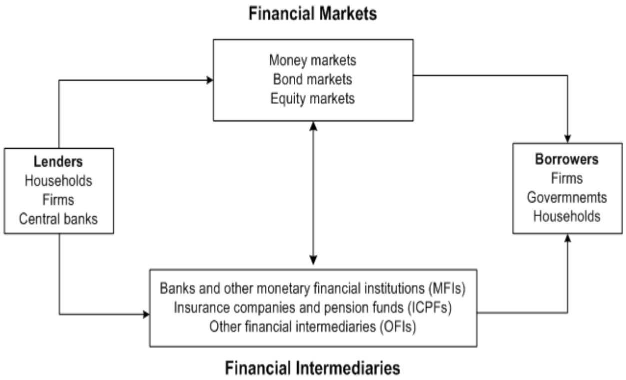

Figure 1. An overview of the financial system. Source: Allen et al. (2004)

Olsen identifies banks as having “a crucial role in the efficient allocation of savings and investments in a market economy and are important for the stability of the whole financial system”[8]. Therefore, high levels of financial risk can lead to bank failures, which can spread quickly by means of the interbank payment system to other banks in other financial systems. Stolz agrees with the previous statement and states that banks contribute to the growth of the economy and corporate governance[9]. Insufficient and weak banking system increases the negative follow-ups and costs of the economic and social problems in the country.

Alexander et al. research proves that a failure of the bank’s operations could lead to the chain reaction in the international banking or even to a global

[7] Sullivan/Sheffrin (2003), p. 551.
[8] Olsen (2005), pp. 15-28.
[9] Stolz (2002), p. 2.

financial crisis. [10] Moreover, Allen and Carletti state that banks collect "demandable deposits and raise funds in the short term capital markets and invest them in long-term assets"[11]. Moreover, banks provide intertemporal smoothing of non-diversified risks and prevent the depositor from unexpected consumption shocks.

Furthermore, Gleeson defines the bank as an institution, which takes deposits from and lends financial resources to the public, but even the simplest bank is more complex than this.[12] Speaking about its functions, the banks provide ways of clearing and setting payment, transforming claims in terms of volume, maturity, liquidity, risk and region, and acting as delegated monitors. The main reason for regulating banks is to maintain confidence and trust in the banking system by setting minimum standards for the safety and soundness of the bank[13].

Therefore, the goal of the banking system is facing its specific properties, visible through the close interaction between the elements, interaction with the environment through the exercise of its functions, its architecture. However, the core of the banking system is directly related to its functions and vice versa. The banking system is determined by the characteristics that distinguish it from other systems; namely, the banking system can be defined as an artificial system, which results from certain human activity; a large system, which includes many elements; a complex system, which traced a huge amount of connections and interactions; and managed system; hierarchical multi-level system; self-focused dynamic system; an open system interacting with the environment.

In general, the banking system is a combination of different types of national banks, banking institutions and credit institutions, operating under a common monetary and credit mechanism, existing in a particular country during certain time period. It seems that the term "banking system" should be understood as historically established set of closely related complementary elements (the Central Bank, credit institutions, banking infrastructure, and the bank's clients) that enables interaction between them and the environment.

Functional structure of the banking system consists of the functions of the banking system, the functions of credit institutions (banks), and the central bank. The essence of the banking system is facing its specifics, the content of which is revealed through the forms of its manifestation, i.e. in terms of its function. The

[10] Alexander / Dhumale / Eatwell (2006), p.15.
[11] Allen / Carletti (2008), p. 16.
[12] Gleeson (2010), p. 3.
[13] Ibid

banking system, like any other system, is endowed with a set of functions; the direct application and implication of these functions ensure the proper operation of the whole system. Simultaneously, the banking system can not be reduced to and expressed in the aggregate of its properties and relations involved Functions are derived from the essence of the banking system, "which refers not only to private entities, the constituent elements, but also to their interaction"[14].

First of all, the banking system performs regulatory functions, which are manifested through the regulation of money circulation in the country, i.e. the volume and supply of both cash and non-cash; operates the payment system. By increasing the money supply, including credit, in times of downturn in the economy, banking system contributes to enhanced productivity, and revitalizes economic actors. Conversely, in periods of recovery, when the growing aggregate demand increases the risks of rising inflation, the banking system is designed to reduce the supply of money with the minimum damage to the economy. Money supply is a significant tool of the banking system, which ensures stability of the price level and in this way affects the economic system growth and development in the favorable way. Consequently, the banking system provides an optimum level of economic growth, while carrying out a catalytic function.

Stimulating activity of the market players takes place also through the role of the banking system as a mechanism for access to financial markets. In addition, the banking system controls the movement of cash flow, counteracting the legalization of illegal incomes and financing of illegal activity, serves as the fiscal agent, i.e., performs the control function. Credit institutions analyze the activity of enterprises, the situation in the economy and financial markets in order to provide this information to enterprises, and publish statistical and analytical information in the press; thus, the banking system performs research and information function.

Functions of banks are functions, arising from the very nature of the bank (fundraising, allocation of money supplies, allocation of cash resources on own account and at own cost and expense, asset management) and social – economic functions (social, financial intermediation).

“Banking supervisors play an indirect role in protecting depositors against losses arising from the failure of an individual bank”[15]. Moreover, the supervisors could ensure the quality and soundness of the bank system demonstrate the bank manager the way they have to perform their duties towards the stakeholders.

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[14] Lavrushina (2006), p. 357. (Russian)

[15] Olsen (2005), pp. 45-63.

Functions of the Central Bank of the Russian Federation include a lot of stakeholders and parties; CBR is the only money-issuing center, it is the bank of the Government, the bank of banks (billing center, the lender of last resort), the conductor of official monetary and exchange rate policies, and in some cases (when there is no special supervisory body available) – controller and supervisor of credit institutions.

It is important to mention the role of non-bank credit institutions in the banking system of the Russian Federation; in particular it is necessary for the analysis to distinguish financial-credit institution and non-banking credit institution. Whereas the financial-credit institution (pension funds, insurance companies, investment funds, etc.) is part of financial services system, which is neither controlled nor regulated by the CBR, on the other hand, the non-banking credit institution is a full part of the banking system.

The CBR is a backbone element in the structure of the banking system, which generates monetary policy and plays a leading role in its implementation, issues licenses for banking activities; verifies statements of the banks; sets the standards for the activities and monitors their implementation; represents the Bank of the Government and the main payment center of the country, acting at the same time as an independent public authority controller in many countries.

The banking system can successfully develop only under consistent cooperation and interaction between the banking system infrastructures elements, including:

- Informational support;
- Scientific and methodological support;
- Technological support (consisting of technical devices, mechanisms and support systems for the banking process);
- Staffing, legal and regulatory framework, market of banking services.

The bank cannot exist without its customers, who constitute one of the most important stakeholder groups of the banking system. The legal consolidation of the relationship is determined in the written contract (contract of the bank account, credit agreement, etc.). Only if legal consolidation of the relations takes place, the bank’s customers become a complete part of the banking system. Bank customers may act as depositors and borrowers, as well as households (population), enterprises, organizations and firms of different ownership forms (including financial institutions).

Acting as an intermediary between clients, who have an excess of cash resources and those who have their temporary shortages, the banking system, redistributes resources to compensate the shortage of the latter, thus, stimulating activities of economic entities and provoking business developments.

Customers of the bank act as depositors and borrowers, representing the main source for generation of assets and liabilities of the banking system[16]. Theoretically, without customers, the banking system can operate only within the framework of the capital base and non-deposit sources of the liabilities of the banking system. Fund allocation in the absence of the borrowers also become obsolete. Thus, without customers the banking system can not function and develop in the traditional way of leading banks.

The general classification of banking systems categorizes banks (see Table 1).

According to the criteria of banks' classification and their functional purpose, along with emission and commercial banks one must emphasis the deposit banks and as part of banks by nature of conducting operations among specialized banks – multi-sector banks, serving primarily one industry and development banks. It is necessary to highlight the traditional and Islamic banks. Therefore, the banking system components should be categorized consistently in order to enlighten the whole picture and be able to access it comprehensively. The banking system differs from country to country; the prevailing institutional model of national banking system depends on the historical, political, socio-economic and cultural characteristic of the country.

Effective functioning of the economic system of the country would not work without the integrity of circulation of capital and production. The banking system, as the subject of the economy, performs the role of financial intermediary between the independent sectors of the economy, redistributing funding, including investments. In developed countries financing of capital investments from all sources is carried out almost entirely through the banking system.

At the macroeconomic level, the investment potential in general and the banking system in particular are formed by the ultimate income of all sectors of the economy: in the real sector - it is gross profit, in the household sector - cash

[16] Under assets and liabilities of the banking system is meant the totality of assets and liabilities of credit institutions operating in the country, except assets and liabilities of the Central Bank.

income, in the public sector - revenue budget, in the financial sector - interest on loan capital.

Frame of reference/criteria	Type of banking system
By levels of organization	I – tier
	II – tier
	III – tier
By level of universality and specialization	dominated by universal banks;
	dominated by specialized credit institutions.
By degree of institutional development of the banking system and financial services market	developed banking system – under conditions of developed market for financial services;
	banking system of the developing economy.
By the specifics of the legal provision of economic systems	continental type, based on European Law;
	English-American type with distinct features, based on English-American Law;
	banking system of Muslim countries, based on Sharia Law.
According to the principles of construction of the economic system	planning and distribution banking system;
	market banking system;
	type of transition banking system.
On the basis of civilization	“traditional” (Western) type of banking system;
	Islamic type of banking system.

Table 1. Classification of the Bank Systems

Each of three types of banking systems can be characterized and differentiated corresponding to existing analysis and research in the field. The first type is centralized (mono-banking) system. The second is decentralized banking system (for example, the U.S. Federal Reserve). The third is the most common type of the banking system in the world today - the two-tier banking system. The first and second models of banking systems have several features in common: they have emerged around the same time; therefore they correspond to certain economic development phase and pattern. Both models are emphasized and explained is the theory of state monopoly capitalism. In both models the elements of the state economic regulation process through the banking system are observed. Nevertheless, there are considerable differences between the two types, i.e. types of ownership for production goods, the assignment principle for managing economic entities and key elements of the final product distribution.

The third model was the last one to emerge; it is the youngest of the banking systems. It has combined different features of the first two models, and therefore is a hybrid option, which is aimed at responding to the new realities; it shares with the two models the presence of elements of market regulation through the mechanism of protection of national producers. In addition, it is based on recognition of self-regulation of business processes based on natural economic market processes. This fact leads to free competition in the banking sector and as a result, inevitably leads to the concentration of banking capital. The number of banks decreases, but at the same time the sizes and the volume of transactions increase. Such operations as large financial transaction, i.e. allocation of the government loans, organization of joint-stock companies are carried out not by one bank, but by the joint cooperation of several banks based on a common agreement. Centralization of bank capital is enabled by mergers of big banks, by banking organizations, by the expansion of banks into network and opening new branches nationally and worldwide. Therefore, the banks pursue the desire to monopolistic transnational incorporation of banks. As a matter of fact, some of such projects have already succeeded and banks became international.

The twentieth century can be referred as the beginning of the strengthening of state intervention in the economy and exploiting the banking system as one of the key tools of influence and regulation. This factor manifests in conditions such as recovery and recession, and affects almost all areas of economic activity. All at all, the banking sector has always been and is midmost of these processes.

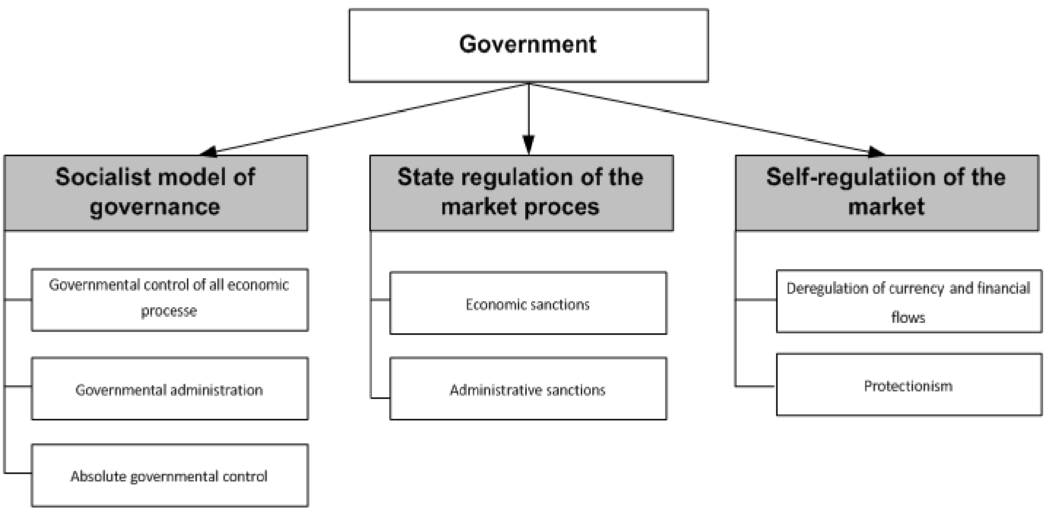

Figure 2. State influence on the economy through the banking system

The forms of state intervention into the banking system is similar in all countries, the main difference is the implementation extent of state-specific forms of regulation (see Figure 2).

By regulating the banking system, the government pursues certain goals. First of all, it seeks to strengthen the influence on the strategic planning of the banking system development and efficient management. The state applies its policies its strategies in several ways. It owns shares of bank capital and is directly involved in the banking sector, which makes possible to use the results of this participation for the solution of economic and political challenges facing the state. On the other hand, the government has to fulfill the function of rehabilitation of the banking sector. This involvement is enforced. To conclude, all government efforts are aimed at preventing banking system crash and its escalation into global economic problems throughout the economy as a whole.

1.2. Characteristics of the Russian Banking System and the role of Banking Supervision

In each country the structure of the banking system reflects the features of the economic and political level of development of the state. The national banking systems of different countries are interconnected. In the last five – ten years, banks have increased the number of and broaden the range of the services: insurance services, brokerage services, service in real estate transactions, etc. Thus, the banking system keeps on strengthening its position of the "strategic industry" for the economy. The banking absorbs and acquires other functions and enterprises. However, by absorbing them, it changes itself without losing its core function - the strategic level of the national economy.

During this period the role of the state is extremely significant, proactive and valuable. Using the legal power and authority, the state can either support or restraint the banking sector. Russia faces a number of sufficient challenges nowadays and one of the most important is the integration into the global economy, while preserving the national banking system. The banking system is an element of financial and credit system of the national economy, which is more or less a structural component of regional and global economy. The banking system formation, development and functioning process in the different countries is affected by both internal and external forces. Internal factors are first of all, macroeconomic indicators of the country's economy, its level of national and historical development. External factors influencing the formation of the state banking system include geographical location and the role in the global community. The listed circumstances largely determine the "national" characteristics of banking.

However, there are general principles of formation and conditions for the expansion and development of the banking sector. The banking system includes a combination of different types of banks and other financial institutions operating within a common monetary system. Institutionally, it plays a key role in financial intermediation in the country. Essential to the functioning of the banking system is the state of the economy. The stability of the economy’s functioning, high rates of its growth, predictability of further development contributes to the formation of savings and business activity in the country, which increases the cash resources of the banking system, extends the possibility of their use in the development of social production and commercial projects. Empirical evidence indicates that a determining factor in the organization and the nature of the banking system is a socio-economic path of development. It is the nature of the organization of social production, its efficiency and stability, the legal conditions for the functioning of the banking system that predetermines its role in the economy.

As it was noted previously, the condition and development of the banking system is affected by various economic and political factors. Thus, the economic crisis, which is accompanied by inflation, devaluation, stagnation in trade and industry, reduces the volume of credit transactions, increases the non-payment of previous commitments, and reduces the credit resources of banks, which leads to an economic imbalance in the function of individual banks and the banking system in the country as a whole. Cost reduction of bank assets, a multiple increase of bank risks, the problem of chronic non-payments, inflation repeatedly aggravate the negative situation in the country's economy. A good illustration for this is financial crisis of 2008 started in the U.S. and spread to the entire world. Stable state of the economy or its accelerated growth facilitates the rapid development and strengthening of the banking system. The banking system, as stressed by Smith B. is of special positive charge in its development phase of economic boom, when demand for banking products and banking services increases substantially. Along with the volume increase of banking transactions increases the banking income, which is used for the development of credit institutions. In the recovery phase reduces economic risks, the banking system becomes stable.

In Russia credit system includes credit institutions, banks and non-banking credit institutions. The Federal Law No. 395-1, dated December 02, 1990 “On Banks and Banking Activity” provides definitions of a credit institution, bank and non-banking credit institution: bank credit institution is a credit institution that has the exclusive right to exercise all of the following banking operations: attracting deposits from individuals and legal entities; placing these funds on its behalf and at their own expense on terms of repayment, interest payment, maturity; opening and maintaining bank accounts of individuals and legal entities. To the contrary, non-bank credit institutions may carry out only certain banking operations.

Credit institutions perform the function of ensuring the public interest, because they realize the direct relationship between distribution and manufacturing areas of the economy. Carrying out deposit, credit and payment transactions, banks within the framework of the banking relations mediate the movement of funds of all parts of the financial system.

After the collapse of the USSR, the monobank system was transformed into two tier banking system with the Central Bank (Gosudarstvenniy Bank, State bank) and commercial banks, such as Sberbank (Sberegatelniy Bank, Savings Bank, Promstroybank (Promyshlenniy I Stroitelniy Bank, Industry and Construction bank), Zilsotsbak (Zhiloy I Socialniy Bank, Housing and Community Enhancing bank), Agroprombank (Bank Agrikultury I Promyshlennosti, Agriculture and Industry bank) and Vneshtorgbank (Bank Vneshney Torgovli, Foreign Trade bank). In general these banks were state-owned and focused on specific industries. Therefore, they were called “spetsbanki” (specialized banks). The privatization of Russian “spetsbanki” led to the emergence of the private banks and decline of the “spetsbanki” in the period of 1992-1999. The majority of the public banks were also created after the collapse of the USSR. Both government bodies and businesses were contributing to creation private or state-owned de novo banks[17,18].

As a result of poor capitalization, poor quality of assets, overexposure to exchange rate, excessive speculative risks, connected lending, the Russian banks were faced with the systemic problems in 1994, 1995, 1998, 2004, and 2008. Therefore, more than 2000 banks bankrupted or had been liquidated since 1990s. For example, the devaluation of Russian currency led to the change of many

[17] Tompson (2004), p. 7.
[18] Vernikov (2007), p.12ff.

Russian banks from positive to negative in August 1998[19]. At the same time, the state-owned banks (Sberbank, Vneshtorgbank, etc.) were covered by the state guarantee.

The Russian banking sector had grown greatly for the last ten years. The Russian lending sector comprised 14% of GDP. In 2008, the lending sector was equal to 35% of GDP. In comparison, the combined sector balance sheet was equal to 32 % of GDP in 2001. In 2008, the ratio reached 68 % of GDP in 2008[20]. However, Russian banking sector remains small in comparison to the size of the Russian economy. Caner and Kontorovich (2004) concluded that the efficiency of Russian banks is lower than the efficiency of European banks after completing their research on Russian banks in 1999-2003[21].

According to Judith Burucks, there were 1.136 Russian banks by the end of 2007. By the end of 2009, the number of banks decreased to 1.058[22]. In 2010, the Russian banking sector consisted of 1.007 banks. In comparison, the countries of relatively the same size have less banking institutions, e.g. Brazil – 163, China – 370, India – 169[23]. According to OECD, only Germany had greater number of banks (1.934) than Russia in 2005. Other European countries had less than 1.000, e.g. Spain – 269, France – 373, Poland – 649, Italy – 773, Austria – 865, Ireland - 42, Switzerland – 295, Luxembourg – 155[24].

During mid-2008s, 25 banks went bankrupt or were rescued by the state due to the economic downturn. In regards to the economic crisis and improvement of the bank's stability the Central Bank of Russia (CBR) increased minimum capital requirements of 180 million rubles ($6 million) in 2009. As a result the number of banks is expected to decline. According to CBR predictions, there would be 200 banks unable to comply with the requirements. Furthermore, the Russian Finance Minister plans to increase the capital requirements to one billion rubles ($33 million) within the next six years expecting that this would gradually reduce the number of banking institutions[25].

According to Sulanco and Sungacova, differently from emerging markets in Central and Eastern Europe and similarly to the Chinese banking sector, the

[19] Perotti (2002), p.359-399.

[20] Sulanko/Fungacova (2010), p. 2.
[21] Kaner/Kontrovich (2004), pp. 357–375. (Russian)
[22] Burucs (2009), p. 44.
[23] Anzoategui/Soledad Martínez Pería/Melecky (2010), p. 5ff.
[24] OECD(2010): OECD/Economic surveys/Russian Federation page.
[25] Ibid.

Russian banking sector is mainly state controlled[26]. At the same time, large fragmentation of the private sector disabled medium-size and small banks to sell franchise, increase their market share, and diversify risks and revenues[27].

As for the 2010, the 20 largest banks comprised to 70 % of total bank assets. In comparison, the six government-controlled banks (Sberbank, VTB, Gazprom, Rosselhozbank, Bank of Moscow, VTB-24) have 52% of the total bank assets and 60% of deposits. Sberbank (Sberegatelniy Bank, The Savings Bank), the largest state owned bank and the largest credit institution in Russia occupy 25 % of the total Russian banking sector. At the same time, there were 108 credit institutions in Russia that had more than 50 % of foreign capital. As for the total banking sector in Russia, foreign banks have 18.3 % of total banking assets and 12 % of deposits[28].

The market share of the top ten banks is provided in Table 2. In 2010, the state-owned banks were dominant in Russia.

Table 3 provides the overview of the financial institutions located in Russia. The financial institutions sector demonstrated growth in terms of percentage of total banking sector assets and percentage of total banking sector capital by state-controlled and large banks. Other credit institutions demonstrated decrease. Moreover, medium sized and small banks demonstrated the greatest decrease of credit institutions for the period of 2009-2010, which led to the decrease of credit institutions to 1058 in 2010.01.01.

The majority of Russian banks focus their services on lending to the companies and other commercials enterprises. As for 2009, more than 60 % of banks received over 50 % of interests from lending to legal entities. In comparison, banks receive 25 % as the interest from lending money to private persons.

According to Rosstat, there is approximately 10 % of corporate investment financed by bank loans in 2010. Only the large banks issuing bonds or equity abroad prepare comply with IFRS when preparing their financial statements. Other financial institutions prepare their financial statements according to Russian accounting standards, which are less transparent than IFRS. At the same time, majority of the banks in Russia do not apply risk management in their business activity. Only the largest banks implemented risk management techniques to

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[26] Sulanko/ Fungacova (2010), p. 4.
[27] Burucs (2009), p. 44.
[28] Anzoategui/Soledad Martínez Pería/ Melecky (2010), p. 5ff.

avoid unexpected problems. As for the other banks, OECD points out that they have high reliance on a few customers (depositors or borrowers). Therefore, implementation of the risk management is not important factor[29].

Corruption is another factor that hinders the development of the Russian banking sector. Weill et al. research points out that corruption negatively affect lending. Plus, Russian banking sector and institutions is poorly rated on the international scale, which affects banking system and entire economy[30].

Bank Name	Percentage of total Banking Assets	Ownership
Sberbank	23.7 %	State
VTB	8%	State
Gazprombank	4.7 %	State
Rosselhozbank	2.9 %	State
Bank of Moscow	2.8 %	State
Alfa-bank	2.5 %	Private domestic
UniCredit Bank	2.1 %	Foreign
Raiffeisenbank	2.1 %	Foreign
VTB-24	2 %	State
Rosbank	1.7 %	Foreign

Table 2. Top ten banks by ownership type

Group of credit institutions	**# of credit institutions**		**% share of total banking sector assets**		**% share of total banking sector capital**	
	2009. 01.01	**2010. 01.01**	**2009. 01.01**	**2010. 01.01**	**2009. 01.01**	**2010. 01.01**
State-controlled banks	17	15	40.5	42.6	47.1	47.6
Foreign-controlled banks	101	106	18.7	18.3	17.2	16.9
Large private banks	136	139	34.6	33.3	27.6	28.7
Medium-sized and small banks based in Moscow and Moscow region	361	335	2.7	2.6	4.3	3.4
Medium-sized and small banks regional banks	443	412	2.8	2.8	3.6	3.1
Non-bank credit institutions	50	51	0.7	0.4	0.1	0.2
Total	**1108**	**1058**	**100**	**100**	**100**	**100**

Table 3. Indicators of credit institutions groups in Russia

[29] OECD(2010): OECD/Economic surveys/Russian Federation page.
[30] Ibid

It should be noted that the financial sector is focused on strengthening the public confidence in the banking system – was established a system of insurance deposits, which includes 934 banks[31]; were established agencies for credit history (currently there are 30[32] of them). At the same time, a number of unsolved problems is notable. Thus, Russia's banking sector remains relatively small and underdeveloped (see Table 4).

	2006	2007	2008	2009	02/2010
Number of CO registered on the territory of the RF	1 409	1 345	1 296	1 184	1 173
active of them	1 253	1 189	1 136	1 066	1 056
CO with foreign part of equity capital	149	200	76	228	29
Registered equity capital of active CO (in mln.rub)	561 023	720 223	863 795	1 153 996	1166742
Branch offices of active CO on the territory of the RF	3 274	3 445	3 491	3 228	3 153
Including: Sberbank of Russia	867	828	783	677	624
Banks with 100% foreign equity capital	88	100	202	246	241
The volume of loans, deposits and other funds placed	8501271	12989038	19756975	20047339	n/a
among them: defaulted debt	128 652	188 587	396 616	1 043 410	n/a

Table 4. Selected indicators of credit organizations as of March 5, 2010

Moreover, its focus on regions is rather irregular, i.e. the banking system does not play a substantial role in the economical development of the country. The opportunity costs of doing banking business are high. Protection level of creditor rights, whose claims are secured, does not meet international standards. Furthermore, there are significant points, which need considerable correction and improvement, such as legal basis for the development of competition in the banking services market, transparency of bankruptcy proceedings and liquidation of credit institutions.

[31] Deposit Insurance Agency (2010), p. 1. (Russian)
[32] CBR (2010): Central directory of credit histories, p.1. (Russian)

Consequently, the main midterm goal of the banking system development is increasing its stability and efficiency. The financial crisis of 2008-2009 deteriorated the performance of credit institutions and reduced the confidence level. However, the country's banking system managed to avoid a protracted crisis and default, which indicates the availability of the formed mechanisms for maintaining liquidity in the banking system.

According to OECD report, the Russian banking system was well capitalized in the beginning of the recent economic downturn. Moreover, "Russian banks have low direct exposure to troubled US assets such as mortgage bonds and derivatives, and they have not engaged in complex lending practices with structured products, a practice which has proved so dangerous in a number of advanced countries"[33].

The activity of credit institutions corresponds to the realities of the economic players, in particular to the needs of the economy. Steady growth of credit investments is preserved, furthermore, according to credit institutions reports, the quality of the loan portfolios has retained its quality level. Interestingly enough, the notable competition on the banking services market, especially for deposits of individuals has taken place. As a result, the market shares of the Sberbank of Russia in the banking sector of the country go down. The financial performance of credit institutions is improving. During 2002 and 2003 their income figures were respectively 93 and 128,4 billion rubles, in 2004 it reached 177,9 billion rubles, and on October 1, 2007 - 343, 5 billion rubles.[34]

Russian banking market is characterized by regional disparities, expressed in a significant market dominance of credit institutions registered in the metropolitan area (see Table 4). In addition, the number of businesses trading in the intermediary sphere in a total volume of loans granted by banks to legal persons (53% as of July 1, 2009) increases. With respect to Russian practice the specified share is hypertrophied, reflecting generally lower investment attractiveness of manufacturing industries (whose share in the structure of bank loan portfolio to corporate clients is only 20%) compared with the trade facilitation industry.

Thus, the need for banking supervision and its relevance improvement in the current context is caused by a large variety of factors, such as the significant role of the banking system in the national economy; development features of the

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[33] OECD (2010): OECD Economic surveys/Russian Federation page.
[34] CBR (2006): Bank of Russia Annual Report 2006, pp. 13 ff.

national banking system; sensitivity of the wide range of individuals and entities to the smooth functioning of the banking system; underdeveloped systems of internal banking control; need of capitalization growth of credit institutions to ensure the increasing demand of the country's economy in credit resources; poor quality of bank audit; increasing presence of foreign capital in the Russian banking system; lack of consolidated supervision; rapid development of the banking services market; inclusion of the banking system in the globalization processes of banking industry management; low efficiency of banks' performance.

Federal District (FD)	Number of CO	% by total amount	Assets, as of 01.07.2009 (bln. rub)	% by total amount	For reference: share of the FD in the RF's GDP
RF	1 080	100,0	27 776	100,0%	100,0%
Central FD	608	56,3	24 395	87,8%	36,5%
Moscow and Moscow Region	541	50,1	24 221	87,2%	28,4%
North-West FD	77	7,1	1 166	4,2%	9,9%
Southern FD	114	10,6	193	0,7%	7,7%
Volga FD	126	11,7	904	3,3%	15,5%
Urals FD	56	5,2	611	2,2%	15,1%
Siberian FD	64	5,9	330	1,2%	10,7%
Far East FD	35	3,2	177	0,6%	4,6%

Table 5. Asset allocation and concentration of CO by federal regions of the RF

Bank supervision is a continuous process of monitoring the condition of the banking system to ensure its stable operations in accordance with the interests of creditors and depositors. Organization of banking supervision requires a systematic and consistent approach. To improve the efficiency of using different types of banking supervision in the organization process the following steps are necessary:

1. Prioritize "risk-oriented" inspection of current situation, what will ensure prevention of negative cases in the banking management. Worldwide trend in the development of the current supervision of banks is to increase its efficiency by switching from extensive to intensive supervision model. This model of supervision is based on the method of allocation of credit institutions in high risk areas and concentration of surveillance in these

areas, so called "risk-oriented" supervision. Risk areas are identified, as well as poorly functioning banks. In both cases, the emphasis is on prevention of problems or their solution at the current stage.

2. Depending on the financial stability of banks, it is advisable to apply differentiated supervision model. Banks with a high degree of stability, having a transparent ownership structure, good corporate governance could be exposed to inspection more rarely. At this stage, a special role belongs to the development of institute of supervisory control.
3. Develop the self-regulatory mechanisms of the supervisory process through the elaboration of the banking community and creating the adequate and comprehensive code of conduct.

Having in mind the international practice experience, it can be stated that supervision systems of commercial banks activities differ in the ways of constructing the supervision structures, the place and role of central banks in these structures. Many of the EU member states have reformed their domestic financial regulation and supervision in the last decade. Some of the most noticeable examples were the UK, Germany, Belgium, the Netherlands and Ireland, as well as some of the new member states (for an overview, see Masciandaro 2005; Masciandaro and Quintyn 2007; Westrup 2007; Quaglia 2008d). Several of these reforms moved towards a similar model of supervision, namely, a single supervisor for the entire financial sector, within or outside the Central Bank.

The European System of Central Banks (ESCB) and the European Central Bank (ECB) have no direct responsibility for banking supervision (on the ECB and the ESCB). However, Article 105.5 of the Treaty on European Union (TEU) states that "the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system". The ECB has some regulatory power in the banking field, and it is involved in a number of working groups in areas such as financial market integration and prudential supervision, such as the Committee of European Banking Supervisors (CEBS) and the Banking Supervision Committee of the ESCB.[35] These issues will be considered in chapter II.

[35] Quaglia (2010), p. 26.

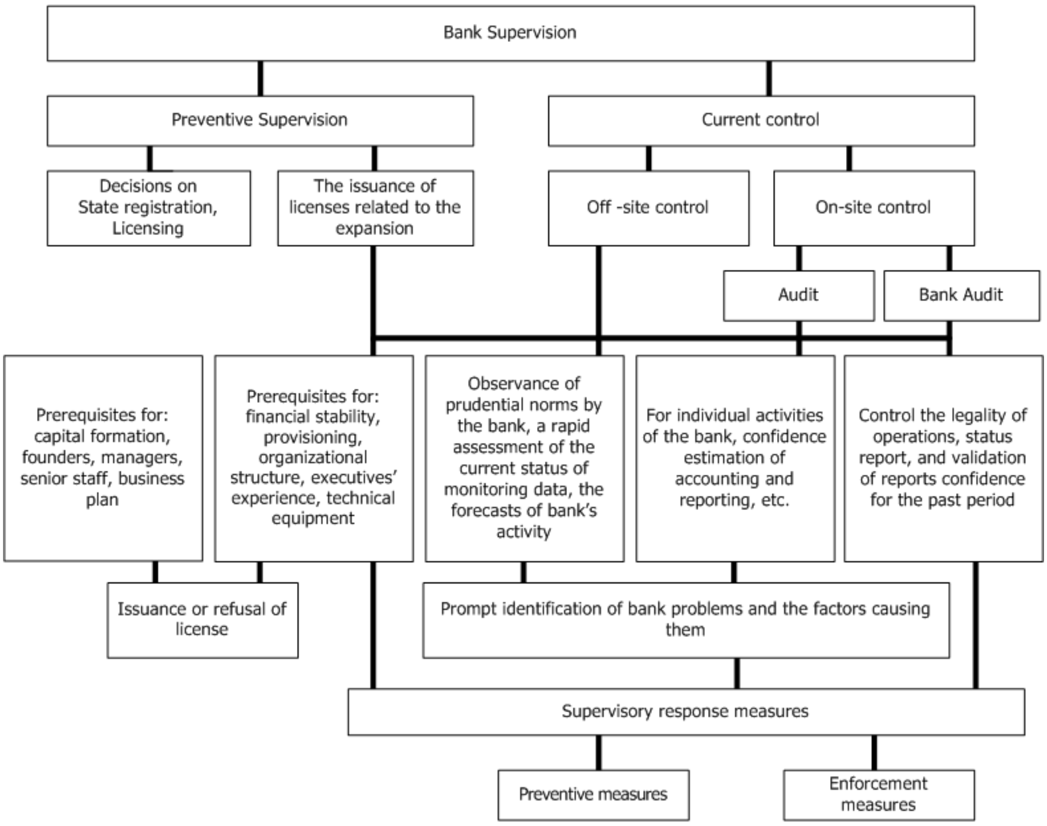

Figure 3. Types of Banking Supervision

Chapter II

Organization of Banking Supervision

2.1. Development Trends of Banking Supervision in Foreign Countries

Thorough the history, there were the trend to impose regulations on banks' activity and minimize the risks, which would lead to the stable economy and economic wellbeing. However, the majority of the regulatory actions were created as a consequence of the banking crisis in order to stabilize the state economy and allow the banks to survive and avoid possible risks since bank failure could take up to 10-15% of GDP[36]. The economic and social consequences of the bank failures are one of the main factors determining the fact that banks are more regulated in comparison to the non-banking entities.

Booth et al. state that bank regulation is a "subsidized monitoring and disciplining of management due to the threat of prompt corrective actions"[37]. Furthermore, the prerequisites of a risk-oriented supervision in foreign countries include the following factors - the growth of financial innovations; the rapid development of new technologies; computerization of the banking business; the forced liberalization of capital movements; a marked softening of the traditional banking industry protectionism, which has resulted to increasing dependence of the banking systems on "external shocks".

In overall the EU enterprises heavily rely on the bank loans for financing their operations. Mainly, banks have dominant position in majority of the EU countries. According to ECB, the banking sector is one of the largest in the UK, Germany, France, Italy, and Spain in terms of total assets of credit institutions[38]. Moreover, all European banks are required to participate in a deposit insurance system[39].

The banking sector began to take on more risks. In this case, the supervisory authorities simply did not manage to identify risks and, accordingly, could not adequately assess and take appropriate neutralizing actions. As a result, since the beginning of 1970 approximately 140 countries around the world have experienced local or systemic banking crises, the latter of which dealt a serious

[36] Cranston (2002), p. 65.
[37] Booth et al. (2002), pp. 1973-1996.
[38] European Central Bank (2008), EU banking structures 2008, pp. 5-7.
[39] Barth et al. (2007), World Bank Policy Research Working Paper, 4646.

blow to the U.S. economy and with varying degrees of exposure affected the financial markets of most countries in the world.

Moreover, all of the banks are interlinked with each other via interbank deposits, payment system, etc. The failure of one bank could lead to the systemic contagion of the entire banking system. Therefore, the regulators strive to ensure stability of the banks, eliminate potential risks, and prevent banks participating in criminal activity, such as money laundering.

However, the primary notion of the bank regulators is to protect depositors and provide a framework for making payments by ensuring their confidence in the system and ensuring proper bank management. At the same time, bank regulators seek to eliminate negative externalities ascribed to a bank failure (bank runs, systemic contagion, systemic risk, etc.), stimulate competition and effectiveness of the banking sector[40].

In order to prevent threats of breach of stability of banking systems, in 1974 was created a special international body - the Basel Committee on Banking Supervision. Committee analyzes and organizes an extensive international experience in banking regulation and supervision, develops standards and recommendations and also welcomes national supervisors to receive guidance in developing the national approaches to supervision, thus contributes to the sharing of and information about the best supervisory and regulatory practices cases.

The first document of the Committee, which received considerable attention and support to the banking community, it was Basel Capital Accord (Basel Capital Accord, Basel I), adopted in July 1988. However, the evolution of intra methods and techniques of risk assessment, as well as trends in the regulation of the banking sector led to the need to revise Basel I. It became clear that the formation of a fundamentally new paradigm of banking regulation and supervision, prompting banks to conduct a prudent and sensible policy, maintaining financial stability and strategic positioning. A new concept of banking supervision was formalized in a prepared by the Basel Committee the New Capital Accord (Basel II). The agreement represents a detailed document formalizing the requirements for three main "pillars" of regulation: the minimum amount of bank capital, the organization of banking supervision and market discipline[41].

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[40] Spong (2000), p. 7.

[41] BCBS (2006): Principles fondamentaux pour un contrôle bancaire efficace. p. 1-2;

The Basel Committee on International Banking Supervision (BCIBS) is an important international standard-setting body, actively influencing the process of banking regulation and supervision. However, in recent years, the International Accounting Standards Committee (IASC) has also stepped out to the arena, as this organization develops and publishes standards for financial and accounting records, which form the basis for financial reports of a large number of banks.

Studies of financial integration in the EU indicate an increase in the integration of the European system of regulation and supervision on the supranational level. From a system consisting of autonomous entities, it evolves in the direction of intensive coordination between them, which ultimately may end their full integration into a single body. Creating a single European supervisory culture is one of the most important goals, as outlined by the European Commission in the so-called "White Paper on financial services policy in the period of 2005-2010"[42].

In industrialized countries is formed a number of forms for control and supervision of banks and other credit institutions. Thus, banking supervision is carried out in a form of travel audits from bank supervisors (such practice exists in the U.S., Italy, France, and Japan). There is also a system, in which enforcement activities are carried out on the basis of the data of an external audit of the bank. Such system was established in Germany and the UK and a system, in which enforcement activities are carried out through the use of materials as well as of travel audit and external audit (this practice is typical for Canada). Compliance and enforcement can be also implemented on the basis of financial statements of the corresponding credit institution. This system exists in Australia and New Zealand.

Investigation of specific administrative and regulatory compliance and enforcement activities in the banking system of foreign countries enables the following. The organizational structure of banking supervision is characterized by considerable diversity. In countries, such as Great Britain, Italy, Netherlands, supervision of commercial banks is carried out by the national central banks. In Canada and Switzerland the banking supervisory authorities exist outside of central banks. In some states, such as USA, Germany, Japan, there is a mixed system in which control and supervision activities in the banking system are carried out as well as by central banks and by specially created public authorities.

[42] EU (2006): Weißbuch zur Finanzdienstleistungspolitik für Jahre 2005-2010 der Europäischen Kommission, S.12

The European System of Financial Supervisory Authorities (ESFSA)[43] with a single supranational supervisory authority at the head will directly control the activities of international financial institutions. The national supervisory authorities will monitor the activities of institutions, working only on the domestic market. The concept of a unified system of financial regulation in Europe can be compared with the organization of the European System of Central Banks.

Creating ESFSA has numerous advantages for the credit institutions performing international activities, which include the reduction of the costs for reporting to the national supervisory authorities; elimination of the competitive inequality and negative impact of the changes in national requirements of supervisory practices. Creating such a structure requires, however, along with the political willpower of the EU member states and national supervisory bodies, forming an extensive legislative framework. Because, despite the advances in the harmonization of the numerous provisions in the area of supervisory practices, the uniform conditions for implementing the supervisory rights in the EU are not available yet. In this regard, the Lamfalussy Process[44] plays currently the central role in the way of creating a converged supervision law of the EU. In addition, to such a body, headed by ESFSA, should be given single sanction right to close the financial institutions, which is also still missing in the practice of the EU. Thus, the European supervisory bodies make important movements towards increased integration. However, the effectiveness of those steps will depend on how well they match the pace of internationalization of banking activities.

Tensions between the national and international regulation of banks have accumulated and grown in volume. As a result, banks, which are the subjects to the set of regulatory procedures by both national and international requirements of banking supervision, face in their work a great number of national banking supervisors and simply become overloaded by unproductive practices.

Such co-existence of different regulatory standards and supervisory bodies is associated with significant costs and hinders the integration of financial markets. Parallel conduct of oversight by various national supervisory authorities

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[43] Decision on new European financial supervisory structure.

[44]The Lamfalussy Process is a method to the development of financial services regulations in the EU (was created by Alexandre Lamfalussy, the chair of EU advisory committee, in March 2001). Includes four levels of legislation's implementation: 1st level: The European Parliament and Council of the EU adopt a piece of legislation; 2nd level: Advice on technical details and vote in front of member-state representatives; 3rd level: Coordinating new regulations with other nations; 4th level: compliance and enforcement of the rules and laws.
http://www.direktbroker.de/unser-service/boersenlexikon/lamfalussy-verfahren-lamfalussy-process--/16331690/L

on a single financial market threatens the existence of the requirement of the supervisory bodies' neutrality with respect to their impact on competition among banks. This problem is relevant for Europe, where they learn not only the process of internationalization of banking supervision, but it is seen a trend moving towards formation of a single European supranational banking supervisory authority. The first step in this direction have already been made, namely, was created so-called system of three Lamfalussy Committees. These committees accomplish two functions: 1) advising the European Commission in the regulation and future legislative initiatives; 2) contributing the convergence of the legislative and supervisory practices in the EU. Thus, at the EU level, was assigned a new task of the interpretation of supervisory law, which before that was considered the exclusive prerogative of national supervisory authorities.

It should be noted that in many foreign countries a rather coherent system of inspection and enforcement activities in the banking system has been established. Control and supervisory activities relate to various relations, which take place in the banking system preventing problematic situations and confusions associated with the protection of depositors' rights and to ensure the safety of their savings. In some countries control and supervisory activities in the banking system are carried out through the governance structures that are independent from central banks.

In the past decade, the notion towards the unification of regulatory bodies has developed, working on various financial markets, into a single body - the mega-regulator. The main reason for the consolidation process is the complexity of the banking business management and the relevance of creation of financial conglomerates, which activities would cover not only the banking services market, but the securities market, insurance, and would include other related services of various financial markets. These structural changes have strengthened the relationship between the once separated activities in financial services and, consequently, led to the need for an integrated approach to their management. In order to increase the value of the decisions, the committees decided to move from a full endorsement to the principle of majority[45].

To conclude, it is important to formulate the concept of international banking supervision in the context of globalization, which consist of the need of: 1) the global supervision (global market requires a change in methodology for banking supervision and the movement toward creating supranational banking

[45] Weber (2007), p.1140

supervisory authority); 2) an integrated financial supervision, i.e. combined supervision, including banking, insurance supervision and supervision of the securities market activities; and 3) presentation of new skill requirements for regulators' qualifications.

2.2. Theoretical Foundations of Banking Supervision in the EU based on the Principles of the Basle Committee

Banking law of the EU is a unique legal phenomenon, evolving continuously over more than half a century. Importance of banking supervision, including the European experience in this area is difficult to overestimate. While at first glance, being the narrowly qualified phenomenon, closed in the system of relations between banks and supervisory authorities, banking supervision is crucial to the state, society and ultimately for everyone in the economy. Banking supervision is designed to ensure stability, effective functioning and economic stability of the entire financial system as a whole, the legitimate interests of investors, protection and preservation of private investors' funds.

The banking law of the EU is a unique regulation with a special international legal status that was created with the help of constant interaction with international law and in accordance with international legal norms. Thus, the EU in contrast to international organizations of traditional type has the ability to enact legislation with legally binding force, which then are implemented into national legislation of the EU member states or have a direct effect on their territory.

Importance of uniformity standards of banking supervision, developed on the basis of international law is obviously. Events of recent decades show that a serious banking crisis within a single state will inevitably have a negative impact on the financial systems of other states and the world economy in general. The need for uniformity standards at the international level has become clear in the seventies of twentieth century; when Basel Committee on Banking Supervision was established as a result of the bankruptcy of several banks in Europe.[46]

[46] Linnikov (2009), p. 24. (Russian)

Year	2008	2010	2013	2015
% adoption rate (World GDP)	46%	58%	69%	77%
Selected countries adopting Basel II	G-10, Chile, Bahrain, Singapore	Russia, S. Africa, Indonesia, Brazil	India, Argentina	Egypt, Pakistan

Table 6. Adoption of Basel II

Table 6 demonstrates the trend of adoption of the Basel II among the European and world's country. Modernization of the legal regulation of the banking supervision system of the EU, occurring in recent years, essentially creates a foundation for the future financial and economic development of nations – the EU members, which also increases the relevance of research problems of the banking supervision in the EU.

In addition, experience of legal regulation of banking supervision and development pathways of this sphere within the bounds of the EU have a significant impact on the development of supervision of credit institutions in Russia, as because of the before mentioned reasons (the value of banking supervision, prompting careful study and use of best practices in this area), and as a result of multifaceted cooperation between Russia and the EU.

Partnership and Cooperation Agreement between Russia and the EU, signed on June 24, 1994, foresees contingence of legislation of Russia and the EU in the field of banking and financial services (Part 2 of Article 55). It also includes information and guidance for cooperation to establish well functioning framework for the sectors of banking, insurance and other financial services in Russia addressing the needs of a market economy. Such cooperation is focused on improving standards of accounting and reporting, adapted to the needs of the market economy and compatible with the standards accepted by member-states; improving the monitoring systems and regulation of banking, insurance and financial services (Article 72).

In accordance with the “Roadmap” on Common Economic Space (approved on May 10, 2005 in Moscow by Russian President Vladimir Putin, Prime Minister of Luxembourg Jean-Claude Juncker, European Commission President JM Durao Barroso and Supreme Representative of the EU for Foreign

Policy and Security Javier Solana)[47], Russia and the EU aim to strengthen cooperation to establish a common economic space. Creation of an open and integrated market between the EU and Russia is announced in Section I of the "Roadmap" as general goal. The challenge is to create the necessary conditions that will promote the availability of economic operators, to enable trade and investment, to facilitate the establishment and operation of companies on a reciprocal basis, to strengthen economic cooperation and the reform process, and as a result to strengthen the competitiveness of the EU and Russian economies[48].

The CBR first aimed to implement Basel II in Russia in 2007 and 2008. However, the implementation of Pillar I of Basel II was postponed in April 2008 due to the (1) economic crisis, which forced to focus on the other priorities before implementing Basel II; (2) three-year cooperation with the ECB to receive expertise on implementation of the Basel II; (3) insufficient pressure from the regulator, linguistic and comprehension difficulties of translating the official texts into Russian; (4) the necessity to change existing regulations, normative acts of the CBR, and approaches of the bank supervision[49,50].

According to the official sources, the Russian banks are obligated to form the reserve of capital to the operating risk from July 1, 2010. Moreover, CBR stated that there would be implementation of the IRB approach provided by Basel II. In general the Russian banks are required to use the simplified standardized approach to the estimation of credit risks. According to CBR, the greatest pressure on capital occurred in the banks, which business is profitable. Russian banks complain about the imperfection of the CBR formula, which directly connects the estimation of the risk of bank with the sizes of its income. The more precise methods, utilized in the West, for the Russian banks are thus far too complex[51,52].

It is important to mention the issues related to the harmonization of legal regulation of banking supervision in Russia with the relevant norms of the EU, based on international (Basel) standards.

Supervision of financial companies at the international level constitutes as follows:

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[47] Diplomatic Journal (1994), pp. 29-59. (Russian)
[48] Tysachnikova (2007), pp. 29-35. (Russian)
[49] Global Risk Regulator (2007), p. 7.
[50] March (16.04.2009), Risk.net. (Financial Risk Management News and Analysis Homepage): news/regulation/Bank of Russia, Basel II, Russian Federation.
[51] Dementyeva (23.08.2010), Russian Financial Corporation Homepage: Basel II: the most profitable banks suffer from the new standards. (Russian)
[52] Kommersant (01.02.2011), Lin.ru. (Legislation & Investment Homepage): news/The risks will be entrust to banks. (Russian)

- Basel Committee on Banking Supervision (see Table 7 and Figure 4);
- Regulation and Supervision of Financial Sector;
- International Organization of Securities Commissions (IOSCO);
- International Association of Insurance Supervisors (IAIS).

Keeping in mind trends of financial globalization effective banking supervision must meet the following basic conditions:

- Integration of banking supervision both by content and by geographic coverage. The supervisory authority under current conditions must be easily identifiable and exchange information and arrange/control/empower the goal-oriented action in crisis situations.
- The supervision must be focused on the market, i.e. be able to react to the market changes and should not hinder the development of financial innovation.
- Must act the principle: "same risks, same rules", i.e. supervision should be neutral with respect to the competition. This should apply both to international competition, and competition among the various areas of financial activity.
- It is necessary to aim for optimization of the ratio “expenses – effect” in conducting supervision of international financial institutions.

In 1988, the BCBS, acting with the Bank for International Settlements, approved the "Basel Accords". It defined the minimum requirements for capital adequacy for large international banks. The agreement was to ensure stability of the global banking system. The Basel Convention, which was originally adopted by the ten most developed countries (excluding the USSR), is now approved in more than one hundred countries around the world. In 1999, it was changed and adjustments were added.

Gradually, Basel’s Agreement ceased to be effective in relation to changes in the activities of financial institutions. Banks initiated the promotion and introduction of the complex financial products, derivative and to spread risks among subsidiaries. In response, the Basel Committee proposed to upgrade the minimum capital adequacy of banks.

Key Principles for Effective Banking Supervision	Basel Committee on Banking Supervision: Basel I – 1997 Basel II – 2004 Basel III - 2010	Problems of determining the adequacy of bank capital and main methods of calculating the required amount of capital to cover market, credit and operational risks	The transition of Russian banks on the standard of Basel II (Begin of implementation in 2008-2009)

Table 7. Regulation and supervision of financial sector

In 2004 the Committee issued a document of the agreement known as Basel-II (Core Principles for Effective Banking Supervision). The principles of Basel II are listed in the Figure 4.

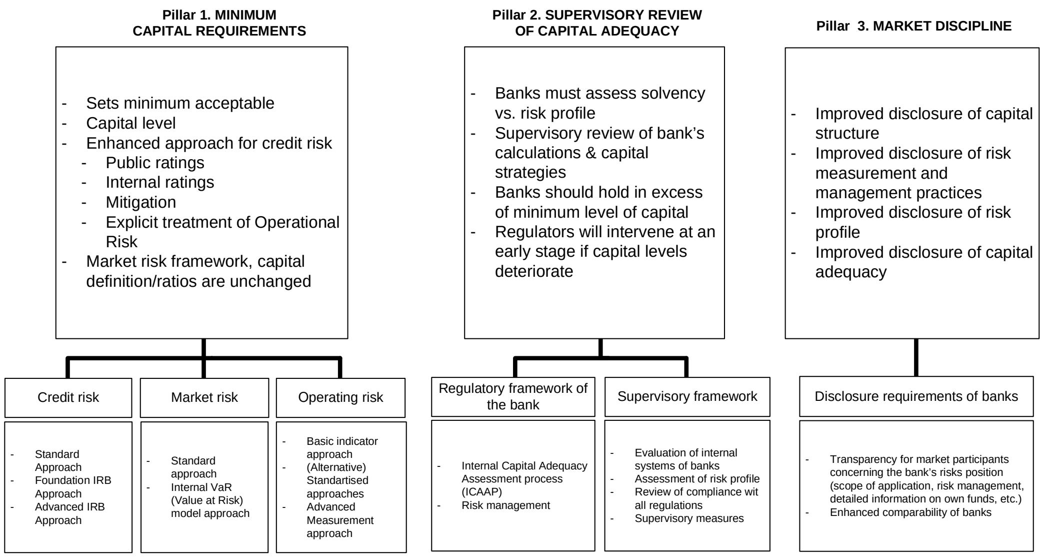

Figure 4. Fundamental Principles of Basel's Agreement

Basel II consists of three pillars: minimum capital requirements, supervisory overview and market discipline retaining elements. This framework is based on the same principles as Basel I. However, Basel II has more focus on the counterparty risk whereas Basel I had more focus on individual credits[53].

The Pillar 1 requires having minimal capital adequacy of 8 % of the total risk-weighted assets related to the potential risks. In comparison to Basel I, the requirement of keeping capital in order to cover operational risks is a new idea. "The credit risk component can be calculated in three different ways of varying degree of sophistication, namely standardized approach, Foundation IRB and Advanced IRB. IRB stands for "Internal Rating-Based Approach". For operational

[53] BIS Homepage (2004): monetary & financial stability/BCBS/Basel II: International convergence of capital measurement and capital standards – a revised framework.

risk, there are three different approaches - basic indicator approach or BIA, standardized approach or TSA, and the internal measurement approach (an advanced form of which is the advanced measurement approach or AMA). For market risk the preferred approach is VaR (value at risk). Asymptotix promotes Siag's Market Risk Engines. Siag's paradigm advance in Market Risk Engine calculation speed and performance with Tier 1 portfolio data volumes means that a full range of VaR calculations may be modelled along with other statistical measures such as VaE, ESF and P&L Vectors; fully stress tested and back tested to full portfolio revaluation in typically only an hour"[54].

The Pillar 2 discusses key principles of supervisory review, risk management guidelines, supervisory transparency and accountability. In general, it requires the banks to evaluate the risks and funds needed to cover them. Afterwards, the supervisor would evaluate the decision and decide whether the bank is legible to take such risk. The supervisor should reevaluate all risks related to the credit, market, operational risks, etc. Pillar 3 is based on the improvement of the transparency of the bank's activity. This pillar allows the banks to evaluate the capital needed internally[55].

In compliance with the Basel's Agreement the bank capital is divided into Tier 1 and Tier 2 capital. Minimum requirements of Basel-II gives banks the freedom to choose, giving the opportunity to rely on data obtained from experience or from external sources, if the bank will be able to conclusively show the involvement of such data to its potential risks. Practically, this means that banks must have the procedure, allowing them to securely collect, store and use statistical data on losses over a certain period of time.

The effects of Basel II on the bank depend on the variety of the factors, such as current risk management processes, size, customers, portfolio, and market since all of the parties are interdependent (see Appendix 2). Moreover, the wide business cases and risk management challenges could affect different parties, such as banks, non-bank competitors, customers, rating agencies, regulators, and global markets (see Appendix 4). In general, banks would be requested to implement risk management system in the entire company, which would tie regulatory capital to economic capital. At the same time, bank customers would need to collect and provide additional information to the banks and experience new risks due to the increased transparency. The global banks would experience additional need to

[54] Asymptotix Homepage (2010): Services/Basel II.
[55] BIS Homepage (2004): monetary & financial stability/BCBS/Basel II: International convergence of capital measurement and capital standards – a revised framework.

securization since financial institutions implement all Basel II requirements. Furthermore, the regulators would be requested to provide a level playing field in regards to the BSC recommendations, which would be implemented in the legislative acts by the countries. Also, rating agencies would have new prominence under Basel II and could experience additional competition[56].

Let us have a look at the content of the principles of Basel Committee. Principle 3 (“The Licensing Authority shall have the right to determine the criteria and reject the founder's statements that do not meet established standards. The licensing process must at least include an evaluation of the ownership structure of banking organizations, directors and senior management, its operating plan and internal controls and its projected financial situation, including his own funds; if the supposed owner or parent organization is a foreign bank, it must be obtained the prior consent of the supervisory authority in the country of origin") discussed the need to evaluate the ownership structure, directors and senior management and internal control system already on the stage of the decision making about granting a banking license.[57]

For the practical implementation of the Principle 4 ("Supervisors should have the authority for review and rejection of any proposals to transfer significant ownership or controlling stakes in existing banks to other parties”) should be clear formalized legal regulation framework for the procedures. As for today, the instruction of the CBR "On the order of the Bank of Russia the decision on state registration of credit institutions and licenses to conduct banking transactions"[58] implies the requirement to obtain prior consent of the Bank of Russia for the purchase of a person (or group of related persons) of more than 20% of stocks (shares) of the credit institution. The Bank of Russia has the right to refuse the consent request for the acquisition of more than 20 % of shares (stakes) due to a number of specified reasons (in the case: establishment of the unsatisfactory financial situation of the purchaser; violations of antimonopoly rules; the presence of the court decision which came into force in respect of purchaser, the court decision established by this purchaser the fact of misconduct in bankruptcy, intentional (or) the fraudulent bankruptcy; and in other cases stipulated by federal law). As seen in this legal act there is no place devoted to meaningful analysis of the consequences of relocating the ownership of the credit institutions, and there

[56] KPMG (2003) Basel II: A Worldwide Challenge for the Banking Business, p. 3.
[57] Moshenskiy (2008), p. 293. (Russian)
[58] CBR (2004): Instruction of Central Bank of the RF #109

is no possibility for the supervisory body of taking decision, based on an informative analysis only.

Furthermore, there is a need to enhance and provide clear instructions on the rights and authority of the supervisors to check/to monitor large transactions taking place in the credit institution, as assigned by Principle 5 ("Banking supervisors must have the authority to establish criteria for testing large mergers or bank investments and ensure that corporate acquisitions or structures are not exposing bank to excessive risks or hinder effective supervision")[59].

Principle 10 outlines the verifying function of banks' transaction by the supervisor ("In order to prevent abuses arising from connected lending, the supervisory authorities should have requirements that banks refrain from providing loans to related companies and individuals, and the allocation of such loans effectively monitored and are taken other appropriate measures to control and mitigate the risks). The most risky and potentially damaging transactions for the financial institutions are those involving individuals, who have the personal appeal and power, which enables them to influence banks' management decision making. The key issue here is the need for a regulatory framework for the definition of related parties (natural and legal and physical), as well as controlling and monitoring function of the bank in relation to "related party transactions", which can significantly enhance the transparency of banks activities and reduce the possibility of the diversion of funds from banks, as well as prevent bankruptcy[60].

Despite of the fact that Principle 6 ("Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks taken by the bank and must identify the components of capital, bearing in mind at the same time its ability to absorb losses. For the banks that are actively engaged in international operations, these requirements must not be less than the requirements established by the Basel Capital Accord ") is used by supervisors and provided by law, the important question is to identify components of capital and its adequacy in application [61].

Certain capital is required for the start of the banking business and for investment in fixed assets. It is also a disciplining and filtering measure for the activities of bank managers. Capital is a source for repayment of unexpected and

[59]BIS Homepage/ BCBS (2006): International convergence of capital measurement and capital standards – a revised framework comprehensive version
[60] Ibid
[61] Kuznetsov (2008), pp. 16-23. (Russian)

increase of banks reliability. Measurement of market capital requirements varies based on the changes of determining and defining the risks in the banking system. Nevertheless, the definition of capital adequacy remains questionable and debatable. First, the question is how to determine the amount of capital; and second, is how to determine the measure of its adequacy. Determining the amount of capital varies depending on the considered components of capital, such as hidden reserves, domestic reserves and reserves for loan losses. Capital adequacy is kind of a shock absorber that allows bank to remain solvent and to continue operations in spite of any event. Undercapitalized bank is exposed to disproportionately higher risk of bankruptcy in case of deterioration of macroeconomic or other economic conditions. At the same time overcapitalized bank is usually low maneuverable and non-competitive on the capital markets and credit resources. Banks traditionally seek to maintain capital at a lower level to improve efficiency and increase profits of investors; on the other hand, supervisory bodies prefer a higher level of capital in order to improve the stability of the banking system.

The common practice of measuring capital adequacy is by preparing the estimations of the ratio of capital to assets or equity to liabilities. Another common way is the approach of weighing risks. This method attempts to relate the risks taken by the bank with the size of the capital. At the same time, financial liberalization alters this traditional method of weighing the risks, which largely determined the concentration of risks by type of asset that keeps the bank. As for now, the method weighing of the risks seems to be narrow and not accurate enough, because some of these risks, while remaining available, can be reduced or minimized by currently developing hedging techniques. In addition, several sources of potential risks, such as the presence of open dealing positions, the sensitivity of interest rates on loans, country risk and the risks of transactions registered on off-balance sheet, expand, and not always are taken into account in the scheme of capital adequacy assessment by weighing the risks[62].

Considerable attention in the basic principles is paid to assessing the presence of supervisors and compliance with applicable bank policies, practices and procedures for monitoring and analysis of performing transactions (Principles 7-8, 11-15). In order to fulfill the supervision function regularly, the supervising bodies should be provided with relevant internal documentation of the bank, and also be able to analyze materials that contain management decisions. It is obvious

[62] Dobrynina (2007), p. 32. (Russian)

that the main work of assessing the banks policies, practices and procedures for monitoring and analysis of performing transactions should be assigned to the inspection division of the Bank of Russia and auditing companies. The analysis of compliance with applicable bank policies, practices and procedures for monitoring and analysis of performing operations is performed by entities in the Bank of Russian and the procedures are constantly being improved and adjusted. However, there is not clear instructions/requirement for the businesses and institutions, which are subject to audit, thus, enhanced regulations are required.

Rapid corrective action in case of banks' non-performance of prudential requirements is one of the key functions and empowerments of the supervisory bodies, (according to the Principle 22 "Banking supervisors must have at its disposal supervisory measures to implement corrective action in case of bank non-performance of prudential requirements (such as minimum capital adequacy ratios), violations of regulations or the emergence of threats to the depositors interests. In extreme situations here should be included the ability to revoke the banking license or to recommend its withdrawal"). This Principle provides the guidance for supervisory bodies action in emergency case and compensates on the limitations of legal framework, which is applied nowadays, as it does not provide such a surgical intervention (up to the revocation of a license or recommendations for withdrawal)[63].

In general, the basic principles imply practicing the philosophy of banking supervision, based on the content evaluation of the quality and value of the assets, liabilities and equity (capital), as well as the quality of corporate governance, backed by a legally enshrined authority on the application of timely (not excluding emergency) measures to the credit institutions. Implementing set of measures in the national banking supervision system requires increasing the accountability of credit institutions involved in the financial system and decreasing the number of transactions by credit institutions aimed at the creditors. As a result the efficiency of the banking supervisory intervention in the activities of credit institutions will be optimized and enhances and effective prevention measures against the threats to the financial situation, as the threat of insolvency or bankruptcy will be enabled.

Widespread implementation of Basel II will increase and strengthen the stability of the banking system; Russian national economy is characterized high

[63] BIS Homepage/BCBS (2006): International convergence of capital measurement and capital standards – a revised framework comprehensive version

dependence on foreign capital, low and uneven capitalization, unequal access to financial resources to credit institutions of different sizes and with different capital structure and high growth rates, and therefore, the application of Basel II is especially relevant and needed for the country now. In addition, the insufficient development of the consolidated supervision of financial institutions, the expansion of the Russian financial companies internationally provides more reasons for Basle Core Principles application and modernization of national legislation in accordance with the international standards.

Chapter III

Principles and Mechanisms of Bank Supervision in Russia

3.1. The Concept and Nature of Inspection and Enforcement Activities in the Banking System of the Russian Federation

Compliance and enforcement in the banking system has been actively developed in the second half of XIX century. It is unfortunately not possible to systematically examine this activity during the Soviet period. Momentous period in the development of compliance and enforcement activities in the banking system can be considered the beginning of the nineties of twentieth century. This is due to the fact that on July 13, 1990 on the basis of the Russian Republic Bank of the USSR Bank was established Central Bank of the Russian Federation (Bank of Russia).

On December 2, 1990 the Law on the Central Bank of the RSFSR (Bank of Russia) was established, under which the Bank of Russia was a legal entity, the main bank of the RSFSR. The law specified the functions of the bank in the field of money circulation, monetary regulation, foreign trade, regulation of joint stock and cooperative banks, as well as functions for the implementation of compliance and enforcement activities in the banking system[64].

In June 1991, was approved the Statute of the Central Bank of the RSFSR (Bank of Russia), and in November 1991 in connection with the formation of the Commonwealth of Independent States and the abolition of the union structures, Supreme Soviet of the RSFSR announced the Central Bank of the RSFSR the only body of the state monetary and foreign exchange regulation of the economy on the territory of the RSFSR. On it were put the functions of the State Bank on the emission and definition of the exchange-value of ruble, as well as challenges in implementing the compliance and enforcement activities in the banking system.

In 1992 – 1995 in order to maintain stability of the banking system the Bank of Russia has created a system of oversight and inspection of commercial banks, as well as a system of currency regulation and currency control. Currently, banking supervision is one of the main functions of the Bank of Russia. It should be said that the function of bank monitoring and supervision is objectively necessary[65].

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[64] Pait (2010), pp. 113-117. (Russian)
[65] Beloglazova/Krovetskaya (2010), p.46. (Russian)

The Basel Committee's consultative document The New Basel Capital Accord also intends to use external credit assessment as the background for evaluating risks[66]. Unfortunately, Russia does not have well developed network of rating agencies. There is a notion that international rating agencies, such as S&P, Moody's or Fitch would be able to evaluate Russian banking sector. However, the international agencies represent the view on the borrowers and foreign investors' issuers. In general, the international rating agencies do not concisely evaluate the particular details of the developing countries. Therefore, the ranking are more applicable for the developed countries and cannot be precisely implemented to the developing world, including Russia.

#	Agency name	A. M. Best	FITCH	Moody`s	S&P	Weiss	Expert RA (Russia)
1	Prime	A++	AAA	Aaa	AAA	A+	A++
2	High grade	A+, A	AA+, AA, AA-	Aa1, Aa2, Aa3	AA+, AA, AA-	A, A-	A+
3	Upper medium grade	A-, B++	A+, A, A-	A1, A2, A3	A+, A, A-	B+,	A
4	Lower medium grade	B+, B	BBB+, BBB, BBB-	Baa1, Baa2, Baa3	BBB+, BBB, BBB-	B, B-	B++, B+
5	Non-Investment grade	B-, C++,	BB+, BB, BB-	Ba1, Ba2, Ba3	BB+, BB, BB-	C+, C, C-	B, C++
6	Highly speculative	C+, C,	B+, B, B-	B1, B2, B3	B+, B, B-	D+, D, D-	C+
7	Substantial risks/ extremely speculative	C-, D	CCC+, CCC, CCC-	Caa, Ca	CCC+, CCC, CCC-	E+, E, E-	C
8	Unsatisfactory/ bancruptcy	E, F,	D	C	CC, C, D	F	D

Table 8. Ranking of rating agencies[67]

Currently, Russia has several Russian ranking agencies, which specialize on ranking of the banking sector. As for 2010, The Ministry of Finances of Russian Federation and Federal Service for Insurance Supervision (FSIS) of Russia accredited Moody's Investor Service, Fitch Ratings, Standard & Poor's

[66] BIS Homepage (2010): Monetary & financial stability/BCBS/Long-term Rating Scales Comparison

[67] Samiev(2004): raexpert.ru-Russian rating agency Homepage. (Russian)

(international rating agencies operating in Russia) and National Rating Agency, RusReiting, Expert RA, and AK&M (Russian rating agencies) The agencies operate in the Russian market and provide the reports for the banking sector altogether with international agencies. According to statistics, Moody's had 187 ratings, Fitch – 145, S&P – 127, Moody's Interfax – 152 ratings by the mid-2010[68].

Russian ranking agencies have approximately the same ranking scale as the international ranking. Table 8 provides the comparison of the main rating agencies in Russia. Thus, Russian banks are able to use both Russian and international agency's ratings in order to comply with the Basel II requirements. Moreover domestic ranking agencies tend to have long-term relationship with its clients and provide additional analysis to the banks and understand the domestic market better than international agencies.

Procyclicality of Basel II is one of the problems in ranking the financial institutions. In general, the ranking agencies are required to evaluate the solvency (ability to return the debt) of the borrower forecasting the potential of the default/ bankruptcy. However, the ranking agencies tend to base their rankings on the previous rankings due to the cost minimization of the evaluation and lack of information. This demonstrates the fact that ranking agencies do not fully comply with the Basel's standards and requirements. Moreover, these rankings could lead the banks to provision of excessive credits during the growth of the economy without consideration how the credits would be returned and decrease the provision of credits during the economic recession, which would stop the economy to revive.

Russian and International ranking agencies could be divided into two groups:

1. All-purpose (Expert RA, Moody's Interfax, Russian subsidiaries of international agencies). These agencies provide their evaluation to the companies from different industries. Moreover, they publish informational and analytical reviews.
2. Specialized (Naufor, RusRating, AK&M). These agencies are focused on the particular segment (e.g. banking) and rate only the participants of this market.

As it was mentioned previously, the Russian ranking companies do not have large experience in ranking of the companies. Therefore, it is suggested to

[68] Global Rating Group Homepage (22.09.2010): Accreditation of the Russian rating agencies.

increase the number of rankings and searching for the supervisory authority effective and trustworthy ranking agencies, which comply with the minimal requirements of Basel II (impartiality, independence, openness, resources, accreditation of the FSIS and professionals).

Direct responsibility for the prudent monetary policy first-hand have banks, and prudential regulation and supervision, being by its nature secondary to banking activities, play only an indirect role in protecting depositors from losses arising from the bankruptcy of individual banks. Purpose of the regulator is to ensure conditions for the stability of individual credit institutions and the banking system as a whole.

The Bank of Russia constantly monitors the compliance by credit institutions and banking groups of banking laws, regulatory legal acts of the Bank of Russia, as well as the Bank of Russia mandatory standards[69].

The objectives of banking supervision are to maintain the stability of the banking system and protect the interests of depositors and creditors. Banking supervision is carried out through the Committee of Banking Supervision. The Committee brings together the structural unit of the Bank of Russia, to ensure compliance with its control and supervisory functions. At the present time the institute of banking supervision is experiencing hard times. In this regard, its improvement depends on a variety of circumstances.

First of all, there is a need to improve administrative and legal framework of banking supervision and the optimal definition of means and forms of control and supervision of the banking system.

Banking supervision is supervision of the Bank of Russia for the observance of performance of commercial banks and other credit institutions, laws and other regulations, implemented in the statutory forms and through specific methods designed to protect the interests of depositors, preventing intentional bankruptcy of credit institutions, as well as opposition to legalization of proceeds from illegal means[70].

According to the legislation of the Russian Federation the oversight of commercial banks and credit institutions is accomplished by the Central Bank of Russian Federation, which has a number of offices performing supervisory functions. These are Audit Bureau of the Bank of Russia, performing audit for major territorial departments of the Central Bank; currently created Department of

[69] CBR (2006): Bank of Russia Annual Report 2006.
[70] Beloglazova/Kroliveckaya (2010), p. 58. (Russian)

banking supervision; and Management of commercial banks inspection. Control and supervisory authorities perform their powers in the process of issuing licenses to carry out banking activities; in the decisions to limit the terms of the operations; in the establishment of prohibitions on the commission of certain banking operations; as well as in the implementation of the jurisdictional activity.

3.2. Forms and Types of Inspection and Supervision Activities in the Banking System of the Russian Federation

Compliance and enforcement in the banking system is carried out in various forms and through various methods. In particular, the enforcement activities carried out during the registration, licensing, inspection of commercial banks and other credit institutions, etc. It should be noted that the control of the banking system can be both internal and external. The rules of internal control in credit institutions, as well as features and procedures for its implementation are determined by the Bank of Russia. The internal control system aimed at achieving the goals defined by the charter relevant credit institution.

Regulatory functions of banking activities are usually divided between the parliament and the government and, actually, the regulatory body, which could be a central bank, integrated or specialized organization. Supervisory function is usually assigned to a state agency.

Function of banking regulation and supervision are universal for most countries of the world and are as follows:

- Prudential regulation - development and expansion of a wide range of regulatory directives for credit institutions;
- Prudential supervision - financial analysis, compliance and implementation by credit institutions the standards and regulations established by the supervisory authority;
- Partial soundness guarantee of the banking activities - the creation of deposit insurance system; providing the function of "lender of last resort" for banks;
- Establishing monitoring and control of insolvent financial institutions - their turnaround or bankruptcy with minimal losses for the customers and depositors;

- Develop ways out of the financial crisis, both actual and anticipated. Implementing measures to prevent crises.

The scope of banking supervision generally includes: an assessment of the financial condition of banks; monitoring their compliance with the requirements of current legislation regulating their activities; the application of appropriate supervisory measures of both as preventive and enforcement nature. The classic variant of banking supervision has two main components: licensing and supervision of daily operations of credit institutions.

The methodology of banking supervision is presented as a management cycle, beginning with the licensing procedures (licensing), following with supervisory action themselves (analysis of documents and inspection) and completes with the control (feedback) and sanitation (financial rehabilitation, or revocation of licenses, reorganization and liquidation).

The methodology of the above mentioned cycle in Russia is constantly being improved, approaching international standards. In accordance with the Basel Principles for effective banking supervision Bank of Russia is using the recommended types and methods of supervision.

Implementation of the main function of the Bank of Russia - to protect and ensure the stability of the ruble - is impossible without influencing the banking sector, whose goal is to maintain the stability of the banking system of Russia, protecting interests of depositors and creditors.

The practice of banking regulation and supervision is reduced to the formulation and implementation of the rules by the relevant bodies, based on existing legislation and considered the specific economic situation.

The Bank of Russia acts as the external subject of the control in relation to credit institutions. However, as part of the Russian banking system the Bank of Russia is a subject to supervision by the State Duma and the Russian Audit Chamber. In carrying out enforcement activities in the banking system, Bank of Russia, however, is not the authority for direct management of financial and credit institutions. On this basis can be stated that the Bank of Russia serves as the subject of functional and operational control in the implementation of banking activities.

Speaking of compliance and enforcement forms, can be noted that the basic form of banking supervision is inspection. In addition, the credit institution is subject to annual verification of audit organization. Moreover, audit is also conducted in respect of the Bank of Russia. Audit of Bank of Russia may be internal or external. Control in the banking system may be preliminary, current and sequential[71].

Considering methods of inspection and enforcement activities, it must be stressed that the Bank of Russia has the right to apply for coercive measures to the credit institutions in accordance with the established procedure: a ban on the implementation by the credit organization of individual banking operations stipulated by the license; to revoke from credit institution the license to conduct banking transactions, etc. All licensing requirements for the credit institution can be divided into four groups: the authorized capital, the founders, management and technical capacity of credit institutions. The purpose of the procedures, carried out under the licensing, is to minimize the risk of admission to the banking services market or in a separate segment of its institutions whose functioning is certainly a threat to the interests of creditors and customers, or a threat of a systemic risk. The reasons for these kind of threats is a potential negligence; insufficient management skills; the opacity of the corporate structure that prevents the implementation of the requirements of market discipline and effective supervision; notorious management inefficiency; the initial weakness of the capital or the inadequacy of material resources; increased risk of excessive risk-taking, etc.

Improvement of licensing should be conducted towards streamline supervision of owners and managers of the credit institutions. Must be installed continuous monitoring of the financial status of legal persons – controlling shareholders in banks, which would eliminate the possibility of bypassing the established regulatory limits on the maximum risk in financing founders and insiders by establishing affiliates and controlled entities[72].

In order to protect the interests of depositors and creditors the Bank of Russia has the right to appoint an authorized representative of the Bank of Russia to the credit institution, in which has been revoked the license for banking operations. In addition, the Bank of Russia is entitled to exercise the administrative and jurisdictional activities. At present time, one can say that the Bank of Russia has rather extensive arsenal of inspection and enforcement activities, but their implementation mechanisms are not fully formed, which affects the efficiency of the concerned activity type.

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[71] CBR (2009): Banking supervision report, pp. 54-95. (Russian)

[72] Pshenichnikov (2009), p.76. (Russian)

The introduction of managers' liability for damages for the caused bank damage as a result of embezzlement and theft of funds should raise the accountability of managers of credit institutions. In some Western countries such liability extends to the all manager's property, until the property of all members of his family.

In contrast to licensing the current control is intended to identify the threats resulting from the operational activities of the banks and the negative influence of the environment. The task of supervisory bodies is to recognize the nature of the risks taken by the bank and ensure the adequate management.

A procedural guideline is a necessary but insufficient element of the oversight. By selecting appropriate measures not only knowledge of techniques is required, but also a great experience, ability to collect and analyze relevant information, as well as intuition. A special role plays the improvement of the inspections quality.

Bank of Russia documents governing the inspection much wider cover the process of organizing inspections, in contrast to the previously applied. This demonstrates the serious work to improve the regulation and supervision of credit institutions, their approach to international standards. To improve the efficiency of inspection is required promptness of delivery and receipt of reliable information needed for work[73].

The bank rehabilitation is considered as an independent element of the supervisory system, due to general insufficient steady state of the Russian banking sector and the availability of troubled banks. The task of the rehabilitation is to provide a special regime of supervision and implementation of the system for corrective actions to credit institutions for which there is a real risk that their financial situation without the use of a special package of measures will go into a critical phase and lead to insolvency. Rehabilitation procedures complete the cycle and lead either to recommendations of a credit institution or to more serious consequences, up to the reorganization and withdrawal of the license.

Particularly topical issue of state regulation of the banking sector is the adoption by the state authorities of Russia the decision to join the WTO. This is undoubtedly an important step towards international integration, participation in the formulation of new rules for international trade based on the principles of: transparency, predictability, non-discrimination and national treatment to

[73] CBR (2009): Banking supervision report, p.91. (Russian)

minimize government intervention in the economy and foreign economic relations.

One of the conditions to entry into the WTO is to open the financial including banking markets, services for foreign capital. The retention of the right of restriction for the penetration to the Russia's foreign capital market is possible, if its necessity will be proved and approved by the WTO - member countries and will be recorded in the Schedule of specific commitments on services. The effectiveness of banking supervision is in direct proportion to the clear definition of responsibilities, powers and purposes of regulation and supervision; building such a model of their organization, which would correspond to the level of development of the domestic financial market.

In addition to the trend towards consolidation of regulatory bodies of different financial markets, should be noted the emergence of fundamentally new approaches to the role definition of the Central Bank in the process of bank regulation. Nowadays, central banks are responsible for systemic stability, and in many cases perform direct prudential regulation and supervision of banks. In countries which have chosen as their model the mega-regulator, the regulatory function is, as a rule, separated from the Central Bank. Nature of the interaction of the mega-regulator and central banks in each country is determined by its specificity and has no certain rules and patterns.

With regard to the nature of the functions of supervisory authorities, there are two main approaches to ensure financial stability, more or less used in contemporary supervisory practice. This is an approach, which relies on the restrictive and prohibitive measures; and the approach that was introduced just two decades ago, aimed at promoting respect for market discipline among the participants of the banking market. In this case, attention of the oversight is focused primarily on an understanding of the risks taken by each individual bank and on the assurance that the bank has the tools which are necessary to identify, measure and control these risks. This approach with the corresponding set of supervisory methods and tools is called risk-oriented supervision.

Chapter IV

Recommendations for Improvement of the Russian Banking Supervision

4.1. Organization Problems of Banking Supervision in Russia

Efficient supervision of the financial enterprises is one of the components of the developed economy. Here, the banking system plays a main role since banks are providing services of the transactions, mobilization and distribution of the deposits and financial assets. Therefore, the supervision should enable the successful accomplishment and reliability of the banking operations. Moreover, the proper supervision would ensure that the funds and bank reserves are sufficient to support their risks. In general, strict and efficient banking supervision serves the entire society and serves one of the main aspects for the financial stability in any country. The bank supervision requires large expenditures; however, its absence could have much more greater price.

The main problems of banking supervision in Russia are given below:

- A relatively small number of national rating agencies and as well as borrowers who have received credit ratings from international rating agencies;
- Lack of internal ratings systems in most commercial banks;
- Lack of statistical data on losses due to credit and operational risks by banks wanting to go to the advanced approaches to risk assessment;
- A relatively small amount of data on the incidence of defaults and migration of external ratings of market debt and internal ratings of bank loans;
- Lack of financial, human and information resources needed to implement more innovative approaches, like the banks and the regulators;
- Uncertainty with the volume of the powers of national supervisory authorities in terms of interpretation and concretization of certain provisions of Basel 2, assigned their competence.

The rigorous effort of the Bank of Russia to develop the regulatory support signals the lack systematic and comprehensive approach. For example, various formal instructions and regulations address issues related to risk management insufficiently; regulatory documents do not objectively reflect the cutting-edge developments in the assessment and calculation of risks. In addition, the changes in the activities of Russian banks are outside of the legislative initiatives of the Bank of Russia. Thus, the rapid development of off-site supervision for banking services, including Internet banking, raises questions of legal regulation and prudential limitations related to operational risks, including technological and legal risks.

The transition to risk-oriented supervision is based on the development of assessment of risk levels according to the evaluations and estimations of the supervisory authority on asset quality, state of liabilities and equity of credit institutions, the management systems, including organization of internal control in place. This approach has been applied by the Bank of Russia in the evaluation of banks on their compliance with the criteria for admission to the deposit insurance system. However, so far the normative act, restraining the powers of Bank of Russia to take significant measures in relation to financial institutions has not been adopted yet[74]. In addition to the degree of readiness of national supervision, not less important criterion for the effective introduction of modern methods of risk assessment and organization of banking supervision is the willingness and flexibility of the banking sector and its resistance to change.

It should be noted that not all Russian banks have the financial capacity to cover the costs required for transition to new standards of risk assessment and supervision. Some of the consulting companies estimate that this would take up to 1 % of their assets to comply with Basel II. According to Credit Suisse First Boston (USA), it would be required $100 million in order to adopt advanced methodology provided by Basel II[75]. The Russian banking system in 2008 provided a positive financial result mainly due to the ten largest banks (61, 4% of profit). Accordingly, these banks have maximum potential to implement Basel standards without compromising their financial stability. For the remaining banks the process of introducing new standards may take years[76].

The expenses necessary for the transition to new standards of risk assessment and the organization of banking supervision are shown in the Figure 5.

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[74] Emelyanova (2007), p. 125.

[75] Gizatullin (2006): Basel capital adequacy ratios: Problems and Prospects on the Reglament.net page. (Russian)

[76] CBR (2009): Banking supervision report, pp. 84-86. (Russian)

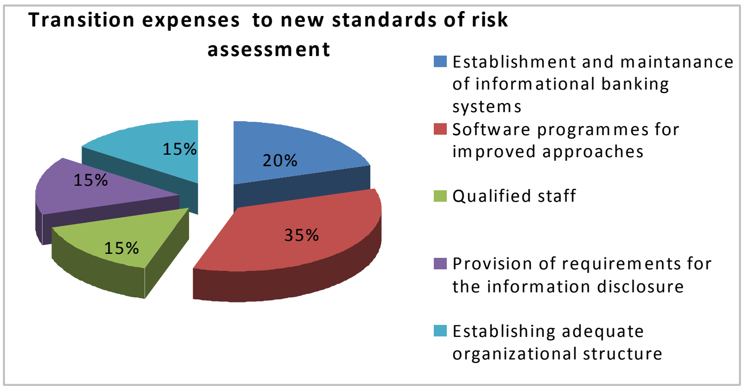

Figure 5. Transition expenses to new standards of risk assessment

Computer software expenses are one of the largest expenditures for the enterprises willing to comply with the Basel II. The computer software would enable the managers to maximize the capacity of the financial institution in collecting information, evaluation and reporting on the particular risks in the organization. ERP (Enterprise Resource Planning) software with the ERM (Enterprise Risk Management) module is one of the alternatives in managing risks strategically, managing efficiency, and combining the solutions on the risk management. Moreover, the Basel II requirement should be applied to the methodology of risk management, data and reporting to every financial institution despite of the regulatory requirements.

Unfortunately, there is no specific information on the requirement for the IT systems and software. However, the adoption of Basel II requires modernization of the bank's IT systems and infrastructure. Therefore, some of the financial institutions could face with the several problems, such as:

- Majority of the organizations do not collect and store detailed information about its processes and operations. However, this is prerequisite of the advanced models of Basel II.
- Basel II requires calculating reserved funds on the scale of the entire organization. This means that all the units of the enterprise need to provide information on their activity and all information should be evaluated and consolidated. Usually, this requires data storage centers, which increases the investment on the development of the IT infrastructure and software.
- IT security is another issue. Considering the fact that financial institution would collect and store large number of confidential information, it would

need to take additional care to its IT security. Moreover, additional means of data storage should also be implemented[77].

Considering all above mentioned, the financial institution should carefully choose the software developer or FSP (Financial Service Provider), which would provide acceptable IT infrastructure of risk management, ERM, and uniting these functions with the efficiency management. One step ahead was made by the legislation of the standard for IT Security СТО БР ИББС-1.0-2006 (Providing the Information Security in Banking Organizations of the Russian Federation) by CBR in January 2006. This standard was focused on creating the complex system for risk management[78].

In addition, majority of the banks would experience difficulties in adopting of Basel agreement due to the lack of the specific knowledge and experience in integrated risk management and project management. Majority of these problems could be solved by membership in the Association of the Russian Banks, which functions as non-government organization and aims to develop the banking infrastructure in accordance to Basel II requirements and ensuring effective management of the risks[79].

Russian banks are also weak and vulnerable in terms of organizational structure. For example, most banks do not have adequate risk management system - today more than half of Russian banks do not identify the risk management function (i.e., the function of the complex risk assessment) as an independent area, which requires human and financial resources. In addition, the level of theoretical development of the risk management of banking activities and information on the field is extremely low and insufficient. In many cases credit institutions simply copy the regulations of Bank of Russia not considering the necessary adjustments. On the other hand, only few large Russian banks, pay attention to risk management and combine the information and instructions of the CBR and foreign developments in order to create an effective risk management system. Nevertheless, among the small and middle-size banks and regional banks the tendency to ignore risk management importance prevails.

An issue of corporate governance of banks is still of increased interest. Despite of the existence of the legal framework, defining the basic principles and creating the preconditions for the corporate culture development, the practice of is

[77] Kompyuterra (12.05.2009) Publog.ru-Technology-News Homepage/Basel II: Capital Measurement and Capital Standards. (Russian)
[78] Ibid
[79] CBR (2005): Ministry of Finance of the RF Homepage/Regulations/State Policy in the Banking Activity/The strategy of banking sector development till 2008. (Russian)

still rather formal and exists only on paper. The main challenge is that the idea is not supported by the top management of the banks and key managers, therefore the way to implement the culture become more and more difficult. Thus, despite of the fact that the country has stepped into previously announced period for the introduction of the renewed regulations and supervision, there is no background platform, which would enable smooth development of the project.

Comparative analysis of forms and types of organization of banking supervision in various countries demonstrates that the key question lies in the participation of the Central Banks in the supervision of the banking activity. There are both positive and negative aspects associated with the problem of allocating the functions of the oversight from the competence of the central bank. Thus, as the positive aspects include the possibility of overcoming the potential conflict of interest between the objectives of monetary policy and supervision, the elimination of excessive concentration of powers within the central bank. However, the central banks have a strong information base, highly qualified staff, have a real opportunity to avoid or minimize systemic risks in the banking sector. In addition, institutional, regulatory and budgetary independence of central banks allow protecting the oversight from political lobbying and pressure, which speaks in favor of preserving this function for them.

In real life, none of the supervisory authority in the banking sector is independent from the Central Bank since all the major problems in the banking sector would lead to the appealing to Central Bank (e.g. as creditor). Therefore, there are tight relationship between the Central Bank and diverse bank regulators. In many cases, of keeping banking supervision by the Central Bank is a question of the political forces, traditional distribution of the power, and regulatory culture[80].

Furthermore, there is no conclusive proof that other supervisory institution would perform better that Central Bank. Currently, there is no research proving that supervisory role of Central Bank of Russia is not capable to protect the economy from recession and/ or enables cooperation of the banks and governmental institutions in the banking sector. It is necessary to create an effective system for rapid information exchange between industry supervisors to assess the overall risk and take appropriate action when problems arise at any institution, which is part of the financial conglomerate, as well as to identify and address regulatory gaps.

[80] Simanovsky (2002), p. 32. (Russian)

This idea was supported by Sokolov and Belyaev, who believe that "the conclusion of the supervisory unit outside the CBR would mean scrapping the current system, violation of finally resulted balance of interests, which is the key to sustainable development"[81]. In addition, the allocation of banking supervision from the functions of the CBR may increase the costs of regulation.

Analysis of relationship of banking community to banking supervision demonstrates a positive perception of the methods of banking regulation and supervision[82]. The banks, depositors, and creditors are interested in the high-quality banking supervision. However, this raises the question to determine the quality of banking supervision. According to the foreign practice of banking regulation and supervision, the level of confidence in the banking sector from the part of depositors and creditors is more effective than the number of revoked licenses from banks.

The low level of confidence of depositors in banks caused the critical situation in the Russian banking system in the summer of 2004. The panic among depositors was caused by the information in the press providing the "black list" of unreliable banks sparked. Therefore, the establishment of the obligatory deposit insurance system in Russia has been a positive factor in increasing the degree of confidence in the Russian banking system[83]. However this should not be overestimated, since in the process of banking supervision compensation to depositors of banks of their funds is the extreme stage. The aim of banking supervision is to prevent bank failure by detection of the potential risk for funds of depositors and creditors, controlling its development, and mitigate the effects of bankruptcy in case it is unavoidable.

The study of supervisory practices in European countries proves that CBR needs transparency in banking supervision in order to protect the interests of depositors and creditors. Moreover, CBR performs as an indirect protector of the other banks and builds the confidence in the banking sector. In fact, any imposition of sanctions to the bank on the part of the supervisory authority will, would allow depositors to make their choice. This would also require an open explanation from the supervisory body for the revealed irregularities in the bank

[81] Sokolov/Belyaev (2007), p. 4. (Russian)

[82] According to the head of the Association of Russian Banks Garegin Tosunyan, "Bank supervision should protect law-abiding banks, rather than suppress 100% of banks due to 1% of the fraud."

[83] This is evidenced by growth in deposits from 1,977.2 billion rubles on 01/01/2005 to 3,793.5 billion rubles. 01.01.2007

and assess the impact of this irregularity on the safety of the depositors and creditors' funds[84].

The international banking supervision practice provides two possible ways for the banking supervision:

- *Formal*: In this case the decisive force has formal legal norms and a substantive, where decisive force is the professional reasonable judgment of bank supervision authority. In the formal approach, the supervisor is working in the mode of the actual condition of the banks, not interfering, and virtually having no interest in their activities.
- *Substantive:* In European practice, the substantive approach to banking supervision is dominating, e.g. banking supervision is almost entirely based on the principle of professional reasonable judgment of the supervisory body, which deals with the interpretation of legal norms. The supervisory body determines the priority of the economic content of the banking transactions over their legal forms and establishes court practice to this approach. The substantive approach states that it is impossible to provide legal norms, governing the detailed rules of conduct of the banks for all occasions. Therefore, the legal norms establish only the general principles of banking and are based on honest and law-abiding banks, and identification and removal from the market of unprincipled banks the society trusts to banking supervisory authorities.

In Russia, a professional reasonable judgment is not required by law determining the principles of bank supervision[85]. Nevertheless, CBR refers to the principles of the Basel Committee from 2003. However, not all banks are satisfied with today's reasonable judgment from the CBR since there is a lack of formal principles of this concept. In case CBR wants to clarify this situation it partially conflicts with the existing law. Thus, there is an example of the imperfection of the convergence of international standards for banking supervision in Russia. From one side, the Bank of Russia has demonstrated its commitment to the Basel Principles; however, the incorporation of these principles in banking regulation has not happened[86]. Consequently, it is necessary to issue a set of regulations requiring the banks to comply with the core Basel Principles.

Currently, Russian banking supervision could be described as intermediate. CBR announced a transition to substantial supervision of its political

[84] Nikitina (2007), p. 97. (Russian)
[85] CBR (2009): Banking supervision report, pp. 83-84. (Russian)
[86] In the EU this Principle is clearly enshrined in the banking legislation of each EU member state.

purpose, and began to apply it to deal with suspicious interpretations. At the same time, the supervisory body fails detect the financial problems of banks on time, to carry out preventive work to strengthen the financial condition of banks, eliminate enterprises that poorly operate in the banking system and threaten the stability of the economy. In addition, the new ideology of substantial supervision is almost not used[87].

Thus, the Russian legislators need to help the supervisory body to move to a qualitatively higher level of performance through reorganization of the supervisory process and improvement of legislation. The principles of substantive supervision and legislative consolidation could be the basis in improving the quality of the supervisory authority. The transition to the principles of extensive supervision will require a new level of public confidence in the banking supervisory authorities. Currently, the level of trust is very low for the supervisory process.

Thus, it can be concluded that the Central Bank of Russia has reached a certain success in terms of improving methods and approaches for the prudential regulation based on international standards and requirements of the BCIBS in the past few years. The rejection to use the exclusive formal criteria during the implementation of the off-site supervision could be one of the main achievements of the CBR. The banking supervision gradually approaches “non-quantitative” qualities, such as a “goodwill”, “stress-testing system”, "behavioral model", "reasonable judgment about the risk level and asset quality, "Institute of supervisory control".

However, a weak system of the Russian banking supervision and regulation is still one of the main factors restraining the ratings of Russian banks in global financial markets. Recently, the Bank of Russia has taken steps addressed to eliminate some shortcomings in the system of banking regulation. This has greatly contributed to set up deposit insurance system (increase coverage to 400 thousand rub.), as well as improvement of banking legislation. In January 1, 2007, the new amendments were issued. They concerned the issues of banks' capital, its adequacy and alignment right in the part of foreign and Russian capital.

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[87] Since 2005, the Bank of Russia has withdrawn more than 100 licenses for banking operations, including 70 credit institutions for violation of the Law № 115-FZ "On Combating Legalization (laundering) of proceeds from crime and financing terrorism."

In 2010 the BCBS proposed a set of measures, known as Basel III, to tighten the existing capital and liquidity standards for banks in order to strengthen the resilience of the financial system. Differently from Basel II, Basel III sets mandatory standards that are legally binding. Moreover, the Central Banks are authorized, and even obligated to punish the banks in case they do not follow the requirements[88]. The new regulation was established as a result of the financial crisis and its impact on the banking system. For example, the IKB, Hypo Real estate, Dresdner Commerzbank, etc. had no real business model took great risks in order to stay in the markets. Moreover, the collapse of Lehman Brothers bank affected the international banking sector. Therefore, the global financial and banking system implemented additional requirements to increase the liquidity reserves, improve their quality, and improve bank’s ability to cope with the crisis[89].

Richard Heinsworth, the CEO of rating agency RusRating and Rustam Botashev, banking analyst at Unicredit Securities, believe that Basel III would not affect Russian banking system since the requirements of CBR are tighter. “The changes required by the Government include, increasing the total equity up to 7%, and then including something that they call a cushion- of about 10.5% – and the minimum required in Russia is 10%[90]. In comparison, the CBR calculations state that 99 % of Russian banks comply with the minimal requirements of Basel III. However, only 8% would be able to comply with advanced requirements of Basel III. However, CBR did not announce the evaluation of the Russian bank’s compliance with Basel III in terms of liquidity.

Another source, The Deutsche Bank report, indicates that Russian banks are the late adopters of the Basel II. Russia may be reluctant to adopt the new rules and indeed has already postponed Basel II to 2012[91]. According to Alexei Simanovskiy, a member of the central bank's board, 99 % of Russian banks meet the Tier 1 capital ratio requirement of 6 %, and 91.5 % of lenders are compliant with the new capital conservation buffer rules required by Basel II. The banks should be ready to implement Basel III by 2018[92].

On the contrary Deutsche Bank experts doubt that Russian banks would be able to comply with Basel III requirements. First of all, the implementation of

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[88] BIS Homepage (2010): Monetary & financial stability/Basel III/ International regulatory framework for banks
[89] Kurleyev (23.11.2010): Jurnal.org/Articles/Global reform of the banking sector.
[90] RT.com (18.10.2010): business/news/Basel III and the Russian banking system
[91] Harverd (2010), Assessing the Basel (III) impact, Deutsche bank.
[92] Vorobyova (02.11.2010): reuters.com/Russia cbank testing banks for Basel III compliance.

Basel II is postponed to 2012. Secondly, the bank crisis had reduced the likelihood for new rules adoptions that were developed by developed-markets regulators. In case Basel III is implemented, Deutsche Bank experts state that Russian banks would have sufficient time to adjust asset and funding structures. Plus, Russian banks would not be significantly affected[93].

Currently, the CBR is working on implementing the measures, which will bring the national principles of banking regulation to the international standards, e.g. the introduction of consolidated supervision of banking groups; simplification of rules for foreign banks acquiring minority stakes in Russian banks (the acquisition of up to 10% of the capital without prior permission of the CBR); the development and implementation of a rating system for early response (CAMEL - Capital adequacy, Asset quality, Management, Earnings and Liquidity) to assess the stability of banks in order to regulate their activities; differentiation of the volumes of regulation and reserve requirements on banks' creditworthiness; the simplification of administrative procedures relating to mergers and acquisitions of banks, realization of the IPO of shares and the organization of regional branches; tightening of limits on credit financing to one client, including related parties; improving and streamlining reporting requirements; tightening regulatory framework governing mortgage lending; the development of legislation on asset-backed securities; improving the quality of governance in banks primarily in the area of risk control; the application of standards of Basel II. However, to evaluate the effectiveness of the impact of these measures on the banking system is still too early.

The transition from formal control on the basis of reporting to the deep qualitative analysis in the process of banking regulation is another major objective of the CBR. Of course, it is a difficult task because of non-transparent ownership structure of banks and low standards of information disclosure in the Russian economy as a whole.

In Russia, regulators of banking activities has been long caring out the oversight on the basis of reporting, and for this reason banks are required to fill out multiple reporting forms with a high frequency. Russian banks are filling more than 100 reporting forms to CBR per month, which is associated with high costs in terms of time and money. The current accounting standards are very formal and are based to estimate quantitative rather than qualitative parameters of the bank's financial condition. Study of practical experience of Russian banks,

[93] Harverd (2010), Assessing the Basel (III) impact, Deutsche bank.

suggests that prudential banking supervision, designed to prevent possible problems in the banking system, is replaced by a formal and bureaucratic procedure control for monitoring compliance with burdensome reporting requirements. The volume and detail of requested information often disable to assess the merits of the financial position of a bank and to identify problems on early stage[94].

Several steps are needed for the bank regulation and supervision in Russia to be effective and comply with the current international. These are:

- Determination of method to be used in banking supervision and enforcement;
- Ensuring the functioning of an early response and application of integrated assessment of credit institutions, including the assessment of quality management and internal controls;
- Improving the efficiency and effectiveness of decisions taken in the framework of banking supervision;
- Providing the interaction mechanism between banking supervisors and auditors at the legislative level.

[94] Gizatullin (2006): Basle capital adequacy ratios: Problems and Prospects on the Reglament.net page. (Russian)

4.2. Areas for Improving Banking Supervision in Russia

Currently, the Russian society is interested in creation of risk-oriented bank supervision and supports the initiatives of the Basel Committee and CBR. Moreover, banks are prepared for constructive dialogue with the supervisory authorities in regards to the adjusting Basel II to the Russian conditions. There are two ways to improve banking supervision in the Russian Federation in various areas of regulation. The most important task in the field of legal regulation is the systematization and improvement of the regulatory framework, such as:

- The supervisory body need to assess the activities of credit institutions in accordance with the international practice based on the comprehensive assessment of banks' activities;
- The highest supervising authorities of the country should have the right to evaluate the activities of credit institutions and to make decisions based on professional assessment of the quality of their assets, size of liabilities and equity and corporate governance, and the transparency of ownership structure;
- Implementation of professional assessment as a basis for analyzing the qualitative aspects of activities.

The existing organizational structure of banking supervision in Russia generally corresponds to supervisory functions. However, this structure has its own characteristics, such as:

- A single supervisor in the face of the Bank of Russia;
- A well-developed territorial structure of banking supervision, which is not available by the majority of foreign countries;
- Sharing the functions of the off-site control and on-site control among subdivisions of the Bank of Russia;
- A significant number of staff in banking supervisory and low level of wages in relation to developed countries.

Therefore, the following recommendations for improving the organizational structure would be proposed:

1. Comply with the Principles of Supervision provided by Basel II (see Appendix 1).[95]

[95] BIS Homepage (10/2006): Monetary & financial stability/BCBS/Core Principles for Effective Banking Supervision.

2. Develop the Expert Council under the Chairman of the Bank of Russia as an advisory body. This committee would be responsible for the accepting all innovations proposed by the CBR in terms of banking regulation and supervision.
3. Improve the legislative base, regulatory environment and seek improved ways of regulating liquidity and reacting to shortages in the banks. At the same time, banks should be required to prepare periodic liquidity reports to Bank of Russia. This would allow CBR to review the activity of the bank and provide the assistance on liquidity to the banks individually.
4. The Supervision activities should be supplemented with additional control functions. It is also advisable to exclude the regional offices and committees with overlapping functions in the supervision of the credit institutions and inspection of credit institutions.
5. CBR should divide banks into categories according to their activity, size, risks, liquidity, etc. This would allow providing different level of supervision and allow concentrating the insufficient resources in the larger banks.
6. CBR should focus on making the capital adequacy requirements countercyclical (e.g. dynamic provisioning rules, higher capital adequacy requirements during the cyclical upswings) regarding the bank's influence to the systemic risks.
7. Defining the mode of banking supervision and enforcement and base it nature of risks taken by a credit institution and the quality of risk management.
8. Create specialized units in the CBR, which would base its work in conjunction with structural units of law enforcement and regulatory authorities for counteraction and money laundering, financing of terrorist, etc. This subdivision should operate under a special agreement between the Bank of Russia, Federal Tax Service of Russia, Ministry of Internal Affairs of Russia, Federal Customs Service and other agencies. This agreement should provide the manner of their interaction to prevent, detect violations and crimes in the banking system. It should include a procedure for exchanging of information that require the particular actions within the competence of those bodies and the direction of the materials, e.g. allow review the facts of law violations; requirements for registration of the

materials sent to the law enforcement agencies for prosecution; the order of reporting about the actions taken in regards to the information received[96].

9. Increasing of the Russian banks transparency. Russia is interested in developing their national banking system, in its entering into the global banking system, as an equal partner, providing on the international markets the interests of country's economy, which is impossible without ensuring stability and transparency of the Russian banking sector.
10. Improving the quality of corporate governance. To improve banking supervision is expedient the implementation in credit institutions of modern governance principles, the development and adoption of standards of quality management.
11. Improve the quality of the on-site supervision and increase staffing and training resources.
12. CBR should inform the banks about avoiding the increased use of direct lending from the large and interconnected borrowers since they could put pressure on banks. At the same time, the banks should explore provision of loans to small and medium size enterprises.
13. Identify forms of legalization (laundering) of criminal activity in the banks. The banks engaged in questionable financial transactions might not be financially sustainable, since their activities are exposed to higher financial, legal, regulatory and bank's image risk. At the present time, there procedures of preventing the suspicious transactions by the banks are not fully developed and accepted. Therefore, supervisors need to search for the effective ways and methods to eliminate the money laundering and other criminal activity in the banks.
14. Activating off-site control with the introduction of remote monitoring system. The method of external supervision should be the base for the off-site control. The main elements of the off-site supervision are listed as follows:
   - Monitoring of the financial condition, results of the operations and future feasibility of individual banks;
   - Identifying the causes of deviations from the average performance of the peer groups;
   - A detailed diagnosis of problems and breaches of regulations;
   - Preparation of recommendations to management;

[96] Kommersant (2006), pp. 10-12. (Russian)

– Preparation for the penalties, fines or other types of supervisory punishment.

15. The development of an Early Warning and Response System, which would ensure the assessment of quality management and internal control, as well as introduction of the Institute of supervisory control. The system will enhance the efficiency and effectiveness of decisions taken in the framework of banking supervision.
16. Develop approaches to the introduction of differential treatment supervision of banks, based on the problems of risk-based supervision and to reduce unnecessary administrative burdens banks.
17. Supplement the system of monitoring the financial soundness of the banking sector, regular monitoring of key banking risks, analysis and recommended by the IMF and World Bank of financial soundness of the banking sector.
18. In order to improve cross-border banking supervision to expand cooperation with supervisory authorities in the countries of origin and host countries credit institutions with subsidiaries in the territory foreign countries, on the basis of concluded agreements on cooperation in supervision.
19. Play proactive role in implementation of the financial regulation's improvement by developing cooperation with the audit organizations on assessing the financial stability of credit institutions in accordance with international recommendations. Moreover, the formal requirements on banks should be rationalized in order to improve risk assessment.
20. To work on improving the approaches to the assessment of internal control in credit institutions.
21. Carry out measures for the transition of the banking sector accounting in accordance with the principles of international standards and financial reporting under IFRS in credit institutions and banks in Russia.
22. Begin to develop on the basis for the third "component" of Basel II approach to the disclosure of quantitative and qualitative information (including the structure and capital adequacy, the nature of risks taken), the frequency of its disclosure and internal control procedures on the matter.
23. Take actions to develop the supervision on a consolidated basis, including the improvement of consolidated reporting and risk analysis of bank groups and bank holding companies on a consolidated basis.

24. Promote the use of IFRS financial reporting for the banking and non-banking sector and continue to work on improving the quality of preparation and submission of financial statements prepared to meet the requirements of existing IFRS and Basel II.
25. Conduct regular training of specialists, is developing a financial reporting to reflect the requirements of IFRS and Basel II as well as risk managers.

Thus, conducting such activities in the organization of banking supervision will be achieved its better functioning.

Development of regulation system of the banking sector should be carried out in the following areas: the completion of the formation of the deposit insurance system; improvement of the accuracy in assessing the financial condition of banks; ensuring the application to them of adequate supervisory response measures; improving prudential reporting by banks through the use of modern information technologies; ensuring transparency of ownership structure of credit institutions; tightening the requirements for unscrupulous managers and owners of credit institutions; improvement of procedures for liquidation of credit institutions at the expense of developing an effective mechanism for implementation of banking assets of liquidated banks, etc.

Systematization of the risks in the banking sector by conducting risk-oriented supervision requires managing them through activities that allow at certain degree to predict the beginning of the risk event and to minimize the likelihood of collapse of the banking system as a whole. In the field of banking risk management are emphasized the following major activities during the risk-oriented supervision[97]:

1. Establishing a risk policy and definition of the principles of risk management of the banking sector;
2. Identification of certain types of banking risks and assessment of information needed to determine the level of risk of the banking system;
3. Selection and use of appropriate methods to assess the likelihood of the risk event;
4. Study the factors influencing the level of risk of the banking system;
5. Establishment of maximum permissible level of bank risk on certain financial transactions;

[97] Borovkina (2007), p. 1. (Russian)

6. Determining the amount of possible financial losses for certain types of banking risks;
7. Establishment and use of internal mechanisms for neutralizing the negative effects of certain types of banking risks;
8. Tightening the requirements for disclosure of risks, namely: the reflection in the accounts not only of outstanding loans separately for individuals and legal entities, but also on certain loan products;
9. Disclosure of prolonged loans and credits with the revised rates and evaluation of performance managing risks of the banking system.

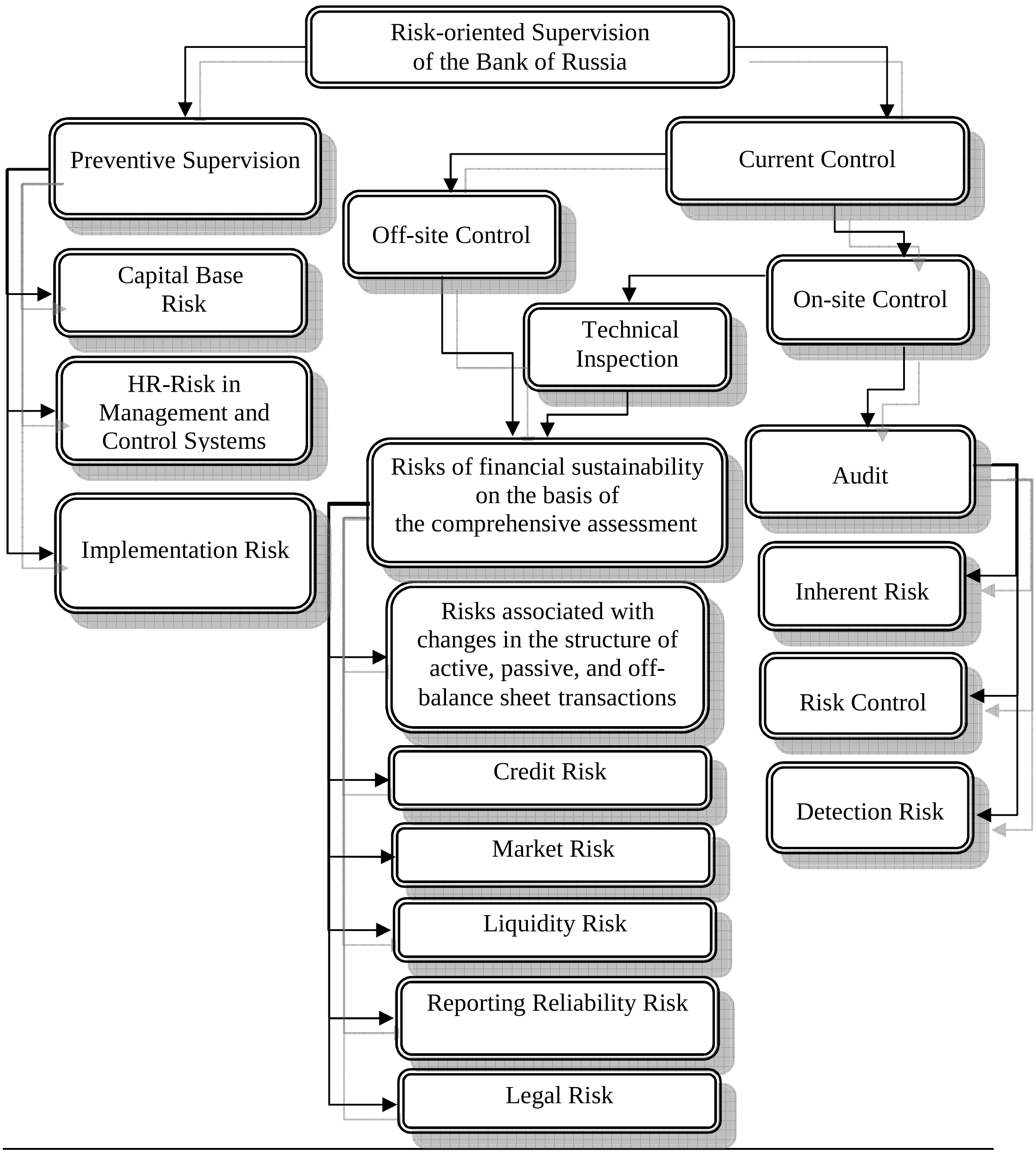


Figure 6. Model of the bank risk-oriented supervision of the Bank Russia

All of the above mentioned areas of the risk-oriented supervision will enhance the transparency of the banks' business and the possibility of assessing the quality of the risk management.

Dedicated areas for monitoring the financial soundness of the banking sector have a corresponding functional value:

1. Monitoring of banking risks. It includes the following areas:
   - Monitoring the credit risk of non-financial enterprises;
   - Monitoring risk in consumer lending;
   - Monitoring of liquidity;
   - Monitoring of market risk;
   - Monitoring of capital adequacy.

   This monitoring is conducted monthly and is intended to help to identify adverse trends in the activities of credit institutions at the earliest stages. In Russia, the monitoring of banking risks is based solely on the coefficient analysis. The reliability of the formal banking accounts is quite low, so the reliability of these systems is not so high. However, it can be used as a generator alarms and a signpost for more in-depth study by use of statistical analysis and field research.
2. Monitoring based on stress-testing is a tool for evaluating the soundness of the banking sector and identification of the banks most exposed to risks, in the uprising event of a tense situation in the economy. The monitoring of stress-testing should expand the use of experience in international banking practice and apply a scenario analysis and sensitivity analysis of the asset portfolio of the bank to modifiable risk factors. Scenario analysis is directed primarily at assessing strategic perspectives, and sensitivity analysis estimates the direct impact on the portfolio of a credit institution of changes a given risk factor. Use of such approaches in the Russian banking practice of monitoring in the banking supervision will ultimately enhance the stability of banks and the banking system as a whole.
3. Monitoring the financial stability of the banking sector. This direction of monitoring reduces to tracking 25 indicators in the banking sector, market liquidity and the real estate market.
4. Monitoring for information on the results of the supervisors activity is intended to identify at early stage problems that threaten the interests of creditors and depositors, and to realistically assess the effectiveness of internal control systems in credit institutions.

Currently the supervision of the CBR has developed all the prerequisites for the active development of techniques for monitoring the financial soundness of the banking sector. For its effective development, must be taken the following actions:

- Creation of a transparent, effective and specific methods of monitoring the banking sector factored in risk;
- Reducing the risks of the banking system as a whole, through the use of the coefficient and statistical analysis and field research;
- Development and improvement of analytical tools for assessing the financial stability of the banking sector;
- Increased use of experience in international banking practice of monitoring on stress-testing and application of scenario analysis and sensitivity analysis of the bank's asset portfolio to changes in risk factors;
- Improving the methodology of calculation of financial soundness of the banking sector and the expansion of their inventory;
- Further development of monitoring, based on the organization of personalized control of the bank.

It seems that the implementation of these measures will lead to the creation of a competitive banking system capable of efficient allocation of credit resources and having a high margin of financial stability, which would exclude the possibility of a systemic banking risk.

Conclusion

Currently, in many countries, including Russia, takes place the process of transition to new standards for risk assessment of banking activities and the organization of banking supervision. This changes are to improve the quality of risk management and, accordingly, to strengthen financial system stability and sustainability. As for Russia, the successful implementation of Basel II would lead to the competitive position among world's banks and easier integration to the international banking sector. However, the expectations and positive results can only be achieved by providing and ensuring necessary legislative, methodological and financial support. In this regard, the decision on the introduction of standards for risk assessment of banking activities and the principles of risk-oriented supervision should be based on credible and realistic evaluation of the development degree of legal, regulatory and accounting systems in the country and knowledgeable understanding of the nature of the potentials risks areas in bank sector and supervisory institutions.

The stability of the banking system plays the key role in creating the "safety cushion" from global and national financial crashes and downturns. The international standards correspond to the progress of the global market, to the increased flexibility and growth, and national economies strive to share the advantages of the new developments and compensate the existing shortcomings, such as inability to provide timely and adequate response to. On the other hand - unavailability of banking supervision to an adequate and timely response to growth in volume and variety of related banking risks. At the same time, as shown by international experience, improved supervision can greatly mitigate the impact of the global financial crisis on the economy.

The Basel Committee on Banking Supervision is one of the key organizations engaged in the development of standards in the field of banking regulation and prevention of financial crises. In 2004 it adopted a set of standards for risk assessment of financial institutions and the organization of banking supervision, known as the New Basel Capital Accord or Basel II. This document reflects the concept of a stable banking system through a combination of supervisory, professional banking risk management and market discipline. Document changes the role of supervision and its philosophy, shifts the emphasis of its activities from formal quantitative performance standards to deeper and more content understanding of the origins and nature of risks and applying knowledgeable assessment methodologies. It should be kept in mind that the standards were developed in the form of recommendations and therefore have no legal restraining function. National supervisory authorities may use them as a guide for developing approaches for supervision in the context of the national economy.

Transition to modern standards of risk assessment and the organization of banking supervision is extremely important; over 100 countries have expressed the willingness to apply the recommendations (at least some elements). However, the question of effectiveness of these standards during the economic recession and financial crisis remains unanswered - the process of its administration began only in January 2007 and by now only in the "Group of Ten". Such caution results in increasing gap between the adoption of standards and their actual introduction. But on the other hand, the caution has a solid background: the introduction of the standards is characterized by complexity of legal, organizational and financial issues to be addressed during the transition to the practical application of standards.

Banking supervision is one of the most important channels of enhancing the legality and eligibility of operations in the banking system of the Russian Federation. In this regard, banking supervision - is supervision by CBRF in compliance with regulatory requirements by credit institutions. This supervision is carried out in the statutory forms and using standardized procedures aimed at protecting the interests of credit institutions and their customers, as well as the preventing intentional bankruptcy of credit institutions. In addition, banking supervision is aimed at counteracting legalization of proceeds from crime and terrorism financial transactions.

Development of the banking system and implementation of Basel II is one of the conditions for the Russian banks to successfully integrate into the international financial system and minimize its risks. It is important to mention that CBR needs to increase its supervision on the Russian banks and improve the regulations for the banking system. First of all, the system for the effective control should be designed and implemented. Secondly, the effective control system of risks and project management should be implemented in the Russian banks. Thirdly, the system of early warning of risks or banking crises should be implemented altogether with optimized accountability. Fourthly, the banking system should be prepared for implementation of Basel II.

It is planned to implement Basel III by 2018. Basel III is aims to improve the operations of banks and supervisory authorities and concentrates on capital and liquidity. Basel II and III norms more greatly are suitable for large banks, which have large number of borrowers and a minimum of three years history of borrower's bankruptcies. For the normal implementation of Basel II it is necessary evaluate the statistics of bankruptcies precisely. In Russia, this statistics is too small. Moreover, Russian banks have insufficient level of automation and incompleteness of the databases. Therefore, banks are unable to collect and store information on all transactions of bank, conditions for all credit contracts, collateral agreements, etc.

CRB introduces the new methods of supervision, created the institution of bank regulators and stated to be ready to evaluate risk of every individual bank. However, as bank auditors acknowledge, that supervision authorities do not possess qualification in order to meaningfully evaluate risks.

To conclude, bank supervision and bank regulation in Russia and successful implementation of Basel II should be followed with the integral strategy at federal, governmental, CBR and at the level of most of credit organizations. The effectiveness of the bank's risks should be based on the international practice, implementation of the advanced procedures of financial management and quantitative analysis. Moreover, the requirements for the credit organizations should be established to disclose information and increase transparency. The CBR should implement risk-oriented supervision in order to ensure that Russian banks would be able to avoid risks or cover the expenses related to the risks.

Appendixes

1. Basel II – Core Principles for Effective Banking Supervision

Principle 1
Objectives, independence, powers, transparency and cooperation: An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Principle 2
Permissible activities: The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.

Principle 3
Licensing criteria: The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.

Principle 4
Transfer of significant ownership: The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

Principle 5
Major acquisitions: The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Principle 6
Capital adequacy: Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.

Principle 7
Risk management process: Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

Principle 8

Credit risk: Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.

Principle 9

Problem assets, provisions and reserves: Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.

Principle 10

Large exposure limits: Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

Principle 11

Exposures to related parties: In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm’s length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

Principle 12

Country and transfer risks: Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

Principle 13

Market risks: Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Principle 14

Liquidity risk: Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.

Principle 15

Operational risk: Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.

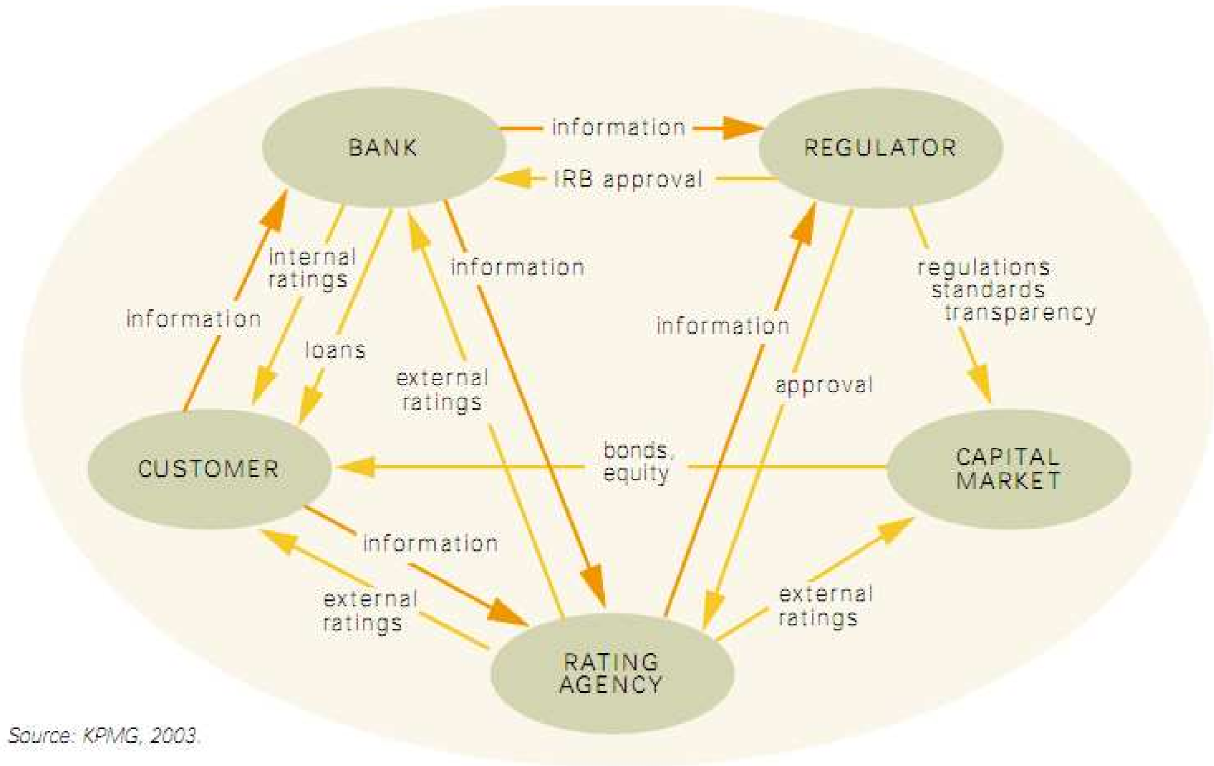
Principle 16

Interest rate risk in the banking book: Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.

Principle 17
Internal control and audit: Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank’s assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
Principle 18
Abuse of financial services: Supervisors must be satisfied that banks have adequate policies and processes in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.
Principle 19
Supervisory approach: An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.
Principle 20
Supervisory techniques: An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.
Principle 21
Supervisory reporting: Supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.
Principle 22
Accounting and disclosure: Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.
Principle 23
Corrective and remedial powers of supervisors: Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.
Principle 24
Consolidated supervision: An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.
Principle 25
Home-host relationships: Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.

2. The Environment of Basel II

Source: (KPMG, 2003)



3. *Three Pillars of Basel Capital Accord, Basel II*

Source: (KPMG, 2003)

PILLAR I Minimum Capital Requirements	PILLAR II Supervisory Review	PILLAR III Market Discipline
Market risk ▪ No changes from Basel I **Credit risk** ▪ Significant change from Basel I ▪ Three different approaches to the calculation of minimum capital requirements ▪ Capital incentives for banks to move to more sophisticated credit risk management approaches based on internal ratings ▪ Sophisticated approaches have systems/controls and data collection requirements as well as qualitative requirements for risk management **Operational risk** ▪ Not explicitly covered in Basel I ▪ Three different approaches to the calculation of minimum capital requirements ▪ Adoption of each approach subject to compliance with defined 'qualifying criteria'	▪ Banks should have a process for assessing their overall capital adequacy and strategy for maintaining capital levels ▪ Supervisors should review and evaluate banks' internal capital adequacy assessment and strategies ▪ Supervisors should expect banks to operate above the minimum capital ratios and should have the ability to require banks to hold capital in excess of the minimum (i.e., trigger/target ratios in the UK; prompt corrective action in the US) ▪ Supervisors should seek to intervene at an early stage to prevent capital from falling below minimum levels	▪ Market discipline reinforces efforts to promote safety and soundness in banks ▪ Core disclosures (basic information) and supplementary disclosures to make market discipline more effective

4. The Implementation of Basel II: Effects, Challenges, and Risks

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Hamburg, den 18.02.2011

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