



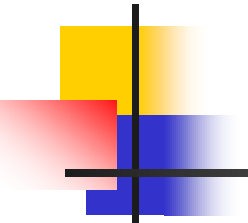
Russian Banking Sector Recent Progress and Challenges For the Future

A decorative graphic on the left side of the slide, consisting of a vertical black line intersecting a horizontal black line. To the left of the intersection are three overlapping squares: a blue one on top, a red one on the left, and a yellow one on the bottom.

**BANKING FORUM OF THE CIS COUNTRIES AND
EASTERN EUROPE,**

**Vienna,
April 24-27, 2008**

**Klaus Rohland
Country Director, Russia
The World Bank**



Russian Financial Sector: Strong performance yet limited outreach

- 1. Russian Banking Sector has grown rapidly in recent years;**
- 2. Regulatory and Supervisory Framework has been strengthened making the system stronger; yet**
- 3. Some Structural Weaknesses remain. Also,**
- 4. The Banking System does not reach everybody in the country.**
- 5. These create several New Challenges going forward.**



Strong recent performance

- n **Russian Banking has had steady rapid growth led by:** (i) A sustained period of political stability, (ii) Favorable macroeconomic conditions; (iii) Growing consumer demand, and (iv) strengthening of the legal and regulatory framework underpinning the Russian financial system. In figures:
 - i Russian banks dominate the financial sector, forming nearly 91% of the Financial System assets.
 - i They have grown at a rate of 40% over the last 4 years. The banking system assets have grown from nearly 4 trillion Rubles in 2002 to nearly 17 trillion Rubles in 2007.
 - i Banking Credits have similarly grown from nearly 2.5 trillion Rubles in 2002 to nearly 12 trillion Rubles in 2007



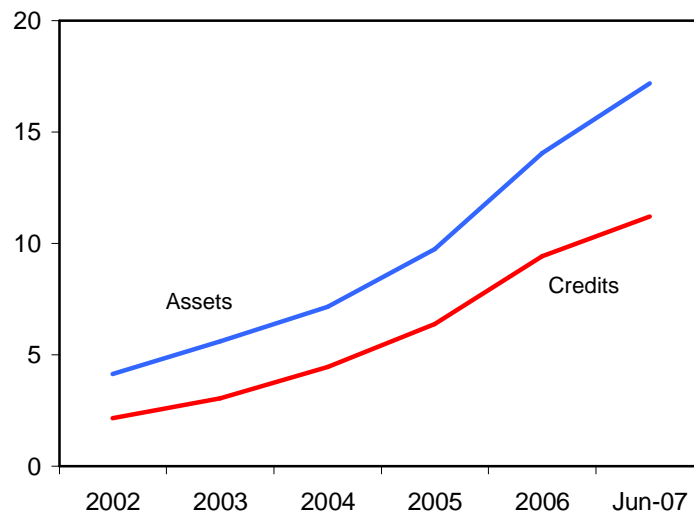
Strong recent performance (Contd.)

- n **Rapid credit growth led to sustained strong earnings:** High interest rates on the fastest-growing credit segments (notably consumer lending), along with low rates on deposits, translated into relatively high spreads by international comparison. e.g.
 - i The banking system ROE (Return on Equity) has grown from nearly 19% in 2001 to nearly 27% in 2006-7, while the ROA (Return on Assets) has grown from nearly 2.4% in 2001 to nearly 3.25% in 2006-2007.

Strong recent performance (Contd.)

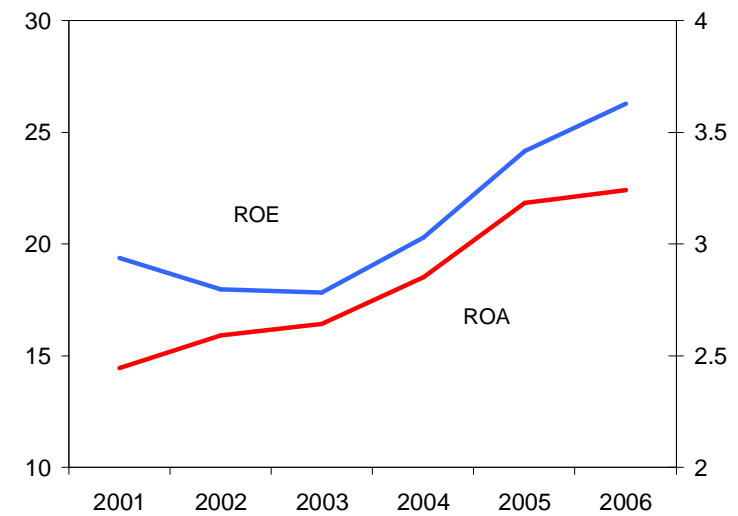
The system has grown rapidly...

Bank assets and credit (Rub trillion)



Boom in lending has supported high margins...

Bank profitability (in percent)





Regulatory and Supervisory Framework has been strengthened

- n **Banking supervision has also improved significantly, through:**
 - ∅ Upgrading of prudential regulations
 - ∅ Progress in move towards risk-based supervision
 - ∅ Passage and implementation of AML Laws
 - ∅ Issuance of guidelines on corporate governance and internal controls
 - ∅ Introduction of accounting rules based on IFRS as of Jan 1, 2008.



Regulatory and Supervisory Framework has been strengthened (Contd.)

- n **The new Deposit Insurance system also helps foster confidence:** Since its inception in 2005, the Deposit Insurance Agency (DIA) played an important role in helping streamline the banking sector and improve depositors' trust in the system. DIA paid off insured deposits in 22 bank closures and acted as bankruptcy receiver (liquidator) in 155 banks.
- n **Banks are working to improve their risk management:** Russian banks are working to bring their internal risk management procedures closer in line with good international practice. In addition, the CBR is currently developing recommendations on bank contingency plans to help further strengthen risk management.



Regulatory and Supervisory Framework has been strengthened (Contd.)

- n **The banking system has remained stable in the face of recent market turmoil:** Reflecting its growing resilience and the well managed liquidity interventions of the CBR, the Russian banking system has been able to weather the recent market turmoil and credit crunch that began last summer.



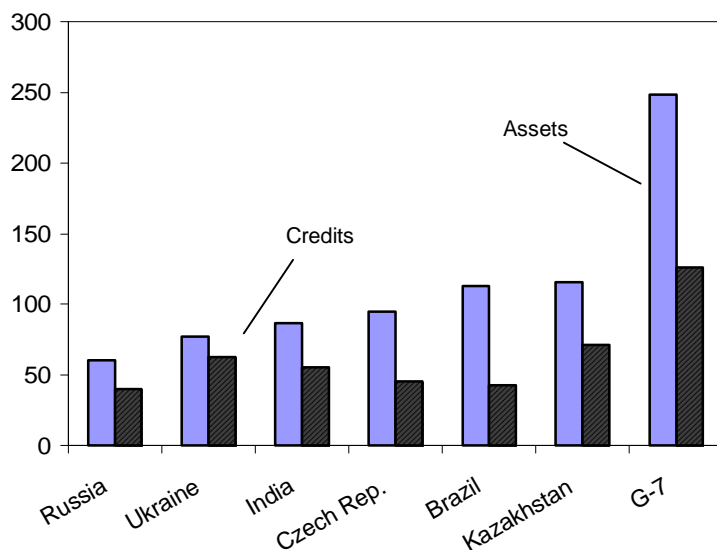
Some Structural Weaknesses Remain

- n **Despite its recent growth, the Russian banking system remains small by international standards.** Total assets of the financial system was around 60% of GDP in 2006, compared with over 250% average in G7 countries, and is still lower than some emerging countries like Brazil, India.
- n **The banking system remains highly concentrated.** The top 5 banks retain nearly 45% of the system assets, the 6-20th banks nearly 20%.
- n **The banking system also remains dominated by state-owned banks.** State-owned banks account for over 1/3 of total banking assets and nearly 60% of household deposits.

Some Structural Weaknesses Remain (Contd.)

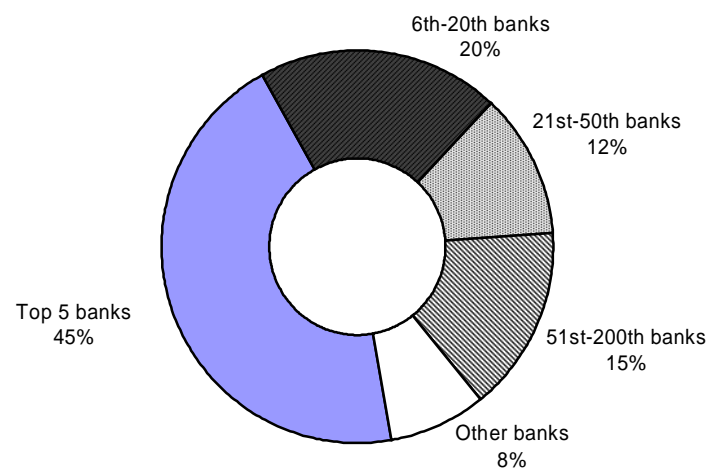
Bank sector remains relatively small

Bank assets and credit to GDP, 2006 (in percent)



... and is highly concentrated

Banking assets, June 2007





Some Structural Weaknesses Remain (Contd.)

- n **Foreign interest in acquiring banks in Russia has grown.** However, foreign banks account only for about 12% of banking assets while the small Russian banks and non-bank credit institutions account for about 10% of the system.
- n **Despite an expanding share of funding options, liquidity in the banking system remains highly segmented.** Half of retail deposits are concentrated in one bank, and some of the large and medium sized banks are increasingly reliant on international funding.
- n **Loan Concentration is also high.** Exposure to the five largest borrowers exceeds 50% of the capital for over half of the banking system in terms of both assets and number of banks.



Besides, the Banking system Has Limited Outreach

- n **Banking assets also tend to be geographically concentrated.** Although Russia spreads over 11 time zones and account for 89 regions, there is a very high concentration of banking assets in the Western part of Russia and in particular the Moscow region.
- n **Resulting in low population outreach to financial services.** The combination of above factors – (i) small size of sector relative to GDP, (ii) structure of the banking sector and (iii) geographic concentration of banks – has not been conducive to developing a financial sector platform that can serve the needs of the broader population. Close to 60 millions Russians are still estimated to be left out of the banking system.



Strategic Challenges Going Forward

1. Maintaining strong & stable growth through market turbulences

- n **Profitability is coming under pressure.** Increased competition in lending is compressing margins. Going forward, funding pressures are also likely to result in lower profits, as banks retrench their lending in an effort to remain liquid. Banks' desire to strengthen their retail base as a substitute for foreign funding will also tend to increase deposit rates, further depressing margins.
- n **Raising capital under current market conditions could be a challenge.** Declining profits will constrain the internal generation of funds. The ongoing turmoil in international markets may also have affected investor appetite for investments in Russia, making it more difficult and costly for Russian banks to tap such markets for capital.



Strategic Challenges Going Forward (Contd.)

2. Strengthening Legal and Regulatory Framework including Contingency Planning

- n **Legal and Regulatory improvements required to further increase resilience to systemic risk:** To monitor and prevent the buildup of risks and vulnerabilities at a systemic level and to strengthen its crisis management tools, the Russian authorities will need to:
 - ∅ Gradually tighten loan-loss provisioning standards to foster appropriate levels of bank capitalization
 - ∅ Review banks' liquidity estimates and develop contingency plans that conform with its recommendations under preparation
 - ∅ Further strengthen risk-based supervision and build off-site capacity



Strategic Challenges Going Forward (Contd.)

- ∅ Strengthen transparency and disclosure by ensuring adoption of standards meeting IFRS requirements
- ∅ Establish the legal concept of “beneficial owner” to address weaknesses in bank licensing, loan classification and provisioning, consolidated supervision, and overall market transparency.
- ∅ Strengthen the remedial action and bank resolution frameworks
- ∅ Provide for development of consolidated supervision of banking groups



Strategic Challenges Going Forward (Contd.)

3. Serving the financial needs of the broader population

- n **Broadening population access to financial services is a Government priority:** The issue of increasing access to financial services became a high priority after former President Putin's address to Russia's State Council in November 2006, where it was emphasized that about 60 million people in Russia were effectively left out of the banking system.
- n **Broadening SME access to credit and other financial instruments:** Deeper financial intermediation allowing micro-enterprises and SMEs to access finance throughout regions will be essential to foster more balanced growth and stimulate economic diversification.
- n **This represents an untapped opportunity** for Russian banks as well as foreign banks - individually or in partnerships with other financial or non-bank institutions.

Strategic Challenges Going Forward (Contd.)



- n **Serving the financial needs of the under-served may also be addressed through branchless banking**, i.e. the delivery of financial services outside conventional bank branches using information and communications technologies and non-bank retail agents.
- n **There is a wide range of non-bank institutions in Russia**, well-positioned for the provision of a broad range of financial services due to their physical infrastructure, technological solutions, accessibility – such as cell phone companies, payment service providers, the postal network, internet-based companies, etc. Russia faces the challenge of incorporating them into the financial system.



The World Bank's Role in Addressing Some of these strategic challenges

- n The World Bank has assisted other countries around the world broaden access to financial services by:**
 - ø Developing legal and regulatory frameworks and mechanisms to use alternative types of distribution networks (postal banking, telephone banking) to provide financial services to a wider segment of the population.**
 - ø Providing tailored technical assistance/credit lines to banks committed to SME lending or helping larger banks channel wholesale funding facilities for SME lending through smaller regional banks.**