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Occasionally Rather Embarrassing
Russian Banks and Russian Diplomacy

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The Russian banking sector is in some respects a rather odd sector for inclusion in the present volume. To be sure, the sector's development and the interactions between financial-sector business interests and the state have had implications for Russian foreign relations. However, despite the overseas ambitions of a few banks, the banking sector remains overwhelmingly focused on the domestic market. It has neither been the source of serious transnational conflict nor an important instrument for advancing Russia's foreign policy agenda. It has, however, complicated Russia's external relations from time to time. Usually, this has been a product of problems that afflict the banking system, such as corruption and money-laundering, or with the authorities' manipulation of the system in ways that have subsequently proved embarrassing. The story of the banks' role in Russian diplomacy is thus a story about the banks' weakness rather than their strength.

The structure and interests of the system

This is not the place for a detailed assessment of the structure and development of Russia's banking sector.[2] However, it is necessary to highlight certain characteristics of the system before considering its actual and potential role in high politics and policy. First, the Russian banking sector, though growing rapidly since 1999, remains small and fragmented (Table 1). Russia still has a very large population of very small banks, a legacy of the administrative chaos of the last years of the Soviet Union and the extremely liberal licensing regime of the immediate post-Soviet period.[3] The average Russian bank at the end of 2004 had total assets of around Rb5.4bn ($197m); the aggregate assets of the smallest 1,100 amounted to under $30.8bn, ($27.9m per bank). Many of these 'dwarf banks' are banks in name only and are used by the owners for other purposes, such as tax 'optimization' or money laundering. Even the largest Russian banks are quite small by international standards. In 2004, Russia's largest bank, the state-owned Sberbank, ranked 152nd in the world by tier-1 capital. The largest private bank, Mezhprombank, was 392nd.[4] The small size of banks is particularly striking when contrasted with the size of Russia's major industrial corporates, many of which are very large by any standards. As a result, Russia's banks, unable to meet the financing needs of the country's biggest borrowers, are losing many of their best clients to foreign rivals and to bond markets. Russia's 'blue-chips' increasingly find that they are able to borrow larger sums, for longer periods and on better terms, from foreign banks and capital markets.

Table 1. Selected balance-sheet indicators of the Russian banking sector

1998–2004 (% of GDP unless otherwise indicated, end of period)

	1998	1999	2000	2001	2002	2003	2004
Number of operating credit institutions	1476	1349	1311	1319	1329	1329	1299
Assets	39.8	32.9	32.3	35.3	38.3	42.4	42.5
Capital (own funds)	2.9	3.5	3.9	5.1	5.4	6.2	5.6
Funds attracted from physical persons	7.6	6.2	6.1	7.6	9.5	11.5	11.7
Funds attracted from enterprises and organisations	10.7	9.7	9.9	10.1	10.1	10.5	11.8
Credits extended to non-financial enterprises and organisations (*as percentage of total assets*)	11.4 (*28.5*)	9.2 (*28.0*)	10.4 (*32.1*)	13.2 (*37.2*)	14.7 (*38.4*)	17.2 (*40.5*)	18.8 (*44.1*)

Source: Central Bank of Russia.

Secondly, the banking system tends to be segmented, along regional, sectoral and 'group' lines. A large proportion of Russian banks (the great majority, according to some observers) are 'pocket banks', controlled by a single large shareholder or a small group of related shareholders, who operate the bank for their own convenience. As noted above, this sometimes involves running banks for legally dubious purposes, but in other cases, such pocket banks merely function as external 'corporate treasuries', reflecting above all the desire of their owners to retain tight control over their own financial flows. Thus, most pocket banks are best understood as tools of business groupings or state institutions rather than independent, profit-oriented businesses, although some pocket banks have gradually developed into more substantial financial institutions. Even they, however, generally retain their links to their founder-owners. Whether pocket banks or not, Russian banks are often closely affiliated with specific financial-industrial groupings—be they middle-sized regional groupings or the 'oligarchic' groups that loom so large on the national political scene. Such banks are chiefly oriented to serving the needs of group members. This tendency is reinforced by factors such as poor creditor protection and lack of transparency, which make intra-group operations less risky than arm's-length transactions. In general, therefore, the banking sector remains highly segmented, with little trust among banks. The inter-bank market, though growing, is under-developed, and there is still very little of the sort of interaction among banks typically found in a well functioning network of financial intermediaries—i.e. there is little pooling, trading or sharing of risk.[5]

Thirdly, despite the efforts of the Central Bank of Russia (CBR) to promote transparency in the sector, both the formal ownership structures of Russian banks and many of their activities tend to be opaque. Banks' connections to their beneficial owners are often concealed behind complex webs of nominee shareholders, trusts and offshore companies, even when the identities of the true owners are well known. This is generally legal. In an IFC survey conducted in 2003, half of the banks responding admitted that they did not disclose the names of their real owners.[6] Opacity of ownership reduces both transparency and confidence in a system where lack of trust is already a problem. It also impedes efforts to implement new criteria concerning who is 'fit' to own and/or manage Russian banks and undermines efforts to control related-party transactions.[7] Moreover, the lack of transparency surrounding ownership is closely linked to the lack of transparency surrounding much of what banks *do*: although the pace of banking reform has accelerated markedly since the appointment of Sergei Ignat'ev as CBR chairman in 2002, the sector remains under-governed, and a great many banks are actively engaged in activities that are—at best—legally questionable and in many cases are clearly criminal.[8]

A fourth important characteristic of the sector is the extent to which it continues to be dominated by the state. At the beginning of 2004, there were 20 banks in which the state (federal or regional authorities) held majority stakes.[9] Such banks accounted for 68% of retail deposits, 29% of capital, 36% of assets and 38% of credit outstanding to the non-financial private sector. They also accounted for 80% of Russian government bonds in the portfolios of Russian banks. In addition, regional authorities held minority stakes in many banks and a large number of state unitary enterprises were part-owners of banks. The most important state-owned banks are the savings monopolist Sberbank and the former foreign trade bank Vneshtorgbank (VTB); they are also the largest banks in Russia in terms of both capital and assets. While ownership of VTB has been transferred to the government, the CBR continues to hold the state's controlling stake in Sberbank. This presents a number of conflicts of interest: the CBR is at once the sector's regulator, its largest single creditor and the owner of its biggest bank. It also has considerable control over most aspects of insolvency proceedings in the sector. Finally, many private commercial banks have developed on the basis of close links to state institutions, relying on political connections to secure various benefits. Many regional banks have established near-monopoly positions on local markets thanks to official backing.[10]

There are good reasons for seeing state dominance as a problem. State ownership and state intervention in credit allocation tend to distort competition, to aggravate moral hazard by encouraging the expectation of a bailout, and to undermine the efficiency of intermediation, as banks often pursue policies that reflect the non-commercial requirements of the authorities rather than good commercial sense.[11] The short history of Russia's banking sector exemplifies many of these problems, particularly with respect to competition and the imposition of hard budget constraints on banks. State-owned banks (both federal and regional) have continued to derive substantial competitive advantages from state ownership, especially Sberbank.[12] In addition to the explicit state guarantee backing their retail deposits, which was scrapped only at the end of 2003, state-owned banks have enjoyed privileged access to state funds, *de facto* exemption from some regulatory norms and, on occasion, financial support from the state. Their cost of capital is reduced by the perception that the state will stand behind them, an implicit guarantee that is little affected by recent legal changes. Sberbank, moreover, is the only Russian bank with a fully developed (indeed, over-developed) branch network. This gives it a near-monopoly in handling things like pension and utilities payments, which bring with them large volumes of low-cost funds. At the same time, state-owned banks have at times been required to perform unprofitable 'social functions' on behalf of the state or to adopt policies that reflect the requirements of macroeconomic management rather than profitability.

Many of the problems outlined above were evident in the banking 'mini-crisis' of May–July 2004, when the CBR's intervention in the case of a bank accused of money–laundering triggered several weeks of turbulence and placed a number of banks under strain.[13] The CBR's attempt to impose a temporary administration on the bank in question, Sodbiznesbank, was bound to be unsettling—it was, after all, the first time such an intervention had occurred *before* a bank had actually defaulted on its obligations. However, the situation was exacerbated by the uncertainty about Sodbiznesbank's ownership, which led to pressure on banks thought to be linked to it via common owners, and by rumors of a 'black list' of banks slated for closure by the authorities, which led to runs on several banks. A number of players in the sector appear to have fuelled the rumors and speculation in an effort to undermine rivals. Lack of trust among banks, as well as the awareness that almost any bank might be found to have shady deals on its books (and thus to be vulnerable to such intervention) led to a drying up of liquidity on the inter-bank market, putting pressure on the hundreds of smaller banks that are highly dependent on it. At the same time, rumors concerning black lists and political vendettas were widely accepted as true, partly because neither the banks nor the general public had much faith in the authorities' impartiality and partly because, in the case of Guta-bank, at least, political factors do seem to have underlain the bank's troubles. While the turbulence eventually abated, the whole episode highlighted problems of opacity and lack of trust, as well as the widespread (and well founded) belief that many banks were engaged in legally dubious activities.

Finally, it is important to note that there is still relatively little foreign involvement in the sector. At the beginning of 2004, non-residents owned stakes in only 128 Russian credit institutions, of which 32 were wholly foreign-owned. The foreign share of the sector's total capital in early 2005 was estimated at 5.2%, down from 10.7% at the beginning of 2000, and majority foreign-owned banks accounted for 7.6% of sector assets. This picture contrasts starkly with Central Europe, where local banking systems are now largely foreign-owned. Russia does not necessarily need or want a banking sector dominated by foreign players, but it does need a higher level of foreign involvement in the sector, if only to reap the benefits foreign banks can bring in terms of skills, technology and credibility. The lack of foreign involvement is partly a product of protectionist policies, but the significance of bank protectionism should not be exaggerated.

While there was, for almost a decade, a 12% ceiling on the foreign capital share in the sector, the cap had never actually had legal force and foreign banks never came close to breaching it anyway, except for a brief period immediately after the 1998 financial crisis.[14] Its real importance was not legal but symbolic: the existence of the ceiling sent a strong signal to foreign investors about the CBR's attitude towards foreign entry. Formally, it was scrapped in 2002, after Sergei Ignat'ev replaced Viktor Gerashchenko as CBR chairman. A number of lesser restrictions on foreign involvement remain, including the requirement that the central bank approve any acquisition of shares in a Russian bank by non-residents, but the CBR under Ignat'ev has adopted a much more positive attitude towards foreign banks and is working to relax many of the remaining restrictions.[15] The most contentious issue remains the Russian authorities' insistence that foreign banks entering the Russian market establish fully capitalized Russian subsidiaries rather than simply opening local branches. That said, the real deterrents to foreign entry are generally reckoned to be informal rather than formal: the weak contracting environment, the attitude of officialdom and the difficulties of operating in Russia's opaque and sometimes unstable financial system all constitute much more serious obstacles to entry than the formal rules administered by the CBR.

The evolving political role of Russian banks

The above overview already suggests a number of important points about the political role of Russia's banking sector. First, the banks are not—and, contrary to popular belief, rarely have been—a particularly powerful sectoral lobby. Secondly, this is at least in part a function of the sector's fragmented structure, which is reflected in its politics. Rarely has it ever acted as a unified force, even when lobbying the authorities with respect to very sector-specific issues—a reality highlighted by the rivalry that exists between the two major banking organizations, the Association of Russian Banks and the Association of Regional Banks 'Rossiya'. Banks' lobbying activities tend to be highly particularistic: individual banks or bankers tend to lobby specific politicians and officials to secure their interests. In this, of course, the banks' behavior is perfectly typical of business lobbying in Russia more generally. Thirdly, major banks identify far more closely with the regions, industrial sectors and business groupings to which they are linked than with any broader sectoral lobby. While groups of banks do sometimes join together in an effort to influence policy, bank lobbying is generally most effective when supported by the large industrial companies and groupings to which so many banks are allied.[16] Finally, a great deal of policy still reflects the entrenched power of the big state banks, particularly Sberbank and VTB, and the authorities' reluctance to restructure them in order to level the competitive playing field between state and private banks.

Banks and the state in the 1990s

A look at the political history of Russian banks illustrates these points and quickly makes clear that Russia's commercial banks have generally been less powerful than they sometimes appear. Banks in the early 1990s were not an especially powerful lobby at federal level. This was the period when industrial lobbies came to dominate the government. The government's industrial lobby grew steadily more influential in the cabinet from June 1992, as growing resistance to the 'market Bolshevism' of the Gaidar government led to the promotion of 'industrialists' like Viktor Chernomyrdin, Oleg Soskovets and Oleg Lobov. The banks did not have much of a role in policy-making at this time, nor did they really need one in order to do well. They were making easy profits from trade finance, foreign exchange speculation and the handling of state accounts, soft credits and other official financial flows. As Frye observes, the banks profited handsomely from the lax financial policies of the time, but these policies were adopted under pressure from industrial and regional lobbies and supported by a CBR chief—Gerashchenko—who regarded support for the real sector as a key priority for the central bank, even at the expense of price stability. In short, the banks were well positioned to appropriate a share of the rents being generated by and for other actors.[17]

The banks did not evince much interest in using their rapidly growing wealth for political ends during this period, beyond ensuring that the state did not curtail the speculative opportunities they were exploiting. The government's remaining liberal reformers, who were later identified very closely with the leading banks, viewed them with suspicion at this stage, for at least three reasons. First, many banks were obviously shaky (and shady) institutions. Secondly, the banks were closely tied to the CBR, then headed by the liberals' *bête noir*, Gerashchenko. Thirdly, the banks were perceived as enemies of stabilisation. It was thus no accident that the liberal architects of Russia's early privatization policies worked to limit the banks' participation in that process. Banks were barred from acquiring equity stakes in enterprises undergoing privatization, and their shareholdings were limited to 10% of the shares of any given company and 5% of the banks' own assets.[18]

These restrictions did not appear to have upset the banks much at the time. In any case, the earliest attempts to organize some sort of real sectoral lobby were encountering limited success, at best, even with respect to issues of direct concern to the sector. The Association of Russian Banks (ARB) purported to speak for the sector, but many of the largest banks refused to join. The organization came to be seen by many as a vehicle for small and medium banks only, although critics argued that its agenda was largely determined by a small number of larger banks.[19] Tensions within the sector manifested themselves in the battles surrounding the passage of the 1995 banking law. On issues where the sector was united, it generally prevailed: the banks preserved a degree of protection from foreign entry in the banking law and gained the right to deal in shares and securities for which no special license was required under federal law. On other issues, however, the banking lobby split. On the issue of charter capital increases, the great mass of small and medium banks, backed by powerful regional elites, secured an important victory over their larger Moscow- and St Petersburg-based rivals. Article 11 of the law stated flatly that the CBR could not apply increases in the minimum charter capital requirement to existing banks. This effectively closed off one strategy for forcing the consolidation of the sector, something smaller banks had feared and some larger banks had seen as a welcome opportunity to extend their reach into the regions. For similar reasons, the big banks based in the capitals pressed for liberal rules on the opening of new branches, which their smaller rivals opposed. That round went to the 'federals', but the big banks soon discovered the limits of their victory, as regional authorities continued in many cases to pursue protectionist policies designed to keep the big metropolitan banks at bay.[20] Tensions within the sector continued to grow in 1995, chiefly as a result of the authorities' renewed push for macroeconomic stabilization. In August 1995, tightening liquidity conditions triggered a crisis on the inter-bank market. Once again, the banking lobby split, as financially stronger banks failed to back the ARB's calls for state support, tacitly favoring the bankruptcy of their weaker rivals instead.

The tightening of monetary conditions in conjunction with the stabilization policies of 1995–98 aggravated both the real sector's problems with access to finance and the government's fiscal problems. The banks, too, felt the strain of stabilization, but, with a near-monopoly on rouble liquidity in an increasingly liquidity-starved economy, they found it easy to exploit the situation. As Gaddy and Ickes observed, 'in the land of the cashless, the man with pocket change is king, or at least an oligarch…. It is the Russian tycoons' relatively cash-rich status in a cashless economy that gives them so much power.'[21] Real sector enterprises needing access to finance thus had every incentive to develop their own pocket banks or to draw closer to friendly banks. At the same time, the government itself came to depend increasingly on the banks for short-term financing—despite the fact that the banks themselves were in some cases actively pursuing strategies that aggravated the government's fiscal headaches. Other factors strengthened the banks further. The beleaguered position of President Boris Yeltsin in 1995–96 left the Kremlin particularly vulnerable to bank lobbying, while the government's remaining liberal reformers searched for allies to help them shore up their positions in a cabinet dominated increasingly by people like Chernomyrdin and Soskovets. Corruption, too, may have played a role: the instability and uncertainty of 1995–96 do appear to have fuelled it, particularly at the highest levels. In late 1995, officials in the government apparatus claimed that the main problem they faced in dealing with the Kremlin was that their colleagues in the presidential administration believed that the Yeltsin era would soon end and were consequently preoccupied with arranging jobs for themselves outside the Kremlin and establishing contacts in the business community.[22] Such officials would have made far easier targets for the banks' lobbying efforts. These circumstances formed the backdrop for the infamous loans-for-shares deals of 1995–97.

It would, nevertheless, be a mistake to view loans-for-shares and other give-away privatizations of 1995–97 solely in terms of the banks' political muscle.[23] While the banking lobby was at its most powerful during 1995–97, such deals generally took place when the banks had managed to forge alliances with key industrial companies. Hostile acquisitions were rare and were fiercely contested. Even prior to the loans-for-shares auctions, banks had generally preferred acquiring stakes in enterprises with whose managers they had close relationships.[24] Despite their enormous financial problems, the industrialists' position was far from weak. In the absence of a credible bankruptcy threat, they did not need to surrender control to outsiders simply because their finances were a mess, nor were they inclined to do so. In the end, the vast majority of enterprises originally slated for inclusion in the infamous loans-for-shares auctions were able to lobby their way out.[25] Only nine of the original list of 64 actually ended up on the auction block. Three of these had the funds to secure control of their own shares, albeit in auctions that effectively excluded other participants, and five were acquired by banks to which they were already closely linked. The only major exception was the non-ferrous metals giant Norilsk Nickel. Oneksimbank acquired a controlling stake in this concern against its managers' wishes and had to fight a protracted legal, commercial and political battle to secure real control. In short, the bank-driven loans-for-shares privatizations are in reality best understood as simply a further stage in the process of privatization to insiders that began with the asset-stripping of the late Soviet period and continued during the voucher phase of 1992–94.

Even at the peak of their political influence, in the mid-1990s, Russian banks were small and often unstable. Their survival depended chiefly on the patronage of the state, to which they were closely linked in every sphere of activity.[26] Indeed, although the banking sector in the mid-1990s was regarded by some as the sector 'most advanced as far as the progress of market reforms is concerned',[27] it actually had a strong claim to being the most *subsidized* in the Russian economy.[28] The subsidies it received persisted even as state support for other sectors dried up, in large measure because they were usually implicit rather than explicit subsidies. The reputed power of Russia's banks in the mid-nineties must thus be viewed alongside this very dependent position vis-à-vis the state. The image of hugely powerful banks dominating a weak state tended to obscure the reality that *both* were weak. The state's reliance on the banks reflected its inability to perform a number of basic functions, while the bank's reliance on the state reflected their limited ability to survive without easy access to state funds. What the scandals of 1996–98 highlighted most of all was the extent to which the banks' futures depended on this access. The so-called 'banking wars' of 1997 thus reflected banks' vulnerability more than their strength. Tighter monetary policies, exchange rate stabilization, falling yields on government securities and lower inflation put the banks under enormous pressure. Central bank credit became more expensive, reserve requirements grew tougher, and access to budgetary funds was curtailed. With so many sources of state subsidy drying up, the battle for those that remained, and especially for control of state assets still to be privatized, could not but escalate.

Banks and the state under Vladimir Putin

The foregoing analysis suggests why the banks have been less politically prominent since the crisis than they were before it. The most important factor of all was clearly the passing of the extreme illiquidity that afflicted the economy during 1995–98. Indeed, the main problem afflicting the financial system during 2000–04 was *excess* liquidity. The re-monetization of the real sector and the related dramatic transformation of state finances greatly reduced the banks' political leverage. The corporate balance of forces also changed. In the post-devaluation recovery that began in 1999, money was made chiefly from the economic rents associated with the exploitation of natural resources. Control over oil, gas and metals, rather than mere liquidity (no longer such a scarce commodity), represented the keys to real wealth and economic power.

This coincided with changes in the structure of the more dynamic groupings like Rosprom and Interros. The centre of gravity within these groupings shifted from the banks to the parent holdings or the core resource-exporting companies.

This shift in the internal balance of power within the groupings also reflects the shift in the sources of their profits. In the mid-1990s, super-profits were earned in the government securities markets, where real yields on short-term GKOs reached triple-digit annual rates. The incentives to strip industrial assets and accumulate payment arrears in order to play the GKO market were enormous, and this is precisely what many managers did. In the post-crisis recovery, however, it was exports, particularly oil exports, which generated huge profits. Even many of Russia's processing industries returned to profit. The banks' role as profit-generators was dramatically reduced. The 'banking wars' of the 1990s gave way to 'oligarch hunting' and conflicts among powerful groupings in various industrial sectors. Battles among oil companies, metals producers and other industrial concerns—not bankers—now tend to dominate the headlines where commerce meets politics. The politically prominent bankers of the 1990s who remained major players after the financial crisis were those with strong positions in other sectors. Those like SBS-Agro's Aleksandr Smolenskii and Inkombank's Vladimir Vinogradov, who failed to establish themselves as dominant players in other sectors, proved far more vulnerable—politically and financially—after the crisis. Thus, Vladimir Potanin is now more closely involved with Interros and, in particular, Norilsk Nickel, than with Oneksimbank's successor, Rosbank. Even before the financial crisis, Mikhail Khodorkovskii left Bank Menatep to head the Rosprom Financial-Industrial Group. The official assault on Khodorkovskii launched in mid-2003 led to the dismemberment of Yukos, while Menatep's successor banks hardly figured in the affair.

One area in which there is all too much continuity with the past is the treatment of state-owned banks. Official policy is that state-owned banks should exist—if at all—to correct market failures. Their activities should be concentrated in sectoral and other niches which the market will not address on its own.[29] In practice, however, the major state-owned banks tend to operate as universal banks, with Sberbank, in particular, exploiting its protected retail monopoly to extend its business in other directions. It is now the dominant bank in a number of market segments, not only retail. Sberbank's size and status thus distort competition in many segments of the banking market. The same might be said, albeit to a lesser degree, of VTB. The inconsistency of policy with respect to state banks was particularly evident during the mini-crisis of the summer of 2004. The CBR, having refused to extend a stabilization credit to the pressured Guta-bank, instead lent $100m to VTB, enabling it to buy Guta and thus to nationalize one of the country's larger private banks. There is some reason to believe that the CBR extended this loan under strong pressure from elements of the presidential administration. At the same time, the CBR appears to have encouraged Sberbank to step up its activities on the inter-bank market in order to ease the liquidity problems of smaller banks. Since Sberbank traditionally does around 90% of its inter-bank lending to foreign banks, this amounted to asking the savings monopolist to undertake a major change in its commercial practices, at very short notice, in order to suit the needs of the monetary authorities. In short, the CBR once again succumbed to the temptation to use Sberbank as a policy instrument.

The banks and foreign policy: the potential for conflict—and embarrassment

Much of what can be said about the role (or lack thereof) of Russia's banks in shaping its foreign policy follows directly from the above analysis of the banking sector and its politics. Rarely do the interests of specific banks or of the banking lobby as a whole appear to have been important in determining the course of Russian foreign policy. This is hardly surprising. Russian banks remain overwhelmingly focused on the rapidly growing domestic market; few are seriously interested in overseas expansion (particularly outside the CIS) and fewer still in a position to pursue that interest. The most active Russian banks abroad tend to be those closely affiliated with major financial-industrial groups. Such banks often move abroad in the footsteps of the other members of their respective groups (an exception is the state-owned Vneshtorgbank). Nor have banks served as important instruments of foreign policy in the way that, for example, Gazprom has sometimes done.

Where the banks' interests and activities do seem to have had a significant impact on Russia's foreign relations, it has been the sector's weakness and its specific pathologies, rather than its lobby power, which have tended to be at issue. The frequent crises, large and small, that have rocked the Russian banking system at intervals since 1991 have sometimes done the country's image considerable, albeit usually temporary, damage. In addition to highlighting Russia's financial fragility, banking crises and scandals have often drawn attention to the seedier side of Russia's often very dirty business environment. A brief analysis of two specific issues—protectionism and money laundering—will serve to illustrate the ways in which banking sector weakness sometimes complicates Russia's foreign relations.

Protectionism

Since the early 1990s, Russia's banks have been protected from foreign competition by a variety of formal and informal mechanisms. The issue of foreign access to the banking sector has loomed large in discussions of Russia's WTO accession. As noted above, for roughly a decade until 2002 there was widely perceived to be a 12% limit on the foreign capital share in the sector. In fact, the quota was never legally enforceable. No method for calculating this quota was ever officially approved and official statements on the subject were contradictory.[30] Since neither the size of the quota nor the formula for applying it was ever agreed, it was simply assumed that the 12% ceiling announced by the CBR in 1993 remained in force. Its formal removal in 2002 thus had little or no legal significance, although it sent a powerful signal to foreign banks about the authorities' attitude towards foreign entry.

There is little doubt that the protectionist measures adopted in the early 1990s were in large measure a product of bank lobbying. A number of local banks actively lobbied for protection, deploying an 'infant industry' argument. In addition to the capital ceiling, the authorities imposed a moratorium on foreign banks' servicing of Russian clients, and a range of other regulations, such as those restricting the employment of expatriate staff and governing the appointment of foreigners as top managers or board members of Russian banks. The practical significance of these rules depended to a great extent upon the judgments of the CBR.[31]

By 1996–97, the domestic political pressure for protection was waning. Thus, the moratorium on foreign banks' handling of Russian clients was allowed to lapse as scheduled, on

1 January 1996, and other restrictions on foreign banks' activities were gradually eased. Later on, the minimum charter capital for establishing a foreign bank was reduced from €10m to the €5m required of new local banks. By 1996–97, the banking lobby had split over the issue of protection, as over so many other issues. The largest and most ambitious banks were starting to think (prematurely, as it turned out in most cases) in terms of overseas expansion. They understood that opening the sector up somewhat would be necessary if they were to enter foreign markets. In any case, it had become clear by the mid-1990s that the threat of foreign competition was exaggerated. Russian banks operating on their home turf enjoyed significant competitive advantages vis-à-vis their foreign rivals.[32] Russian firms found local banks quicker to take decisions and less demanding when it came to their requirements for financial information. Many Russian businesses were unable or unwilling to provide information that would meet western standards. While their professional and technological sophistication grew rapidly in the mid-1990s, Russian banks continued to levy much lower fees for their services. They were also—and this was, for many businesses, a crucial consideration—far more willing than their foreign rivals to participate in 'grey' tax-evasion and capital-export schemes, which were legally dubious but were nonetheless standard operating procedures for many Russian corporates.

There was and is, to be sure, some danger than foreign banks entering Russia on favorable terms might be able to 'cherry pick' the most promising of the Russian banks' clients—chiefly, the country's large resource exporters, plus a few prominent companies oriented towards the domestic market, such as Wimm-Bill-Dann. However, such companies have hitherto tended to retain Russian banks for local services, while successfully tapping foreign capital markets and banks abroad. Access to external markets means that the remaining protections in force do little to prevent large Russian corporates from raising foreign capital.

As the foregoing implies, many of the most important barriers to foreign entry arguably had little to do with the sort of explicitly protectionist measures adopted in 1993–96. The under-governed, often corrupt nature of the financial system itself was a deterrent to many foreign banks, as was the recognition of the fact that the attitudes of officials—federal or local, in the CBR or in other state institutions—mattered at least as much as the formal rules in determining what kind of welcome a foreign bank might receive on entering any given market. The elaborate system of foreign exchange controls constituted another impediment to foreign entry. Gradually relaxed before 1998, the currency control regime was tightened up again after the crisis, and the lifting of those controls is still not complete. Currency controls—which were viewed as a nuisance by Russian as well as foreign banks—were adopted as tools of macroeconomic management but their effect was undoubtedly to discriminate against foreign banks.

Nevertheless, while the domestic political pressure for protection waned after the mid-1990s, numerous restrictions on foreign involvement have remained in force. Even now, the CBR must approve any acquisition of shares in a Russian bank by non-residents. The CBR is pressing for the removal of many of these restrictions, but it continues to stand firm on what has become the most contentious issue of all: Russia's insistence that foreign banks wishing to enter the sector must form fully capitalized subsidiaries, registered in the Russian Federation, rather than simply opening local branches of their overseas parent banks.

How, then might we account for continued protectionism, if not in terms of the power of the banking lobby? The first point to make is that declining pressure for protection should not be equated with mounting pressure for liberalization. There was no strong domestic lobby *in favor* of opening up the banking sector, and a substantial part of the banking community, as well as many nationalist politicians, did remain opposed. The role of the latter in maintaining some protections should not be underestimated, as the fear of a foreign-dominated financial system runs deep among elements of Russia's political elite. Moreover, the access regime in place after 1993–95 effectively left the CBR as the gate-keeper to the sector, a role that some in the CBR, including Viktor Gerashchenko, appear to have been determined to retain. Their preferred model for foreign entry, particularly after the crisis, was for foreign investors to buy—with CBR approval, of course—stakes in Russian banks.[33] In any case, since there was little evidence that liberalization would trigger a flood of foreign investment into the sector, the Russian authorities had little incentive to liberalize autonomously—many policy-makers clearly preferred waiting until there was a *quid pro quo* on offer, which is why the issue came to be so important in the context of Russia's WTO negotiations.

This brings us to the issue of branching versus subsidiaries, which remains one of the most problematic WTO accession issues. Here, the principal source of opposition is the CBR rather than the banking lobby, although the commercial banks generally seem to support the CBR position. Allowing foreign branches to operate freely within Russia really would create a competitive situation that could threaten the interests of Russian commercial banks. Nevertheless, it is the central bank's position that is somewhat puzzling and that requires some consideration. The CBR is broadly in favor of greater foreign access and, under its current leadership, it has done much to facilitate such access. Yet it rejects foreign branching. For the CBR, the key issue is: who regulates? A fully capitalized, locally registered subsidiary is effectively a local bank, albeit a foreign-owned local bank, and is regulated by the host country regulator—in this case, the CBR. A branch, by contrast, is not a legal entity independent of its parent and it thus falls under the prudential supervision of the parent bank's home-country regulator.

Concerns about branching are focused on this distinction. First, the CBR is not happy with the idea that banks operating in Russia will not all be subject to the same oversight. Secondly, it is concerned about the quality of supervision that can be expected from some foreign central banks, including some in offshore jurisdictions from which banks could well be expected to try to branch into Russia. Thirdly, it is not clear that even the most competent developed-country regulators have an adequate understanding of Russian realities.[34] Fourthly, some Russian officials fear that branching would make it easier for foreign banks to withdraw from the Russian market in the event of a crisis; in their eyes, a fully capitalized subsidiary represents more of a commitment to the market.[35] Finally, even if the quality of supervision is good in both Russia and the home jurisdiction, the different regulatory regimes associated with the two forms of representation can generate very different regulatory responses to the same information. While both arrangements have their drawbacks, the model devised by Calzolari and Lóránth suggests that branching is more likely to be problematic, as it likely to lead, *ceteris paribus*, to softer regulation of the home unit, while the home country regulator's behavior towards the foreign unit will vary depending on its assessment of the home unit's prospects and may be softer or tougher than it ought to be.[36]

It is worth noting that central banks and banking regulators in many developed countries also dislike the presence of foreign branches in their jurisdictions and often restrict the range of activities in which they may engage. This may be one reason why, to date, Russia appears to have been able to avoid yielding on the branch/subsidiary distinction in its bilateral WTO accession talks. Its May 2004 agreement with the European Union reportedly allows Russia to continue to insist on the creation of subsidiaries rather than branches and to retain a limit, rumored to be of the order of 50%, on foreign participation.[37] The crucial test here will be the negotiations with the United States.

'Dirty laundry'

Although the issue of bank protectionism has been much discussed in recent years in the context of WTO accession, it has most often been the banking sector pathologies, rather than its desire for protection, that made it a source of international conflict, or at least embarrassment, for Russia. This was highlighted most spectacularly in 1999–2000 with the eruption of the so-called 'BONY case', which centered on the illegal movement of an estimated $7–10bn of Russian money through the Bank of New York (BONY) over a period of just four years.[38] Of course, problems such as money laundering, tax evasion and illegal capital flight from Russia were hardly unknown prior to the summer of 1999: there had already been widespread discussion of these issues in the West, not least in conjunction with investigations into claims that IMF funds had been spirited out of the country just prior to the August 1998 financial collapse. Nevertheless, the *New York Times* investigation of BONY, which found that $4.2bn had moved through a single account in more than 10,000 transactions over a six-month period, highlighted the scale of the problem and drew attention to the involvement of an apparently 'respectable' western bank.

It is not possible to assess with any precision the role of Russian banks in capital flight. Estimates of total capital flight from the country vary widely, depending on the definition and methodology used.[39] There is, however, little doubt that the sums involved are enormous: even the lowest estimates suggest a figure of at least $10bn per annum since 1992 and some of the higher but still plausible estimates run to $20bn. These are staggering sums for an economy the size of Russia's. While a large part of this money has left Russia via mechanisms that avoid the Russian banking system altogether (such as the failure to repatriate forex earnings from export operations in the first place), the Russian banks were probably directly involved in the illegal export of at least $5bn a year from 1992 on—and probably substantially more than that. The Russian authorities in the 1990s estimated that up to one-third of the funds leaving the country illegally were themselves the proceeds of criminal activity, which suggests that money laundering operations amounted to between $3bn and almost $7bn per year.[40] This estimate, it should be noted, appears to include contraband trade in otherwise legal goods (in order to avoid customs duties), as well as more serious forms of organized crime, such as narcotics trafficking.

In focusing attention on the problem, the BONY scandal prompted western banks to undertake widespread checks of accounts held by Russian physical and legal persons and caused considerable embarrassment to Russia abroad. Politicians across the Russian political spectrum denounced the affair as a deliberate attempt to smear Russia for political or commercial reasons—a claim rendered all the more plausible in Russian eyes by the speed with which western press coverage of the story went well beyond the known facts. Within Russia, after all, such stories would likely have received wide circulation only if influential interests were promoting them. While western headlines focused attention on large-scale money-laundering by the ‘Russian mafia’, most of the suspicious transactions appear to have been attempts to evade taxes, tariffs or currency controls, rather than money-laundering by organized criminal groups. While tax evasion and capital flight were, of course, illegal, most Russian observers saw them in entirely different terms from laundering the proceeds of organized criminal activities.

Nevertheless, the money laundering issue would not go away, and the BONY scandal did prompt the CBR to begin scrutinizing offshore transactions more closely. This was not enough, however, to satisfy the OECD-based Financial Action Task Force (FATF), formed by the G7 to coordinate efforts to combat money-laundering—the FATF placed Russia on its ‘black list’ of non-cooperative jurisdictions. This was not merely an embarrassment to Russia: the prospect of sanctions against states on the FATF threatened to complicate Russia’s integration into the world economy. In mid-2001, therefore, Russia at last adopted a new law on the prevention of money-laundering and the establishment of a new Financial Monitoring Committee to which banks and other organizations report on certain types of financial and property transactions.[41] (The committee became the Federal Service for Financial Monitoring during the March 2004 reorganization of federal executive bodies.) Further amendments were adopted in October 2002, providing for banks to act if they have reason to believe that an account or transaction is being used to finance terrorist activities. The amendments also extended the remit of the original statute to cover a wider range of entities, including investment funds, casinos, private pension funds, lottery operators, bookmakers and dealers in precious metals and stones.[42] The amendments were adopted at the request of the FATF, which in October 2002 finally removed Russia from its list of states that fail to fight money laundering. The FATF decision entailed the removal of some restrictions on western banks’ links to their Russian counterparts. In June 2003, the FATF went further, inviting Russia to become a full member of the task force.

The impact of these steps is difficult to assess. While they clearly have not come anywhere close to putting an end to money-laundering in Russia, they should not be dismissed as meaningless. Within six months of the adoption of the 1999 regulations, wire transfers from Russian banks to offshore centers had dropped significantly, and the CBR also succeeded in imposing stricter requirements concerning the establishment of correspondent relations with offshore banks.[43] In 2004, the CBR withdrew the licenses of 28 banks for failure to comply with anti-money-laundering rules, accusing two of those banks (Sodbiznesbank and Novocherkassk City Bank) of involvement in money laundering. In March 2005, the Federal Service for Financial Monitoring announced that it would be pressing the CBR to act against a further ten banks it believed to be involved in money-laundering activities. Nevertheless, as of this writing (April 2005), enforcement activities have focused entirely on small banks. Moreover, some observers have suggested that, as regulation in Russia has been tightened, Russian banks’ illegal activities have been increasingly conducted via their subsidiaries and affiliates in less well regulated CIS states, particularly in unrecognized statelets such as Abkhazia, where they are beyond the effective reach of any regulator. At the same time, the high level of corruption in Russia, the porousness of its borders and the vast international financial flows into and out of the country all mean that it remains a relatively attractive jurisdiction for individuals and groups interested in laundering the proceeds of criminal activities.

If the BONY scandal centered on the activities of private agents, its state-centered counterpart was arguably the FIMACO affair, which likewise blew up in the months following the financial crisis. In February 1999, less than half a year after the August meltdown, it emerged that the CBR had for a numbers of years in the 1990s secretly used the Jersey-registered Financial Management Company (FIMACO) to manage a portion of its foreign exchange reserves. Formed in 1990 with a charter capital of just $1,000, FIMACO was a subsidiary of the Paris-based Eurobank, which was wholly owned by the RCB. FIMACO began to manage CBR funds in July 1993. While it is not unknown for central banks to rely on private companies to manage a portion of their funds, this idea was extremely unpopular in Russia, and the case of FIMACO aroused serious concerns in both Russia and the West, for a number of reasons. First, FIMACO's activities were wholly opaque—its transactions, profits and losses did not show up anywhere in the published CBR accounts and the IMF was unaware of its existence until early 1999. Ordinarily, international 'best practice' requires that a central bank's reserves be invested by and in the name of the central bank. Indeed, in the brouhaha that followed the initial revelations about FIMACO, it also emerged that the CBR had at times—apparently deliberately— mis-stated the level of its reserves. Secondly, the whole point of using private managers for central bank reserves is to draw on superior expertise and experience. Yet instead of employing an experienced and prestigious international firm, the CBR used an unknown subsidiary. Finally, Gerashchenko openly admitted that one purpose of FIMACO was to keep the CBR's reserves hidden at a time when there was a risk they might be seized by foreign creditors. Technically, at least, this argument may have had some validity up to the mid-1990s: until the CBR's independent status was enshrined in law, the funds it held technically belonged to the government and could in theory have been seized. After 1994, however, this was no longer the case.[44]

Unlike the BONY case, the FIMACO affair did not result in criminal convictions, nor did any leading Russian officials even lose their jobs over it—Gerashchenko weathered the crisis, despite the fact that he had been chairman in 1993 when the CBR first started to use FIMACO as a secret offshore vehicle. The IMF did, however, insist that the CBR undergo an audit by PricewaterhouseCoopers, the results of which were (briefly) posted on the IMF web site, over the protests of the CBR.[45] The Fund also required the CBR to revise its method of reporting foreign-exchange reserves to the public, excluding such assets as loans to its foreign subsidiaries, and to adopt International Accounting Standards in its reporting. In the end, the repercussions of the FIMACO affair were less dramatic than they might have been, because Russia was, in any case, coming to the end of its dependence on IMF credit. Relations with the Fund were strained on many counts—not just over FIMACO—and the combination of oil price rises abroad and post-devaluation recovery at home was reducing the Fund's leverage on the Russian authorities. Thus, the IMF's demand that the CBR withdraw from its participation in the five state-owned banks abroad (the so-called *Roszagranbanki*) was never fully implemented.

Conclusion: *der Primat der Innenpolitik*?

I have chosen to conclude the above discussion with the FIMACO case, as it illustrates two important points that remain relevant today, not least in connection with such issues as the still mysterious financing of Rosneft's purchase of Yuganskneftegaz. First, the Russian authorities have been as prone to exploit and manipulate the weaknesses of the country's financial system as have private entrepreneurs. While this is most often linked to rent-seeking and corruption on the part of officials, at times it is also done in order to facilitate the implementation of specific policies. Secondly, as noted at the outset, most Russian banks have tended to be, first and foremost, tools of their owners rather than independent, profit-oriented financial intermediaries.

This is true of both state and private banks. In many cases, these tools have been—or are—used for purposes that are often nakedly opportunistic and sometimes simply criminal. Many of these activities spill across Russia's borders daily, especially when it comes to tax evasion and money laundering, and from time to time, they cause Russia international embarrassment and even economic loss.

The state of the banking system—and, indeed, of the financial sector as a whole—undoubtedly continues to complicate Russia's efforts to pursue integration into the international economy. However, the current, unreformed state of the Russian banking system suits many powerful domestic actors, and the international costs of such a system are frankly limited, at least as far as those actors are concerned. After all, Russia's most powerful companies now face little difficulty in raising capital abroad. In any case, the diplomatic costs of banking weakness are dwarfed by the price Russia pays for its weak financial system in terms of slower growth. The evidence linking financial development to growth is now extremely strong, and there are good reasons to believe that Russia, in particular, needs a sound and efficient banking system in order to sustain the kind of growth rates it requires over the longer term.[46] Recent progress with respect to banking reform suggests that this may be changing, but progress is slow and efforts to improve transparency and strengthen prudential supervision continue to meet fierce resistance from entrenched vested interests. Unless and until Russia's governing elite is prepared to give up the easy, short-term rents that can be gained by manipulating an opaque and under-governed financial system, Russia's banking sector is likely to remain a drag on growth at home and a source of periodic embarrassment abroad.

Notes

1. Senior Economist, Non-Member Economies Division, Economics Department, Organization for Economic Cooperation & Development; *william.tompson@oecd.org*. The opinions expressed in this paper are those of the author and do not necessarily reflect the views of the OECD or its member states.

2. For such an analysis, see William Tompson, 'Banking Reform in Russia: Problems and Prospects', *OECD Economics Department Working Paper* No. 410 ECO/WKP(2004)33 (9 November 2004).

3. Hundreds of banks emerged in the last years of the Soviet era under the very permissive provisions of the Law on Cooperatives. Politicians challenging the power of the centre used the lax entry regime then in force to undermine the financial power of the all-Union authorities, while managers and bureaucrats quickly discovered the rents that could be derived from running a bank. This rapid growth continued into the post-Soviet period, as high inflation made it easy for would-be bankers to meet minimum capital requirements. As late as 1994, a new bank needed only $65,000 in charter capital.

4. 'Top 1000', *The Banker* (July 2004), pp. 167ff. Gazprombank was ranked 352nd, but I have opted not to treat Gazprombank as a private bank, as it is an arm of the state-controlled (if not yet majority state-owned) Gazprom.

5. R. Hainsworth, O. Yeremenko and S. Tubin, 'Rossiiskie banki: sektor ili sistema?', *Rynok tsennykh bumag* (May 2001).

6. In fact, probably rather fewer than half actually did so.

7. OECD, *Related Party Transactions and Beneficial Ownership and Control: Issues Paper for Discussion* (Paris: Organization for Economic Cooperation and Development, March 2004).

8. See OECD, *Economic Surveys: Russian Federation* (Paris: Organization for Economic Cooperation and Development, 2004), chapter 5.

9. These figures exclude the former Soviet trade banks abroad and banks under the tutelage of the Agency for Restructuring Credit Organizations. State ownership is confined to federal and regional executive organs, the Bank of Russia and state unitary enterprises. The data do not include numerous stakes held by state-owned joint-stock companies.

10. See OECD, *Economic Surveys: Russian Federation* (Paris: Organization for Economic Cooperation and Development, 1997), pp. 100–02; William Tompson, 'Old Habits Die Hard: Fiscal Imperatives, State Regulation and the Role of Russia's Banks', *Europe-Asia Studies* 49:7 (November 1997) and William Tompson, 'The Present and Future of Banking Reform', in David Lane (ed.), *Russian Banking: Evolution, Problems and Prospects* (London: Edward Elgar, 2002). Competition for political favours is, of course, competition of a sort, but it is unlikely to produce more efficient intermediation.

11. J.R. Barth, G. Caprio Jr and R. Levine, 'Bank Regulation and Supervision: What Works Best?', *NBER Working Paper* 9323 (November 2002); S. Djankov, R. LaPorta, F. Lopez de Silanes and A. Shleifer, 'The Regulation of Entry', *Quarterly Journal of Economics* 117:1(2002), pp. 1–37; and K. Sherif, M. Borish and A. Gross, *State-Owned Banks in the Transition: Origins, Evolution and Policy Responses*, (Washington, DC: The World Bank, 2002).

12. Sberbank's position is examined in detail in William Tompson, 'Russia's "Ministry of Cash": Sberbank in Transition', *Communist Economies and Economic Transformation* 10:2 (June 1998).

13. See Richard Hainsworth, 'No Echo of 1998 in Current "Banking Crisis"', *Moscow Times*, 23 June 2004; A. Boulgakov and P. Westin, 'About Storms and Teacups', *Aton Capital Flash Note*, 10 June 2004; S. Moiseev, 'Kak lechili krizis', *Vedomosti*, 12 August 2004; and V. Kudinov, 'Sami vinovaty', *Vedomosti*, 16 August 2004.

14. According to CBR officials, the foreign capital share breached the 12% limit after the August crisis, simply because so many local banks suffered severe damage during the crisis. However, CBR chief Gerashchenko took no action and, indeed, no figures for the foreign capital share in late 1998 or early 1999 have been published. At the start of 2000, the foreign share was about 10.6% and falling.

15. See OECD, *OECD Investment Policy Reviews: Russian Federation: Progress and Reform Challenges* (Paris: Organization for Economic Cooperation and Development, 2004), pp. 71–3 for further detail on these and other restrictions on foreign banks. There has been pressure from the banking lobby to establish a 25% ceiling on the foreign capital share, but the authorities have so far resisted such proposals, which run counter to their overall policy of seeking to encourage greater foreign participation in the sector.

16. As I have argued at length, the role of industrial lobbies was at least as important as the influence of the banks in pushing the notorious 'loans-for-shares' scheme of the mid-1990s.

17. Timothy Frye, 'Governing the Banking Sector in Russia' (mimeo: Ohio State University, October 2003); see also Tompson, 'Present and Future'.

18. *Sobranie aktov Prezidenta i Pravitel'stva Rossiiskoi Federatsii* 1, st. 2 (January 1994).

19. Later, as more of the large banks became active in the ARB, a rival association, the Association of Regional Banks 'Rossiya', began to grow rapidly.

20. On the passage of the 1995 banking law, see 'Banking Sector', *Oxford Analytica Daily Brief*, 8 February 1995; and 'Banking Laws', *Oxford Analytica Daily Brief*, 11 April 1995.

21. Clifford Gaddy and Barry W. Ickes, 'Russia's Virtual Economy', *Foreign Affairs* 77:8 (September–October 1998), p. 73.

22. Private information.

23. For one of the best available accounts of the collateral auctions, see Duncan Allan, 'The Banks and Loans-for-Shares', in David Lane (ed.), *Russian Banking: Evolution, Problems and Prospects* (London: Edward Elgar, 2002).

24. Lev Freinkman, 'Financial-Industrial Groups: Emergence of Large Diversified Private Companies', *Communist Economies & Economic Transformation* 7:1 (March 1995), p. 61.

25. The initial bank proposal for the scheme involved a list of 64 enterprises. Yeltsin's August 31 decree included a list of 44, but within a fortnight this was reduced to 29, then 26 and, finally, by mid-October, just 16 (mainly in oil, metallurgy and river transport). For an excellent analysis of the collateral auctions, focusing on their dubious legality, see *Nezavisimaya gazeta*, 27 January 1998.

26. See Pekka Sutela, 'The Role of Banks in Financing Russian Economic Growth', *Post-Soviet Geography and Economics* 39:2 (1998); William Tompson, 'The Future of the Russian Banking System: Liquidation or Mergers?', in Graeme Herd (ed.), *Russia in Crisis* (Sandhurst: CSRC, 1998), pp. 7–25; and Tompson, 'Old Habits', pp. 1170–8.

27. Elena Zhuravskaya, 'The First Stage of Banking Reform in Russia is Completed: What Lies Ahead?', in Jacek Rostowski (ed.), *Banking Reform in Central Europe and the Former Soviet Union* (Budapest: CEU Press, 1995), p. 167.

28. For details, see Tompson, 'Old Habits'.

29. See 'Kontseptual'nye voprosy razvitiya bankovskoi sistemy Rossiiskoi Federatsii', *Vestnik Banka Rossii* 12 (February 2001); and 'Strategiya razvitiya bankovskogo sektora Rossiiskoi Federatsii: prilozhenie k zayavleniyu Pravitel'stva Rossiiskoi Federatsii i Tsentral'nogo banka Rossiiskoi Federatsii 30 dekabrya 2001 goda', *Vestnik Banka Rossii* 5 (January 2002).

30. CBR documents on the issue stated that it applied only to the share of charter capital of 100% foreign-owned banks in the charter capital of the sector as a whole. Calculated on this basis, the foreign share would never have approached 12%, even after the financial crisis. The banking law, by contrast, stated that the indicator should be calculated on the basis of *all* foreign participation in the charter capital of banks in Russia, but the law nowhere specified the size of the quota, which was to be agreed between the CBR and the cabinet, along with the formula for calculating it.

31. There has been pressure from the banking lobby to establish a 25% ceiling on the foreign capital share, but the authorities have so far resisted such proposals, which run counter to their overall policy of seeking to encourage greater foreign participation in the sector.

32. See 'Foreign Banks', *Oxford Analytica Daily Brief*, 17 January 1997.

33. See Tompson, 'Future'. See also CBR First Deputy Chairman Oleg V"yugin's comments in *Vremya novostei*, 19 August 2003.

34. The author discussed this issue with CBR officials and with the representatives of the Association of Russian Banks at some length in 2003.

35. *Nezavisimaya gazeta*, 22 August 2003. Up to a point, this view may be correct. However, the liability of the parent is far more easily limited in the case of a separate subsidiary—as the Argentine case shows, multi-national banks can and sometimes will simply abandon local subsidiaries to their fate.

36. Giacomo Calzolari and Gyöngyi Lóránth, 'Regulation of Multinational Banks: A Theoretical Inquiry' *CEPR Discussion Paper No. 4232* (February 2004).

37. This summary reflects press coverage of the agreement, the text of which remains confidential.

38. For a summary of the BONY case, see 'Russian Money Laundering Operation' in *Money Laundering and Financial Crimes* (Washington, DC: US Department of State, 2000).

39. For assessments of the scale of capital flight from Russia in the 1990s, see Prakash Loungani and Paolo Mauro, 'Capital Flight from Russia' (mimeo: International Monetary Fund, April 2000); and Willem H. Buiter and Ivan Szegvari, 'Capital Flight and Capital Outflows from Russia: Symptoms, Cause and Cure', *EBRD Working Paper No. 73*, June 2002.

40. See William H. Cooper and John P. Hardt, *Russian Capital Flight, Economic Reforms, and U.S. Interests: An Analysis* (RL30394 CRS Report to Congress, Washington, DC, March 2000). See also the comments of then-First Deputy Finance Minister Oleg V"yugin quoted in Chase Bank, *Next Week*, 1 October 1999, p. 20.

41. 'Federal'nyi zakon RF ot 07.08.2001 № 115-FZ "O protivodeistvii legalizatsii (otmyvaniyu) dokhodov poluchennykh prestupnym putem"'.

42. 'Federal'nyi zakon RF ot 30.10.2002 № 131-FZ "O vnesenii izmenenii i dopolnenii v federal'nyi zakon «O protivodeistvii legalizatsii (otmyvaniyu) dokhodov poluchennykh prestupnym putem»"'.

43. For details, see the Russia country note in *International Narcotics Control Strategy Report 2005* (Washington: US Department of State, 2005).

44. Gerashchenko appears to have had in mind the Geneva-based Nessim Gaon, whose companies sued Russia for $600 million. Gaon succeeded in freezing Russian accounts in Switzerland and Luxemburg in 1993.

45. The audit report was posted on the IMF web site on 5 August 1999 and withdrawn by 4 September of the same year, at the request of PricewaterhouseCoopers.

46. See Tompson, 'Banking Reform in Russia', for an extended discussion of the importance of banking reform for growth and the prospects for its success.