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Department of Social Sciences

Comparing the governance systems of the Russian and European banking sectors

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Tsypilma Gunsueva
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Supervisor: Harry Bremmers
Second reader: Anna Sabidussi

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It is my minor thesis about the governance systems of the Russian and European banking sectors. I hope my research will contribute to the development of the European and Russian financial sciences.

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Management summary

This research is concerned with the comparison of two governance systems of banking sectors – the Russian and the European.

The goal of the thesis is the comparison of the governance systems of the European and Russian banking sectors to provide recommendations that are based on the analysis and integration of the best practices of governance in the European and the Russian banking systems. They are found to be helpful for the financial institutions and their effective governance.

The comparative method of research is used in this paper. We compare two governance systems of the banking sectors for identifying their best practices. The analysis of the governance systems of the Russian and European banking sectors is necessary to identify the best practices in governance. Good experience of management practices and decision-making in one banking system could be adopted and be used within another. Both governance systems can learn a lot from each other on how to improve themselves. Of course, they have different ways of development. For example, the Russian banking systems was established in an extremely short period of time. After the collapse of the Soviet Union the restructuring of economic relations required the creation of a new banking system, which was built within two years. In contrast, the European Union worked for a long time to create a single economic area. The first steps towards the start of the integration processes in Europe took place after the Second World War. And there are many other examples which underline the difference between the Russian and European governance systems.

However, the comparison of the governance systems can help improve them and strengthen the international banking system, since these systems are part of the global economy. The certitude of the globalization processes and awareness of common interests are making the European Union and Russia to establish effective collaboration. Europe has a great experience of the capitalistic way of social development that is likely to be applied by Russia with adaptation.

The results of the research are a set of recommendations which are valuable and beneficial for both governance systems to overcome their weaknesses and avoid threats. By analyzing the differences in the governance and performance of the banking systems, both governance systems of the Russian and European banking sectors both might learn a lesson in order to secure their positions for the future.

The research results have shown that the banking system in Europe is more advanced than in Russia. The environmental conditions in the European Union were more advantageous. The establishment of the present governance system in Europe was conducted gradually. The rapid changes in the Russian economy affected the quality of the financial system adversely, which led to stagnation and economic downturn in 1998. The liberal regulation of the Russian banking sector in the 1990s switched to the policy of strict control and tough regulation to avoid the repeat of the 1998 situation in the financial sector.

For governance systems of the Russian and European banking sectors recommendations are provided pertaining to the quality of financial regulation and supervision. As a standard for quality of banking governance systems we considered a governance according to 25 Basel Core Principles for Effective Banking Supervision (see Appendix 1). Since the introduction of BCP (Basel Core Principles), these principles have come to be regarded as the global standards for the quality of countries' banking governance systems.

Both governance systems need to pay special attention to risk management practices as well as the effectiveness of the supervisory review process, disclosure, market discipline. The Russian governance system needs to eliminate or at least reduce corruption, encourage transparency and accountability, contribute to the consolidation of the banking sector, which is still fragmented. The European governance system need to improve risk management. Because of complexity of existing banking services offered in the European banking market and high consolidation of the banking sector which increase its vulnerability, the supervision becomes more difficult. The improvement of risk management practices can reduce the probability of financial distress in the EU, especially under the global financial crisis conditions.

I have some remarks concerning my thesis. The thesis is a theoretical research. All recommendations are developed based on the scientific literature related to the governance systems in Russia and the EU. All findings have a recommendation character. This research could be useful for the development of the further research and investigations in the financial governance's sphere.

List of abbreviations

BIS	Bank for International Settlements
BCBS	Banking Committee on Banking supervision
BCP	Basel Core Principles
CBR	Central Bank of Russia
CRD	Capital Requirements Directive
GDP	Gross Domestic Product
EC	European Community
ECB	European Central Bank
ECU	European Currency Unit
EMI	European Monetary Institute
EMU	European Monetary Union
ESCB	European System of Central Banks
IFRS	International Financial Reporting Standards
EU	European Union
NCBs	National central banks
SWOT	Strengths, Weaknesses, Opportunities, Threats
RF	Russian Federation

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Chapter 1. Introduction. Research design

1.1 Introduction

The banking sector plays an important role in an economy. Banks provide financial services to households and businesses. Banks accept deposits, make business loans, and offer related services. Commercial banks also allow for a variety of deposit accounts, such as checking, savings, and time deposit. Banks most operate in order to make a profit. Therefore, the primary goal of commercial banks is making profit. At the same time banks play important intermediary role in the economy. Banking activities facilitate the process of production, distribution, exchange and consumption in the economy. Thus, banks encourage economic development by providing their services[1].

A network of banks that provide financial services forms a banking sector. It consists of all business entities engaged in financial intermediation in any given economy. The central bank regulates the activities of commercial banks. It is a financial institution designed to regulate and control the money supply of a nation, with the goal of fostering economic growth without inflation. The fundamental responsibility of the central bank is conducting monetary policy: balancing the supply of money with the needs of the economy. The main goal of the central bank and its policy is a price stability, which would mean that an economy would not experience inflation or deflation[2].

The central bank plays a key role in financial regulation and supervision. It is a main part of the governance system of the banking sector. The governance system of the banking sector means a set of institutions and structures of authority to allocate and regulate capital resources and control banking activity in the economy. An effective governance of the banking sector helps increase its performance and maintains an economic stability to strengthen the economy as a whole.

This research is devoted to comparing the governance systems of the Russian and European banking sectors. There are similarities and differences between the governance of banks in Russia and the EU. A comparison of the two governance systems and identifying what the basic governance principles of the systems are could improve them and strengthen the

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[1] Source: http://www.investorwords.com/955/commercial_bank.html
[2]Source: http://encyclopedia2.thefreedictionary.com/central+bank

international banking system, since these systems are part of the global economy. Nowadays the globalization processes become relevant more than ever. The certitude of these processes and awareness of common interests are making the European Union and Russia to establish effective economic collaboration. Europe has a great experience concerning the capitalistic way of social development that possibly could be applied for Russia with some adaptations. It is therefore necessary to identify gaps and problems in the Russian and in the European governance systems of the banking sectors and try to explain their structure, taking into account the external and internal factors which have had an effect on the establishment of the modern governance systems of the banking sectors in the EU and in Russia. The goal of the thesis is to gain the necessary knowledge with respect to the governance structures that can form a basis for the recommendations to improve of both governance systems. The research is descriptive and based on the theoretical sources; all findings have a recommendation character.

The banking systems are compared keeping in mind that there are strong national differences between Europe and Russia. Russia is a federal state, so Russian regions have a relative autonomy. The European Union is a political and economic union. This means European countries are on a high level of integration. Both banking systems, Russian and European, are quite young – European integration has started in 1980s and actively continued during the 1990s. The modern Russian banking system was born after the collapse of the Soviet Union at the end of 1980s with an intensive development during 1990s. Also it should be mentioned that both banking sectors are involved in an international financial system and they are under same conditions, e.g. from 2008 they are suffering from the global financial crisis equally.

Different aspects are taken into account to compare the governance systems of the EU and of Russia's banking sector. Based on aspects such as the structure of banking system, the role of the Central Bank, banking legislation, the place of commercial banks in the banking system, it is possible to build the whole picture concerning each banking sector and its governance and to identify the strong and weak sides of each governance model. A SWOT analysis of the banking sectors will provide the information that is helpful for comparing the governance system of the European and Russian banking sectors. Examinations of strengths and weaknesses of each banking system can lead us to the discussion of lessons that could be learnt by the banking sectors from each other.

The paper consists of 7 chapters. The first chapter is devoted to the research design and identifying the problem. Motives for research, research objective, research questions are defined in this chapter. Also the research model and research framework are presented in the first chapter.

The second chapter is related to the theoretical background concerning a governance and a governance system of the banking sector. The definition of the key concept is given and the institutional structure of the governance system is explained in the chapter. The good/poor governance, prudential supervision and Core Principles for Effective Banking Supervision are considered in the second chapter. The theoretical background helps to understand better the subject of research.

The third chapter is about the factors which are have impacted on the establishment and development of the current governance systems of the Russian and European banking sectors. The two groups of factors are considered: external (related to the environment of the banking sector) and internal (related to the banking sector).

The fourth chapter is devoted the current state of the governance systems of the Russian and European banking sectors. The four aspects of each governance system are considered: the structure, legislation on banking, the role of the Central Bank in the governance system, the place and role of the commercial banks in the banking sector.

The fifth chapter deals with the SWOT analysis. The strong and weak sides of the banking systems in Russia and Europe were identified in order to assess internal and external factors about the banking sector itself, its short-term and long-term priorities, which might be effective for further supervision and regulation of the financial institutions.

In the sixth chapter recommendations for each governance system of the banking sector are given to improve the governance itself based on the identified best practices in the governance of the Russian and European banking sector.

The seventh chapter includes the overall conclusion and discussion concerning the prospects for the further investigation of the research subject.

1.2 Research design – conceptual design

1.2.1 Problem background and problem analysis

There is a guidance called "Enhancing Corporate Governance for Banking Organisations" which was issued by the Basel Committee at 2006 "...to help ensure the adoption and implementation of sound corporate governance practices by banking organisations" (Enhancing, 2006). It is applicable for supervisory authorities and banking organisations worldwide. It provides guidance on corporate governance in banks. The guidance draws on supervisory experience with corporate governance problems at banking organisations and suggests the types of practices that could help to avoid such problems. However the guidance "Enhancing Corporate Governance for Banking Organisations" is applicable for concrete banking organisation, not for the banking sector taken as a whole.

This paper focuses on the governance system of the EU's banking sector and the Russian banking sector. The European and Russian governance systems are different and have different ways of regulation and supervision. At the same time both banking systems are operating in an international banking context, so they have interconnections with each other.

The research is devoted to (1) analysing the European and Russian approach of bank governance; (2) identifying existing and possible problems in governance system of banking sector and way of solving them; (3) determining what could be learnt from each system and provide recommendations that could be useful for efficient governance of the banking system. In other words the governance of the banks will be analysed to give recommendations how to govern the banks as a whole, based on the best practices which follow from benchmarking of the European and Russian governance systems of the banking sector.

1.2.2 Motives for research

With the course of time the integration process of the world economy is a constantly rising and strengthening trend. Nowadays the relationships between EU and Russia have become a highly sensitive issue because of political and economical factors (gas supply problems, war in Georgia, global financial crisis, etc.) (Wilson, 2009). Both sides are interested to improve their relationships which might lead to further economic collaboration of EU and Russia.

Banks play an important intermediary role in an economy. Nowadays the international banking system is being hit most by the global financial crisis. Effective governance for banking organisations and the banking system as a whole is of great importance for the global financial system, especially under crisis conditions when there is a high degree of banks' sensitivity to real and potential difficulties arising from ineffective governance. The lack of guidance which regulates and controls the governance of banking system creates a strong theoretical and practical motive for research on governance issues.

It should be remembered that Russia and Europe become more and more integrated economically – they are economically dependent upon each other. After the last EU enlargement Russia became closer to Europe. Europeans broadly agree on a number of issues in their relations with Russia: the common eastern neighbourhood; the deepening of economic interdependence and energy co-operation; training and cultural matters, and the need for cooperation on strategic issues such as how to deal with Iran or climate change. The bright example of necessity of fruitful economic cooperation of EU and Russia is energy provision. The January 2009 gas crisis vividly demonstrated the problems caused by the lack of a functioning internal EU energy market (Wilson, 2009). Russia has a great natural potential for providing gas and oil.

However the institutional structure of governance is different in Russia and in Europe, especially in the financial system. Determination of best practices concerning governance systems of the banking sector could be useful for regulatory agencies, banking organisations to guide the actions of directors, managers, etc.

1.2.3 Research objective

The goal of the thesis is the comparison of the governance systems of the European and Russian banking sectors to provide recommendations, which are useful for the governance of the banking sector to improve the banking regulation and supervision and rise the efficiency of the governance system of the banking sector. They are based on the analysis and integration of best practices of banking governance in the European and Russian banking systems. The set of rules have a recommendation character.

1.2.4 Research model

The research model aims to help understanding the structure of research. It shows the logical links in research.

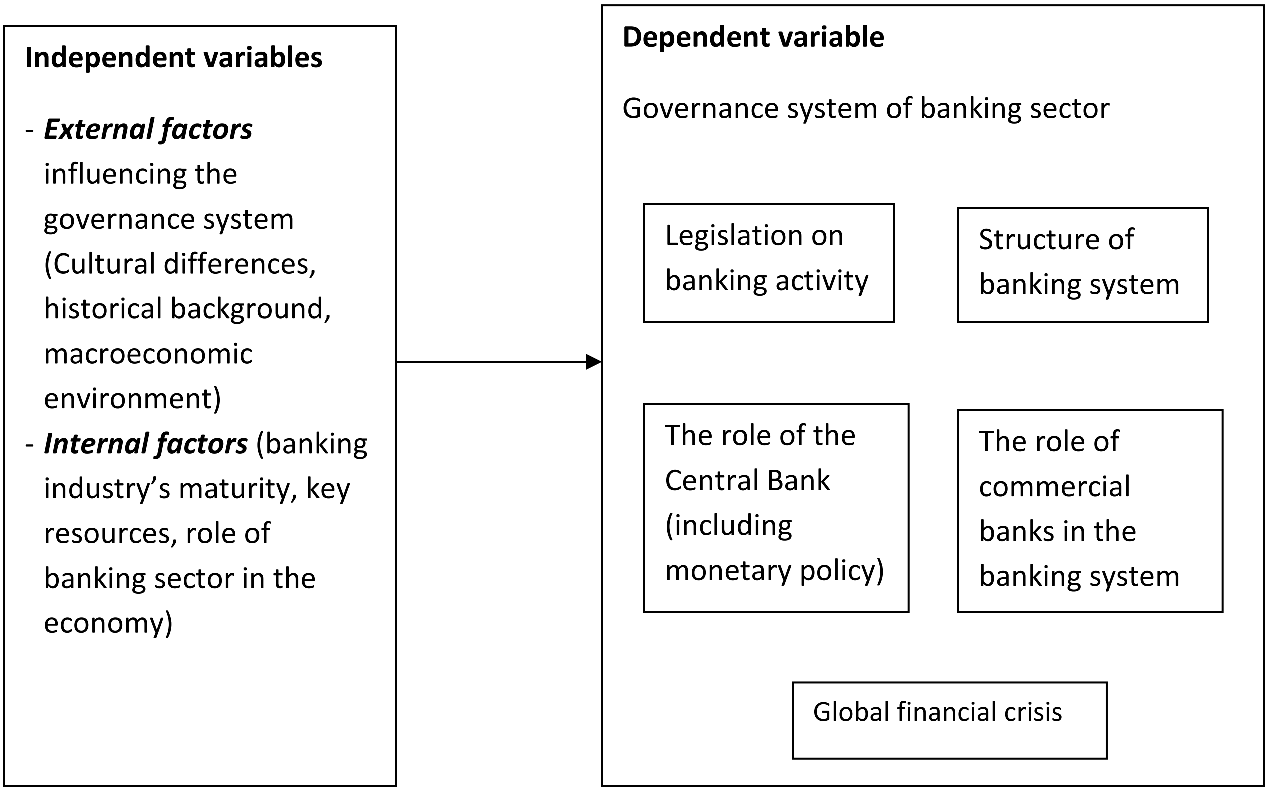

Figure 1. Research model

This model can be explained in the following way. External and internal factors influence the development of the governance system of the banking sector. They are independent variables in the model. The external factors are related to the environmental factors which have an impact on the governance system. In this research they are cultural differences of nations, historical background of the development of each banking system, macroeconomic environment. The internal factors are concerned with what influences the governance system inside of the banking system. In this case they are banking industry's maturity and size, key resources, role of banking sector in the economy. Of course, there are many other factors influencing the governance system, but in this research limited number of factors were considered.

The external and internal factors have an impact on the current state of the governance systems in the European Union and in Russia. Therefore, the dependent variable is the governance system of banking sector. The governance system of the banking sector has several aspects which are analyzed in this research. They are structure of the banking system, legislation on banking activity, the role of the Central Bank and the role of the commercial banks. The analysis of these four aspects gives us a picture of the current state of each governance system of the European and Russian banking sectors. It should be mentioned that the global financial crisis is a topical problem now. Therefore, the current situation and the measures taken by the governance systems to avoid and to prevent the adverse consequences of the global financial crisis are considered in the research.

Based on the analysis of the current state of governance system in Russia and in Europe a SWOT analysis of banking sector is conducted. The SWOT analysis helps us to show which strengths and weaknesses each governance system actually has. On the basis of analysis of the current state of governance system and on the SWOT analysis the benchmarking of the governance systems of Russia and Europe is made. The recommendations for improvement of the governance system of the banking sector in Russia and Europe will be the result of benchmarking.

1.2.5 Research framework

The research framework defines the categories of outputs that this research can produce. It also defines a set of different research activities. It indicates how the research will be accomplished.

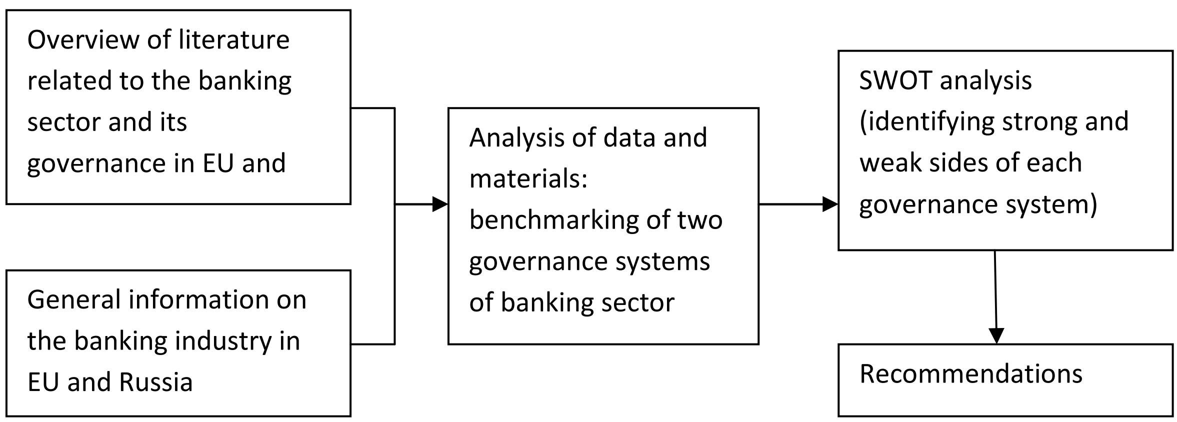

Figure 2. Research framework

This research based on the theoretical sources, and there is no empirical part in the research framework. The theoretical part of research is based on two types of sources:

literature related to the banking sector and its governance in EU and Russia (articles, publications, etc.) and sources providing the general information on the banking industry in EU and Russia (statistics, bulletins, etc.) After studying the literature the current state of the governance systems of the European and Russian banking sector will be analysed and interpreted. This leads to conclusions on the research problem and recommendations concerning the improvement of the governance systems of both banking sectors based on the experience of each other.

1.2.6 Research questions

Research questions are questions to guide the research and for which the research is designed to answer. The general research question relate to the knowledge that is relevant for gaining the goal of research. Answers on the special research questions help to find an answer on the general research question.

General research question:

What can be learnt by European and Russian governance systems of the banking sectors to avoid weaknesses of both and improve them?

Specific research questions:

1. What is the governance system of the banking sector?
2. Which factors influence the development of the governance system of the banking sector in Russia and in European Union?
3. What is the present governance system of the banking sector in Russia and in the European Union?
   - What are the strengths and weaknesses of the governance system of the Russian banking sector?
   - What are the strengths and weaknesses of the governance system of the European banking sector?
4. How is it possible to avoid weaknesses of the governance systems of the European and Russian banking sectors based on their benchmarking?

1.2.7 Methodology of research

This kind of research is analytical and has a theoretical value. Actually the subject of the research concerns the European Central Bank and the Central Bank of Russian Federation and all commercial banks in the EU and Russia which are also involved in the international banking context.

The methodology is the systematic study of methods that are, can be, or have been applied within a discipline. It includes the methods, procedures, and techniques used to collect and analyze information.

The method used in this paper is a comparative research which can help the researcher to ascend from the initial level of exploratory case studies to a more advanced level of general theoretical models.

Articles related to the governance of the banking system and the governance of the banking organization and regulatory documents concerning the banking legislation and standards in the EU and Russia are used in the research.

1.2.8 Results of research

The expected result of research is to define managerial implications and give recommendations which could be used as a basis for developing rules for the governance of the banking system. These rules should be unified and include guidelines and recommendations concerning the decision-making of commercial banks. These guidelines will be inferred from investigation of Russian and European banking systems and determining the best practices in both bank governance approaches. As a possible consequence of applying these recommendations, the governance and the performance of both banking sectors could be improved.

Chapter 2. Governance system of the banking sector. Theoretical overview.

2.1 Definition

The governance system of the banking sector is an integrated part of the regulation system of the financial sector. The term “governance” is closely related to the “supervision and regulation”. According to Institute of Internal Auditors governance is “the combination of processes and structures implemented by the board to inform, direct, manage, and monitor the activities of the organization toward the achievement of its objectives”[3]. Therefore the governance system means a structure which conducts the governance. The governance system contains the elements which are proceeding and executing the governance. They are institutes which have functions to supervise, to regulate and to control. They form an institutional structure of the governance system.

In particular in the banking sector the aim of governance is to allocate and regulate capital resources in an efficient way and without imposing unnecessary costs and control banking activity in the economy for gaining or maintaining financial stability. The definition of the financial stability is following: “Financial stability is a condition in which an economy’s mechanisms for pricing, allocating, and managing financial risks (credit, liquidity, counterparty, market, etc.) are functioning well enough to contribute to the performance of the economy” (Schinasi, 2004). Thus the definition of the governance system of the banking sector is following:

The governance system of the banking sector is a set of institutions and structures of authority to allocate and regulate capital resources and control banking activity for maintaining financial stability.

The governance of the banking sector is necessary for monetary and financial stability, for establishment and development of efficient and competitive financial system, for protection of depositors and investors.

[3] http://www.theiia.org/guidance/standards-and-guidance/ippf/standards/full-standards/?i=8317

2.2 Institutional structure of the governance system of the banking sector

The institutional structure refers to issues related to the number and structure of agencies responsible for the regulation and supervision of banking sector and market. The main institute, or regulatory agency, is a central bank. It plays an important role in banking regulation and supervision. In the vast majority of countries the central bank is the main regulatory agency concerning banking governance. However, it is not universal; for example, in the UK in 1997 the responsibility for the supervision of banks was taken away from the Bank of England and vested, along with all other regulation of financial institutions and markets, in the Financial Services Authority (FSA) (Llewellyn, 2006).

The institutional structure financial regulation and supervision, and in particular the governance system of the banking sector, depends on national differences of each countries, for instance historical evolution, political structures, traditions, size of the country and size of the financial, in particular the banking, sector (Llewellyn, 2006).

There are several types of the governance system of the banking sector. The arrangement of the governance system depends on the institutional structure of the regulation and supervision of the financial sector as a whole, because banking sector is its integrated part.

- Separate regulatory and supervisory institute for banking, as well as for capital markets and investment services, and for supplementary pension insurance (Zimkova, 2006). In this case the Central Bank is responsible only for banking sector of the financial system. Each single segment of the financial market) and are assigned to a distinct agency for the entire complex of activities. In this regulatory model, which follows the old segmentation of the financial system into three markets, we thus have three regulatory and supervisory authorities dealing with, respectively, banks, financial intermediaries and mutual funds, and insurance companies (Giorgio, 2005).
- Partial integration of supervision, for example the linking of banking supervision with regulation and supervision of the insurance market or the “two-pillar system”. The "two-pillar system" takes place when the central bank regulates and supervises banks, and another independent institution regulates and supervises non-banking financial institutions and the capital market (Zimkova, 2006).

- Single institution supervising all the core financial services, including banking and the capital markets (Zimkova, 2006). In some cases it is the Central Bank (e.g. the Singaporean Model, in which the central bank is also the super regulator)[4], however, there are cases when another agency is responsible for all financial system, and the Central Bank plays relatively insignificant role in the financial regulation and supervision.

Four areas of regulation and supervision are identified which could be accommodated within an institutional structure of the governance system of the banking sector (Llewellyn, 2006).

1. Prudential regulation. It is focussing on the safety and soundness of individual financial institutes, for example commercial banks.
2. Systemic regulation and supervision designed to oversee the stability of the financial system as a whole and most especially the banking and payment system.
3. Consumer protection focussed on conduct-of-business arrangements designed to protect the consumer from factors such as incomplete information, bad practices by financial firms, unfair practices, etc.
4. Competition. This area of regulation designed to ensure that there is an appropriate degree of competition in the financial system and that anti-competitive practices by financial firms are abandoned.

Based on this classification of areas of financial regulation and supervision, it is possible to develop the functional typology of the governance systems of the banking sector. The governance system of the banking sector could perform only systemic regulation of the financial system. In many cases it is usual practice of the Central bank. Sometimes the Central bank is responsible not only for systemic regulation, but for the prudential regulation and supervision. In case when the Central Bank is a single authority regulating the financial system all this area are under Central bank's umbrella.

Here is several illustrations of the different governance systems of the banking sector. James R. Barth, Gerard Caprio, Jr., and Ross Levine conducted two surveys to assemble international databases on banking policies. The first survey was conducted from 1998 to 1999. It covered slightly more than 100 countries and included information on almost 200 regulations

[4] http://www.drnarendrajadhav.info/drnjadhav_web_files/speeches/Single%20versus%20Multiple%20Regulator.pdf page 12

and supervisory practices. The second survey was conducted from 2003 to 2004, and covered an additional 50 countries and included another 100 questions. They use these datasets to compare and contrast banking sector policies across countries and to examine which policies work best to promote sound banking around the world (Barth et al, 2005).

This database provides information on the regulatory structure and practices that are used to monitor and control bank behaviour. As regards structure, only 26 countries, including the United States, assign banking regulation to multiple authorities. The remaining 126 countries have a single regulatory authority, with the central bank being that authority in slightly more than half of these countries. In 118 countries the regulatory authorities can forebear certain prudential regulations regarding bank restructuring and reorganization. 55 of 150 countries, including Argentina and Brazil, hold their regulators legally liable for their actions. The remaining 95 countries (including the United Kingdom and the United States) do not allow this practice (Barth et al, 2005).

The review of international experience indicates a wide variety of institutional structures. (see Goodhart, et al., 1998 in Llewellyn, 2006). Some countries have created a single agency for prudential supervision, while others have opted for multiple agencies. Some have also created unified agencies. It is argued below that there is a spectrum of alternatives rather than an either/or choice, and there is considerable variety within the spectrum and even within the same basic model (Llewellyn, 2006).

2.3 Objectives of the governance system of the banking sector

For the governance system of the banking sector to be effective, it is necessary to have clearly defined objectives of banking sector's governance. In respect that different institutional structures are possible according to national specifics of each country, different priorities of the banking sector's governance can be defined. The most usual goals are:

- The pursuit of financial stability. Safeguarding of the macro-stability of the system translates into macro-controls over the stability of the financial system as a whole, and over financial exchanges (Giorgio, 2005). Ideally, bank regulation should thus keep fluctuations in business activity and problems at individual banks from interrupting the flow of transactions across the economy and threatening public confidence in the banking system (Spong, 2000). This goal is set when the Central bank supervise and regulate not only banking sector, when its functions have a wide range;

- Prudential supervision. It means the supervision/regulation of institutions such as banks, building societies and friendly societies where the supervising authority seeks to ensure that the depositors are protected by the institution in question being financially sound[5].
- Transparency of banking market. At the macro level, transparency rules impose equal treatment and the correct dissemination of information. At the micro level, such rules aim at non-discrimination in relationships among intermediaries and different customers (conduct of business rules) (Giorgio, 2005).
- Regulation of banking sector should also target efficiency, which may be defined as the safeguarding and promotion of competition in the financial sector, in particular in the banking sector (Giorgio, 2005).

2.4 Poor and good governance. Prudential supervision. Core Principles for Effective Banking Supervision

The evaluation of a quality of the governance leads us to the issue what good governance and poor governance are.

Poor governance of the banking sector impedes achieving the goal of the price stability. The sources of poor governance could be extreme circumstances, such as political, ethnical or religious conflicts, etc. The social inequality and tension, excessive control and monopoly power of government, lack of transparency also would be reasons of the poor governance. Under poor governance substantial parts of the benefits are diverted against the will of the producers and distributed among people who did not contribute to their production and, hence, the producers will reduce their efforts after a certain period of time. (Wagener, 2004). The task of the central bank and the government is to find a solution for those problems of banking sector which caused its poor governance.

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[5] http://www.finance-glossary.com/define/prudential-supervision/1188/0/P

The key elements of good governance are accountability, transparency, combing corruption and enabling legal framework (Agere, 2000). It is a general approach to the defining content of good governance, but it could be applied in the narrow sense of the governance of the banking system So the governance of the banking system is good when it is transparent, accountable, corruption is unacceptable, and there is an appropriate legal basis for governance.

Accountability focuses on the ability to account for the allocation, use and control, for example, budgeting, accounting, and auditing. Transparency is defined as public knowledge of the policies of government and confidence in its intentions.

Combating corruption is a key indicator off commitment to good governance. Corruption is defined as the abuse of public office of public trust for private gains. Corruption erodes the authority and effectiveness of public institutions. However, improvements in the effectiveness and transparency of economic policies and administrative reform can contribute powerfully to the fight against corruption as well as enhance good governance (Agere, 2000).

A pro-governance and pro-development legal system is one which laws are clear and are uniformly applied through an objective and independent judiciary.

The good governance of the banking sector realises through the prudential regulation. The prudential supervision involves government regulation and monitoring of the banking system to ensure its safety and soundness. Supervising prudentially the government establishes regulations to reduce risk taking and then supervisors monitor banks to see that they are complying with these regulations and not taking an excessive risk. Prudential regulation is needed to ensure the safety and soundness of the banking system (Mishkin, 2001).

According to Mishkin (2001) prudential supervision takes on following basic forms:

- Restrictions on asset holding and activities. Governments impose banking regulation that restrict banks from holding risky assets and these restrictions are a direct means of making banks avoid much risk;
- Separation of the banking and other financial service industries such as securities, insurance, etc.;
- Restriction on competition. Increased competition can increase moral hazard incentives for banks to take on more risk. These regulations have taken following forms: regulations separating banking and non-banking business; restriction on entry foreign banks; restriction on branching; ceiling on rates charged on loans or ceiling on rates charged on

deposits. However, the restrictions on competition have obvious serious disadvantages. They can lead to high prices and can decrease the efficiency of banks, which do not have to compete as hard;

- Capital requirements. When a bank is forced to hold a large amount of equity capital, the bank has more to lose if it fails and is thus more likely to pursue less risky activities;
- Risk-based deposit insurance premiums. Premium for the insurance provided by the government were priced appropriately to reflect the amount of risk taken by a bank. The higher capital adequacy is and the better the bank’s supervisory rating is, the lower its insurance;
- Disclosure requirements. More public information about the risks incurred by banks and the quality of their portfolio can enhance market discipline. Stockholders, creditors, depositors become able to evaluate and monitor banks and act as a deterrent to high risk taking;
- Bank chartering. Through chartering, proposals for new banks are screened to prevent undesirable people from controlling them;
- Bank examination. Banks must be monitored to see if they are complying with these regulations. Banks are required to file periodic reports that contain such information as the bank’s assets and liabilities, income, dividends, ownership, foreign exchange operations.

As a standard for quality of banking governance systems we considered governance according to 25 Basel Core Principles for Effective Banking Supervision (see Appendix 1). Since the introduction of BCP, these principles have come to be regarded as the global standards for the quality of countries’ banking governance systems.

The Basel Committee on Banking Supervision (BCBS) was created in 1974. The Basel Core Principles for Effective Banking Supervision (henceforth referred to as BCPs) were issued by the BCBS in September 1997. The BCPs serve only as a benchmark against which the effectiveness of banking supervision regimes can be assessed and is not binding or enforceable. The BCPs comprise twenty five basic Principles for effective supervisory system. According to the BCBS, they fall under the following categories: (1) objectives, autonomy, powers, and resources of the supervisory body; (2) licensing and structure of banks; (3) prudential regulations and requirements for banks; (4) methods of ongoing banking supervision; (5)

information requirements for banks; (6) remedial measures; and (7) cross-border banking[6]. (For full list of principles see Appendix 1).

These principles have been used by the IMF and World Bank as the standard against which banking systems of member countries are assessed, and they are a key element of the Financial Sector Assessment Program and the Reports on Observance of Standards and Codes.

However, these principles are not a guarantee of the good governance. There is a relatively high degree of compliance in the principles related to the legal and institutional framework for supervision and the authorization and conduct of banking business. Notwithstanding, in this paper the Core Principles are considered as a standard.

2.5 Summary

To sum up, the governance system of the banking sector is a part of the financial regulation and supervision. The governance system of the banking sector defines as a set of institutions and structures of authority to allocate and regulate capital resources and control banking activity. Thus the governance system has its own institutional structure, which includes regulatory agencies with functions to regulate, supervise and control the banking sector and market.

The governance system depends on the structure of the regulation of the financial system. The specifics of the institutional structure of the governance system of the banking sector caused by the national differences such as historical evolution, the structure of the financial system, political structures and traditions, the size of country and the size of the banking sector. There are many alternatives for the arrangement of the governance system of the banking sector. Each country has its own model of the governance driven by its specific approach to govern, which was developed for a long time.

The objectives of the governance system of the banking sector includes the financial stability, prudential supervision, transparency of banking market, efficiency of banks' activities.

The evaluation of a quality of the governance leads us to the issue what good governance and poor governance are. Poor governance of the banking sector retards achieving goal of the price stability. Under poor governance substantial parts of the benefits are diverted

[6] http://www.estandardsforum.org/about_standards/core-principles-for-effective-banking-supervision

against the will of the producers and distributed among people who did not contribute to their production and, hence, the producers will reduce their efforts after a certain period of time. (Wagener, 2004). The key elements of good governance are accountability, transparency, combing corruption and enabling legal framework (Agere, 2000). The governance of the banking system is good when it is transparent, accountable, corruption is unacceptable, and there is an appropriate legal basis for governance.

The prudential regulation is a necessary part of the good governance of the banking sector. The prudential supervision involves government regulation and monitoring of the banking system to ensure its safety and soundness. Supervising prudentially the government establishes regulations to reduce risk taking and then supervisors monitor banks to see that they are complying with these regulations and not taking an excessive risk. According to Mishkin (2001) prudential supervision takes on following basic forms: restrictions on asset holding and activities, separation of the banking and other financial service industries such as securities, insurance, etc., restriction on competition, capital requirements, risk-based deposit insurance premiums, disclosure requirements, bank chartering, bank examination.

As a standard for quality of banking governance systems we considered a governance according to 25 Basel Core Principles for Effective Banking Supervision (see Appendix 1). Since the introduction of BCP, these principles have come to be regarded as the global standards for the quality of countries' banking governance systems. According to the BCBS, they fall under the following categories: (1) objectives, autonomy, powers, and resources of the supervisory body; (2) licensing and structure of banks; (3) prudential regulations and requirements for banks; (4) methods of ongoing banking supervision; (5) information requirements for banks; (6) remedial measures; and (7) cross-border banking.

However, these principles are not a guarantee of the good governance. There is a relatively high degree of compliance in the principles related to the legal and institutional framework for supervision and the authorization and conduct of banking business. Notwithstanding, in this paper the Core Principles are considered as a standard.

Chapter 3. Factors influencing the governance system of the Russian and European banking sectors

3.1 Introduction

In this chapter we consider factors which have influenced the formation of the governance system of the Russian and European banking sectors. This chapter is devoted to answer the specific research question “Which factors influenced on the development of the governance system of the banking sector in Russia and in European Union?” and help to answer other research questions.

The independent variables in the research model (see 1.2.4) are related to external and internal factors impacting on the current state of the governance system of the banking sectors of Russia and the EU.

The external factors are the factors which are related to the environment in which banking sector exists. They include a culture of the nations and the historical development of Russian and European banking sectors, macroeconomic environment.

The internal factors influencing the governance system of the Russian and European banking sectors are concerned what influences the governance system inside of the banking system. In this case they are banking industry’s size, level of development, key resources, and role of banking sector in the economy. Of course there are many other factors which have an influence on the development of the governance system, but in this research we focus mainly on these factors.

3.2 External factors influencing the governance system of the Russian and European banking sectors

3.2.1 Cultural difference of Russia and Europe and their impact on the governance system

Culture and economic development of countries are interrelated. The relationship between culture and economic development is extremely complex. On the one hand it is supposed that economic development brings pervasive cultural changes. On the other hand cultural values are an enduring and autonomous influence society; so they influence the economic changes. For this research it is important to recognise that there is a strong relation between cultural values of a nation and economic development. We are investigating the governance system of the banking sector as a specific field of research. Both banking systems, Russian and European, are quite young, so it is not relevant for us to suppose that changes in banking sector could have some influence on the extended process of evolution of cultural values. Therefore, we assume that the cultural factors have had a significant impact on the development of the governance system of the banking sector.

Russia and Europe have a different historical backgrounds, different cultural values, mentality, etc., which play an important role in the economic development of these two regions, especially on the governance systems. The comparison of two different cultures using Hofstede framework (Hofstede, 2001) is one of the factors on which our benchmarking of Russian and European governance systems is based. The different styles of governance have historical and cultural background. Mentality of a nation has a great impact on the process of decision making. Hofstede (2001) formulated four national dimensions (or social values):

- Individualism vs. collectivism – This dimension measures how much members of the culture define themselves apart from their group memberships;
- Low vs. high power distance – This dimension measures how much the less powerful members of institutions and organizations expect and accept that power is distributed unequally. It measures rather the way people perceive power differences;
- Low vs. high uncertainty avoidance – This dimension measures how much members of a society attempt to cope with anxiety by minimizing uncertainty. It is a degree to which society is uncomfortable with ambiguity and uncertain future;
- Masculinity vs. femininity – the extent to which gender roles are differentiated and performance. This dimension measures the value placed on traditionally male or female values (Hofstede, 2001).

Hofstede conducted the study of how values in the workplace are influenced by culture (Hofstede, 2001). A mentality of culture is one of the characteristics of each nation that is essential for understanding current state of governance system. Russians have a different view on the same things compared to Europeans. The main feature of the Russian mentality is that it has a binary nature: Russians are contradictory in their values (White, 2005). There are many examples from the Russian history that could be a good evidence of this statement (such as the division of faith, dual-power, etc.). On the one hand Russians have a negative attitude towards laws and power. On the other hand they need to be dependent – the Russian society is looking for some higher power to keep it in order. The contradiction of cultural values is undoubtedly the result of the "boundary" geo-political position of Russia between the East and the West and has been acquired over many centuries of collisions and mutual penetrations of the features of both sides (White, 2005).

The 70-years Soviet period has played its role in the evolution of cultural values of Russians. It explains the strong collectivism of Russian nation which is the result of a tradition of communal self-government with an ethic of equality in sharing scarce resources and the necessity of mutual interdependence for protection against a hostile environment and despotic rules. So the communistic ideology is still popular in Russia. At the same time the individualism of Russians is well developed, they have a high motivation for gaining personal goals by any ways. It explains with the survival instinct and a reaction to a prolonged and extreme suppression.

The Power Distance Index (PDI) in Russia is one of the highest in the world (see Appendix 2). Also the high score of PDI is in Arabic speaking countries, China, India (Hofstede, 2001). In Russia several features may be observed which are common for countries with high power distance. For instance, open demonstration of rank by authorities, underestimation of subordinates, close relationships between boss and subordinate, class division within society, etc. All these features are observable in Russian culture more or less, especially in governance culture, because governance and management is closely related with power relationships (White, 2005).

The collectivism/individualism and the level of power distance are closely related with the cultural autonomy. Cultural autonomy defines people as bounded entities who should be encouraged to cultivate their unique ideas and feelings. In high autonomy cultures, individuals need the law as a transparent, a-contextual source of guidance (Licht et al, 2007). In Europe the cultural autonomy is higher than in Russia, which is explained by the fact that the current socio-economic arrangement has established earlier in Europe than in Russia and the development had a systemic character, while the Russian way of the socio-economic development was changed several times. Thus the modern mentality and self-awareness of Europeans was cultivated for centuries, and Russians had to be adapt to the fast-changing environment.

The femininity of Russians is a result of the mutual interdependence required to cope with a hostile environment, which made important the cultivation and maintenance of close relationships that could be profitable (score is in Appendix 2).

The Russian nation is characterized also with strong uncertainty avoidance, which is a result of frequent foreign invasions and aggression, high-pressure environment, absence of social mobility, suppression of individual initiative, ambitions and freedom by the communal system and harsh autocratic rules. It reflects in anxiety and lack of stability of Russians' attitudes and values (Hofstede, 2001).

However, there are many specifics concerning the economic behaviour of Russians which will be relevant for this research such as a low level of rationality, an opportunistic behaviour of counterparties, an investment myopia (the present financial flows are more preferable than future) in making investment decisions, a low personal responsibility, and behavioural dependency (White, 2005). As a result most decisions made by managers with usual Russian mentality lead to the ineffective distribution of resources on the micro-level, and low investments in assets and human resources, which is a reason of technological stagnation. Another notable feature of Russian culture is a total expansion of bureaucracy into all spheres of social life. The state controls every move and step of its citizens directly or indirectly. The immense bureaucratic machine dictates life in Russia, which stems from communism period. It also influences the Russian governance style.

We considered the main features of Russian culture which are relevant for the research. Undoubtedly Europeans have differences in their cultural values comparing with Russia. Most European countries encompass a number of cultures within European Union' borders. Europe includes many countries with their own cultural uniqueness and historical background. This cultural diversity has hampered past attempts to unify Europe (Dodor, 2007). At this moment the European Union consists of 27 Member States located primary in Europe region. All together they form an economic union with a standardised system of laws which apply in all member states, ensuring the free movement of people, goods, services, and capital. Of course, each Member State has its own autonomy, with national legislation and governance.

European values were defined by the EU in the Copenhagen criteria of 1993 as "stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities", as well as the "existence of a functioning market economy" and the "capacity to cope with competitive pressure and market forces within the Union" (ECB, 2009a).

The Amsterdam treaty of 1997 made clear that “any European country which respects the principles set out in Article F(1) – liberty, democracy, respect for human rights and fundamental freedoms, and the rule of law – was eligible to apply to become a member of the European Union” (European Commission, homepage. www.ecb.int).

Hofstede (2001) examined the cultural differences of European countries. According to Hofstede’s framework concerning individualism-collectivism all countries were in the upper half of the individualism index with the exception of Portugal, Bulgaria, Romania and Greece (see Annex 1). So, Europeans are more individualistic, independent and egocentric than Russians. They feel themselves less members of a group, so they count more on their own strength. However, the Eastern Europe’s countries are close to Russians’ mentality (former socialistic countries), the westerner countries have the greater a difference between Russian and European mentality than eastern (Diliguenski, 2000).

The power distance index varies in different European countries, but it is lower than Russian PDI, except Slovakia (Hofstede, homepage. www.geert-hofstede.com). There is a low power distance culture in Europe, so we can propose that the following features are relevant for characterising the European mentality such as small distance between the boss and the subordinates, liberal democracy, etc.

With respect to masculinity and femininity, the Scandinavian countries, the Netherlands, and Portugal were decidedly feminine, with France and Spain moderately so. Czech Republic, Belgium and Greece were slightly masculine, with Austria, Switzerland, Italy, Ireland, UK, Hungary, Poland and Germany more masculine (see Appendix 2).

To sum up we can conclude that there are consistent and often substantial differences in culture and mentality between Russians and EU-citizens. Russians bias towards collectivism more than Europeans. They have stronger uncertainty avoidance. The power distance in Russia is much higher than in Europe. All of these differences cause the difference in governance systems. The cultural background plays a significant role in the evolution of the governance system. Licht A.N. et al (2007) conducted a research concerning the casual relationships between national culture and governance. The general hypothesis was that, in the long run, widespread modes of wielding power (governance) should be conceptually consistent with the prevailing cultural orientations in a society (Williamson, 2000; Roland, 2004 in Licht et al, 2007, p.663). As a result of their research Licht et al. (2007) document a substantial influence of cultural orientations on governance.

3.2.2 Historical background. Development of modern banking system in Russia and European Union

3.2.2.1 Russia

The historical background of the banking sector of a country plays an important role in explaining the governance system of banking sector, because it shows how the current system was built and developed.

The history of the modern Russian banking system is quite short, but intensive. The dynamic of changes in the financial sector of the economy varies from sharp fall to steady growth. There are stages in the establishment of the modern two-tier banking system of Russia according to Murychev (Murychev, 2007)

The first stage (the end of the 1980s-1992) started from the reforms in the banking sector in the end of the 1980s which took place in the framework of Perestroika. After the collapse of the Soviet Union Russia's financial sector, in particular its banking system, has been one of the fastest changing elements of the economy (Murychev, 2007).

The reason for rapid growth of the banking sector of Russia was that it provided numerous opportunities to make a significant profit. There are certain circumstances in Russia in the beginning 1990s which made the banking sector very profitable (Murychev, 2007):

1. Shortage of banking services in Russia, while a number of private business entities were increasing rapidly. The simplest operations, such as opening of bank account or transactions, were problematical for clients, but profitable for banks which could supply these services;
2. High inflation in the early 1990s and existing mechanism of fixing interest rates on borrowed funds which was not tied to inflation;
3. Liberal banking legislation in Russia in the 1990s, which did not provide for direct control over interest rates that banks offered on deposits and charged for loans;
4. Redistribution of the centralized loans that was very profitable for banks which were involved in this process.

The formation of non-governmental financial and credit structures reached a peak in late 1991 following the commercialization of state banks and the emergence of private banks (Murychev, 2007).

The Russian banking system has developed from a highly centralized system of the Soviet period into a two-tier system. The first tier is represented by state-owned banks and banks where the state has blocking package of stock or more. The second tier is represented by private commercial banks where the state' package of stock is either below the blocking package or non-existent.

The centralisation of banking sector in Russia is still high, because the first tier of the banking system has the actual power. It is represented by state-owned banks and banks where the state has a blocking package of stock or more. The second tier is represented by private commercial banks where the state' package of stock is either below the blocking package or non-existent (CBR, homepage. www.cbr.ru). That is the standard structure in market-based economies, but there are specifics in the Russian banking system. As we have seen high centralisation and high power distance have had an influence on the structures which have been created.

The second stage took place from 1992 till the beginning of the 2000s (Murychev, 2007). It should be mentioned that the Russian banking system developed in 1992-1998 under the unfavourable macroeconomic conditions, including political and social instability, continuous decline in production and high inflation (Vernikov, 2007b). The banking crisis was an inseparable component of the system's financial crisis which occurred in 1998. The macroeconomic situation in the early 1990s was characterized by extremely high inflation rates and thus, negative real interest rates (Vernikov, 2007b).

The major part of the Russian commercial banks was inefficient (compared with their foreign competitors) and could exist only under conditions of the high profitability of banking operations. Banking profits were gained by delays in the transfer of the client's funds and extremely high yields of the federal bonds, external debt and sharp rouble rate depreciation. As a consequence the commercial banks were on the eve of bankruptcy along with a sharp cut of volume of household's deposits. Russian households and the foreign investors faced a large scale of losses, the financial markets were depressed (Vernikov, 2007b).

The crisis in August 1998 in Russia was the overall financial crisis by its nature, including the foreign debt payments, foreign currencies, banking and financial market crises. As a result of payments on public and private external debts had been temporary frozen, the sharp depreciation of the rouble rate was observed (Murychev, 2005). In August, 1998, the Russian authorities unilaterally declared a moratorium on all rouble-denominated public debt, froze for a three-month period all foreign obligations of the domestic banking sector; this amounted to a de facto complete default by the government and the banking system. The rouble rapidly lost two third of its value vis-a-vis the dollar, while a dramatic liquidity crisis and massive bank runs ensued (Perotti, 2001).

The most remarkable features of the Russian crisis is that it occurred due to the several factors demonstrated by currency crisis: a deterioration of fundamentals, multiple equilibria and self-fulfilled expectations, herding behaviour, financial liberalisation and asset market contagion (Gunji, 2002).

Directly after the system financial crisis in August 1998 the further development of the Russian banking system continued with a state invasion into financial sector of Russian economy to recover it. The first features of the recovery appeared only in the middle of 2002 compare with the 1998 (pre-crisis level).

We suppose that the *third stage* lasted from the beginning of the 2000s till 2008. The banking system's recovery through their own resources under governmental control gave positive results as the recovery of all the key indicators of the banking system compared with the per-crisis level (Vernikov, 2007b).

The fundamental indicators of the Russian economy have been strongly positive during five years after 1998. The growth rates of the produced GDP, industrial production, capital investments have been positive in the real terms, the rouble exchange rate has been stable, the federal budget surplus had been fixed and the inflation rates fell (Murychev, 2005).

In fact the state invasion into banking system was executed under the limited financial resources for the systemic banking reform. The government of the Russian Federation (RF) got under control the key financial flows in the two key sectors of the banking system: households' deposits as the cheapest banking liabilities and export revenues as the significant part of the enterprises' and budgets' revenues. At the same time Russian government spent limited financial resources for banking reform. In this situation the banking sector of Russia was in an unfavourable situation: in spite of the full recovery of the banking transactions the total banking capital was on the relatively low level along with a high level of the different kind of the financial risks. The volume of the banking loans to the real sectors has been grown during the post-crisis period, but not sufficient for the sustainable growth (Murychev, 2005).

As we can see, the history of modern banking system in Russia is quite dynamic. During the last 20 years the Russian banking sector suffered from a deep financial crisis (in 1998), the government’s policy concerning the regulation of financial sector was changed several times from liberal (in the beginning of 1990s) to very strict regulation and supervision (after 1998). These changes had an impact on the development of governance system of Russian banking sector. It formed the specific governance culture in the Russian financial sector.

The financial crisis 1998 gave a Russian financial sector and economy as a whole the experience which could be useful under conditions of the global financial crisis. The lessons learnt from 1998 crisis could be relevant for bank supervision and international stability. Gaidar (1999) drew a number of lessons from the Russian experience:

- If the socialist economy no longer functions, the government should try to disinflate as rapidly as possible. A delayed disinflation will be much more painful.
- If the government is confronted with delayed disinflation, it should cut budget deficits radically.
- The illusion of being able to finance the deficit out of a short-term portfolio should be abandoned.
- Consideration should be given to the vulnerability of the exchange rate regime to changes in commodity prices.
- It should be understood that hardening the budget constraint is important not only for raising budget revenues but also for allowing market mechanisms to work and thus for increasing the efficiency of the economy.

Gunji (2002) considers two possible implications of the 1998 Russian financial crisis. First, it is important to keep the international liquidity ratio low in order to avoid a self-fulfilling crisis. The phenomenon of self-fulfilling crisis is when the decision depends on the inflationary expectations of economic agents. A continuous deterioration of fundamentals and especially international liquidity makes it difficult for a government to peg the exchange rate. Asymmetric information can lead to multiple equlibria, in which nobody knows when a bad equilibrium may occur. Second, it is necessary for emerging markets to control capital inflows. In Russia’s case, the rapid sale of short-term sovereign bonds and stocks by non-residents triggered the crisis.

As we can see the main lesson of the 1998 financial crisis is that the regulation and supervision should be done prudentially. The specific steps how to avoid and prevent financial crisis depends on the certain situation, but the lessons of the 1998 Russian crisis could be useful to define possible failures and to avoid them. Prevention is much less painful than cure.

3.2.2.2 European Union

During the last 20 years forces such as globalisation, technological change, and European integration have fundamentally transformed the European banking sector (Goddard, 2007). The realisation of European Economic and Monetary Union (EMU) at the end of the 20th century, as a part of European integration, was unique in that it introduced a new monetary regime with a single currency for a large part of Europe. It meant a new level of cooperation among the Member States. The establishment of a new supranational monetary organisation, the ECB, and the integration of NCBs into a European central banking system, the ESCB, and its sub-set, the Eurosystem, are representative of the new level of integration of European central banking (Kindleberger, 1984).

The first steps to the start of the integration process in Europe took place after the Second World War. The important step towards European integration was made with signing the Treaty of Rome in 1957. Its signatories established a common market, approximated their economic policies, and forced closer relationships accepting the Treaty (Barbour, 1996).

In 1978-1979 the proposal for a European Monetary System (EMS) was put forward. And in March, 1979 the EMS came into being. All EC members apart United Kingdom became linked to the Exchange Rate Mechanism, which allowed a ±2.25 % band of fluctuation among currencies. In addition, The European Currency Unit (ECU) was created, representing a basket of currencies (a weighted average) of the countries which were members of EMS (Barbour, 1996).

Then during 1980s the preparation for prospect integration was conducted actively. For instance, the Single European Act (SEA) launching the European Union's internal market program and the Maastricht Treaty – aiming to create a single currency by 1999 the latest – were initiated in the early 1980s.

The EU Finance Ministers decided in 1988 to liberalise capital movements by July 1, 1990, with some exemptions until 1994 for the poorer countries. At the European Council meeting in Hannover the heads of governments agreed to establish a committee to study the possibilities for a monetary union. There are three initiatives that formed a broader strategy pursued to advance the EU towards political union. They were: 1) completing the internal market; 2) liberalisation of capital movements; 3) monetary union. The 1989 Delors Report led to the negotiations for the Treaty on the European Union and amended the Treaty establishing the European Committee.

Progress towards Economic and Monetary Union (EMU) in Europe took place in three stages. The first stage (1990-1993) was characterised by the full achievement of a single European market, through the dismantling of all internal barriers to the free movement of persons, goods, capital, and services within Europe. However, the full integration is impossible because of the economic conditions, culture, language and differences in legal systems of Member States (Scheller, 2006).

Stage two (1994-1998) started with the creation of the European Monetary Institute (EMI), and was dedicated to the technical preparations for a single currency, the avoidance of excessive deficits, and enhanced convergence of the economic and monetary policies of the Member States (to ensure stability of prices and sound public finances). The main tasks of EMI were to strengthen central bank cooperation and monetary policy coordination and to make the necessary preparations for establishing the ESCB, for the conduct of the single monetary policy and for creating a single currency in the third stage of EMU.

Stage three began in 1 January, 1999 with the irrevocable fixing of exchange rates, the transfer of monetary policy competence to the European Central Bank (ECB) and the introduction of the euro as the single currency. The introduction of the euro opened the way for the further deepening of banking sector integration (ECB, 2009a).

Against this background, the European financial sector made extensive preparations for operating in the integrated financial markets as from the start of Stage Three. The financial industry was itself interested in a rapid and comprehensive changeover of financial markets to the euro and no group of market participants wished to be left behind by its competitors. Financial market associations agreed on conventions for unifying market practices, and leading interest rate indicators were developed with the assistance of the EMI.

The introduction of the EMU reduces some of the competitive advantages of local and national banks (advantages which were based on factors like currency risk, lack of price transparency and greater knowledge of national monetary policy), but it also increases competition in all financial-product market segments. The structural changes due to the adoption of the single currency and a common monetary policy are exerting a profound impact on the Euro area finance sector and intensifying competition for banking services. The relationship between financial integration and economic growth is currently emphasised by authors like (Obstfeld and Taylor, 2003), being particularly relevant in the context of the new EU.

The governance system of European banking system was established in the last two decades. In this period there was a great challenge to integrate European countries on the economic and then the political basis. The development of a supranational governance system led to the creation of new institutions such as the European Central Bank, and a new legal framework which reflect a new level of integration. Under the integration processes in Europe the governance system of banking sectors has gained a new quality level, from the governance of the national banking sector to the governance of the banking sector of the European Union.

3.2.3 Macroeconomic environment of Russia and the European Union

Macroeconomic stability is a minimum and a necessary condition for the economic development. It is a precondition for attracting private investment. Stability enhances growth prospects, increases employment and incomes, etc. It is an important external factor which influences the banking sector and its governance system. The main macroeconomic indicators such as real GDP, gross domestic investments, gross domestic savings, consumer price index, money supply (M2), exchange rate are directly affect the situation in the financial sector of the economy, or more specifically on the banking sector.

The Russian economy has suffered from extremely unstable macroeconomic conditions during 1990s. Since 2000s the macroeconomic situation in Russia were stabilized by executing a set of reforms in financial sector. In the Table 1 a dynamic of the main macroeconomic indicators in Russia were represented.

Table 1

Dynamic of the main macroeconomic indicators in Russia

Annual percentage volume changes, unless otherwise indicated

	2000	2001	2002	2003	2004	2005	2006	2007
GDP	10.0	5.1	4.7	7.3	7.2	6.4	7.4	8.1
Gross fixed capital investments	17.4	10.0	2.8	12.5	13.7	10.9	16.7	21.1
Final consumptions expenditures	5.6	6.8	7.0	6.0	9.2	8.8	8.9	10.6
Annual consumer price index, inflation rate %[7]	20.2	18.6	15.1	12.0	11.7	10.9	9.0	11.9
Money supply (M2), billions rub. (billions €)[8]	1154.4 (44.2)	1612.6 (60.9)	2134.5 (64.5)	3212.6 (87.3)	4363.3 (115.4)	6044.7 (176.8)	8995.8 (259.24)	13272.1 (369.4)
International reserves, including gold, ml $ US	28.0	36.6	47.8	76.9	124.5	182.2	303.7	477.9
Reserves in the Stabilisation Fund, billions rub.	-	-	-	-	106.0	522.3	1237.0	2346.9

Source: Federal State Statistic Service. www.gks.ru

Table 2

Dynamic of the exchange rates, Rub/€

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Rub/€	26.14	26.49	33.11	36.82	37.81	34.19	34.70	35.93	45
Growth rate, %	-	1.3	25.0	11.2	2.7	-9.6	1.5	3.6	125

Source: Federal State Statistic Service. www.gks.ru

After the deep recession of 1998, annual growth rates between 2000 and 2007 averaged about seven per cent. Factors that supported Russia's growth in the years 2000 to 2008 included the substantial boost from the terms of trade, the very favorable environment in international capital markets, or the implicit subsidy to the Russian industry through discounted domestic energy prices, and the benefits of slack capacity following the 1998 recession (Berglof, 2009).

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[7] The annual Consumer Price Index is calculated by dividing the volume of

[8] To make the volume of money supply understandable and comparable there is the same indicator in euro in brackets calculated on the basis of Table 2

A stable macroeconomic environment and responsible fiscal policies in the period 2000–2008 created favorable conditions for financial development. Unlike in the 1990s even if the financial sector has not necessarily led economic growth it has undoubtedly supported economic growth during that period. Regulatory improvements and, more importantly, better enforcement combined with the rapid development of individual institutions provided much better conditions for sustained high economic growth. Yet, the liquidity problems in the wake of the global financial crisis in 2007 and 2008 highlight important vulnerabilities in the financial sector (Berglof, 2009). The situation concerning the global financial sector will be shows further, in subchapter 2.4.4.

In the European Union, after the introduction of a single currency, euro, the macroeconomic conditions were stable. The inflation rate was about 2%, which is targeted by the monetary policy of the European Central Bank. The real GDP had a stable growth rate, with declining in 2008 which is caused by the negative influence of the global financial crisis. Other macroeconomic indicators are relatively stable. In the Table 3 dynamic of the main macroeconomic indicators in European Union are shown.

Table 3

Dynamic of the main macroeconomic indicators in European Union

Percentage change on previous year, unless otherwise indicated

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Real GDP	3.9	2.0	1.2	1.3	2.5	2.0	3.2	2.9	0.8
Annual private final consumption expenditure	3.4	2.3	1.7	1.7	2.1	2.0	2.3	2.2	0.8
Annual gross fixed capital formation	4.6	0.7	-0.5	1.3	3.0	3.6	6.1	5.7	0.1
Gross national income	7.2	4.0	3.7	1.9	5.3	4.3	5.6	5.5	1.1
HICP annual average inflation rate	1.9	2.2	2.1	2.0	2.0	2.2	2.2	2.3	3.7

Source: EU economic data, 2009

Comparing the macroeconomic conditions of Russia and the EU, we can conclude that during 2000-2007 the situation in both economies was relatively stable, without significant changes. The macroeconomic conditions in Russian and European economies were favourable for further economic development and particularly for development of financial sector.

The specific of the Russian economy is that the period 2000-2007 was a post-crisis period. The strict monetary policy of the Central Bank and reforms in the financial sector are responsible for quite fast recovery of the financial sector after 1998 and for the stabilisation of the Russian economy. Of course, it has an impact on the building the specific governance system of the Russian banking sector.

3.3 Internal factors influencing the governance system of the Russian and European banking sectors

3.3.1 The banking industry in Russia and in the European Union: size, level of development

The size of the banking sector and its maturity are important for building an appropriate governance system suitable for the banking sector.

The Russian banking system is quite young. The modern banking system was established in the beginning of 1990s as we have already known from the historical background. The liberal policy of the Central Bank of Russia during 1990s led to fast increase of the banking sector. However, during 2001 – 2008 the total number of banks decreased from 1311 to 1136. The Table 4 represents the number of credit institutions and the size of the banking sector in Russia.

Table 4

Number of credit institutions in Russia

	2006	2007	2008
Number of credit institutions	1409	1345	1296
including banks	1253	1189	1136
Number of banks with foreign capital	136	153	202
including banks with 100% foreign capital	41	52	63
Number of branches of credit institutions operating in Russia	3295	3281	3455
including branches of Sberbank	1009	859	809
Total commercial banks, %	100	100	100
Percentage of banks with foreign capital, %	10.85	12.87	17.78
Total branches of credit institutions operating in Russia, %	100	100	100
Percentage branches of Sberbank, %	30.62	26.18	23.42

Source: Federal State Statistic Service. www.gks.ru

As we can see the number of banks is reducing, as well as the total number of credit organisations. The percentage of the banks with a foreign capital is small, no more than 18% in 2008. About quarter of total branches of credit institutions operating in Russia is a branches of Sberbank. It shows that Sberbank has the most extensive network in the banking sector of Russia. However, there is a tendency for reducing the percentage of Sberbank's branches in the total amount of the credit institutions' branches.

If we compare the total number of credit institutions in Russia with the same indicator in the EU (see Table 5), the Russian banking sector is about four times smaller than European one.

Table 5

Number of credit institutions in the EU[9]

	2007	2008
Stand alone credit institutions	4418	4488
Banking groups	457	465
Credit institutions	4875	4953
- domestic credit institutions	3876	3908
- foreign controlled subsidiaries and branches	999	1045

Source: European Central Bank www.ecb.int/stats/

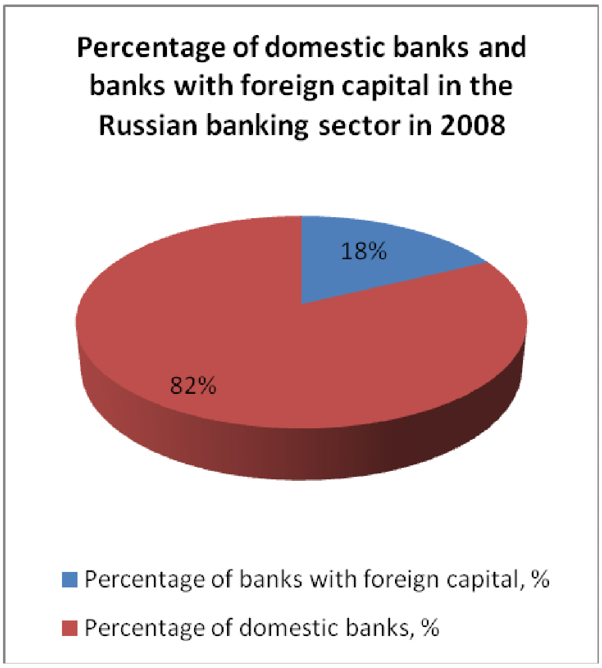
The European banking sector is much bigger than Russian one, which is explains with a well-developed banking network in Europe and relatively favourable macroeconomic conditions which allowed the European banking sector to increase and developed intensively.

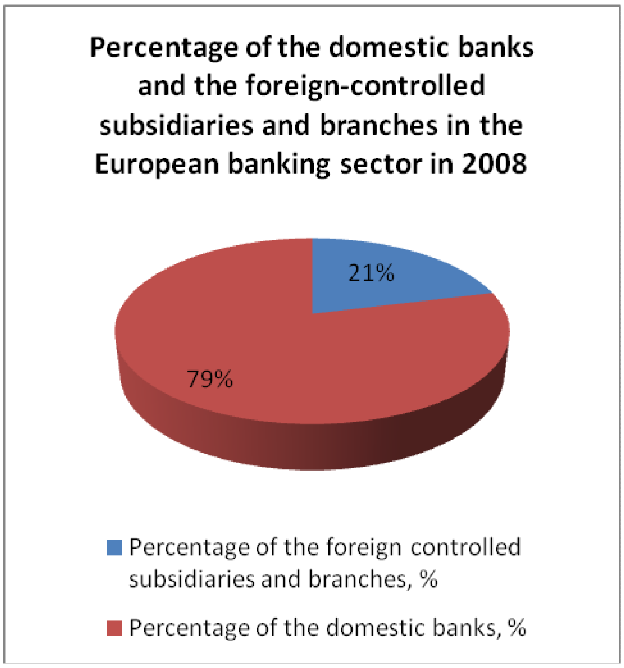
As we can see the percentage of the foreign banks in Russian banking sector is raised from 10% to 17.9 %. The same indicator in the European banking sector is higher (see Graphs 1, 2). The Russian legislation on banking is still strict for foreign investments into the banking sector, so the level of foreign invasion is lower than in Europe.

[9] This statistic is provided for 2007-2008 period, after the last enlargement of the European Union after joining Bulgaria and Romania

Graph 1

Graph 2





Source: Federal State Statistic Service. www.gks.ru

Source: European Central Bank www.ecb.int/stats/

Concerning the total assets of the credit institutions, the Russian banking sector is also much smaller than European. The Russian commercial banks have a lower capitalisation (except the largest state-controlled banks). Next table (Table 6) represents the amount of total assets of the Russian and European credit institutions in 2008.

Table 6

The amount of total assets of the Russian and European credit institutions in 2008

	Russian credit institutions	European credit institutions,
Total assets of the credit institutions in 2008	20241 billions roubles (449.8 billions €)*	37720 billions €

*the exchange rate is 45 roubles for 1 €

Source: European Central Bank www.ecb.int/stats/; Federal State Statistic Service. www.gks.ru

As we can see the size of the European banking sector is much bigger than Russian. The capitalization of European commercial banks far outstrips the capitalization of Russian banks. Moreover, the European Union has a strong currency, the euro. Therefore the value of European banks' assets is higher than rouble assets of the Russian commercial banks.

To measure the level of development of the banking sector, it could be helpful to use banks' assets to GDP ratio. The ratio is calculated as the total assets of commercial banks operating in the banking sector divided by current GDP. This ratio reflects the overall level of development of the banking sector, and the level of inter-bank competition in well-developed banking sectors[10]. The results of the calculations of banks/GDP ratio are represented in the Table 7.

Table 7

The level of development of the banking sector (banks' assets/GDP ratio) in 2008

	Russian banking sector	European banking sector
GDP, billions €	926 (41668 billions roubles)	13000
Total assets of the credit institutions, billions €	449.8 (20241 billions roubles)	37720
banks' assets/GDP ratio	0.486	2.902

Source: European Central Bank www.ecb.int/stats/; Federal State Statistic Service. www.gks.ru; ECB, 2009b

The banks' assets to GDP ratio is very small in Russia. This is an evidence of the low level of the development of the Russian banking sector. The same ration in European Union is six times higher than in Russia. Therefore, we can conclude that the Russian banking sector is undeveloped than European one.

To sum up, the Russian banking sector is smaller than European and the level of banking sector's development in Russia is lower than in the EU. Because of small size and the relatively low level of development the Russian banking sector needs to be governed in an efficient way for further development. The small and weak banking sector in Russia has had an effect on the establishment of the current governance system in Russia. Probably, it is explains the strict control of the banking sector from the government and the Central Bank of Russia.

3.3.2 The role of the banking sector in the Russian and European economies

The banking industry plays a central role in every economy. The Russian and European economies are not exceptions. They would be unable to function without the bank services which include providing loans to enterprises and households, accepting deposits, investing to

[10] Demirguc-Kunt in Tennant D. http://sta.uwi.edu/conferences/salises/documents/Tennant%20%20D.pdf

the financial sector, etc. Furthermore, banks play important intermediate role handling payments and securities transactions, manage savings.

In Russia government pays a lot of attention to the banking sector, because large financial flows of the Russian economy are concentrated there. The governance of the key financial flows in Russia gives enormous power and opportunities to influence the main decisions accepting by the parliament. It is explained by the fact of the high power distance of the Russian nation and social inequality. The handful of wealthy persons (top-managers of the financial groups, of oil and gas companies, businessmen, famous politicians) have a great impact on the financial sector of the Russian economy, because they owns significant capital and manage it to make profit for themselves.

For instance, three large, state-controlled banks dominate in Russia's banking sector: Sberbank, VneshTorgBank (VTB) and Gazprombank, accounting for as much as 40% of the sector's assets (Vernikov, 2007b). It means that three top-managers of these banks have a great power to manage about a half of total assets of the banking sector. It is a political aspect of the importance of the banking sector in the Russian economy.

From an economic point of view we have seen that the level of development of Russian banking sector is low (see previous subchapter). It was not able to play a significant role in the international financial market and could not maintain continuing growth under conditions of the global financial crisis. Therefore, the contribution of the banking sector to the Russian economy is not as high as the contribution of European banking sector to the European Union's economy.

In the EU the banking sector contributes directly to the economic growth. The sector can help to improve the European economy productivity by enhancing its own effectiveness. The more efficient the banking sector, the more opportunities there will be to pursue innovation in the real sector of the economy. Loan financing remains the main source of funding for small and medium-sized enterprises. Much bank support takes place as part of the regular provision of services to small and medium-sized enterprises.

To sum up we can conclude that the Russian banking sector plays a significant role in the political stage as a source of the financing a power in country. So the high importance of the banking sector for politics explains the tough control of the financial flows in banking sector. In Europe the importance of commercial banks as a sector is explained by the economic and social functions which they execute. Therefore, the contribution of the banking sector to the economic growth is higher in the European Union compared to Russia.

3.3.3 Key resources

For each banking sector the financial resources have a pivotal importance. In Russia under conditions of tough regulation of money supply the banking sector suffers from the lack of liquidity. Monetary authorities conducts policy which included the restriction of money supply and creating investment foundations, such as Stabilisation Fund of the Russian Federation, Reserve Fund, National Wellbeing Fund, which led to the limitation of the money supply and surge in money demand in Russia. Thus, the liquidity of the Russian banks dropped and economic growth slowed down.

The main sources of liquidity are the government support of banks and high prices on the natural resources (oil, gas). The government supports a set of banks which plays a significant role in the economic development in judgment of state administration. They include Sberbank (in which hands the half of households' deposits are concentrated), VneshTorgBank (Russia's second largest public sector bank by assets which controls foreign trade transactions), Gazprombank (providing banking services for gas industry enterprises).

In Victoria Belozerova, senior banking analyst with the rating agency RusRating, opinion "the relative stability of Russian banks during the current crisis owes a great deal to official support. As well as providing a substantial volume of funds in the form of loans, the government has provided "psychological" support by reinforcing the banks' public image. In effect, the authorities have signalled that they stand behind the banks – the top hundred, anyway – in the event of a system-wide crisis. That has played a critical role in shaping the behaviour of both clients and investors"[11].

The raw materials' industry performs another source of liquidity for the financial sector of the Russian economy. Energy supplies' and raw materials' industry is highly liquid, and makes high returns, which releases large amounts of cash into the economy. Strong exports of oil and other commodities generate large foreign currency profits, which tend to flow back into the

[11] http://www.rusrating.ru/en/index.php?option=com_content&task=view&id=570&Itemid=74

country as cash. Thus the Russian banking sector became dependent on the raw materials' industry.

One of the three largest banks in Russia is a Gazprombank (51 % of shares is owned by the state). Gazprombank was founded by the world's largest gas producer and exporter Gazprom to provide banking services for gas industry enterprises. It is highly profitable and has increased its lending considerably recently which is explained by the fact that there are high incomes from the sales of the natural resources.

As far as we know from the Chapters 2.2.2.1 and 2.2.3 there were relatively favourable macroeconomic conditions during the period of 2000-2008. In spite of the record indicators of economic growth and rapid growth in the banking sector, the banking system of Russia was quite weak. The government support (for instance, liquidity injections into the system via several channels, and regulator-sponsored bailouts) and external financing (incomes from the sale of the natural resources) were two factors which supported the positive changes in the Russian banking sector (Nikulina, 2009).

In case of the Europe the banking sector relies on its own resources. The profitability of European banking sector is enough for the contribution to its own development and to the economic growth. A lot attention is paid to the human resources which competence could influence highly on the performance of the banking sector. The competent manager is able to make a greater profit by managing existing financial resources than enormous investments without prudential control and cold calculus.

So we can conclude that the dependency of the Russian banking sector from the external financing creates conditions for the regulation of the banking sector. The holders of the financial resources for the banking sector have a great power to influence on the financial sector of Russian economy. It also explains the high level of state involvement, because one of the key sources of liquidity for banks is a government support.

The European banking sector operates under market conditions, where the sector is like a self-regulated mechanism. It is not necessary to intervene into the banking sector except as under extreme conditions such as the financial crisis when banks are not able to survive based on its own resources.

3.4 Conclusion

As we can see the banking sectors of Russia and the European Union have a different background concerning the impact of external and internal factors such as the cultural characteristics of the nations, the historical development of the banking sectors, specific features which are influenced on the building the governance system of each banking sector.

The governance system of the Russian banking sector characterises the high level of centralisation, which is caused by the cultural specifics of the Russians and extremely unfavourable macroeconomic environment during 1990s, when the banking sector actually established. The present governance system of Russian banking sector has several specifics which made it different than European governance system.

The speed of the development of the Russian banking sector influenced the quality of its governance. As we know from the historical background the development of European banking system has an evolutional character. All changes were planned and carefully considered before implementation. The development of modern Russian banking system was precipitous. After the collapse of the USSR the economic growth of new Russia was unpredictable. For sure it influenced adversely on the efficiency of the governance system.

The specific mentality of Russians also has affected the development of the present governance system of the Russian banking sector. Comparing to the Europeans the Russians have a low level of responsibility, high power distance, they are more collectivistic, etc. All these features of Russian nation are a heritage of the Soviet period. The brains of Russian people could not be transformed so fast as well as a state structure and an economy arrangement.

The macroeconomic environment is the next factor which has significant impact on the establishment of the present governance system in Russia and in the EU. There were very favourable macroeconomic circumstances in euro-area during last 20 years. The economic growth, inflation and other macroeconomic indicators were very stable in Europe. In Russia's turn, the situation in Russian economy was extremely disadvantageous. The rapid economic changes created an unstable environment in which a good performance of the banking sector was impossible. After 1998 crisis the policy concerning financial regulation and supervision became stricter to overcome the negative processes in the Russian economy. The strict governance has been still remaining.

Chapter 4. Governance system of Russian and European banking sectors. Theoretical framework

4.1 Introduction

In this chapter we consider the current state the governance system. This chapter is devoted to answer the specific research question “what is the present governance system of the banking sectors in Russian and the European Union?” and make a basis for identifying strengths and weaknesses of each governance system.

There are the several aspects included in the research model to present the current state of the governance systems of the Russian and European banking sectors. (see 1.2.4).

The dependent variable presents the governance of each banking system, which depends on the external and internal factors (they were considered in Chapter 3). They reflect the current state of the governance system of the European and Russian banking sectors. This group is divided in four subgroups to build the picture concerning the governance in the banking sectors of Russia and EU. They characterise the structure of the banking system, its legislation on banking activity, the role of the Central Bank in each governance system, as well as the commercial banks in the banking sector.

4.2 Legislation on banking activity in Russia and European Union

The governance system of the Russian banking sector is based on the legislation on banks and banking activity in the Russian Federation. The legal regulation of banking activities is implemented by the Constitution of the Russian Federation, the Civil Code of the Russian Federation, which provides the basis for the legal relations under loan and credit agreements and bank deposit and account agreements and the relations that rise in connection with the effectuation of settlements, the Federal Law on the Central Bank of the Russian Federation, Federal Law on Banks and Banking Activities and other federal laws and Bank of Russia regulations (CBR, homepage. www. cbr.ru).

All laws on banks and banking activity can be classified as a “horizontal” legislation and a sectoral legislation. The “horizontal” legislation regulates the Central Bank of Russia and the banking sector as a whole. The sectoral legislation is relevant for commercial banks. The list of

Federal Laws, which were classified according to this criterion, is in the Appendix 4 (CBR, homepage. www. cbr.ru).

The Federal Law on Banks and Banking Activities is one of the main laws on banking in Russia which describes the components of the Russian banking system. It specifies the banking operations and other transactions and the operations conducted by credit institutions on the securities market. Also the Law on Banks and Banking Activities sets up the procedure for registering credit institutions, licensing banking activities and opening branches and representative offices of credit institutions. The principles underlying the relationship between credit institutions and their customers and the state are set by the Law on Banks and Banking Activities. In addition it establishes the grounds for the revocation of banking licence, formulates the principles of ensuring stability of credit institutions and establishes the banking secrecy regime and anti-monopoly restrictions for credit institutions in Russia (CBR, homepage. www. cbr.ru).

Lack of transparency and fair operations of economic agents also are the features of modern banking system. Asymmetric information and dodgy behaviours of banks, clients, shareholders, etc. are frequent. Opacity of the shareholders and of the intra group operations is common. However, the Russian legislation on banking activity has been bringing into line with the International Financial Reporting Standards (IFRS). Transition to International Accounting Standards was started on June 2, 2003. The Central Bank of Russia issued the Official Notice ”On the Transition of the Russian Federation Banking Sector to International Accounting Standards” enabling the transition of all credit institutions to compiling financial statements to International Financial Reporting Standards from January 1, 2004 (CBR, homepage). The process is still underway. Russian banking legislation is currently being actively upgraded as the banking sector of the country’s economy is developing and expanding. Also the Bank of Russia is involved in the Basel II framework which is the internationally accepted principles of the Basel Committee on Banking Supervision. These principles are gradually implemented in Russia to support banks in the implementation of advanced risk management standards with the aim of improving the stability and soundness of the financial system (BIS, homepage www.bis.com).

The legislation on banking in the EU is based on the fundamental principles of European legislation. The fundamental principles of European law include the principle of supremacy and the principle of the direct effect. As we can see in the history of integration process in Europe the development of general principles of legislation within the member States of EU has taken place over a number of years. The principle of supremacy means that European Community law is superior to national laws. The national courts must apply the directly applicable EU rules and laws and must do it in priority over any conflicting provisions of national law. The direct effect is a consequence of the supremacy of EU (Fairhurst, 2007). These principles are applied in all spheres of social relationships in EU.

The basis of integration of European countries in legal regulation of banking activity derived from the Treaty of Rome in 1957. The Treaty established the basis for uniformed European legislation, and forced closer relationships between European countries (Barbour, 1996).

The European banking legislation has attempted to eliminate the barriers to an integrated banking sector. The aim was to decrease the regulatory costs, to facilitate entry into foreign countries, to increase competition, and to facilitate legal proceedings in the event of a wind-up of an international bank.

Regulation in the EU has focused on integrating the financial markets of the member States. With this objective, the policy makers have traditionally relied on regulatory harmonisation to achieve that integration. In effect, regulatory harmonisation in the EU has set a lower bound on safety and soundness and implicitly has made regulatory coordination possible among countries. (Garcia, 2005)

At the turn of the century it was recognised that the EU's existing legislative process could not ensure a homogenous transposition of the EU directives' agreed principles into national regulations. The key idea of the new architecture, adopted first by the Lamfalussy Committee for the securities industry but subsequently applied to the banking and insurance industries, is to separate the process of preparing and approving the main principles (so-called "primary legislation") from the development of such principles into more detailed rules (so-called "secondary legislation"), which could then be more efficiently modified. Lamfalussy architecture will have to demonstrate that it is a faster and more efficient procedure for passing secondary legislation (technical rules) and that they can be amended via simple procedures. But it is also have to assure an appropriate degree of homogeneity of national regulations throughout the EU.

This new architecture foresees a sectoral and decentralised model of financial regulation of financial intermediaries in the EU. It is sectoral because it has separate legislative processes and supervisory cooperation fora for securities firms, banks, and insurance companies. It is decentralised because the regulatory/supervisory functions remains at national level. Moreover, the new architecture is neutral with regards to the national institutional arrangements. This architecture envisages improved cooperation with market participants and among national financial market regulators and supervisors and across financial sectors. (Garcia, 2005)

The main legal acts impacting on the banking and financial sector of the EU are included in Appendix 3.

4.3 Structure of governance system of Russian and European banking sectors

There is a two-tier banking system in Russia. The first tier is represented by the Central Bank of Russia, state-owned banks and banks where the state has blocking package of stock or more. The second tier is represented by private commercial banks where the state's package of stock is either below the blocking stake or non-existent. A blocking stake is a package of shares of 50% of total equity plus 1 share (Murychev, 2007). Actually a holder of a blocking package has a great influence of the company's activity (management, decision making, etc.)

The European banking system is three-tier: the first tier is a European Central Bank, second tier is represented by national central banks and third tier includes private banks. European Central Bank (ECB) and the national central banks of all EU Member States form European System of Central Banks (ECB, 2009a). The institutional structure of European banking system contains:

- European Central Bank;
- National central banks (The functional integration of the NCBs into the Eurosystem does not infringe upon their existing institutional, financial and administrative autonomy. The NCBs of the non-participating in Eurosystem EU Member States are also members of the ESCB but have a special status. They are responsible for their respective national monetary policies and are thus excluded from taking part in the core activities of the Eurosystem, in particular the conduct of the single monetary policy) (ECB. 2009a);
- Private banks.

In Russia's turn the institutional structure is simpler than in Europe. The Central Bank of Russia is a single regulatory agency that is responsible for supervision and regulation of the banking sector. According to the Federal Law of Russia "On Banks and Banking Activity" the Russian banking system includes the Central Bank of Russia, credit organisations, branches and subsidiaries of foreign banks. Credit organisations are banks and non-banking credit organisations (credit union and associations) (Murychev, 2007).

The difference of banking systems is explained with the fact that Europe is not a state; it is a union, so the Member States have relative autonomy compared to the Russia's regions. Also, this institutional structure reflects that the European banking system is more decentralised than the Russian one. The government of Russian Federation and the Central Bank of RF are the key player in the governance of the Russian banking sector. The high level of centralisation is one of the main features of power relationships in the Russian economy and the banking sector is not an exception. It shows that there is an incredible power of the state over the Russian economy. It explains the high power distance index (see subchapter 3.2.1).

In Russia there are a number of rules and laws related to the regulation and supervision of the banking system. Their main aims are evolution, consolidation and maintenance of the banking system's stability as well as defence of the depositors and creditors' interests. The Russian government is striving for these aims through strict control of banking sphere (Vernikov, 2007b).

In Europe the direct responsibility for banking supervision and financial stability remains with the competent authorities in each EU Member States, but the Treaty has assigned to the ECB the task of "contributing 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" (ECB, 2009a).

Actually both governance systems, Russian and European, have a same aim – to maintain the stability of financial system, but there is a difference that in Europe it is the aim of European System of Central Banks (ESCB), which includes two levels of banking structure: European Central Bank and national central banks. So the actions for gaining this goal are distributed between ECB and NCBs, which is also an evidence of the decentralisation in the European banking sector. In Russia the aim is realised mostly by the Central Bank of Russia. Only Russian government and the Central Bank of Russia are authorised to make decisions concerning the financial sector of the economy.

The ESCB are governed by the two main decision-making bodies of the ECB: the Governing Council and the Executive Board. A third decision-making body, the General Council, will exist as long as some EU Member States have not adopted the euro. The functioning of these decision-making bodies is governed by the Treaty, the Statute of the ESCB and the relevant Rules of Procedure (Scheller, 2006).

The decision-making bodies of the ECB have a double function: to govern the ECB itself, and to govern the Eurosystem and the ESCB. *The Governing Council* is the main decision-making body of the ECB and is entitled to take the most important and strategically significant decisions for the Eurosystem. *The Executive Board* is the operational decision-making body of the ECB. It is responsible for all the decisions that have to be taken on a day-to-day basis. *The General Council* ensures an institutional link between the Eurosystem and the NCBs of the non-euro area Member States. Its existence, composition and responsibilities are a consequence of the different levels of integration in European Monetary Union (Scheller, 2006).

There are three ways to carry out the main task of ESCB. First, the ESCB monitors the financial stability at the EU level. This activity complements and supports the corresponding activity at the national level, carried out by the national central banks and supervisory authorities in order to maintain financial stability in their respective country. Second, the ESCB gives advice on the design and review of regulatory and supervisory requirements for financial institutions. Much of this advice is provided through the ECB's participation in the relevant international and European regulatory and supervisory bodies, such as the Basel Committee on Banking Supervision, the European Banking Committee and the Committee of European Banking Supervisors. Third, the ESCB promotes cooperation between central banks and supervisory authorities on issues of common interest (e.g. payment system oversight, financial crisis management). These activities are carried out with the assistance of the Banking Supervision Committee, which brings together experts from the EU central banks and supervisory authorities (ECB, 2009a).

To sum up the main difference in the institutional structure of governance in the European and Russian banking sectors is in the number of regulatory agencies that are responsible for regulation and supervision in the banking sector. In Russia there is only the Central bank, in the European Union the Eurosystem, which includes the European Central bank and national central banks, conducts the governance of the banking regulation and supervision.

Therefore, it is obvious that there are different levels of centralization in the governance systems of the European and Russian banking sectors.

4.4 The role of the Central Bank in governance system of Russian and European banking sectors

The Central Bank is a key player in any governance system of the banking sector. It has the power to make regulations, take decisions, make recommendations and deliver opinions to the extent necessary to implement its tasks and carry out its responsibilities within its area of competence: the monetary policy. The Central bank is a regulatory agency which is responsible for a prudential supervision and conducting measures to gain the main aim of the governance of the banking sector: financial stability.

The following table (Table 8) represents the main characteristics of the Central Bank of Russia, the European Central Bank and the national central banks.

Table 8

The comparison of the Central Bank of Russia and the European System of Central Banks

	Russia	**European Union (ESCB)**	
	The Central Bank of Russia	The European Central Bank (ECB)	National central banks (NCB)
1. Legal status	The Law of the Central bank of Russia established the status of the Bank of Russia, established the principles of implementing monetary policy and its major instruments, specified the operations and transactions conducted by the Bank of Russia, banking regulation and supervision powers, etc. (www.cbr.ru)	The ECB has legal personality under Article 107(2) of the EC Treaty and enjoys the most extensive legal capacity accorded to legal persons under the respective national law of each Member State under Article 9.1 of the Statute of the ESCB. (Scheller, 2006).	Each NCB of the Eurosystem has legal personality within the national law of its respective country (ECB, 2009a).
2. Legislati-on	The Central Bank of Russia operates according to the Constitution of RF,	The Maastricht Treaty, which was annexed to the Treaty establishing the	To integrate the NCBs into the Eurosystem, the relevant national

	the Federal law of the Central Bank of Russia (www.cbr.ru)	European Community, provides the legal basis for the European Central Bank (ECB) and the European System of Central Banks (ESCB). (Barbour, 1996)	legislation has been brought into line with Community law: national laws and statutes have to ensure, in particular, that the NCBs and their decision-making bodies are independent of the authorities of the respective EU Member States (Scheller, 2006)
3. Main Task	Article 75 of the Constitution of the Russian Federation stipulates that its main function is **to protect the rouble and guarantee its stability**. (www.cbr.ru)	The main task of ECB is **to maintain the price stability**. Under Article 9.2 of the Statute of the ESCB, the ECB ensures that the tasks of the Eurosystem are carried out either by its own activities or through the NCBs. (www.ecb.int)	The main tasks of NCBs are the **implementation of single monetary policy and the contribution to ECB Tasks**. (Scheller, 2006)
4. Other tasks	Article 3 of the Federal Law On the Central Bank of the Russian Federation (Bank of Russia) stipulates the basic tasks of the Bank of Russia as follows: - protecting the rouble and ensuring its stability; - developing and strengthening the banking system of the Russian Federation; - guaranteeing the efficient and uninterrupted functioning of the payment system (www.cbr.ru). In particular the Central Bank of Russia is responsible for: - Issuing the currencies and managing them;	According to the Treaty establishing the European Community (Article 105.2), the basic tasks are - the definition and implementation of monetary policy for the euro area; - the conduct of foreign exchange operations; - the holding and management of the official foreign reserves of the euro area countries (portfolio management). - the promotion of the smooth operation of payment systems. In particular, the ECB is responsible for: - Defining Eurosystem policies; - Deciding, coordinating and monitoring the	NCBs carry out those Eurosystem tasks which have been delegated to them by the ECB in line with the principle of decentralisation and act in accordance with the guidelines and instructions of the ECB. (Scheller, 2006) The NCBs are responsible for - Execution of monetary policy operations; - Operational management of the ECB's foreign reserves; - Management of their own foreign reserves; - Operation and supervision of payment system; - Joint issuance of banknotes together with the ECB; - Functions outside the

	- Implementing the monetary policy; - Making rules for the payment system; - Operating the banking system smoothly; - Holding the international reserves; - Conducting banking operations, etc. Apart from this, the bank is also responsible for maintaining an interest rate structure, which is consistent with the scale of economic activity in the country. (Murychev, 2007)	monetary policy operations; - Adopting legal acts; - Authorising the issuance of banknotes; - Interventions on the foreign exchange markets; - International and European cooperation; - Statutory reports; - Monitoring financial risks; - Fulfilling advisory functions to Community institutions and national authorities; - Running the IT systems; - Strategic and tactical management of the ECB's foreign reserves. (www.ecb.int)	ESCB. (www.ecb.int)
5. Functions	According to the Central Bank Law the Bank of Russia performs the following functions: - elaborates and pursues a single state monetary policy in interaction with the Government of the Russian Federation; - efficiently manages international reserves of Bank of Russia; - supervises the activities of credit institutions and banking groups; - organises and implements foreign exchange regulation and foreign exchange control in compliance	In line with this statutory role, the ECB exercises several specific functions. In particular, it: - is the decision-making centre of the ESCB and the Eurosystem; - ensures consistent implementation of ECB policies; - exercises regulatory powers and the right to impose sanctions; - initiates Community legislation and advises the Community institutions and EU Member States on draft legislation; - monitors compliance with the provisions of Articles 101 and 102 of the Treaty;	Some functions are performed by the national central banks. Under the Statute of the ESCB, the NCBs may perform non-Eurosystem functions on their own responsibility, provided that these functions do not interfere with the objectives and tasks of the Eurosystem. Non-Eurosystem functions vary according to countries and mainly consist of various types of financial and administrative services to the governments of the respective countries (Scheller, 2006).

	with federal legislation; - establishes the procedure for effecting settlements with international organisations, foreign states and also legal entities and private individuals; - performs other functions in pursuance of federal laws. (www.cbr.ru)	- carries out those tasks of the former EMI which still need to be performed in Stage Three of EMU because not all EU countries participate in EMU. (www.ecb.int)	
6. Indepen -dence	A key element of the legal status of the Bank of Russia is the principle of independence. The independence of Bank of Russia status is proclaimed in Article 75 of the Russian Constitution and Articles 1 and 2 of the Federal Law on the Central Bank of the RF (Bank of Russia). The financial independence of the Bank of Russia implies that the Bank of Russia makes its expenditures out of its own revenues. (www.cbr.ru)	Independence is an indispensable element which facilitates the pursuit of price stability. A cornerstone of the monetary order of the euro area is the independence of the ECB and the national central banks (NCBs) of the Eurosystem, which has been given “constitutional” status, as it has been enshrined in both the Treaty establishing the European Community (EC Treaty) and the Statute of the European System of Central Banks (ESCB Statute), rather than in secondary legislation. The concept of independence includes: - Functional independence; - Institutional independence; - Personal independence; - Financial independence (see in Definition list) (www.ecb.int).	

As we can see from the Table 8 the Central Bank of Russia, the European Central Bank and national central banks have a legal status which was established by the relevant legislation. The main task of the Central Bank of Russia is to protect the rouble and guarantee its stability. The European Central Bank has the same priority. The national central banks have tasks related to enhancing a single monetary policy in EU.

The main difference between Russian and European governance systems of the banking sector is the level of centralisation as we noticed in the previous subchapter. There is a more centralised structure in Russia than in Europe. It reflects in institutional structure of banking sector and the distribution of tasks: in Russia only the Central Bank is responsible for conducting monetary policy and maintaining price stability, in Europe these tasks are distributed between the European Central Bank and national central banks. Thus the banking sector of Russia is more centralised, so the Central Bank of Russia has a great power and influence in the financial sector of the economy.

Because of the high centralisation of the governance system of the Russian banking sector the CBR performs all functions concerning the maintenance of price stability in Russia (see in Table 8). In EU the functions are divided between ECB and NCBs, The ECB focuses on formulating the policies and on ensuring that the decisions are implemented consistently by the NCBs.

Usually the central bank regulates the money supply and interest rates by a central bank in order to control inflation and stabilize the currency. The monetary policy is an instrument for the government to influence the economy. In Table 9 the monetary policies of the Central Bank of Russia and of the European Central Bank are compared.

Table 9

Monetary policy

	The Central Bank of Russia	The European Central Bank
1. Inflation	Inflation rate (consumer prices) in Russia in 2009 is 14 %. The same indicator in previous year was 9%[12]. (www. cbr.ru)	In EU inflation is measured by an index which has been harmonised across all EU Member States: Harmonised Index of Consumer Prices (HICP). (ECB, homepage) The annual HICP in 2008 was 3.3%. During the first quarter of 2009 the HICP was 1%, EU inflation was 0.3% in September 2009, down from 0.6% in August.
2. Goal of monetary policy	The monetary policy of CBR aims to maintain financial stability by influencing the level of liquidity in the economy and keeping under control inflation development turned out to be rather low.	To maintain price stability is the primary goal of the Eurosystem and of the single monetary policy for which it is responsible. This is laid down in the Treaty establishing the European Community, Article 105 (1) (ECB, homepage)
3. Benefits of price stability	The Central Bank of Russia works to reduce the volatility of the economic and financial systems. The financial stability means:	The objective of price stability refers to the general level of prices in the economy. It implies avoiding both prolonged inflation and deflation. Price

[12] It should be mentioned that there are several inflation rates: official and real. And there is significant difference between these two rates. In 2009 the CBR announced that the inflation rate is about 9.5 %, but real one is higher (about 14%).

	- Low stable inflation; - High and stable real growth, together with high employment; - Stable financial markets; - Stable interest rates; - Stable exchange rates.	stability contributes to achieving high levels of economic activity and employment by - improving the transparency of the price mechanism; - reducing inflation risk premium in interest rates. This reduces real interest rates and increases incentives to invest; - avoiding unproductive activities to hedge against the negative impact of inflation or deflation; - reducing distortions of inflation or deflation; - preventing an arbitrary redistribution of wealth and income as a result of unexpected inflation or deflation. (ECB, homepage)
4. Monetary policy instruments	There are several monetary policy tools available to achieve the financial stability: - Open market operations; - Refinancing rate; - Required reserve rates; - Deposit operations; - Credit Institutions' Refinancing (Lending) System (Overnight/intraday loans, Lombard loans, etc.); - Swap operations, etc. (www.cbr.ru)	The operational framework of the Eurosystem consists of the following set of instruments: - open market operations; - standing facilities; - minimum reserve requirements for credit institutions (ECB, homepage).
Quantitative indicators of monetary policy		
- **Refinancing rate**	From October 2009 the current refinancing rate of the CBR is 9.5%.[13]	In EU the same indicator is 1.00 %, the lowest in the ECB's history. It is effective from May 2009.
- **Interest rates (on**	In Russia the interest rate on deposits[14] is 9.1 % from August	In EU the present rate on the deposit is 0.25 %, effective from April 2009.

[13] The refinancing rate is the rate at which the CBR lends money to commercial financial institutions like banks. By changing this interest rate, the Central Bank can influence the interest rates on the money on capital markets.

deposit)	2009.	European commercial banks can put their surplus capital with the respective of the national central bank at this rate.
- **Interest rates (on loans)**	The current interbank rate[15] is 7.2 % from September 2009.	The current rate on marginal lending facility[16] is 1.75 % from May 2009.
- **Exchange rates**	The CBR sets daily exchange rates that are intended to function as benchmarks for price formation. RUB (October 30, 2009): USD/RUB – 29.34 JPY/RUB – 0.3233 EUR/RUB – 43.01 GBP/RUB – 48.22	Having a single currency automatically implies having a single exchange rate and thus also a single exchange rate policy. All currencies against 1 euro (October 30, 2009): EUR/USD – 1.48 EUR/JPY – 134.66 EUR/RUB – 43.01 EUR/GBP – 0.89

As we can see in the Table 2, the inflation rate in Russia is much higher than in EU. In Russia managing money supply stands out as the dominant monetary policy tool rather than the interest rate (Murychev, 2007).

In order to achieve price stability the ECB must influence conditions in the money market, and thereby the level of short-term interest rates. The ECB has adopted a strategy to ensure that a consistent and systematic approach is applied to monetary policy decisions. A main element of the ECB Governing Council's monetary policy strategy is the ECB aim to maintain inflation rates below but close to 2% over the medium term. This underlines its commitment to provide a sufficient safety margin to guard against the risks of deflation.

The NCBs' abilities to set economic policy are much lower than before the creation of EU. The ESCB includes the NCBs of all EU Member States, even those which have not adopted the euro because of their special status (Denmark and the United Kingdom) or because of derogation (Sweden and the ten new EU Member States). As the non-participating Member States have maintained their monetary sovereignty, their respective central banks are not involved in carrying out the System's core functions (Scheller, 2006).

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[14] Deposit rate - an average-weighted rate on household rouble deposits with credit institutions for a term of up to one year.

[15] Interbank Rate - an average-weighted rate on overnight interbank rouble credits on the Moscow market.

[16] Marginal lending facility is an overnight facility by which liquidity is offered to the financial sector from the Eurosystem. Banks receive credit from respective national central bank at a pre-specified interest rate against eligible assets or securities.

The NCBs of the non-participating EU Member States are also members of the ESCB but have a special status. They are responsible for their respective national monetary policies and are thus excluded from taking part in the core activities of the Eurosystem, in particular the conduct of the single monetary policy. These NCBs are not involved in implementing the single monetary policy and related functions (Scheller, 2006).

The Central Bank of Russia does a lot to maintain national currency stability which is problematical under condition of relatively high inflation. The main tools, which are used but the CBR, are managing the refinancing rate and open market operations (see the definition of open market operations in Definition list). Also the CBR uses required reserve ratios (or reserve requirements) to sets the minimum reserves each bank must hold to customer deposits and notes according to Basel II. Since January 2008 the reserve requirements for commercial banks, which are operating in Russia, is 180 ml roubles (approximately € 4 ml).

The operational framework of European monetary policy consists of open market operations, standing facilities and minimum reserve requirements for credit institutions. Open market operations of ECB can be divided into main refinancing operations, longer-term refinancing operations, etc. The Eurosystem also offers two standing facilities – the marginal lending facility and the deposit facility. Finally, the European credit institutions are required to hold on accounts with the NCBs: these are called “minimum” or “required” reserves. The amount of required reserves to be held by each institution is determined by its reserve base multiplied by a reserve ratio. The reserve base of an institution is defined in relation to the short-term liabilities on its balance sheet.

And we can conclude that the Central Bank of Russia has a great power and plays a key role in the banking regulation in Russia. In the EU the ECBs works with close cooperation with a national central banks to carry a single monetary policy and gain a financial stability. The ECB is more powerful than NCBs, it has full right to hold and manage its reserves and the right of the ECB to impose restrictions on NCBs’ behaviour. Thus the ECB is the most important agency in the institutional structure of the governance system of the European banking system.

4.5 The role of commercial banks in the Russian and European banking sectors

An efficient functioning banking system is essential for sustained growth. The commercial banks are one of the tiers of each banking system. They actually form a banking sector. Banks, in most countries, play a crucial role in providing financial intermediation between savers and those who demand credit, because their functions are increasing savings, increasing investments, transferring money, providing loans and credits, etc. All these operations are essential for a good development of the economy as a whole and for economic growth.

As we know from the history of banking sectors (see subchapter 2.3), the development of the sector took different ways in Russia and EU. To describe it briefly, we can say that in Russia the development of the banking sector as well as the development of economy as a whole has a revolutionary character. On the contrary, the development of European banking sector occurred more evolutional. The changes in Russian economy have occurred rapidly with the changes in state structure (collapse of USSR). So there were several circumstances which influenced on the current state of the banking sector and its development. First of all, the lack of banking services in the country which led to the rapid growth of banking sector. During 1990 Russian government conduct liberal policy concerning financial sector which led to the turmoil in banking sector that was one of the reasons of financial crisis in 1998. After 1998 the government implemented the policy of state invasion into the financial sector.

Nowadays the key financial flows are concentrated in the hands of government. There are three stated-controlled banks: Sberbank (SB), VneshTorgBank (VTB), Gazprombank. The state-controlled banks account for almost half of the domestic loan market. The three government banks account for 35 percent of assets and 41 percent of credit granted to borrowers within the Russian banking system (Murychev, 2007).

Sberbank is clearly the largest Russian bank that accounts for half of all household deposits due to its de facto state guarantee. The top bank, Sberbank, by itself controls roughly three quarters of the deposits of the Russian population. VTB and Gazprombank are mainly corporate sector banks: VTB has a governmental support to encourage foreign economic transactions of Russian enterprises; Gazprombank was founded by the largest gas producer and exporter Gazprom to provide banking services for gas industry enterprises. The leader banks (all state-controlled) have access to state capital and control the majority of the market (Vernikov, 2007b). State-controlled banks have a great effect on the banking industry as a whole, the rest of banks, so-called private or commercial banks, have a insignificant market share and their main goal is to survive.

The high extension of the government into the banking sector and high level of state's influence on the decision making process of banks has negative impact on the competition inside the banking sector of Russia and makes the largest banks dependent on the state financial support.

The top tier of banks is rounded off by the more powerful of the oligarch-controlled[17] banks (such as Alfa Bank, Rosbank and Uralsib) and a few other state-controlled banks (Rosselhozbank in particular). There are also a few strong regional banks, particularly the City of Moscow-controlled Bank of Moscow and Moskovskoe Ipotechnoe Agentstvo as well as the Tatarstan regional government-controlled Ak Bars Group and Tatfondbank[18].

Following the onset of privatization in 1993, new private Russian banks have taken large equity positions in the Russian industrial sector, via controversial loan-for share deals, government provisions and insider-dominated privatization sales. Taking advantage of the limited competition offered by capital market investors, groups began to consolidate holdings in controlling blocks by 1994: the emerging corporate structure was termed the financial-industrial group (henceforth FIG) (Perotti, Gelfer, 2001).

The rest of the banks are essentially tiny and insignificant, ranging from private investment firms to small regional institutions. They have very little political clout and even less deposits from which to back loans to creditors. In 2006 nearly 45 percent of the Russian market share is therefore divided among more than 1,290 banks, each of which controls less than 0.1 percent of the overall market (Murychev, 2007).

There are a few foreign banks operating in Russian banking sector, such as Raiffeizenbank, UniCredit Bank, Rosbank (SocGen), Citibank, Absolut Bank (KBC Group), ING Bank, BSGV (SocGen), Orgres Bank (Nordea), HCFB (PPF Group), ABN. AMRO Bank, Credit Europe Bank, OTP Bank, Deutsche Bank, Rusfinance Bank (SocGen) (Vernikov, 2007a). Potential of foreign expansion to the Russian banking sector remains relatively high. However, the

[17]Here: Oligarchy is a small group of people having control of a country. Source: http://www.encyclopedia.com/doc/1O999-oligarchy.html
[18] www.stratfor.com/analysis/20080925_global_market_brief_further_consolidation_russias_banking_sector

government and the Central Bank of Russia keep tough control of foreign banks and their subsidiaries.

In EU the situation in the banking sector is different. In the banking sector, European integration has continued further in terms of deregulation, free movement of capital, the common currency and cross-border cooperation. Financial sector reform's main aims were to increase competition and remove all remaining barriers to the integration of EU banking sectors. With the creation of EU the tendency for much cross border banking activity became stronger, but there are barriers for full integration and creation of a single market such as cultural differences, language, different level of economic development, etc. Different languages and cultures, and taxation and legal disparities have proved to be limiting factors in the development of a truly single market. The single currency has strengthened opportunities by reducing the cost of cross-border investment and transactions within the EU (Goddard, 2007).

This concentration of property in the European banking sector is accelerating recently, and it has produced a modification in the credit structure of EU, which are moving from small bank companies to large-scale banks. The primary goal of that processes was explicitly to improve the efficiency of the banks. Growth has enabled banks to realise scale and scope economies, reduce labour and other variable costs, and reduce or eliminate operational inefficiencies (Goddard, 2007). However, high concentration makes the banking sector very sensitive to real and potential difficulties arising from ineffective governance, unfavourable circumstances (for instance, global financial crisis), etc.

The cross-border mergers and acquisitions in the European banking sector became possible because of the relatively liberal regulation of the banking sector. The commercial banks which are operating in the European banking sector, have the freedom of establishment, set out in Article 43 of the Treaty and the freedom to provide cross border services, set out in Article 49, are two of the "fundamental freedoms" which are central to the effective functioning of the EU Internal Market. The principle of freedom of establishment enables an economic operator (whether a person or a company) to carry on an economic activity in a stable and continuous way in one or more Member States. The principle of the freedom to provide services enables an economic operator to provide services in one Member State to offer services on a temporary basis in another Member State, without having to be established there[19].

With the last EU enlargement the governance of the European banking sector faced difficulties. Several factors can generate efficiency differences across banking sectors of EU members. There were discrepancies in operational environment in new EU, for instance country-specific elements, etc. National discrepancies in operational environment can derive from macroeconomic differences or differences in financial infrastructure and institutional system, as well as from other country-specific factors (ECB, 2009a).

Both banking sectors, Russian and European, have different ways of development which is associated with the different background. In the Table 3 specifics of European and Russian banking sector are compared.

Table 10

Specifics of the Russian and European banking sector

Russian banking sector	European banking sector
1. High state invasion in the banking sector of Russia 2. High centralisation of the banking sector 3. Continuation of reforms in banking sector under conditions of limited resources; 4. Mergers and acquisitions in the financial sector of Russia, spreading networks only of Moscow's banks; 5. Weakening of the competition in the Russian banking sector, which was a result of the government's policy of the maintaining and privileging the state banks; 6. High barriers for foreign banks to enter into Russian banking sector.	1. High concentration of the banking sector, mergers and acquisitions; 2. Relative freedom of commercial banks (the freedom of establishment and the freedom to provide cross border services); 3. Relatively competitive banking market in EU; 4. European banking is one of the sectors in which private, public (state-owned), mutual and cooperative firms operate together in a competitive market (Goddard, 2007); 5. The western Member States are more economically developed than eastern. Much of the banking sector of eastern Europe is owned by western European banks

[19] http://ec.europa.eu/internal_market/services/principles_en.htm

As we can see, the main difference of the Russian and European banking sector is the level of state involvement. In Russia the state plays a significant role in the development of the banking sector. Possibly it is caused by the continuing reforms in the Russian banking system. The dominant role of state-controlled banks and insolvency of the commercial banks adversely impact the competition among them. The protectionist policy towards state-controlled banks led to the deformation of in the structure of assets allocation among the banks. The most financial assets are concentrated in the hands of a few dominant banks, mostly in the western part of Russia (Moscow and Moscow region). The level of state involvement (for instance, the invasion of ECB or NCB into banking sector) is not so crucial in Europe, compared to Russia. Commercial banks are relatively free in their activities. The European banking market is competitive, and competition is encouraged by ECB.

4.6 Global financial crisis and the reaction of the governance system of the Russian and European banking sectors

Nowadays the main problem of the international banking system is the global financial crisis. The financial crisis has hit both the euro area and Russia. In both the euro area and Russia, foreign demand for exports has declined, and domestic demand has been negatively affected by declining confidence and a tightening of financing conditions.

The start of the turbulences began in August 2007. The interactions of very bad risk management and wrong incentives in the financial industry, excessive complexity in financial products and underlying global imbalances caused the credit boom and then ensuing crisis. Then, the collapse of a major financial player, USA financial system, mid-September 2008 transformed a large-scale crisis of confidence into a global financial panic. Financial intermediaries scrambled to restore liquidity buffers, reduce risk and tightened lending conditions. Collectively, they engaged in a large-scale process of "deleveraging". Credit spreads surged and trading activity in a large number of markets collapsed[20].

The macroeconomic situation in Russia and the EU took a turn for the worse. The inflation rate in Russia was 13.3 % in 2008, which is higher than in 2007 (11, 9%). In 2008 the

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[20] http://www.ecb.int/press/key/date/2009/html/sp091123_1.en.html

growth rate of Russian GDP was 5.6 %[21]. The same indicator was 8.1 % in the year earlier. The HICP in the EU was 2.3 % in previous year. In 2008 the GDP of the European Union reduced by 1.7% than in 2007 (ECB, 2009b). These figures show that the Russian and European economy's performance has reduced which is caused by the negative processes of the global financial crisis.

In these circumstances the primary mission of ECB and CBR was to preserve price stability and contribute to the financial stability.

To complete the picture of comparing the governance systems of Russian and European banking sector, we has considered the measures which were taken by both governance systems (see Table 11).

Table 11.

Measures taken by the Central Bank of Russia	**Measures taken by the European Central Bank**
In late 2008, economic conditions changed significantly and the Bank of Russia adjusted its monetary policy. It began actively to use the instruments of monetary regulation to preserve banking sector stability and took additional measures to boost banking sector liquidity. In Russia the anti-crisis measures pursued two objectives: to preserve the national monetary and banking systems and let them operate steadily and, secondly, it was essential to ensure the Russian economy encounters a recession with minimal losses possible with positive trends to be seen in the second half of 2009, i.e. signs of economic recovery. Taking into account the instable situation in the financial market the government assumed measures to prevent and minimise the negative consequences of the global financial crisis. - enactment of the Federal Law	The financial crisis has presented exceptional challenges to central banks to support the functioning of money markets and the funding liquidity of banks, to stabilise economic activity and to preserve price stability. The ECB responded swiftly to these challenges by engaging in non-standard monetary policy and aggressively cutting policy interest rates (as the inflationary pressures seen over the summer 2008 receded, ECB swiftly reduced its policy interest rate down to 1%). The unconventional policy taken consisted of four main types of measures - Supplying liquidity in unlimited amount at the policy rate to the banks demanding

[21] Source: Institute of complex strategic researches. http://www.icss.ac.ru/userfiles/file/macro_mini.pdf

"Concerning Additional Measures for the Maintaining of Financial System of the Russian Federation"; - budget investments to three state-controlled banks – Sberbank, VneshTorgBang and Gazprombank; - increasing the maximum of the insurance indemnity limit for deposits up to 700 thousands roubles; - reduction of the rates of contribution for the Reserve Fund to raise liquidity of economy. These measures have some positive results, but they don't solve all problems of the banking sector of Russia at a whole, because they concerned not recovery of the banking system under crisis conditions, but the support of the mostly resilient financial structures like state-owned banks. Due to strong exports of oil the government made reserves which could help to overcome the negative consequences of the crisis. Looking ahead the Bank of Russia will face the challenges created by the world financial crisis above all. Despite the problems related to the financial turbulence, the Bank of Russia has set itself the task of gradually bringing inflation back onto the downward path. It is still committed to switch to inflation targeting and will continue to scale down its involvement in the rate-setting process on the foreign exchange market for the purpose of moving to a floating exchange rate regime.	refinancing; - The expansion of the list of assets eligible to allow the banks to refinance with ECB a larger share of their balance sheet; - ECB's support of banks in maintaining longer-term credit commitments. ECB has provided liquidity for longer period; - Provision of liquidity in foreign currencies, most notably in US dollars. Thanks to this policy banks could count on an ongoing access to foreign currency balances. This policy is non-standard; it was first and foremost aimed at expanding that form of credit in volume and maturity. *T*he measures implemented by the Eurosystem were specifically targeted at the banking sector. The reason for concentrating on the banking sector stems from structural features of the euro area's economy, particularly the fact that its financial system is predominantly bank-based. Through these measures, the ECB aimed to mitigate the risk of systemic illiquidity in the euro area banking sector and to guarantee a steady flow of banking credit to euro area households and firms.

The global financial crisis is the stress test from which both Russian and European banking sectors undergo. It is a great challenge for governance system to maintain a stable state of the economy. As we have seen in Box 1 the measures of the European and Russian governance systems of banking sectors are relatively the same. The Central Bank of Russian and the European Central Bank decided to make bailouts to supports the financial institutions which are important for maintaining the financial stability. Most probably it was a least-evil solution. Otherwise, the collapse of the financial sector would be very much so possible.

We can conclude that under the global financial crisis conditions both governance systems have taken same measures to keep a relative stability on the financial sector. The level of state involvement into the banking sector rose in the EU, and the regulation of the Russian banking sector became tougher. The financial sectors in the EU and Russia are in the same situation and have same problems how to deal with the crisis and its consequences. The main challenge for the supervision of the European banking sector is to maintain a financial stability and to exit and to retain control of banking sector at the right moment, because under crisis conditions the governance institutions actively intervene to the European banking sector. For Russian governance system it is very important to keep the situation under control and soften the negative effects of the crisis on the economic development. However, it will be possible after the revising the governance policy concerning the banking supervision and regulation. Firstly, it is crucial to keep the current state of economic development and do not allow to worsen the situation.

4.7 Conclusion

The European governance system of the banking sector is much more liberal than the Russian. The main assumption of the European governance is that the financial system is a self-regulating mechanism and the state ought to intervene under certain conditions (for instance, measures taken by the ECB and the European Community to reduce the adverse impact of the global financial crisis). The Russian governance system is tough because of immaturity of the banking sector. The banking sector is not developed enough to operate as a self-regulated mechanism. It is necessary to control it to avoid the recurrence of the 1990s situation.

Concerning the institutional structure of the governance system the main difference is in the number of regulatory agencies that are responsible for regulation and supervision in the banking sector. In Russia there is only the Central bank, in the European Union the Eurosystem, which includes the European Central bank and national central banks, conducts the governance of the banking regulation and supervision. Therefore, it is obvious that there are different levels of centralization in the governance systems of the European and Russian banking sectors.

Concerning the role of the Central Bank in the governance system we can conclude that the Central Bank of Russia has a great power and plays a key role in the banking regulation in Russia. In the EU the ECBs works with close cooperation with a national central banks to carry a single monetary policy and gain a financial stability. The ECB is more powerful than NCBs, it has full right to hold and manage its reserves and the right of the ECB to impose restrictions on NCBs' behaviour. Thus the ECB is the most important agency in the institutional structure of the governance system of the European banking system.

In Russia the state plays a significant role in the development of the banking sector. Possibly it is caused by the continuing reforms in the Russian banking system. The dominant role of state-controlled banks and insolvency of the rest of commercial banks adversely impact on the competition among them. The protectionist policy towards state-controlled banks led to the inequality in assets allocation among the banks. The most of financial assets are concentrated in the hands of few dominant banks, mostly in the western part of Russia (Moscow and Moscow region). The level of state invasion (for instance, the invasion of ECB or NCB into banking sector) is not so crucial in Europe, than in Russia. Commercial banks are relatively free in their activities. The European banking market is competitive, and competition is encouraged by ECB.

We can conclude that under the global financial crisis conditions both governance systems have taken same measures to keep a relative stability on the financial sector. The level of state involvement into the banking sector rose in the EU, and the regulation of the Russian banking sector became tougher. The financial sectors in the EU and Russia are in the same situation and have same problems how to deal with the crisis and its consequences. The main challenge for the supervision of the European banking sector is to maintain a financial stability and to exit and to retain control of banking sector at the right moment, because under crisis conditions the governance institutions actively intervene to the European banking sector. For Russian governance system it is very important to keep the situation under control and soften the negative effects of the crisis on the economic development. However, it will be possible after the revising the governance policy concerning the banking supervision and regulation.

Chapter 5. SWOT analysis of the governance systems of the Russian and European banking sectors

To compare the governance systems of the Russian and European banking sector it is important to identify the strengths and the weaknesses of both systems and the opportunities and the threats. A SWOT analysis should be taken into account to identify the best practices in the governance of banking sector. In this chapter we have performed a SWOT analysis of both governance systems based on the investigated literature. In the first section we describe the strong and the weak sides of the Russian governance system, the opportunities, which could be potentially useful for further improvement of the system, and the threats with which the governance of the Russian banking sector is faced. In the second section a similar analysis was made concerning the governance system of the European banking sector. This chapter is devoted to answer the third specific research questions.

5.1 SWOT analysis of the governance system of the Russian banking sector

In the Table 12 the SWOT of the governance system of the Russian banking sector is presented.

Table 12

	Strengths	**Weaknesses**
Internal factors	- Strong control of financial sector, which aimed to prevent the financial instability and financial falls. Stability is not under threat as the government is firmly in control; - Experience of crisis in previous years. The lessons of the 1998 crisis could be helpful in financial regulation, in particular the governance of the banking sector; - Big reserves of the government help to soften the negative impact of the crisis	- High level of political interference into the governance of the banking sector - Over-centralization blocks the development of a competitive economy; - Lack of prudential supervision; - Weak corporate governance of commercial banks; - Corruption; - Immaturity of the banking sector; - Low foreign investments; - Weak competition;

		- Dependence on the natural resources.
	Opportunities	**Threats**
External factors	- Increase a foreign inflow to the banking system could lead to strengthening competition and exploit opportunities offered a global capital market; - Development of information technologies and the appearance of new competitors linked to rapid innovation and promoted the intensification of competition.	- Asymmetric information in the financial system; - Global financial crisis; - High inflation and worsening the macroeconomic conditions; - Reduction of natural resources' (in particular oil's) prices.

The strong and weak sides of the Russian governance system are explained by the institutional structure of the financial supervision. The Central Bank is an regulatory agency which is responsible for the regulation and supervision of the banking sector of Russian economy. The centralisation of the governance of the banking sector is relatively high (in comparison with the governance of the European banking sector). The centralisation of the governance reflects in a domination of political power in all spheres of social life. The modern political regime in Russia is commonly described as 'bureaucratic authoritarianism', with an emphasis on the dominant position of state officials (bureaucracy, or the political class) in the policy-making process and the shaping of social institutions (Ledyaev, 2008). The state has a great influence the governance of all economy's sectors, in particular the financial sector. A bureaucratic domination has been reproduced throughout Russian history despite the circulation of political elites and revolutions (Ledyaev, 2008). The centralised regulatory and supervisory authorities provide unified rules and laws for individual sectors of the financial market in particular banking sector. Taking into account the Russian mentality specifics (see page 16) the tough regulation of banking sector is very important; the high power distance and needs of higher power to keep everything in order build a background for the high centralisation of the governance.

The strength of the Russian style of governance is that the control mechanisms of the socio-economic life (including the regulation of the financial sector) ought to prevent the repeat of the collapses (in particular 1991 – collapse of the Soviet Union) and revolutions (in particular the October Revolution in 1917)[22]. The government still remember the bad experience of the 1990 when the property relations have been privatized so that the state lost control over local resources. The liberal supervision of the Russian banking sector caused the situation of 1998 crisis. To prevent occurrence of such cases the control and regulation has been tightened especially in financial sector. So the strong side of the centralisation and strict control is the prevention of sharp falls in economy.

Another argument for the state involvement into the financial sector is the government support of the banking sector. It is of interest of this time under the global financial crisis' conditions (see Table 11). The government has a significant power to maintain the financial sector by the provision of financial support. Big reserves of government could help to soften the negative impact of the crisis. However the issue how and to whom the government provide this financial support is arisen. The fact that the Russian government has enough financial reserves is not enough for effective solution financial problems caused by the global crisis. The distribution of the financial reserves should be made in an efficient way, not only favouring liquidity to the key Russian banks.

The use of crisis experience acquired in previous years could be a strong side of the governance of the financial sector, in particular in the banking sphere. The lessons that was learnt could be useful if the crisis situation occurs again, for instance under conditions of global financial crisis (see page 32). Russia's banking sector has suffered repeated crises since the start of transition. Policy makers could improve the stability of the banking system by converging on existing best practice as regards the implementation of prudential supervision. The number of lessons drawn from the 1998 financial crisis was mentioned in Chapter 3.2.2.1. Of course, the situation of 1998 crisis was unique, but it contains useful lessons for any countries facing simultaneous problems of public debt sustainability and low international liquidity (Perotti, 2001).

Russia does potentially have a lot of strengths, but its basic weaknesses will impede exploiting them. The over-centralisation of the Russian economy have led to a high level of political interference into the governance of the banking sector. The commercial banks do not operate on the commercial basis. Political interference in Russian financial sector regulation

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[22] http://www.stratfor.com/weekly/20090302_financial_crisis_and_six_pillars_russian_strength

was explained the necessity to prevent the repeat of crisis. However, political pressures weakened financial regulation generally, they hindered regulators and the supervisors who enforce the regulations from taking action against banks that ran into trouble. In so doing, they crippled the financial sector in the run-up to the crisis, delayed recognition of the severity of the crisis, slowed needed intervention, and raised the cost of the crisis to taxpayers (Quintyn, 2004).

A lack of prudential supervision caused the high level of state interference into financial regulation. In case of Russia, most capital and liquidity standards show some level of enforcement, although the enforcement of liquidity regulations is not necessarily good news. It may indicate that the CBR mainly de-licenses banks that are already illiquid instead of anticipating future trouble. In addition we find indications that the CBR leaves the banks room to gamble for their resurrection (Claeys, 2007).

It can also not be rejected that there is increased regulatory forbearance in the short run. Specifically, frequent breaches of liquidity standards face less punishment in regions with low regional competition, frequent breaches of capital requirements are less enforced for sizeable banks and severe breaches of liquidity standards requirements are forborne when the bank is operating in a poorly banked region. The CBR is also quite reticent about withdrawing bank licenses from banks that repeatedly and severely violated the households' deposits-to-capital ratio, supposedly because this might affect depositor trust and systemic stability (Claeys, 2007).

The government ownership of the banking sector (when the government owns the key large banks, or the most of the largest banks) reduces the incentives for banks to accurately price loans, for depositors to access the strengths of banks they use, and for supervisors to carefully monitor the banks. It creates the expectation that the banks will be bailed out if they are in trouble. The high level of political interference into the banking sector, the government ownership, over-centralisation of regulation and supervision lead to inefficient allocation of resources, especially if government-owned banks are more likely to lend to industries and companies preferred by the state. According to Forbes (2004), empirical studies show that greater governance ownership of banks is associated with more poorly developed banks and financial systems, as well as with lower growth of income per capita and productivity.

A lack of transparency in the ownership structures and poor corporate governance of commercial banks slow down the development of the sector and impede financial decisions and prudential supervision. The banking sector of Russia is too young and it is underdeveloped in relation to Russia's GDP (see Table 7). The Russian banking sector has already experienced sharp falls (in particular the financial crisis 1998) and gradual growth (growth in 2003-2007), but only two decades has gone when the modern banking sector was born. It is not enough for establishment an optimal governance system of the banking sector, which would meet all requirements and would be highly efficient and effective.

Also the cultural context affects corporate governance as a component of the environment. As we know from Chapter 3 among important Russian cultural traditions are low trust, high uncertainty avoidance, relatively high power distance, and reliance upon personal networks. No corporate governance system can be effective without public trust in the actions of company managers, boards of directors, and organizations including auditors and financial institutions. In Russia, there has been a cultural tendency for citizens to distrust individuals, groups, and organizations that fall outside their sphere of personal relationships (McCarthy, 2003).

The poor corporate governance, which is explained by the underdevelopment of the banking sector and by cultural factors, makes a favourable atmosphere for corruption and bribery. Corruption is a constraint for the pursuit of economic development. Bribery increased the costs of government development programmes. Diversion of resources from their intended purposes distorted the formulation and execution of public policy.

The regulation of the entrance of foreign banks has a negative effect on the competition in the banking market. The efficiency of the Russian banking institutions is low, because they do not have to compete with strong rivals. The level of the foreign invasion into the Russian banking sector is very low (see Graphs 1, 2). The Russian legislation on banking is still strict for foreign investments into the banking sector. The low foreign investments mean that the competition in the banking market is much weaker than in the banking markets where the level of foreign invasion is high.

The most significant weakness in the structure of Russia's economy is its dependence on the export of raw materials, including its hugely valuable energy resources. With the price of oil tied to world geopolitical events, such dependency places the country at risk of losing control over its economic progress. Russia's boom in 2003-2007 was driven by rising oil prices and capital inflows. Economic diversification remained limited. High trade and current account surpluses increased confidence in the capacity of Russian borrowers to service their external liabilities.

The changes of the energy resources' prices could influence dramatically the amount of liquidity circulating in Russian economy. Thus the changes (especially reduction) of oil's and gas' prices threaten the stability of the banking sector and economy as a whole, because a lack of liquidity in the banking sector has a great impact on the real sector of economy. So the overall welfare of state would be undermining if the raw materials' prices change. It is already about threats of the governance system of the Russian banking sector. The dependence on the prices of the natural resources weakens the Russian banking sector. Thus the weak banking sector creates challenge for the governance to strengthen it.

Another challenge for governance system of the Russian banking sector is the high inflation. The Central Bank of Russia takes measures to reduce the real rate of inflation, however under the global financial crisis' conditions it became more difficult to keep the inflation rate stable. In this situation two related threats challenging the governance system of the banking sector. They are global financial crisis and worsening the macroeconomic environment in Russia.

The asymmetric information is a crucial impediment to the efficient functioning of the financial system. Asymmetric information means a situation in which one party to a financial contract has much less accurate information than the other party (Mishkin, 2001). The development of the Russian banking sector in 1990s showed that asymmetric information contributes to default: the population of former Soviet Union was economically ignorant, and they trusted anybody who promised a high income. Thus the state treasury bills became popular, but it led to the dramatic situation in the financial sector. Since 1998 he governance system conducted a number of reforms to improve the exchanging of information between counterparties, but the threat of asymmetric information is still actual.

Opportunities for the governance system of the Russian banking sector include an increase a foreign inflow to the banking system and development of information technologies and the appearance of new competitors linked to rapid innovation and promoted the intensification of competition. The relaxation of entrance requirements for foreign banks gives an opportunity to increase the capital inflow into economy and to encourage the competition in the banking sector. The foreign investments and appearance of the new competitors could give a chance to the Russian banking sector to exploit opportunities offered a global capital market. The adoption of new technologies can positively influence the efficiency of the banking activities and quality of banking services.

5.2 SWOT analysis of the governance system of the European banking sector

In the Table 13 the SWOT of the governance system of the European banking sector is presented.

Table 13

Internal factors	**Strengths**	**Weaknesses**
	- Low level of political interference into the banking sector; - Low level of state ownership; - Developed supervisory framework to ensure financial stability; - Developed legislation: matching banking legislation to the international accounting and auditing standards; clear guidelines and instructions of the ECB for commercial banks.	- Risk management practices concerning the cross-border financial institutions; - Regulatory backwards related to the consolidation of the banking sector, which makes financial sector more vulnerable (lack of homogeneity);
External factors	Opportunities	Threats
	- Development of new technologies (technical progress) and innovations in financial industry	- Global financial crisis - Information asymmetry

The European banking sector is characterised by the low level of the political inference in comparison with the Russian one. The commercial banks operate on a commercial basis; they are able to freely set their prices for loans and deposits. Therefore, the state ownership in the banking sector is lower. The largest banks are not owned by the government. It characterises the European banking sector as advanced in comparison to the Russian one.

The current European framework to guard financial stability is well-developed and consists of three layers: crisis prevention, crisis management and crisis resolution. These are described in Appendix 5. According to the ECB crisis prevention is initiated by the supervisors, who guard the solidity of financial institutions, and the central banks, which guard the stability of the financial system as a whole. The supervisors may raise the required capital to be held by a financial institution or they may impose a reorganisation, while the central bank may provide liquidity. Crisis management and crisis resolution mainly concern sharing information and the procedures for collaboration among the various national supervisors. In this connection, in 2005 the various parties have signed a memorandum of understanding (MoU) for collaboration during a crisis (Eijffinger, 2009).

The European legislation on banking is developed: it is matching to the international accounting and auditing standards; it contains clear guidelines and instructions of the ECB for commercial banks. The Lamfallusy framework of the legislation on banking in the EU shows that it is efficient procedure for passing secondary legislation (technical rules). It will have to reduce the scope for diversity in the transposition of EU directives into national laws and regulations (Garcia, 2005). However, the new architecture would need to encourage a more consistent application of the secondary legislation in order to promote homogeneous and transparent supervisory practices throughout the EU.

Concentration in the banking industry is justified by the virtuous character of economies of scale. These economies of scale means benefits from reduced costs, by spreading the fixed costs out over a larger level of production. The consolidation process is based on the possibility of reaping profitability, reducing cost inefficiency, increasing market power, and exploiting scale and scope economies (Cavallo, 2001).

At the same time consolidation in the financial services industry and increasing cross-border activities by large complex financial institutions may pose a threat to international financial stability. It presents a challenge to regulators responsible for preventing and managing financial crises should one of these large international institutions fail (Garcia, 2005).

Cross-border groups operate as integrated entities with provision of services, such as risk management, liquidity management, etc. And not all services are necessarily centralised in the same country. Therefore, the problem of information sharing is popped-up, because information on banking groups' financial conditions is not always available. Since there are multiple authorities in each Member State, whose range of powers and competences often do not match, the efficient cross-border coordination is difficult to achieve. Each state member remains responsible for its own financial stability, where there are large cross-border institutions such stability will depend on actions of the authorities of other countries. Thus, the weakness of the governance system of the European banking sector is an insufficient homogeneity of the financial regulation and supervision (Mayers, 2007). However, The EC Treaty (article 105(6)) and the ESCB Statute (article 25.2) leave open the possibility that the ECB might gain responsibility for the prudential supervision of credit institutions and other financial entities, with the exception of insurance companies. In order to assign these responsibilities, a qualified majority of the EU Council must decide in favour according to the Constitutional Treaty (Garcia, 2005).

The threat of asymmetric information is also actual for European governance system as well as for Russian. Accurate information is very important to enable authorities to use their financial safety net to resolve the problems of complex financial companies operating nationally and internationally. Timely access to accurate information for regulators and markets to overcome the problem of asymmetric information where the banks knows its conditions better than anyone else. Gaining access to adequate information is difficult even in the domestic markets where it will be require different regulators to share information. The regulators also have to decide what information to reveal publicity to promote market discipline without encouraging panic. It is incomparably difficult for regulators to obtain and share in the international arena, where nations are in competition with, or hostile to, one another may need to cooperate. (Garcia, 2005).

The euro-area acknowledged the problems of permitting information to be asymmetrically distributed between banks and their regulators. It also recognised that it is costly to obtain the information on banks' financial situation needed to alleviate the regulators' information disadvantage. The view of the ECB was that prudential regulation for banks in the euro-area should be the responsibility of the national central banks, rather than other separate supervisory agencies. From the ECB's perspective, this attribution of responsibility was desirable from two points of view. First, it would allow central banks to understand better the financial condition of banks and other financial intermediaries. Second, it would implicitly improve coordination between the supervisory and monetary policy functions (Garcia, 2005).

From the point of view of the EB, centralisation of prudential supervisory functions across the banking, securities, and insurance industries in the national central banks would have aligned the incentives of both the central banks and the supervisors to gather information and would have avoided the duplication of monitoring costs within the ESCB. Further, giving prudential supervisory powers to national central banks has become more acceptable given their recent independence from the political process. At the national level, the institutional structures for the supervision of financial intermediaries are diverse in the EU. However, the separation of prudential supervision and central banking does not necessarily imply that regulators and central bankers will not share costly information.

Information asymmetry is more problematic with regards to the financial condition of banks. To reduce the asymmetry, the ECB, the central banks and supervisory agencies have signed a memorandum of Understanding (MoU) on the exchange of information on the financial conditions of distressed banks. Nonetheless, this approach has limitations. First, while it provides moral suasion in favour of cooperation, the MoU lacks legal enforceability and as result no penalties are envisaged in case the contract is breached. Secondly, in the absence of full regulatory harmonisation, differences in accounting rules leave a room for a lax interpretation of bank's financial condition. Thirdly, the MoU is confidential, which could limit accountability for the institutions involved. Thus far, the roles of the deposit insurer and ministers of finance have not been considered (Garcia, 2005).

In order for bank supervisors to use their powers effectively, they must have an accurate understanding of the bank's and banking group's financial condition. A potential problem for a prudential supervisor of a cross-border banking group is that of determining the status of those parts of the group outside its supervisory control (Mayers, 2007).

At the present time the main threat for the supervision of the European banking sector is to maintain a financial stability and to exit and to retain control of banking sector at the right moment, because under crisis conditions the governance institutions actively intervene to the European banking sector. In both the euro area and Russia, foreign demand for exports has declined, and domestic demand has been negatively affected by declining confidence and a tightening of financing conditions.

Opportunities for the governance system of the European banking sector include an development of information technologies and rapid innovation. The adoption of new technologies can positively influence the efficiency of the banking activities and quality of banking services.

5.3 Summary

The governance systems of the Russian and European banking sectors have their own strong and weak sides, opportunities to improve themselves, and threats which are necessary to avoid.

The strengths of the governance system of the Russian banking sector include the control of financial sector, which aims to prevent the financial instability and financial falls; experience of crisis in previous years, as well as big reserves of the government help to soften the negative impact of the crisis.

The strength of the Russian style of governance is that the control mechanisms of the socio-economic life (including the regulation of the financial sector) ought to prevent the repeat of the collapses. Another argument for the state involvement into financial sector is the government support of the banking sector. It is of interest under the global financial crisis' conditions (see Table 11). The government has significant power to maintain the financial sector by the provision of financial support. Big reserves of the government could help to soften the negative impact of the crisis. However the issue how and to whom the government provides this financial support was arisen. The fact that the Russian government has enough financial reserves is not enough for an effective solution of financial problems caused by the global crisis. The distribution of the financial reserves should be made in an efficient way, not only favouring liquidity to the key Russian banks. The use of crisis experience acquired in previous years could be a strong side of the governance of the financial sector, in particular in the banking sphere. The lessons that was learnt could be useful if the crisis situation occurs again, for instance under conditions of global financial crisis (see page 32). Russia's banking sector has suffered repeated crises since the start of transition. Policy makers could improve the stability of the banking system by converging on existing best practice as regards the implementation of prudential supervision.

The weaknesses are related to the lack of prudential supervision in the banking sector. A lack of prudential supervision causes a high level of state interference into financial regulation.

The commercial banks do not operate on a commercial basis. Political interference in Russian financial sector regulation was explained by the necessity to prevent the repeat of crisis. However, political pressures weakened financial regulation generally, they hindered regulators and the supervisors who enforce the regulations from taking action against banks that ran into trouble.

The government ownership of the banking sector (when the government owns the key large banks, or the most of the largest banks) reduces the incentives for banks to accurately price loans, for depositors to access the strengths of banks they use, and for supervisors to carefully monitor the banks.

A lack of transparency in the ownership structures and poor corporate governance of commercial banks slow down the development of the sector and impede financial decisions and prudential supervision.

The regulation of the entrance of foreign banks has a negative effect on the competition in the banking market. The efficiency of the Russian banking institutions is low, because they do not have to compete with strong rivals.

The most significant weakness in the structure of Russia's economy is its dependence on the export of raw materials, including its valuable energy resources. The changes of the energy resources' prices could influence dramatically the amount of liquidity circulating in the Russian economy. Thus the changes (especially reduction) of oil and gas prices threaten the stability of the banking sector and economy as a whole, because a lack of liquidity in the banking sector was a great impact on the real sector of economy. So the overall welfare of state would be undermined if the raw materials' prices change. This are threats of the governance system of the Russian banking sector, which closely interrelated with its weaknesses. The dependence on the prices of the natural resources weakens the Russian banking sector.

Another challenge for governance system of the Russian banking sector is caused by high inflation. The Central Bank of Russia takes measures to reduce the real rate of inflation; however under the global financial crisis' conditions it became more difficult to keep the inflation rate stable. In this situation two related threats are challenging the governance system of the banking sector. They are the global financial crisis and worsening macroeconomic environment in Russia.

The asymmetric information is a crucial impediment to the efficient functioning of the financial system. Since 1998 the governance system conducted a number of reforms to improve the exchanging of information between counterparties, but the threat of asymmetric information is still actual.

Opportunities for the governance system of the Russian banking sector include an increase of a foreign inflow to the banking system and development of information technologies and the appearance of new competitors linked to rapid innovation and the intensification of competition. The relaxation of entrance requirements for foreign banks gives an opportunity to increase the capital inflow into the economy and to encourage the competition in the banking sector. The foreign investments and appearance of the new competitors could give a chance to the Russian banking sector to exploit opportunities offered in a global capital market. The adoption of new technologies can positively influence the efficiency of the banking activities and quality of banking services.

In the EU the banking sector is characterised by a low level of the political inference in comparison with the Russian one. The commercial banks operate on a commercial basis without political interference. Therefore, the state ownership in the banking sector is lower.

The current European framework to guard financial stability is well-developed and consists of three layers: crisis prevention, crisis management and crisis resolution. These are described in Appendix 5. The European legislation on banking is matching to the international accounting and auditing standards; it contains clear guidelines and instructions of the ECB for commercial banks. The Lamfallusy framework of legislation on banking in the EU shows that it is efficient procedure for passing secondary legislation (technical rules). It will have to reduce the scope for diversity in the transposition of EU directives into national laws and regulations (Garcia, 2005). However, the new architecture would need to encourage a more consistent application of the secondary legislation in order to promote homogeneous and transparent supervisory practices throughout the EU.

The consolidation process is based on the possibility of reaping profitability, reducing cost inefficiency, increasing market power, and exploiting scale and scope economies. These economies of scale mean benefits from reduced costs, by spreading the fixed costs out over a larger level of production. (Cavallo, 2001).

At the same time consolidation in the financial services industry and increasing cross-border activities by large complex financial institutions may pose a threat to international financial stability. It presents a challenge to regulators responsible for preventing and managing financial crises should one of these large international institutions fail (Garcia, 2005). Since there are multiple authorities in each Member State, whose range of powers and competences often do not match, the efficient cross-border coordination is difficult to achieve. Thus, the weakness of the governance system of the European banking sector is an insufficient homogeneity of the financial regulation and supervision (Mayers, 2007).

The threat of asymmetric information is also actual for European governance system as well as for Russian. Timely access to accurate information for regulators and markets to overcome the problem of asymmetric information where the banks know its conditions better than anyone else. Gaining access to adequate information is difficult even in the domestic markets where it will be require different regulators to share information (Garcia, 2005).

Information asymmetry is more problematic with regards to the financial condition of banks. To reduce the asymmetry, the ECB, the central banks and supervisory agencies have signed a memorandum of Understanding (MoU) on the exchange of information on the financial conditions of distressed banks. Nonetheless, this approach has limitations. First, while it provides moral suasion in favour of cooperation, the MoU lacks legal enforceability and as result no penalties are envisaged in case the contract is breached. Secondly, in the absence of full regulatory harmonisation, differences in accounting rules leave a room for a lax interpretation of bank's financial condition. Thirdly, the MoU is confidential, which could limit accountability for the institutions involved. Thus far, the roles of the deposit insurer and ministers of finance have not been considered (Garcia, 2005).

In order for bank supervisors to use their powers effectively, they must have an accurate understanding of the bank's and banking group's financial condition. A potential problem for a prudential supervisor of a cross-border banking group is that of determining the status of those parts of the group outside its supervisory control (Mayers, 2007).

At the present time the main threat for the supervision of the European banking sector is to maintain a financial stability and to exit and to retain control of banking sector at the right moment, because under crisis conditions the governance institutions actively intervene to the European banking sector. In both the euro area and Russia, foreign demand for exports has declined, and domestic demand has been negatively affected by declining confidence and a tightening of financing conditions.

Opportunities for the governance system of the European banking sector include development of information technologies and rapid innovation. The adoption of new technologies can positively influence the efficiency of the banking activities and quality of banking services.

Chapter 6. Conclusion and discussion

In this chapter the overall conclusions and discussion will be given. The answers on the specific research questions will provided, which help to answer the main research question. This will be done in section 6.1. Discussions will be given in section 6.2 to propose point what could go on further with the research.

6.1 Conclusion

In this section the general and specific research questions will be answered. First we will provide the answers on the specific research questions. Than based on this we will answer the general research question.

The first specific research question is

What is the governance system of the banking sector?

The governance system of the banking sector is a part of the financial regulation and supervision. The governance system of the banking sector defines as a set of institutions and structures of authority to allocate and regulate capital resources and control banking activity. Thus the governance system has its own institutional structure, which includes regulatory agencies with functions to regulate, supervise and control the banking sector and market.

The arrangement of the governance system depends on the structure of the regulation of the financial system. The specifics of the institutional structure of the governance system of the banking sector caused by the national differences such as historical evolution, the structure of the financial system, political structures and traditions, the size of country and the size of the banking sector. There are many alternatives for the arrangement of the governance system of the banking sector. Each country has its own model of the governance driven by its specific approach to govern, which was developed for a long time.

The objectives of the governance system of the banking sector includes the financial stability, prudential supervision, transparency of banking market, efficiency of banks' activities.

The evaluation of the quality of the governance leads us to the issue what good governance and poor governance are. Poor governance of the banking sector impedes achieving the goal of the financial stability. Under poor governance substantial parts of the benefits are diverted against the will of the producers and distributed among people who did not contribute to their production and, hence, the producers will reduce their efforts after a certain period of time. (Wagener, 2004). The key elements of good governance are accountability, transparency, combing corruption and enabling legal framework (Agere, 2000). The governance of the banking system is good when it is transparent, accountable, corruption is unacceptable, and there is an appropriate legal basis for governance.

The necessary part of the good governance of the banking sector is the prudential regulation. The prudential supervision involves government regulation and monitoring of the banking system to ensure its safety and soundness. Supervising prudentially the government establishes regulations to reduce risk taking and then supervisors monitor banks to see that they are complying with these regulations and not taking an excessive risk. According to Mishkin (2001) prudential supervision takes on the following basic forms: restrictions on asset holding and activities, separation of the banking and other financial service industries such as securities, insurance, etc., restriction on competition, capital requirements, risk-based deposit insurance premiums, disclosure requirements, bank chartering, bank examination.

The execution of the prudential supervision is not a guarantee of the good governance, but it is a mean by which capable hands could govern the banking sector effectively.

The different governance system of the banking sector have a different institutional structure, they use different means for regulation and supervision, but the goal of any governance system of the banking sector is a financial stability, which means the balanced conditions which are necessary for economic development. So the good governance system of the banking sector needs to maintain these conditions for economic development.

The second specific research question is

Which factors influences the development of the governance system of the banking sector in Russia and in the European Union?

As we can see the banking sectors of Russia and the European Union have different backgrounds concerning the impact of external and internal factors such as the cultural characteristics of the nations, the historical development of banking sectors, specific features which are influenced on the building the governance system of each banking sector.

The governance system of the Russian banking sector is characterised by the high level of centralisation, which is caused by the cultural specifics of the Russians and extremely unfavourable macroeconomic environment during 1990s, when the banking sector actually established. The present governance system of Russian banking sector has several specifics which made it different than European governance system.

First of all, a speed of the development of the Russian banking sector influenced the quality of its governance. As we know from the historical background, the development of European banking system has an evolutionary character. All changes were planned and carefully considered before implementation. The development of the modern Russian banking system was precipitous. After the collapse of the USSR the economic growth of new Russia was unpredictable. There was no plan of actions for complex development of Russian economy. For sure it influenced adversely on the efficiency of the governance system.

The specific mentality of Russians also has affected the development of the present governance system of the Russian banking sector. Comparing to the Europeans, the Russians have a low level of responsibility, high power distance, they are more collectivistic, etc. All these features of Russian nation are a heritage of the Soviet period. The brains of Russian people could not be transformed so fast as the state structure and an economy arrangement.

The macroeconomic environment is the next factor which has significant impact on the establishment of the present governance system in Russia and in the EU. There were very favourable macroeconomic circumstances in the euro-area during last 20 years. The economic growth, inflation and other macroeconomic indicators were very stable in Europe. In Russia's turn, the situation in Russian economy was extremely disadvantageous. The rapid economic changes created an unstable environment in which a good performance of the banking sector was impossible. After 1998 crisis the policy concerning financial regulation and supervision became stricter to overcome the negative processes in the Russian economy. The strict governance has been still remaining.

The third specific research question is (with two subquestions)

What is the present governance system of the banking sector in Russia and in the European Union?

Concerning the institutional structure of the governance system the main difference is in the number of regulatory agencies that are responsible for regulation and supervision in the banking sector. In Russia there is only the Central bank, in the European Union the Eurosystem, which includes the European Central bank and national central banks, conducts the governance of the banking regulation and supervision. Therefore, it is obvious that there are different levels of centralization in the governance systems of the European and Russian banking sectors.

Concerning the role of the Central Bank in the governance system we can conclude that the Central Bank of Russia has a great power and plays a key role in the banking regulation in Russia. In the EU the ECB works in close cooperation with the national central banks to carry out a single monetary policy and gain financial stability. The ECB is more powerful than NCBs, it has full right to hold and manage its reserves and the right of the ECB to impose restrictions on NCBs' behaviour. Thus the ECB is the most important agency in the institutional structure of the governance system of the European banking system.

Concerning the situation on the banking sector we can see, that the main difference of the Russian and European banking sector is the level of state involvement. In Russia the state plays a significant role in the development of the banking sector. Possibly it is caused by the continuing reforms in the Russian banking system. The dominant role of state-controlled banks and insolvency of the commercial banks adversely impact the competition among them. The protectionist policy towards state-controlled banks led to the deformation of in the structure of assets allocation among the banks. The most financial assets are concentrated in the hands of a few dominant banks, mostly in the western part of Russia (Moscow and Moscow region). The level of state involvement (for instance, the invasion of ECB or NCB into banking sector) is not so crucial in Europe, compared to Russia. Commercial banks are relatively free in their activities. The European banking market is competitive, and competition is encouraged by ECB.

Concerning the situation with the global financial crisis we can conclude that both governance systems have taken the same measures to keep relative stability in the financial sector. The level of state involvement into the banking sector rose in the EU, and the regulation of the Russian banking sector became tougher. The financial sectors in the EU and Russia are in the same situation and have the same problems how to deal with the crisis and its consequences. The main challenge for the supervision of the European banking sector is to maintain financial stability and to exit and to retain control of the banking sector at the right moment, because under crisis conditions the governance institutions actively intervene into the

European banking sector. For Russian governance system as well as for EU it is very important to keep the situation under control and soften the negative effects of the crisis on the economic development. However, it will be possible after the revising the governance policy concerning the banking supervision and regulation.

- *What are the strengths and weaknesses of the governance system of the Russian banking sector?*

The answer on this question could be presented in the table. The following Table is the same as in the Chapter 5.1 (Table 12) and it represents the strengths and weaknesses, opportunities and threats of the governance system of the Russian banking sector.

	Strengths	**Weaknesses**
Internal factors	- Strong control of financial sector, which aimed to prevent the financial instability and financial falls. Stability is not under threat as the government is firmly in control; - Experience of crisis in previous years. The lessons of the 1998 crisis could be helpful in financial regulation, in particular the governance of the banking sector; - Big reserves of the government help to soften the negative impact of the crisis	- High level of political interference into the governance of the banking sector - Over-centralization blocks the development of a competitive economy; - Lack of prudential supervision; - Weak corporate governance of commercial banks; - Corruption; - Immaturity of the banking sector; - Low foreign investments; - Weak competition; - Dependence on the natural resources.
	Opportunities	**Threats**
External factors	- Increase a foreign inflow to the banking system could lead to strengthening competition and exploit opportunities offered a global capital market; - Development of information technologies and the appearance	- Asymmetric information in the financial system; - Global financial crisis; - High inflation and worsening the macroeconomic conditions;

	of new competitors linked to rapid innovation and promoted the intensification of competition.	- Reduction of natural resources' (in particular oil's) prices.

- *What are the strengths and weaknesses of the governance system of the European banking sector?*

The answer on this question could be presented in the table. The following Table is the same as in the Chapter 5.2 (Table 13) and it represents the strengths and weaknesses, opportunities and threats of the governance system of the European banking sector.

Internal factors	**Strengths**	**Weaknesses**
	- Low level of political interference into the banking sector; - Low level of state ownership; - Developed supervisory framework to ensure financial stability; - Developed legislation: matching banking legislation to the international accounting and auditing standards; clear guidelines and instructions of the ECB for commercial banks.	- Risk management practices concerning the cross-border financial institutions; - Regulatory backwards related to the consolidation of the banking sector, which makes financial sector more vulnerable (lack of homogeneity);
External factors	Opportunities	Threats
	- Development of new technologies (technical progress)	- Global financial crisis - Information asymmetry

The fourth specific research question is

How is it possible to avoid weaknesses of the governance systems of the European and Russian banking sectors based on their benchmarking?

As we can see, the level of development of the governance systems of the European and Russian banking sectors because of a set of factors. The governance system of the Russian banking sector is over-centralised, with high level of state ownership in the banking sector, which is always politically interfered. The weaknesses of the governance system are related to the high state involvement to the Russian banking sector. To overcome these weaknesses a policy of prudential supervision needs to be conducted, as it is done in the European banking sector's regulation. For this it is necessary to ensure the basic precondition for effective banking supervision. It is a clear definition of the responsibilities, authorities and objectives of each supervision agency, which should also be independent and legally protected. Banking supervision can only be effective if it works within a suitable macroeconomic frame with a sound and sustainable macroeconomic policy, a well-developed infrastructure, effective market discipline, procedures for the efficient resolution of problems, and a mechanism for providing an appropriate level of systemic protection (Olsen, 2005).

The weaknesses of the governance system of the European banking sector are related to the high level of consolidation of the financial sector and insufficient homogeneity of regulation. In this case it is necessary to centralise regulatory and supervisory functions to a single agency which is responsible for the EU-wide operations of the cross-border financial structures. Thus, threat of asymmetry of information could be reduced.

The benchmarking analysis shows that the efficient governance of the banking sector is in between the Russian governance system and European one. The first governance system is too centralised, which affected negatively on the development of the banking sector. The second one is more liberal, but the decentralisation of regulatory function led to asymmetry of financial information, which also influences negatively. The main challenge of both governance systems is to find a balance between this two types of the governance styles.

The general research question is

What can be learnt by European and Russian governance systems of the banking sectors to avoid weaknesses of both and improve them?

The Russian governance system is too strict and the level of state control is high. The Russian banking system is still relatively underdeveloped. To avoid the negative consequences of high state involvement in banking sector it is necessary to reduce the power of state-controlled banks in Russia. The case of the governance of the European banking sector illustrates that the lower state invasion could be more efficient and beneficial than tough regulation, because performance of the European banking sector is much better than of the Russian one.

The governance system as well as the European banking sector was established evolutionary for a long time. Therefore, the European governance system has a great experience concerning development of financial legislation and conducting a policy of prudential supervision. In particular, the Russian governance system can adopt the European experience for enhancing the competitive environment in the banking sector. Also it is possible to improve monetary policy of the Central Bank of Russia according to international standards. Europe has been championing in the consistency at international level, for instance the accounting standards in the EU is clearer than In Russia.

Making prudential supervision, facilitating effective competition and reducing the state's role as an owner of banks would be important steps for the raising the performance of the banking sector and improving its governance system. All these things could be learnt on the basis of European banking sector's experience.

In particular, the Russian supervisors can study European experience concerning development of financial legislation, establishment of the legal framework for the decentralised governance system, gain knowledge about development of risk-oriented supervision of banks, implementation of Basel II (which still in process, probably in 2010 it will adopted in Russia), licensing of credit institutions, ongoing supervision (off-site supervision based on the financial reporting of banks and inspections), supervisory corrective actions, financial rehabilitation of credit institutions, control and monitoring of banks, monitoring of financial stability in the financial sector, and improving the deposit insurance system. All these fields of regulation of the banking sector could be useful for Russia if the supervisors decide to reduce the state power in the financial sector, which would be a first step to improvement of the Russian governance system.

The European governance system of the banking sector could also gain knowledge concerning banking regulation and supervision by a single agency (in Russia it is the Central Bank of Russia). The experience of Russian financial sector in the 1998 crisis could be useful for European supervisors to prevent negative consequences of the current financial crisis.

Comparing the governance style of banking system in Russia and in the European Union, we have found the weak and strong sides of each governance system. It emerged that the strong sides of the one governance system is a weak sides of another.

6.2 Discussions

Effective banking supervision has become the cornerstone of financial supervision in recent years resulting from the recognition that weaknesses in banking systems have been at the core of financial crises in many countries over the past several decades. As banking crises have affected many countries, both developed and emerging economies, the monitoring of banking systems have become both more critical and more challenging for supervisors.

The governance system of the banking sector could have a different institutional structure, it could use different means for regulation and supervision, but the goal of any governance system of the banking sector is a financial stability, which means the balanced conditions which are necessary for economic development. So the good governance system of the banking sector needs to maintain these conditions for economic development.

Indeed, the banking sector is important because of its weight in the economy and because it is crucial to provide finance to firms. Apart from the stability concern that may induce regulation, It is well known that banks are special because they are more vulnerable to instability than firms in other sectors. The potential instability of the banking system and the need of consumer protection are the fundamental rationales behind the introduction and development of regulation. The vulnerability of banks to runs and systemic crises and the consequent concern for consumers' wealth are the main factors justifying the need of regulation and safety net arrangements in the form of deposit insurance and lender of last resort.

The research could be continued in several directions:

- the governance system of the banking sector (Russian or European) under the crisis conditions, in which the measures and results of measures taken to alleviate the crisis influence on the financial sector would be considered;
- risk management within the governance system of the banking sector, in which the policy of banking sector’s governance would be considered;
- case study of certain cross-border financial credit structures operating in the European banking sector;
- prudential supervision and its role in the governance of the banking sector;
- corporate governance of banks and its role in the governance of the banking sector.

Here is several possible directions in which this research could be deepened.

Chapter 7. Recommendations

This chapter provides the recommendations for improvement of the governance systems of the Russian and European banking sectors. In the previous chapter we identified the weak and the strong sides of each system. The following recommendations are provided as a possible solution of current problems concerning the governance of the banking sector. They could be helpful to overcome the weaknesses and strengthen one banking sector and its governance based on the experience of another. This chapter is devoted to answer the fourth research question: how is it possible to avoid weaknesses of the governance systems of the Russian and European banking sectors based on their benchmarking?

7.1 Recommendations for the improvement of the governance system of the Russian banking sector

The analysis of the governance system of the Russian banking sector brought to light the problems which the governance of banking sector faces. To overcome weaknesses of the governance system of the Russian banking sector that were identified in the previous chapter (see Chapter 5.1) a set of recommendations is developed. The recommendations are based on the comparison of two governance systems of the banking sector: Russian and European.

Policy makers face two broad regulatory challenges in seeking to improve the stability of the banking system: to converge on existing best practice as regards the implementation of prudential supervision and (a challenge shared with many other countries) to address defects in bank regulation which amplify economic cycles and give insufficient weight to liquidity considerations.

As we can see, the Russian banking system suffers from a lack of prudential supervision. It reflects in a lack of transparency, corruption, inconsistent interpretation and implementation of banking legislation, etc. Establishing and improvement the range of prudential regulations (capital requirements, restrictions on asset holding and activities, disclosure requirements, bank monitoring and examination) is necessary to accurately evaluate risk and capital adequacy of banking assets.

The legal infrastructure for the banking sector is well developed, but supporting legislation for banking supervision and implementation practices need to be improved by proactive assessment of the operating conditions and integrity of banks; focus on facilitating the exit of problem banks; strengthening guidelines for “fit and proper tests” and enhancing the transparency of bank ownership; enforcement of consolidated supervision (Financial, 2003).

Usually the quality of the financial data and reports generated by banks are poor and misleading due to deficiencies in the applied accounting procedures and controls. These circumstances can lead to understatement of the banks’ reported large exposures and exposures to related parties.

Some improvements in the legal foundation would also complement the further strengthening of the banking supervision in the areas of: transparency of bank ownership and suitability of shareholders; qualified immunity for directors, officers and employees of the CBR; strengthening of criminal statues to define what constitutes misappropriation of funds, personal benefit and other illegal actions in the financial sector (Russian, 2003).

Russian monetary policy should be revised concerning foreign invasion to the Russian financial sector. One of the possibilities of further development of Russian banking sector is the involvement of the foreign banks into the national banking reform. It could be beneficial for Russian economy to reduce barriers to foreign direct investment. It suggested the growth of the inflows of the capital of the foreign banks to the national financial system. The governance system needs to revise its policy concerning the activity of foreign agents in the Russian banking market. However, the foreign banks see no reason for investing to the Russian commercial banks due to socio-political risks and the current conditions of the financial sphere. For instance, the attractiveness of the fuel-energy enterprises is much higher for the investors than the banking sector.

One of the main problems of Russian banking sector and its governance is the high level of state involvement in financial industry, especially in banking sector. The state has concentrated in its hands the main financial flows of the Russian economy. It led to the poor development of commercial banks, which had an adverse impact on the competition within the banking industry: commercial banks are not able to compete with the largest state-controlled banks such as Sberbank or VneshTorgBank. This disproportion breaks the further development of the banking system. The governance system should change its policy concerning the support of ‘favourite’ banks. The incentive of the Russian state to control the key financial flows is understandable: governance of the financial flows gives enormous power, not only economic, but political too. Russia is a very political state – all important processes have a political background. However, the performance of the banking sector is hurt because of its total control and tough regulation. To avoid the negative consequences of high state involvement in the banking sector it is necessary to reduce the power of state-controlled banks in Russia. The government should encourage competition among banks and intervene in banking sector's affair in case of emergency. Certainly it means the reduction of state control in banking sector, but the efficiency of banks would be improved. And total beneficial effect would be higher than with the tough regulation and supervision.

The main question to answer is: To what extent should the Central Bank be involved in financial services supervision, or more specifically, in banking supervision? This issue remains open.

Russia's financial system, despite its recent rapid expansion, is still relatively underdeveloped, leaving considerable scope for financial deepening to contribute to long-term growth. A number of reforms would contribute to such deepening. First, although Russia has many banks, competition overall is weak, especially at the regional level. Consolidation of the sector would help, as this would lift more banks above a minimum efficient scale, which is necessary to contribute to effective competition. Over the long term, competition and efficiency would be improved by streamlining the state's involvement in the sector. Here, as with state-owned enterprises in other sectors, policy goals are mixed with commercial ones, mandates are unclear, and institutions with sub-optimal corporate governance arrangements are given major roles. Beyond being boosted by competition, banking efficiency would benefit from improvements in the rule of law, faster convergence to international financial reporting standards, and measures to lengthen the effective duration of bank liabilities (Economic survey of the Russian Federation, 2009).

Efficiency and competition are closely linked. In a competitive banking system, banks must operate efficiently and utilize their resources wisely if they are to keep their customers and remain in business. Without such competition, individual banks might attempt to gain higher prices for their services by restricting output or colluding with other banks. Competition is also a driving force in keeping banks innovative in their operations and in designing new services for customers. A further consideration is that for resources throughout the economy to flow to activities and places where they are of greatest value, competitive standards should not differ significantly across banking markets or between banking and other industries.

The promotion of an efficient and competitive banking system carries a number of implications for regulation. Competition and efficiency depend on the number of banks operating in a market, the freedom of other banks to enter and compete, and the ability of banks to achieve an appropriate size for serving their customers. For instance, too few banks in a market could encourage monopolization or collusion, while banks of a suboptimal size might be unable to serve major customers and might be operating inefficiently. Consequently, regulators must be concerned with the concentration of resources in the banking industry and with the opportunities for entry and expansion across individual banking markets. Banking regulation must also take an approach that does not needlessly restrict activities of commercial banks, place them at a competitive disadvantage with less regulated firms, or hinder the ability of banks to serve their customers' financial needs. Finally, regulation should foster a banking system that can adapt and evolve in response to changing economic conditions and technological advances (Spong, 2000).

It is necessary to ensure the basic precondition for effective banking supervision. It is a clear definition of the responsibilities, authorities and objectives of each supervision agency, which should also be independent and legally protected. Banking supervision can only be effective if it works within a suitable macroeconomic frame with a sound and sustainable macroeconomic policy, a well-developed infrastructure, effective market discipline, procedures for the efficient resolution of problems, and a mechanism for providing an appropriate level of systematic protection (Olsen, 2005).

7.2 Recommendations for the improvement of the governance system of the European banking sector

According to Garcia (2005) there are certain regulations, which can alleviate financial distress and prevent causing a financial crisis. They are the lender as a last resort, a system of prudential supervision and regulation, as well as deposit insurance. As we can see these regulations have weaknesses, because the problem of the global financial crisis affected strongly on the stability of the European financial sector. Taking into account problems of financial regulation and supervision in the EU related to the activity of cross-border financial institutions (including banks), we can conclude that it is necessary to strengthen the homogeneity of the financial governance, in particular the governance of the European banking sector. Establishment of a single body of regulation and supervision of the financial sector can eliminate a problem of insufficient homogeneity of the European governance system.

It is easier in many instances if a single body of law governs the safety net's provision, where one body is responsible and accountable for ensuring the stability of the financial markets (Garcia, 2005). For this it is necessary to broaden the competence and power of the ECB, or establish a central regulatory agency that works together with the national financial authorities (e.g. NCBs). Thus, the issue of reorganising the overall financial regulation structure is highlighted. The banking system is a part of the financial system, and the governance system of the banking sector is a part of the governance system of the European financial sector. So should this central agency be responsible for overall supervision and regulation of EU-wide operation in the financial sector? To my mind, it should, because the banking sector, capital market, and insurance industry are closely interrelated and distribution of the regulatory functions to the separate agency for each sector does not solve the problem of the insufficient homogeneity of the governance system.

While countries will differ over the means and the extent to which their central bank is held accountable for ensuring domestic financial stability, this responsibility typically falls, implicitly if not explicitly, to the central bank. The central bank may or may not also be responsible for supervision of financial institutions, resolving failed institutions and compensating depositors (Garcia, 2005). There is a high level of economic integration in the EU. And the need of structured unified supervision of highly consolidated financial sector is obvious. The appearance of the cross-border financial groups and institutions are the consequence of consolidation of the European financial sector. Therefore, it is necessary to establish a single regulatory agency which is responsible for prudential regulation of cross-border financial companies at the European level. This central body should be given full responsibility for the EU-wide operations (branches, subsidiaries of pan-European financial institutions).

Also it is important to enhance cooperation between national authorities, especially in case of sharing information concerning the financial conditions of cross-border financial groups). Currently the regulation of pan-European companies is executed in the following way:

the home authority is responsible for a financial group and its EU-wide branch networks. The host authority is responsible for a group's subsidiaries. In this situation full information concerning the financial state of group could be implicit, because of the possibility that not full information was shared between the home and host authorities. To avoid this home and host financial supervisors need to cooperate closely for financial governance and stability.

To reduce the threat of asymmetric information close cooperation of the national central banks and the ECB within Eurosystem is necessary. The need for information sharing among the supervisors is recognized in the Capital Requirements Directive, Article 132, which establishes that the: "competent authorities shall cooperate closely with each other. They shall provide one another with any information which is essential or relevant for the exercise of the other authorities' supervisory tasks under this Directive. In this regard, the competent authorities shall communicate on request all relevant information and shall communicate on their own initiative all essential information. […] Information shall be regarded as essential if it could materially influence the assessment of the financial soundness of a credit institution or financial institution in another Member State. In particular, competent authorities responsible for consolidated supervision of EU parent credit institutions and credit institutions controlled by EU parent financial holding companies shall provide the competent authorities in other Member States who supervise subsidiaries of these parents with all relevant information. In determining the extent of relevant information, the importance of these subsidiaries within the financial system in those Member States shall be taken into account" (Mayers, 2007). The institutions within individual member states need to have incentives to cooperate sufficiently and promptly to avoid a financial crisis.

While the information sharing mandated by the CRD (Capital Requirements Directive) should provide national supervisors with the information they need, ad hoc sharing on a banking-group by banking-group basis is likely to be inefficient and leave room for gaps in information sharing. Mayes and Vesala (in Mayers, 2007) advocate the establishment of a common data base. At a minimum this data base should contain quarterly consolidated financial statements from all insured banks and their nonbank corporate parents (when one exists) that is available to all bank supervisors and ideally these financial statements would be publicly available (Mayers, 2007).

List of definitions

Banking system is a network of commercial, savings, and specialized banks that provide financial services, including accepting deposits and providing loans and credit, money transmission and investment facilities[23].

Basel II framework is the internationally accepted principles of the Basel Committee on Banking Supervision. The Basel II framework was conceived to support banks in the implementation of advanced risk management standards with the overall aim of improving the stability and soundness of the financial system in all the economies around the world.

BIS (Bank for International Settlements) is an international organisation which fosters international monetary and financial cooperation and serves as a bank for central banks.

Central Bank financial institution designed to regulate and control the money supply of a nation, with the goal of fostering economic growth without inflation. The responsibilities of the central bank usually include maintaining adequate reserve backing for the nation's commercial banks and regulating the exchange rate of the nation's currency. Such duties are met by controlling the discount rate, making reserve advances to commercial banks, trading in government obligations, and acting as the government's fiduciary agent in its dealings with other governments and other central banks.[24]

Commercial bank is an institution which accepts deposits, makes business loans, and offers related services. Commercial banks also allow for a variety of deposit accounts, such as checking, savings, and time deposit. These institutions are run to make a profit and owned by a group of individuals, yet some may be members of the Federal Reserve System. While commercial banks offer services to individuals, they are primarily concerned with receiving deposits and lending to businesses[25].

Governance system of banking sector is a set of institutions and structures of authority to allocate and regulate capital resources and control banking activity in the economy.

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[23]Source: http://dictionary.bnet.com/definition/banking+system.html
[24] Source: http://encyclopedia2.thefreedictionary.com/central+bank
[25] Source: http://www.investorwords.com/955/commercial_bank.html

Eurosystem is related to the structure of central banking in the euro area. The Eurosystem as the central banking system of the euro area comprises: the ECB, and the national central banks (NCBs) of the 16 EU Member States whose common currency is the euro. The Eurosystem is thus a sub-set of the ESCB.

ESCB (European System of Central Banks) comprises the European Central Bank (ECB) and the national central banks (NCBs) of all 27 EU Member States.

ECB (The European Central Bank) is the organisation for the conduct of monetary policy and the performance of other central banking functions for the euro. It carries out these tasks together with the national central banks of the euro area. The ECB is at the heart of the Eurosystem and the European System of Central Banks (ESCB). It was established in June 1998, replacing its precursor, the European Monetary Institute (EMI).

EMU (European Monetary Union) is the agreement among the participating member states of the European Union to adopt a single hard currency and monetary system. (http://www.uiowa.edu/ifdebook/faq/faq_docs/EMU.shtml)

EU (European Union) is an association of European countries, originally formed to further a common economic market, but since developed into a union to work toward a broader range of policies in the economic, social, and political spheres. Within the association, member countries retain their sovereignty as independent countries in all other areas not governed by the Union.[26]

Financial independence. The ECB and the NCBs must be able to autonomously avail themselves of sufficient financial resources to fulfill their mandates. The ECB has its own capital, subscribed and paid up by the NCBs. It also has its own budget independent from that of the other European institutions. As regards the NCBs, Member States may not put their NCBs in the position of not having sufficient financing resources to carry out their ESCB-related and own national tasks.

Financial stability is a condition in which an economy's mechanisms for pricing, allocating, and managing financial risks (credit, liquidity, counterparty, market, etc.) are functioning well enough to contribute to the performance of the economy (Schinasi, 2004)

[26] http://www.carleton.ca/ces/EULearning/lesson_plans/EuropeanUnionGovernance_Canadian.pdf

Functional independence requires a primary objective determined by clarity and legal certainty that provides the central bank with the necessary means and instruments to achieve this objective, independently of any other authority. The primary objective of the ESCB, as enshrined in the EC Treaty and the ESCB Statute, is the maintenance of price stability.

Harmonised Index of Consumer Prices (HICP) is the measure of inflation which the Governing Council uses to define and assess price stability in the euro area as a whole in quantitative terms. The HICPs are economic indicators constructed to measure the changes over time in the prices of consumer goods and services acquired by households. The HICPs give comparable measures of inflation in the euro-zone, the EU, the European Economic Area and for other countries including accession and candidate countries. They are calculated according to a harmonised approach and a single set of definitions. They provide the official measure of consumer price inflation in the euro-zone for the purposes of monetary policy in the euro area and assessing inflation convergence as required under the Maastricht criteria. (http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/introduction)

IFRS (International Financial Reporting Standards) are a set of accounting standards developed by the International Accounting Standards Board (IASB) that is becoming the global standard for the preparation of public company financial statements.

(http://www.ifrs.com/ifrs_faqs.html#q1)

Institutional independence. The principle of institutional independence is expressly referred to in Article 108 of the EC Treaty and Article 7 of the ESCB Statute. These provisions prohibit the ECB, the NCBs and members of their decision-making bodies from seeking or taking instructions from Community institutions or bodies, from any government of a Member State or from any other body. In addition, they also prohibit such institutions, governments and bodies from seeking to influence the members of the decision-making bodies of the ECB or the NCBs.

Mentality is a system of values, and ideas, morals and customs.

Monetary policy means the regulation of the money supply and interest rates by a central bank in order to control inflation and stabilize currency. Monetary policy is a way the government can impact the economy.

Open market operations are the means of implementing monetary policy by which a central bank controls its national money supply by buying and selling government securities, or other financial instruments. Monetary targets, such as interest rates or exchange rates, are used to guide this implementation

Personal independence. The Statute's provisions on security of tenure for members of the ECB's decision-making bodies further safeguard central bank independence. Such provisions stipulate a minimum term of office of five years for NCB governors (renewable), and a non-renewable term of office of eight years for the members of the ECB's Executive Board. Furthermore, members of the decision-making bodies may not be dismissed for reasons other than those stipulated in the ESCB Statute.

Price stability The ECB's Governing Council has defined price stability as "a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term".

Price stability is a situation in which prices in an economy don't change much over time. Price stability would mean that an economy would not experience inflation or deflation. It is not common for an economy to have price stability.

SWOT analysis is a strategic planning method used to evaluate the Strengths, Weaknesses, Opportunities, and Threats involved in a project or in a business venture. In this case the object of SWOT analysis is the banking sector with respect to its governance as a whole. SWOT involves identifying the internal and external factors that are favorable and unfavorable for the situation.

Rate of refinancing – the key interest rate of any Central Bank – used to have rather nominal status. This is because the refinancing mechanism doesn't play any significant role in the economy. In post crisis period the interest rate policy of the Bank of Russia as a whole has been of limited significance and was low efficient. The Central Bank officially adopts a growth target for money supply (aggregate M2) as an intermediate anchor to its policy.

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Appendix

Appendix 1

Core Principles for Effective Banking Supervision

The Basel Core Principles comprise 25 basic principles that need to be in place for a supervisory system to be effective. The Principles relate to:

Objectives, autonomy, powers and resources	CP 1	CP 1.1 deals with the definition of responsibilities and objectives for the supervisory agency. CP 1.2 deals with, skills, resources and independence of the supervisory agency. CP 1.3 deals with the legal framework. CP 1.4 deals with enforcement powers CP 1.5 requires adequate legal protection for supervisors. CP 1.6 deals with information sharing.
Licensing and structure	CP 2	deals with permissible activities of banks.
	CP 3	deals with licensing criteria and the licensing process.
	CP 4	requires supervisors to review, and have the power to reject, all significant transfers of ownership in banks.
	CP 5	requires supervisors to review major acquisitions and investments by banks.
Prudential regulations and requirements	CP 6	deals with minimum capital adequacy requirements. For internationally active banks, these must not be less stringent than those in the Basel Capital Accord.
	CP 7	deals with the granting and managing of loans and the making of investments.
	CP 8	sets out requirements for evaluating asset quality, and the adequacy of loan loss provisions and reserves.
	CP 9	sets forth rules for identifying and limiting concentrations of exposures to single borrowers, or to groups of related borrowers.

	CP 10	sets out rules for lending to connected or related parties.
	CP 11	requires banks to have policies for identifying and managing country and transfer risks.
	CP 12	requires banks to have systems to measure, monitor and control market risks.
	CP 13	requires banks to have systems to measure, monitor and control all other material risks.
	CP 14	calls for banks to have adequate internal control systems.
	CP 15	sets out rules for the prevention of fraud and money laundering.
Methods of ongoing supervision	CP 16	defines the overall framework for on-site and off-site supervision.
	CP 17	requires supervisors to have regular contacts with bank management and staff, and to fully understand banks' operations.
	CP 18	sets out the requirements for off-site supervision.
	CP 19	requires supervisors to conduct on-site examinations, or to use external auditors for validation of supervisory information.
	CP 20	requires the conduct of consolidated supervision.
Information requirements	CP 21	requires banks to maintain adequate records reflecting the true condition of the bank, and to publish audited financial statements.
Remedial measures and exit	CP 22	requires the supervisor to have, and promptly apply, adequate remedial measures for banks when they do not meet prudential requirements, or are otherwise threatened.
Cross-border banking	CP 23	requires supervisors to apply global consolidated supervision over internationally active banks.
	CP 24	requires supervisors to establish contact and information exchange with other supervisors involved in international operations, such as host country authorities.
	CP 25	requires that local operations of foreign banks are conducted to standards similar to those required of local banks, and that the supervisor has the power to share information with the home country supervisory authority.

Source: http://www.bis.org/publ/bcbs30a.pdf?noframes=1

Appendix 2.

Geert Hofstede's Cultural Dimensions: European countries and Russia

	Power Distance Index (PDI)	Individualism (IND)	Masculinity (MAS)	Uncertainty Avoidance Index (UAI)
Austria	11	55	79	70
Belgium	65	75	54	94
Bulgaria	70	30	40	85
Czech Republic	57	58	57	74
Denmark	18	74	16	23
Estonia	40	60	30	60
Finland	33	63	26	59
France	68	71	43	86
Germany	35	67	66	65
Greece	60	35	57	112
Hungary	46	80	88	82
Ireland	28	70	68	35
Italy	50	76	70	75
Netherlands	38	80	14	53
Poland	68	60	64	93
Portugal	63	27	31	104
Romania	90	30	42	90
Russia	**93**	**39**	**36**	**95**
Slovakia	104	52	110	51
Spain	57	51	42	86
Sweden	31	71	5	29
Switzerland	34	68	70	58
United Kingdom	35	89	66	35

Source: http://www.geert-hofstede.com/hofstede_dimensions.php

Appendix 3.

Legislation impacting on the EU banking and financial sectors

1977	First Banking Directive. Removed obstacles to the provision of services and establishment of branches across the borders of EU member states. Harmonized rules for bank licensing. Established EU-wide supervisory arrangements.
1988	Basle Capital Adequacy Regulation (Basle I). Minimum capital adequacy requirements for banks (8% ratio). Capital definitions: Tier 1 (equity); Tier 2 (near-equity). Risk-weightings based on credit risk for bank business
1988	Directive on Liberalization of Capital Flows. Free cross-border capital flows, with safeguards for countries with balance of payments problems.
1989	Second Banking Directive. Single EU banking licence. Principles of home country control (home regulators have ultimate supervisory authority for the foreign activity of their banks) and mutual recognition (EU bank regulators recognise equivalence of their regulations). Passed in conjunction with the Own Funds and Solvency Directives, incorporating capital adequacy requirements similar to Basle I into EU law.
1992	Large Exposures Directive. Banks should not commit more than 25% of their own funds to a single investment. Total resources allocated to a single investment should not exceed 800% of own funds.
1993	Investment Services Directive. Legislative framework for investment firms and securities markets, providing for a single passport for investment services.
1994	Directive on Deposit Guarantee Schemes. Minimum guaranteed investor protection in the event of bank failure.
1999	Financial Services Action Plan (FSAP). Legislative framework for the Single Market in financial services.
2000	Consolidated Banking Directive. Consolidation of previous banking regulation
2000	Directive on e-money. Access by non-credit institutions to the business of e-money issuance. Harmonised rules/standards relating to payments by mobile telephone, transport cards, and Basle payment facilities.
2001	Directive on the Reorganisation and Winding-Up of Credit Institutions. Recognition throughout EU of reorganisation measures/winding-up proceedings by the home state of an EU credit institution
2001	Regulation on the European Company Statute. Standard rules for company formation throughout the EU.
2002	Financial Conglomerates Directive. Supervision framework for a group of financial entities engaged in cross-sectoral activities (banking, insurance, securities)
2004	New EU Takeover Directive. Common framework for cross-border takeover bids.
2005–2010	White paper on Financial Services Policy. Plan to implement outstanding FSAP measures, consolidation/convergence of financial services regulation and supervision
2006–2008	Capital Requirements Directive. Updates Basle I and incorporates the measures suggest in the International Convergence of Capital Measurement and Capital Standards (Basle II). Improved consistency of international capital regulations. Improved risk-sensitivity of regulatory capital. Promotion of improved risk-management practices among international banks

Source: John Goddard et al., 2007

Appendix 4.

Legislation on banking in Russia

All laws on banks and banking activity can be classified as a “horizontal” legislation and a sectoral legislation.

The “horizontal” legislation on the Central Bank and banking sector:

- The Federal Law “On Banks and Banking” No. 395-1 of December 2, 1990 (as amended by the Federal Law No. 17-FZ of February 3, 1996 and others)
- The Federal Law “On the Central Bank of the Russian Federation (Bank of Russia)” No. 86-FZ of July 10, 2002;
- The Federal Law “On Insolvency (Bankruptcy) of Lending Institutions” No. 40-FZ of February 25, 1999 (as amended).
- The Federal Law No. 115-FZ of August 7, 2001 “On Combating Legalization (Laundering) of Criminal Profit and Financing of Terrorism”.
- The Federal Law No. 173-FZ of December 10, 2003 "On Currency Regulation and Currency Control".

Sectoral legislation:

- On minimum capital requirements (The Federal Law № 60-FZ of May 3, 2006): the minimum authorized capital of a newly registered bank should equal the rouble equivalent of 5 million; the minimum authorized capital of a newly registered non-bank credit institution should equal the rouble equivalent of € 500,000.
- Federal Law № 246-FZ of December 12, 2006 – equalizing the rules for foreign and Russian investors to acquire stakes in a bank and allowing up to 20% to be bought without needing CBR approval (only notification), whereas larger stakes need to be pre-approved.
- Federal Law No. 177-FZ” of December 23, 2003 “On Insurance of Individuals’ Deposits in Banks of the Russian Federation" established special requirements that the banks authorized to receive deposits from individuals.

- Federal Law No. 218-FZ December 30, 2004 “On Credit Histories”. This law was promulgated to facilitate the further development of the market, mainly in the field of consumer and mortgage lending.
- Transition to International Accounting Standards - on June 2, 2003 the CBR issued the Official Notice ”On the Transition of the Russian Federation Banking Sector to International Accounting Standards” enabling the transition of all credit institutions to compiling financial statements to IFRS from January 1, 2004. The process is still underway.

The EU framework for safeguarding financial stability

Functions	**Structures for cross-border cooperation between authorities**
Crisis prevention	
Supervisory functions	Level 3 Committees for the convergence of supervisory practices Colleges of Supervisors
Financial stability monitoring by central banks	ESCB Committees
Crisis management	
Supervisory measures	Colleges of Supervisors EU MoUs
Provision of liquidity by central banks	Eurosystem
Actions on payment systems	ESCB Committees EU MoUs
Crisis resolution	
Private sector solutions	EU MoUs
Public sector measures by finance ministers	EU MoU's
Reorganisation and winding up of financial institutions	Bilateral relationships between the competent authorities of Member States
Deposit guarantee schemes	Bilateral relationships between the competent authorities of Member States

Source: ECB (2008, Table 1). Note: MoU = Memorandum of Understanding