THE WORLD BANK OPERATIONS EVALUATION

Russia: Bank Assistance for Financial Sector Development

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Acronyms

ARCO	Agency for the Restructuring of Credit Organizations
BRU	Bank Review Unit
CAS	Country Assistance Strategy
CBR	Central Bank of Russia
CEE	Central and Eastern European
CMDP	Capital Markets Development Project
EBRD	European Bank of Reconstruction and Development
ECA	Europe & Central Asia Regional Office
ESP	Enterprise Support Project
ESW	Economic and sector work
FI	Financial institution
FIDP	Financial Institutions Development Project
FIG	Financial-industrial group
FIL	Financial Intermediary Loan
IAS	International Accounting Standards
ICR	Implementation Completion Report
IFC	International Finance Corporation
IFI	International financial institution
IMF	International Monetary Fund
MFTP	Management and Financial Training Project
MOF	Ministry of Finance
OD	Operational Directive
OED	Operations Evaluation Department
QAG	Quality Assurance Group
RFCSM	Russian Federal Commission for the Securities Market
SAL	Structural Adjustment Loan
SME	Small and medium-sized enterprise
SOE	State-owned enterprise
TA	Technical assistance
TCA	Technical Cooperation Agreement

Contents

Preface

This paper is one of the background papers prepared as an input to the Russia Country Assistance Evaluation (CAE Task Manager, Gianni Zanini) by the Operations Evaluation Department (OED) of the World Bank. Findings are based on a review of project appraisal and completion reports, sector reports, and a number of other documents produced by the Borrower, the Bank, and research papers in the academic literature. The author (a former Adviser in the Financial Sector Development Department at the World Bank in May 1998-November 2000, and former Resident Representative of the World Bank office in Peru, in 1994-January 1998. He held senior, lead, and principal economist positions in the World Bank during 1975-1998) visited Russia in February 2001 and interviewed current and retired government officials and Russian experts. Bank staff were interviewed at both headquarters and in the field office. An earlier preliminary version was discussed at a small workshop in Moscow in February 2001, with participation of central government officials, academics and members of policy research institutes, and representatives of project implementation units of Bank-supported projects. Their valuable assistance and feedback is gratefully acknowledged.

The author is grateful for the comments received on subsequent drafts by the CAE task manager, other contributors to the CAE background work (Laurie Effron of OED and Ivan Szegvari of EBRD) and ECA staff (Michael Fuchs and Paul Siegelbaum), and Russell Cheetham (former ECA director of the department including Russia), which have been taken into account in the July 2001 version. However, the views expressed in this paper remain entirely those of the author. They do not necessarily represent the views of the World Bank.

An earlier draft dated July 5, 2001 was sent to the Russian Government for review. Comments were received from consultants engaged by the Federal Centre for Project Finance (FCPF) on behalf of the Government, and have been taken into account in this paper.

Executive Summary

Overview

1. World Bank lending operations began in mid-1992, following the Russian Federation's entry into membership. Several reports and loans over the next six years were devoted exclusively or in part to promoting financial sector reforms. Lending operations included Rehabilitation Loans I and II, approved in 1992 and 1995 respectively; the Financial Institutions Development Project (FIDP), the Enterprise Support Project (ESP), and the Management and Financial Training Project (MFTP), all in 1994; the Capital Markets Development Project (CMDP) in 1996; and SALs I and II in 1997.[1]

2. The central emphasis of the Bank's assistance strategy and program has, from the beginning, been to support private sector development and the institutions and policies needed to underpin a stable and growing market economy. The development of a sound, commercially oriented financial system, particularly the banking sector, has been seen as crucial to the strategy. At the start of the 1990s, Russia's financial sector faced major developmental challenges broadly similar to those encountered in other transition economies. In addition, an abrupt opening of the system for the creation of cooperative and other non-state banking institutions led to a rapid proliferation of financial institutions, formed variously by sector ministries, state enterprises, cooperative enterprises, and private financial-industrial groups (FIGs). By 1994, almost 3,000 new banks had been licensed, with little, if any, effective evaluation or control of the quality of their operations and management. At the same time, trading in debt and equity instruments was growing rapidly. However, fraud was commonplace, and equity issues were utilized primarily to establish control over existing enterprise assets rather than to finance new investment.

3. In addition to the political and economic uncertainties that characterized the past decade, major institutional weaknesses impeded the emergence of a healthy, market-oriented financial system, among them the persistence of soft budget constraints in both state enterprises and state banks; the lack of and resistance to the introduction of adequate accounting and reporting standards; lack of understanding of, and the skills needed to manage, banking risks in a market economy; the absence of progress toward effective bank and securities market supervision; weak definition and enforcement of property, shareholder, and creditor rights; inadequate bank and corporate governance; lack of transparent and effective processes for resolving failed banks; resistance to foreign participation in the banking sector; and the political power of financial-industrial groups, interested in maintaining all of these obstacles in place.

4. The Bank and other International Financial Institutions (IFIs) and donors sought over the 1990s to promote and assist efforts by the Russian authorities to ameliorate these weaknesses and to promote the development of the financial system. The Bank's financial sector assistance through 1996 focused on technical assistance, information systems hardware, and policy advice aimed at building the basic legal, regulatory and institutional framework for a market-based banking system. The 1997 Country Assistance Strategy (CAS) announced a shift from this

[1] At least two other projects—Environmental Management (1995) and Enterprise Housing Divestiture (1996)—included intermediated credit lines, but those projects have not been reviewed for this paper.

"nuts-and-bolts" approach in order to take advantage of a perceived "window of opportunity" for enhanced policy dialogue and the acceleration of structural reforms. The program supported by SALs I and II included most of the financial sector reforms outlined from the outset of the Bank's involvement in the sector.[2]

5. Only modest accomplishments can be attributed to these efforts, and a general facade of progress crumbled in the financial crisis of 1998, which left financial institutions accounting for the bulk of the system's assets insolvent and destroyed public confidence in the banks. Disbursements under Bank loans were halted, new loans under preparation were shelved, and efforts were begun to pick up the pieces of the strategy and to restructure the outstanding portfolio. After more than a decade of ostensible reform, the emergence of a stable, market-oriented, growth-supporting financial system remained an uncertain long-term vision. The 1998 crisis itself may have helped to galvanize the authorities' determination to mount the efforts needed to achieve it, but effective action remains to be taken.

Assessment of the Bank's Strategy and Program

6. The Bank's appreciation of the importance of financial sector development to the success of the overall reform process, and its diagnosis of the measures needed for that development to occur, have changed little over the decade of its involvement in Russia. The diagnosis has been basically correct and has generally been backed by good analysis and policy advice. The analytical work and the documentation accompanying loan proposals have recognized the technical and political difficulties of the required reforms and institution-building processes, and the risk that the objectives might not be accomplished in the timeframes foreseen. Nevertheless, several aspects of the Bank's program appear open to question:

i. Although most of the (ESW) and technical working papers have been of high caliber, program and project design did not take into account some fundamental aspects of the analysis and advice. Moreover, loan documents and project supervision reports prior to the 1998 crisis presented an overly optimistic view of (a) the speed with which attitudes, traditions, and institutions could be changed; (b) how much was already being achieved; and (c) the extent to which the Russian authorities had bought into the recommended reforms and were prepared to carry them out.[3] It is possible that these overoptimistic assessments may have led counterparts to doubt the seriousness of the commitments being asked of them, and caused donors to underestimate the cost and time of the assistance commitments that would be required.

ii. The FIDP, which was intended to promote and support the development of viable commercial banks and to build both the authority and technical competence of the CBR's supervision function, was the flagship of the Bank's assistance program for the

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[2] SAL III covered practically the same policy agenda as the first two SALs, but without tranche release conditions associated with the financial sector

[3] It should be noted that this review is based principally on formal loan, loan supervision, Operations Evaluation Department (OED) and Quality Assurance Group (QAG) review, and ESW documents, and a limited number of interviews with Bank, Fund, and IFC staff. Informal written and oral communications not known to the reviewer and thus not reflected here might throw a different light on some of the issues raised.

development of the banking system. Its explicit assumptions were that banks for the foreseeable future would be the main sources of outside control over enterprise managers, and that bank credit decisions would crucially affect the speed and direction of enterprise restructuring and growth. However, the assumed demand for investment financing from creditworthy borrowers was not present in the wake of the political uncertainties, deep depression, and high inflation and interest rates of the 1990s. The assumption that banks would exercise a positive discipline over their borrowers was also questionable, given the continued softness of budget constraints on enterprises, the continued importance of the State banks, and the strong interlocking ownership and control of banks and enterprises through FIGs. In practice, the banks used the flawed accreditation and monitoring process under FIDP primarily to access other sources of finance to support interbank lending, their own associated enterprises, currency speculation, and purchases of government debt, all of which turned bad in the 1998 crisis. The monies available for strengthening bank supervision were left unused prior to the crisis, and no progress was made in the adoption of international accounting standards (IAS).

iii. Much of the effort under CMDP to strengthen the legal, regulatory, and institutional framework for capital market development was premature, given the lack of prior progress and continuing commitment to resolving the key issues of disclosure standards, corporate governance, and the protection of shareholders' rights, without which, improvements in market infrastructure would prove sterile.

iv. The "window of opportunity" that ostensibly encouraged the shift from project lending to adjustment lending in 1997 was, at least in the financial sector, more apparent than real. The policy objectives might better have been served by continuing to focus on the fundamental issues at the nuts-and-bolts level, with more vigorous monitoring and active pressing of the institution-building objectives, and more active involvement of senior Bank management in the policy dialogue, particularly when it became apparent that objectives were not being achieved. The crucial training activities pioneered by the MFTP should also have been followed up as originally intended.

v. A significant gap in the Bank's strategy and attention was its delayed recognition of the importance of restructuring and redefining the roles of the state-owned banks. Although this issue was highlighted in the 1995 report on the banking sector, it has only recently become an important element in the Bank's policy dialogue with the authorities.[4] The dominance of these banks in the financial system was significantly increased by the financial crisis. However, little information is available about their financial condition, and their activities are not transparent. Meanwhile, many Russian officials and legislators continue to advocate and promote a major role for the state banks, including two newly created development banks, as pillars of the financial system.

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[4] According to comments from the Bank's first Country Director for Russia, there were "extensive discussions" with the authorities on this issue in 1992-94, but the MOF and CBR made clear that there was no interest in dialogue with the Bank in this area. (I have seen no other reference to this discussion.) The issue was revived by the joint IMF/Bank financial sector missions following the 1998 crisis, and, in November 2000, the Bank sponsored a conference in Moscow on the role of the state banks. A specific review of the role to be played by Sberbank (Savings Bank) was also launched. These initiatives were financed by the restructured FIDP.

vi. Unlike the approach taken in other Central and Eastern European (CEE) countries, the policy dialogues surrounding enterprise and bank restructuring in Russia have not been clearly integrated. Regarding the first, the Bank's attention during the first half of the decade focused primarily on rapid privatization. Separate treatment of banking reform was perhaps justified by the smaller share of enterprise financing by banks in Russia than in other countries, and by the fact that inflation wiped out banks' bad portfolios. However, it may also have contributed to the overly sanguine approach taken in the FIDP to ownership and governance issues and to the quality of bank lending.

vii. On the basis of the documentation reviewed, it would appear that the Bank could have been more forceful in expressing its concerns at a number of important junctures during the 1990s, when key financial sector decisions were being taken. Primary examples are the damaging "loans-for-shares" program of the early 1990s, the unsustainable growth of the public debt during the mid-1990s, the deteriorating state of the banking system prior to the 1998 crisis, and the decisions made in the late 1990s to create new state development banks.

Attribution of Bank Program Results

7. Although aspects of the Bank's program might have been better designed and implemented, and better coordination might have been achieved between the Bank and other IFIs and donors,[5] it is difficult to assert that the results would have been very different as a consequence. The strong external pressures to provide assistance rapidly to Russian reforms, and to show quick results, may account in some measure for flaws in design and implementation and for the excessive optimism of the related reports. External economic factors, particularly the eruption of the Asian crisis, also played a contributing role in bringing on the 1998 financial crisis in Russia. However, that contribution primarily concerned timing, rather than fundamental causation. Macroeconomic management and the business decisions being made by Russian financial institutions, encouraged by distorted incentives and the weak legal and regulatory framework, had made the banks exceedingly vulnerable to any shocks that might affect the continued flow of liquidity to the sector or alter asset/liability price relationships.

8. Most important and central to the results achieved by the Bank's assistance program was the situation within Russia itself. Arguably, in a country experiencing such severe political and economic instability, efforts to promote the development of a sound, market-based financial system would be considered ill-advised and doomed to failure. It could plausibly be argued that the initial assistance from outside should instead have been focused on the stabilization and rationalization of the state-owned banking system, while moving more gradually to build domestic understanding of the legal and regulatory framework needed to support a system of private banks. This has been the tack taken in a number of other transition economies, but such an approach would probably have been resisted by the Russian authorities and would have received little international support, given the urgency being attached to supporting private sector growth in Russia. Moreover, the decisions on bank licensing taken in the late 1980s had made

[5] The responsibility for problems in this regard was widely shared among the parties involved.

putting the rapidly proliferating private commercial banks on a sound footing a high-priority issue.

9. The technical and political difficulties of the institutional and policy issues to be resolved were reflected in the limited access of Bank staff to decision-makers, frequent changes of Bank counterparts, and the sometimes abrupt shifts of policy positions and commitments from one meeting to the next. There was little consensus within the government on many crucial issues, which in turn weakened the ability of counterparts to convince a skeptical and often resistant legislature of the needed action. It has often been difficult to know whether the dialogue was or is progressing or regressing. This complex and often opaque context must be taken into account in assessing Bank performance in the financial sector. At a minimum, the Bank might have done more to carry a strategic vision for financial sector development (and its role in overall development) beyond the confines of its non-reactive direct project counterparts and thus seek to inform a broader public understanding and debate of the key issues.

10. Since the August 1998 crisis, frequent joint missions of Bank and Fund staff have focused on spurring long-sought reforms and enhancing coordination of the assistance offered by the international community. A systematic effort has also been made to explain and "sell" the reforms to a broader range of parties and interests than had previously participated in the dialogue. With leadership provided by the Bank and Fund, an Inter-Agency Coordinating Committee, chaired by the CBR, has drafted a framework agreement for the provision of technical assistance and for the coordination and monitoring of the delivery of the commitments made by donors. Agreements were also reached with the authorities on the amendment of the FIDP, ESP, and CMDP. The focus of the amended FIDP has been sharpened to support banking supervision, accelerate the adoption of IAS, improve the legal framework and supervisory criteria for bank restructuring and liquidation, and strengthen ARCO, the recently created bank restructuring agency.

Agenda for the Future

11. The thrust of the Bank's efforts to support Russia's financial sector development since the 1998 crisis is essentially a correct one. The policy advice and technical assistance provided have helped to create a promising foundation of laws and institutional capacity. What remains to be demonstrated is the determination of the Russian authorities to move forward from this foundation to provide the incentives necessary to sound banking and financial intermediation. The long-standing agenda in this regard has been well defined. As it did throughout the 1990s, the Bank continued at the end of 2000 to be faced with drawing the line between (a) cutting losses in the face of poor progress and (b) its responsibility to maintain a dialogue and the capacity to respond to opportunities to assist. Given the crucial role of the banking system, a strong case remains for "keeping a foot in the door." However, the case for extending CMDP at this juncture seems weaker.

12. The attention now being given in the policy dialogue to the future role and restructuring of the state banks should be intensified. Given their size and dominance of the banking system, and the strong political pressures to maintain and expand them, their operations, at least in the medium term, are likely to have a greater impact on the stability and efficiency of the financial

system than developments in the private banking sector. It will be important to ensure that the agenda for improving incentives for private financial institutions (FIs) is applied also to state-owned FIs. This has not been easy anywhere, but the alternative of privatization does not seem a likely option in the foreseeable future. In this intensified dialogue, the issues of hard budget constraint (including eliminating the use of arrears as a means of financing) and the restructuring of state enterprises will surely have to be joined.

13. Adjustment lending has not proven to be an effective instrument in Russia for advancing the policy agenda in the financial sector. As the present dialogue advances, a more promising "window of opportunity" could open. In any event, intensive technical assistance and advice will continue to be the essential tools of Bank assistance. By their nature, the provision of these services, whether financed by the Bank or by other donors, requires intensive supervision and dialogue. To be effective, the Bank will need to continue the very significant commitment made in the last two years in this regard. Given the apparent success of the MFTP and the continuing need to develop modern banking and other financial market concepts, attitudes and skills, the Bank should consider renewing support via a training project for bankers and bank supervisors at both the managerial and technical levels. Managers and staff of the state-owned FIs should be included in such training opportunities.

14. Although IFC is now working with local banks to develop SME finance, the Bank has done little thus far to promote the development of sound rural and micro- finance. This is understandable given weak property and creditors' rights and the lack of real property markets that could provide security to lenders. Nevertheless, opportunities should be sought to take advantage of the successful innovations introduced elsewhere to reduce the costs and control the risks of providing financial services to these groups.

15. On July 26, 2000, the Government of Russia adopted a Social Policy and Modernization Action Plan,[6] which, for the first time, set out as its own objectives in the financial sector—albeit with varying degrees of precision—virtually the entire financial sector agenda of legal, regulatory, and institutional reforms discussed above. This is a promising development. Nevertheless, it was clear that Russia, both within and without the government, was still far from having reached a working consensus on crucial issues of financial sector reform. Notably absent in the Action Plan, for example, was any reference to the state-owned banks. The Government's own commitment to the road ahead, and its political ability to walk that road, will require a growing convergence of understanding and views of the policy agenda and the directions of institutional change. As it has already begun to do, the Bank should increasingly seek and take advantage of opportunities to promote and inform the debate among both public officials and the general public regarding these issues. Progress in financial sector reforms seems unlikely to accelerate from the snail's pace of the last decade, unless a consensus is built outside the bureaucratic interests and rivalries and the vested private interests that have heretofore confined and impeded the debate.

[6] Directive No. 1072-r.

Introduction

This assessment of the World Bank's strategy of assistance for the development of Russia's financial sector has been carried out as a desk study, on the basis of an extensive review of formal documents provided by the Bank to the reviewer, interviews conducted by the reviewer, and comments received on earlier drafts.[1] The period covered is 1990-2000.

1. Sector Performance and Challenges

1.1 At the start of the 1990s, Russia's financial sector faced major developmental challenges, broadly similar to those encountered in other economies entering the transition from central planning to a market-based economy. Significant reforms of the former Soviet banking system, which had essentially been a quasi-fiscal vehicle for the centrally directed allocation of resources, began in the late 1980s. The system at that time consisted of four state banks: Gosbank (State Bank), which provided short-term credits to the state-owned enterprises (SOEs) and served as a fiscal agent for the government; Sberbank (Savings Bank), which mobilized household savings for financing the state budget; Stroibank (Construction Bank), which provided long-term investment credits to the SOEs; and Vneshtorgbank (Foreign Trade Bank), which conducted foreign exchange operations on behalf of the state, managed the international reserves, and provided credit to exporting enterprises. Beginning in 1987, commercial banking activities were removed from Gosbank, which became a second-tier bank, with principal responsibility for monetary control. Three state banks specialized by sector—agriculture (Agroprombank), industry and construction (Promstroibank), and social investment (Zhilsotsbank)—were created to channel credit to SOEs and assume the former commercial banking activities of Gosbank. The Savings Bank and the Foreign Trade Bank (renamed the Bank for Foreign Economic Affairs—Vneshekonombank) continued essentially their former operations

1.2 This reform was intended to provide the specialized state banks greater independence in their lending decisions, subject to sectoral credit ceilings set by Gosbank. They remained dependent on their respective branch ministries, however, and on directed credit lines from Gosbank. Credit allocation thus continued in practice to be administered. Competition was also precluded by virtue of the banks' strictly defined sectoral responsibilities. With no effective hard-budget constraints on either lenders or borrowers, there was little incentive for banks to concern themselves with assessing the creditworthiness of their borrowers or the profitability of the activities being financed. The economic benefits of such assessments would have been undercut, in any event, by price distortions in the real economy.

1.3 A new law in 1988 authorized the establishment of cooperative banks to serve the cooperative enterprise sector, and SOEs were authorized soon afterward to create their own financial institutions (FIs). This abrupt opening of the system led to a rapid proliferation of FIs, which numbered more than 400 by September 1990. Unlike the specialized state banks, these FIs had greater freedom to compete for both household and enterprise clients. Instead of credit ceilings, their lending levels were controlled indirectly, through a mandatory reserve

[1] In addition, the reviewer has benefited from several reports of interviews conducted by others. A list of documents consulted and of interviewees is provided in Attachment 1.

requirement. Serious gaps remained, however, in the legal and regulatory framework governing banking, including the lack of definition and enforcement of ownership rights.

1.4 In 1990, the state banks were converted into joint stock banks, and some branches were made independent. New commercial banks were also allowed to form. Thus, the control of the Plan over credit allocation was sharply reduced. With the dissolution of the USSR in 1991, Gosbank's operations in the Russian Federation were assumed by the Central Bank of Russia (CBR), which was placed under the direct control of the Parliament. The proliferation of new banks accelerated, the number having grown to about 1,000 by the end of 1991, with no effective control over the quality of the institutions being granted banking licenses. In principle, banks were made responsible for their own credit decisions and risks, but virtually all enterprises remained state-owned, and most credit was directed by the CBR through both the state and commercial banks. Many banks were created or spun off from the specialized state banks by branch ministries to serve the financing needs of SOEs under their jurisdiction. The interlocking ownership of enterprises and banks was intensified later by the privatization process, during which banks controlled by increasingly powerful private interests accumulated large equity holdings in enterprises in return for loans to keep the enterprises in business and reduce the burden on the state budget and CBR. "Voluntary" lending was thus captured largely by the enterprises that either owned or were owned by their associated banks. Although responsibility for safeguarding the system's health formally rested with CBR, there was little consciousness of or preparation for the needed regulation and supervision of an increasingly decentralized banking sector.

1.5 Meanwhile, in the continuing context of controlled prices and growing supply shortages in the real economy, a large monetary overhang had accumulated, primarily in the form of household deposits. The result, when prices were freed in January 1992, was a fourfold increase in the price level. Inflation accelerated through early 1993, fueled by large government budget deficits and monetary expansion. The resultant hyperinflation led to a significant demonetization and disintermediation of the economy. Accompanied by rapid currency substitution and capital flight, total domestic credit outstanding fell to 14 percent of GNP by September 1993, down from 90 percent in 1990.[2] The real value of deposits was sharply eroded, effecting a massive transfer of wealth from household and enterprise savers to debtor enterprises, the values of whose respective assets and liabilities were largely wiped out. While banks had been effectively cleaned of the accumulated bad debts that accounted for a large share of their previous assets, they had failed to become significant intermediaries of resource flows in the economy and had lost credibility as repositories for voluntary savings. Bankable investment opportunities were few, and trade and other obligations (e.g., taxes, wages, and pensions) were increasingly financed by non-monetary means, i.e., payments arrears and barter arrangements.

1.6 At the same time, Russia, beset by massive political and economic uncertainties, disrupted institutions, weakening central authority, and powerful conflicting interests, and lacking consensus on fundamental reform issues, had, since 1990, fallen into a rapidly deepening economic depression, perhaps worse than had ever before been experienced by an advanced

[2] Credit demand during 1990-1991 had remained high as interest rates lagged behind inflation.

industrial society.[3] Despite enormous needs for restructuring of the real economy, real investment opportunities were few, whatever profitable investment demand for credit may have existed went largely unsatisfied, as funds were channeled instead to keeping loss-making enterprises afloat. The number of banks continued to grow, reaching nearly 3,000 by the end of 1994.[4] As noted, credit allocation was determined largely by the directed credits originating from CBR rediscounts. The large number of banks linked to state enterprises and industrial groups served a treasury function for those companies, placing their liquid resources and any additional funds they might raise externally in the interbank market or in highly remunerative public debt instruments, the interest rates on which remained extremely high, even after inflation had begun to abate in 1993.

1.7 In brief, by the time the World Bank entered into serious involvement in the financial sector (see below), banks dominated Russia's financial sector, accounting in the mid-1990s for more than 95 percent of financial assets. Russian banks were no longer burdened by the bad portfolios common to the banks of other transition economies. Russia had also gone further faster than other Europe & Central Asia Regional Office (ECA) countries in leaving behind the massive state banking structures of the central planning system and permitting the entry of non-state financial institutions. Most of the new banks were quite small, however, and the sector as a whole remained highly concentrated. By the mid-1990s, the 10 largest banks still accounted for one-half of total bank assets, and Sberbank, by virtue of the state guarantee of its deposits, still held 70 percent of household savings deposits. Significant barriers remained, moreover, to the emergence of a healthy, market-oriented banking system able to provide efficient intermediation services to a growing economy.

1.8 Among the most significant of these barriers were: the persistence of soft budget constraints in both state enterprises and state banks that left little motivation for either to be concerned with credit assessment, risk management, and bottom-line performance; a grossly inefficient payments system; accounting and reporting standards that provided unreliable and misleading information about the financial condition of the banks and the performance of their managers; lack of understanding of, and the skills needed to manage, banking risks in a market economy; a barely incipient understanding of modern bank supervision housed in an institution, CBR, whose traditions and skills were geared to overseeing compliance with plans and mechanical ratios rather than ensuring the soundness of institutions and the safety of deposits; weak legal definition and enforcement of property and creditor rights; inadequacies of bank and corporate governance that included ownership interlocks among them; lack of both the political will and legal framework for resolving the fate of failed banks—or even an agreed definition of failure; strong resistance to any foreign participation in the banking sector; and the growing political power of financial-industrial groups (FIGs), whose interest was to maintain these obstacles in place.

[3] Data problems, including the apparently large shift of economic activity and employment to a growing informal "underground" economy, make measurement difficult. A detailing and analysis of Russia's macroeconomic evolution is, in any event, left for other reviewers.
[4] Some consolidation occurred in the wake of a serious liquidity crisis in mid-1995, and the number of banks declined afterwards to between 2,000 and 2,500.

1.9 At the same time, by the mid-1990s, a modern capital market was still barely incipient. Trading in debt and equity instruments was growing rapidly, and new institutions were appearing in response to the rapid growth of shares generated by the voucher privatization program, as well as by government debt issues. Nevertheless, market development was inhibited, as was banking development, by the lack of a legal and regulatory framework, basic infrastructure, information, enforceable property rights, protection of shareholder rights, etc. Fraud was commonplace, and equity issues and trading were utilized primarily to establish control over existing enterprise assets, rather than to fund new investment. Non-bank financial institutions (pension funds, insurance companies, investment funds, and finance companies) played a marginal role in the provision of financial services.

1.10 As described below, uneven efforts were made over the 1990s, with the support of the Bank and of other International Financial Institutions (IFIs) and donors, to make progress toward the removal of these barriers and thus to promote the development of the financial system. Some accomplishments can be recounted, including an improved payments system, but a general facade of progress crumbled in the major financial crisis of 1998, and by the end of 2000 little progress was yet evident against the barriers recounted above. As a result, after more than a decade of ostensible reform, the emergence of a growth-supporting, stable, market-oriented financial system remained an uncertain long-term vision. Recent documents offer some optimism that the 1998 crisis itself may have galvanized understanding of, and the authorities' determination to mount, the efforts needed to achieve it.

2. Evolution of the Bank's Sector Assistance Strategy[5]

2.1 The Bank began its involvement in Russia as one of the institutions participating in a four-agency study of the USSR undertaken in 1990.[6] That report, *inter alia*, urged that the reforms of the financial sector already under way be carried forward as quickly as possible to support the emerging private sector. It pointed up the need to establish a strong banking supervisory authority and a common regulatory framework for the specialized state banks and the new commercial and co-operative banks. Attention was also given to the urgent need to modernize the payments system. The report set out practically the entire agenda of reforms that became the focus of later discussion and donor support, with particular emphasis of the training needs of both banks and bank regulators. It urged that licensing requirements for new banks be tightened, even at the cost of slowing entry, and recommended that efforts to strengthen the banking system be given priority over the promotion of capital market development. Many of the problems that later emerged in both banking and capital market development were foreseen, but the study's recommendations were general and offered no blueprint or timetable for the needed actions.

2.2 In November 1991, the Bank and the USSR signed a Technical Cooperation Agreement (TCA), under which a trust fund was established to finance technical assistance (TA) in support of reforms during the period leading up to USSR membership in the Bank. Some US$13.6 million was spent under this program on individual TA projects in Russia, which included

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[5] This section outlines the sequence and content of bank operations and ESW aimed at supporting financial sector development in Russia. The impact of these efforts is assessed in the following sections.
[6] IMF/IBRD/OECD/EBRD, *The Economy of the USSR*, OECD, Paris, 1991.

support for banking reform and contributed importantly to the Bank's limited knowledge base regarding the Russian financial sector. Particular attention was given to the development of a program to encourage commercial banks to adopt international banking standards, the development of a deposit insurance scheme, the strengthening of banking law, and the upgrading of accounting concepts and practices. Bank lending operations began in mid-1992, following Russia's entry into Bank membership.

2.3 From the beginning of and throughout the ensuing decade, the central emphasis of the Bank's assistance strategy and program has been support for private sector development and for the institutions and policies needed to underpin a stable and growing market economy.[7] The financial system, and the banking sector in particular, was seen as crucial to the strategy. The development of commercially motivated, privately owned banks was considered essential for efficiently allocating the resources formerly directed by the central planning process and for providing effective external pressures for sound management on rapidly privatizing enterprises, most of whose managers had previously responded to the dictates of the planning system. The above-mentioned limitations on sound financial sector development were generally well understood by the Bank and other donors, and a series of lending operations and technical assistance operations were mounted to attack them.[8]

2.4 The Bank's first lending operation in Russia, Rehabilitation Loan I, was a US$600 million, fast-disbursing loan approved in 1992 to support an agreed broad program of reforms and preparations for reforms. In the financial sector, these included the preparation, to be completed before the end of 1992, of a new commercial banking law and of proposals for recapitalizing, restructuring, or liquidating problem banks; movement toward positive real interest rates; the introduction of international accounting standards and audits of major banks; drafting of a securities law and of a law to govern the pledging of collateral; a review of the payments system with accompanying recommendations; and reduction of the number and volume of directed, subsidized credits. As a rehabilitation loan, there were no specific reform-related disbursement conditions other than agreement on the program itself.

2.5 This loan was followed in mid-1994 by two closely interrelated operations: the US$200 million Financial Institutions Development Project (FIDP) and the US$200 million Enterprise Support Project (ESP).[9] The FIDP consisted of three major components aimed at supporting (i) institutional strengthening and systems modernization of selected private commercial banks; (ii) development of the on-site supervision capability of CBR; and (iii) the introduction of modern accounting and auditing standards and practices. The ESP was a financial intermediary loan intended to channel needed investment credit to private sector enterprises through the banks

[7] Macroeconomic stabilization and needed fiscal reforms were recognized as crucial elements in the enabling environment for market development and received priority attention, but the principal interlocutor with the authorities in this area was the IMF. Concern regarding the expected social costs of transition was also present from the beginning, and received increasingly urgent priority as the economic situation deteriorated, and as the magnitude of the social costs and the inability of existing institutions to protect the people worst affected exceeded initial expectations.

[8] A significant gap in Bank concerns seems to have been the relative disregard given to the lack of effective hard budget constraints. The apparent assumption was that rapid privatization would automatically impose this constraint (see below).

[9] Both operations were co-financed with loans of US$100 million each from the EBRD.

accredited under the FIDP, with the dual intent of supporting enterprise restructuring and growth and strengthening the participating banks. The approach taken, to selectively support and motivate a small number of banks that had demonstrated serious intent to achieve efficient intermediation and proper risk management in pursuit of commercial viability, was based largely on work done under the TCA and a Bank sector report prepared in 1993.[10]

2.6 Following quickly on the heels of the previous two operations, a US$40 million Management and Financial Training Project (MFTP) was approved in December 1994. This operation was designed to be the first phase of a long-term commitment to build training capacity and increase the numbers of well-trained practitioners and trainers in enterprise management, financial sector, and public finance. With specific regard to the financial sector, the project supported the training of bank executives in strategic planning, credit risk management, financial and human resource management, and the establishment of internal control systems. Mid-level managers and credit officers were to be trained, *inter alia*, in credit assessment and lending policies and procedures.

2.7 A second US$600 million Rehabilitation Loan was approved by the Board in mid-1995. It contained no prior conditions related to the financial sector, but included the introduction of a "truth-in-advertising" regulation for financial institutions and of improvements in financial reporting and commercial bank supervision among the "other actions" to be carried out under the program.

2.8 The next explicitly financial sector operation was the US$89 million Capital Markets Development Project (CMDP), approved in mid-1996.[11] Its objectives were to help build a policy and regulatory framework for capital market development, including the institutional capacity of the Russian Federal Commission for the Securities Market (RFCSM), a securities regulatory commission established in 1994, and improved efficiency and transparency of the trading, clearance and settlement processes. It sought also to establish an efficient system for the issuance, servicing, and registration of the public debt. Toward these ends, the project financed consultant services and the upgrading of information systems.

2.9 As outlined above, the Bank's financial sector assistance through 1996 followed an essentially "nuts-and-bolts" approach, financing technical assistance, information systems hardware, and policy advice towards building the basic legal, regulatory, and institutional framework for a market-based financial system. A significant change in this approach was heralded by the 1997 Country Assistance Strategy (CAS). With the apparent success of the government's stabilization efforts and perceived improvements in project implementation, an important "window of opportunity" was seen for enhanced policy dialogue and the acceleration of structural reforms. The result was a series of three large structural adjustment loan operations (SALs). Sequenced closely together with overlapping conditionality, they are probably best seen as successive tranches of a single operation. The SAL program elements concerned with the

[10] "Russia: The Banking System during Transition," 1993.

[11] At least two other projects—Environmental Management (1995) and Enterprise Housing Divestiture (1996)—have reportedly included intermediated credit lines, but those projects have not been reviewed for this paper. See, however, my general comments in the final section.

financial sector emphasized the legal and regulatory framework for the banking system, a focus consistent with a recent bank sector report.[12]

2.10 SAL I (US$600 million) was approved as a one-tranche operation in May 1997. The broad program supported by the SAL included most of the financial sector reforms outlined from the outset of the Bank's involvement in the sector, with emphasis on measures to strengthen prudential regulation and supervision of the banks and the resolution of illiquid and insolvent banks. Disbursement was based on a list of prior actions, which, in the financial sector, included the completion of on-site inspections of at least 15 of the largest 100 banks per quarter of 1997, the introduction of a multi-window system for processing commercial bank payments in the Moscow region, and submission of legislation to the Duma specifying procedures for the withdrawal of bank licenses and for the timely liquidation of de-licensed institutions.

2.11 SAL II (US$800 million), to be disbursed in two equal tranches, was approved in November 1997. Its stated objectives and priorities were essentially the same as those asserted under SAL I. First-tranche conditions included CBR having taken decisions on measures for dealing with 27 identified problem banks, and the on-site inspection of an additional 15 of the largest 100 banks in the third quarter of 1997. No financial sector conditions were specified for second-tranche release.

2.12 SAL III (US$1.5 billion), to be disbursed in three increasing tranches, was approved in August 1998. It covered practically the same policy agenda as the first two SALs, but without tranche-release conditions associated with the financial sector.

2.13 The Bank's assistance program, and support to the financial sector in particular, was severely impacted by the general financial crisis that exploded in August 1998, when the Russian Government defaulted on both its domestic and international debts and removed support from the foreign exchange market, resulting in a deep devaluation of the ruble. The results, *inter alia*, included widespread insolvency of and loss of public confidence in the financial system, the cessation of financial inflows from abroad, and heightened political uncertainty. Disbursements under existing Bank loans were virtually halted, new loans under preparation were shelved, and efforts were begun to pick up the pieces of the strategy and to restructure the outstanding portfolio.

3. Assessment of the Bank's Assistance Program

3.1 As will be discussed further in Section 4, assessing the overall quality of the services and products provided by the Bank in support of financial sector development in Russia is exceedingly difficult and speculative. A more complicated situation, both in terms of the complexity of the interrelated reforms and the economic and political context in which they had to be carried out, is difficult to imagine. Similar complexities have been and are being confronted in varying degrees in all the transition economies, but they have arguably been made more difficult in Russia by the speed with which pre-existing institutions and political

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[12] "The Russian Banking Sector: The Years of Stabilization," (green cover internal draft), May 1997. It is not clear to the reviewer whether this report was ever discussed with the Government. (Three different sources have suggested, respectively, that it was discussed, it wasn't discussed, and it was discussed but not at an official level).

relationships collapsed, the depth of the recession and the redistribution of economic and political power that followed, and the frequency with which government leadership and counterparts in the reform dialogue were changed. Also complicating the situation was the extraordinary interest, high expectations, and political involvement of the international community in promoting Russia's rapid transition. In this light, what can be said about the quality of the Bank's diagnostic work, the specific solutions proposed, and the support instruments chosen?

The Analysis and the Instruments

3.2 The Bank, as reflected in its strategy papers, economic and sector work (ESW), and loan documentation, has throughout the course of its program and dialogue in Russia viewed the development of an efficient, commercially oriented financial system as fundamental to Russia's successful transition to a market economy and for underpinning sustained economic growth. Most of the ESW and technical working papers have been of high caliber. The analyses and background documents informing the program have generally been clear in their understanding and discussion of the practices, policy issues, and gaps in laws and institutions that needed to be resolved if such a financial system was to evolve.

3.3 The analytical work and the documentation accompanying loan proposals have also generally been clear and transparent in recognizing the technical, as well as political, difficulties of the required reforms and institution-building processes, and the risks that the objectives might not be accomplished in the timeframes foreseen. However, as discussed below, some crucial observations of the analytical work appear not to have been taken fully into account in program and loan design. Moreover, loan documents and subsequent project supervision reports prior to the 1998 crisis tended to present overly optimistic views of: (a) the speed with which attitudes, traditions, and institutions could be changed; (b) how much was already being achieved; and (c) the extent to which the Russian authorities had bought into the recommended reforms and were prepared to carry them out.[13] Even under easier circumstances and in the context of a clearer consensus with and among the Russian authorities, the achievement of the objectives set out in CASs and project documents would have required much longer time horizons. The overly optimistic expectations expressed may indeed (speculation) have led counterparts to doubt the seriousness of the commitments being asked of them, and led donors and Bank management itself to underestimate the cost, length, and continuity of the assistance commitments that would be required.

3.4 The FIDP, supplemented by the ESP, was the flagship of the Bank's assistance program for the development of the banking system. FIDP was intended to promote and support the development of viable commercial banks and to build both the authority and technical competence of the CBR's supervision function. Its explicit assumptions were that banks, for the foreseeable future, would be the main sources of outside control over enterprise managers, and

[13] It should be noted that this review is based principally on formal loan, loan supervision, OED and QAG reviews, ESW documents, and a limited number of interviews with Bank, Fund, and IFC staff. Informal written and oral communications not known to the reviewer and thus not reflected here, might throw a different light on some of the issues raised. (See, for example, footnote 38).

that bank credit decisions would crucially affect the speed and direction of enterprise restructuring.

3.5 It was asserted that, of the more than 2,000 commercial banks then operating, about 100 were improving their performance and progressing toward viable commercial operation.[14] Of these, 20 had been selected to undergo a detailed review by international auditing firms. Banks that were found by the reviews to be relatively sound financially,[15] that volunteered to accept gradually more rigorous performance standards and supervision, and that were willing to enter into corrective action plans for removing deficiencies and building their intermediation and risk-management capacities would be accredited for participation in the program. Additional banks (up to a total estimated at 30-40)[16] would be able to apply to enter the program, once underway. Continued participation was to depend on compliance with the tightening performance standards and the corrective action plans. Some 95 percent of FIDP funds were allocated to support the technical assistance to banks, to be effected in part through twinning arrangements with foreign banks, and equipment upgrades required by the action plans. In addition to FIDP financing, participating banks were eligible to intermediate the funds made available by the ESP.[17]

3.6 The FIDP and ESP were thus conceived as part of a strategy under which a separation would be made between the small, commercially oriented banking sector, that would provide financing and financial discipline for an expanding private enterprise sector, and the larger banking sector (including the state banks) that would continue to serve as channels of resources to SOEs and other borrowers not yet subject to market forces. Over time, as privatization proceeded and state subsidies were reduced, it was expected that the market sector and its banks would grow, and the socialized sector would shrink. Although innovative in concept, these operations suffered from serious flaws in their underlying assumptions, design, and implementation—briefly:

- The assumption that banks would exercise effective pressure on the managers of borrowing enterprises to improve performance ignored both the continuing flow of state subsidies to enterprises and banks, and the consequent lack of hard budget

[14] This number was frequently repeated in CASs and other internal documents, but its basis is unclear.
[15] Eligibility criteria were to include capital adequacy, profitability, liquidity, credit policies and procedures, managerial capacity and autonomy, and focus of operations on the private sector. A Task Force, operating under the joint aegis of the MOF and CBR and advised by a Bank Review Unit composed of senior bankers and IT experts, was responsible for accrediting and monitoring the performance of participating commercial banks.
[16] The ESW report had originally suggested the inclusion of 20-30 banks. The original mission recommendation, according to interviews, was to limit selection to 10 banks. According to two of the interviewees, the target number expanded during the ESW and loan review processes under the pressures of Bank senior management and external donors, partly to avoid the program's becoming limited to banks in Moscow and St. Petersburg.
[17] Under the original concept, participating banks were also to receive other special incentives, such as lower borrowing costs from the CBR, preferential treatment with respect to deposit insurance, lower risk weights in calculating capital adequacy, and preferential approval of new branches. These were dropped, however, from the final project proposal.

constraint even in the ostensibly privatized enterprises,[18] and the pattern of interlocking ownership that drew enterprise and bank managers to a common bed.[19]

- The assumption that there was a substantial unmet demand for creditworthy investment credit in the enterprise sector, and that credit decisions would, therefore, enhance the speed and quality of enterprise restructuring and growth, flew in the face of the collapse of creditworthy investment demand that had occurred (in the wake of deep depression, high inflation, and disruption of production), the relative attractiveness of high-interest public debt, and the diversion of resources through the above-mentioned subsidies to non-investment uses.[20]

- In this atmosphere, access to IFI credit lines for medium-term re-lending and twinning arrangements aimed at improving credit processes were unlikely to be important motivating factors for banks to enter the program. In practice, it was principally the public accreditation itself that banks sought as a vehicle for improved access to other sources of finance, including foreign loans, to support their own associated enterprises, interbank lending, heavy involvement in forward foreign currency contracts, and purchases of government debt.[21] These activities and their failure to develop a base of core deposits made the banks and banking system

[18] The mechanism of subsidization, which has continued through barter arrangements and arrears settlement arrangements even after direct state subsidies were reduced, is described in Brian Pinto, et al., "Give Growth and Macroeconomic Stability in Russia a Chance: Harden Budgets by Eliminating Non-Payments," (draft), 2001.

[19] The earlier ESW had emphasized that the strategy would not work, unless the interlocking ownership problems were resolved.

[20] A commentator from the ECA Region attributes the low level of investment lending more to supply-side inhibitions--particularly the inability to enforce creditors' rights--than to lack of creditworthy demand. The head of the Bank Review Unit (BRU) under FIDP, however, observed that "there were too few quality borrowers for banks to do business with—thus developing a loan portfolio for good quality borrowers was virtually impossible." (Robert Porter, "The Crisis in Russian Banking: Lessons Learned as Head of Russia's Bank Review Unit," June 9, 1999, p. 12).

[21] It had been expected that banks participating in ESP would, on the basis of their initial experiences, re-lend repayment proceeds for new investment. Audits conducted after the 1998 crisis, however, revealed that none of the banks had reinvested in new ESP loans. IFC credit lines to banks for medium-term investment financing also went largely unused. (A comment from ECA staff argues that banks in fact found ESP funds highly attractive, and that low disbursements initially were largely the result of the stringent requirements established for access to them, compared to the relative ease of accessing syndicated loans abroad. The ESP project manager in the field prior to the 1998 crisis also points to the slowness and rigor of the initial accreditation process as the principal bottleneck to ESP disbursements. However, accreditation itself eventually facilitated banks' access to other monies, which were not being used for investment financing. (Stephen Bartoletti,, "Financial Intermediary Lending: Experience from Russia's Enterprise Support Project and Implications for Bank Policy," [internal draft], 2001) The ECA commentator also notes that re-lending in the pre-crisis period would have been ill-advised in any event. It is doubtful, however, that what was being reflected was wise credit risk management by the banks in view of the other extremely high-risk activities that continued unabated. Moreover, as the commentator notes, it was precisely in 1997, as foreign lending terms tightened--and, according to Bartoletti, as accreditation criteria broke down--that commitments under ESP began to increase.) Anders Aslund, an expert observer close to the Russian scene argues that the ESP was fundamentally flawed precisely because it pushed the technically best banks "to go for broke" in unwise, high-risk investments. He argues further that Russia at the time was "flooded with money," and the Bank should not have contributed to the flood. Finally, FCPF, in its comments on the earlier draft, correctly note the inadequacy of prudent risk management on the part of foreign bank lenders, which helped to undermine FIDP's stricter eligibility criteria. FCPF also notes that more than US$2 million of ESP repayment proceeds under seven loans have now been reinvested.

particularly vulnerable to the sovereign default and devaluation that occurred in August 1998.

- The bank accreditation process itself was inevitably flawed by the inadequacy and unreliability of the accounting data going into it. The financial soundness of the participating FIs, or progress towards it, could not be determined on the basis of the information that they would make available.[22] Even if Bank staff could not know the true financial status of the FIs being accredited, they should have been aware of the unreliability of the data being used in the process, and that the activities in which banks were engaged made them highly vulnerable to the crisis that eventually ensued.[23] Moreover, the expected introduction and application of international accounting standards in enterprises and banks was never accomplished and had never been "bought into" by the Ministry of Finance, which, among other things, feared the possible impact on tax collections.[24]

- The desire of banks to gain accreditation for the market advantages which it offered reportedly resulted in severe pressures on Ministry of Finance (MOF) and the project implementation agency to relax application of the eligibility criteria.[25] In the event, a "second window" for accreditation was opened with even less clear criteria. Although banks entering by the second window were denied access to the IFI credit lines, no public distinction was made in the quality of their accreditation. At the same time, the monitoring of corrective action plans was exceedingly weak or nonexistent, and only one bank had accreditation withdrawn for falling out of compliance with eligibility criteria.[26]

- CBR reportedly showed little effective interest in the supervision-enhancing aspects of the program, and no funds from this component were disbursed prior to FIDP's eventual restructuring in 2000.[27]

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[22] According to interviews, some observers have also raised doubts about the professional quality and integrity of the original diagnostics carried out by the "big six" international accounting firms.

[23] According to Bartoletti (*op.cit.*), the problem was not one of data or of limited monitoring resources. According to him, the Bank Review Unit (BRU) "could clearly see that the riskiness of the banks was excessive, and resisted the massive expansion that doubled the number of banks in February 1997." He cites as the chief problems pressure from the IFIs to disburse to achieve desired implementation ratings as well as pressure from large, politically connected banks to get accredited. Bank headquarters staff, in contrast, claimed during interviews that the BRU withheld financial information about the banks from them. Whatever the facts in this regard, it seems clear that communications left a great deal to be desired.

[24] The requirement on enterprises and financial institutions to apply international accounting standards is now mandated to begin in January 2004.

[25] As reported in interviews and in Bartoletti *op.cit.*,. It is not clear from interviews that agreement was, in fact, ever reached between the Bank and the authorities on either the eligibility criteria to be applied or on procedures for dropping banks that had fallen out of compliance with the program.

[26] Toko Bank, long a favorite of western investors, was finally put under "temporary administration" in May 1998, even though the BRU had found serious problems in its financial condition and management as early as September 1996. (See R. Porter, *op cit*.,) Given the high visibility of the accreditation decision, the authorities may understandably have been concerned about the possible announcement effects of a dis-accreditation decision, both for the specific bank and for the banking system as a whole.

[27] As noted above, the bulk of FIDP funds were allocated to supporting the development of the commercial banks, and only US$2 million were allocated to the CBR for strengthening bank supervision. It was expected that the latter

3.7 The projects effectively came to a halt with the financial crisis of August 1998. By that time, 40 banks, aggregating about half the assets of the private commercial banking sector, had been accredited (through one or the other window). In the wake of the crisis, the MOF suspended further loan-funded commitments to the accredited banks. Only about US$72 million of the FIDP and US$40 million of the ESP had been disbursed by that time.[28] The institutional development achieved in most of the participating banks was minimal, and the CBR had made practically no progress in strengthening its supervision. Although default had been declared on only two of the 43 sub-loans made under ESP before the crisis, and most borrowers remained current in their debt service,[29] little or nothing had been accomplished to stimulate term finance for enterprise expansion or restructuring. By the end of the crisis, the three state-owned banks accounted for the bulk of bank lending,[30] and only three of 18 large banks assessed on the basis of international accounting standards were found to be solvent.

3.8 With technical assistance from IFC and bilateral donors, the Russian authorities made progress in the early to mid-1990s in establishing basic capital market infrastructure and legal framework. However, the same problems of information disclosure, governance, and non-enforcement of regulations predictably hindered market development. Whatever good investment opportunities may have been available to savers in the market were effectively squeezed out by high-interest government debt. Moreover, the government itself apparently lost interest in capital market development after the 1996 elections, just as the CMDP was being approved.[31]

3.9 FIDP, ESP, and CMDP have all subsequently been restructured, including the cancellation of US$59.5 million from the FIDP and US$36 million from CMDP.[32] In the

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would be supported primarily from bilateral sources. One of the factors inhibiting the use of FIDP funds for bank supervision was apparently the Ministry of Finance's insistence that the funds be passed to CBR as loans, which the latter refused to accept. Interviewees also reported chronic difficulty in engaging CBR in effective dialogue prior to the 1998 crisis.

[28] Commitments under ESP had reportedly reached US$100 million, however. By the end of 1999, its disbursements had reached US$50.7 million.

[29] The repayment record under ESP has been surprisingly good, given the economic environment in which borrowing enterprises were operating. The competitiveness of many borrowing enterprises apparently benefited from the 1998 devaluation, more than offsetting the consequently higher debt service obligations. According to the ESP project manager in the field (Bartoletti, *op.cit.*), the largest default occurred on a related-party loan that had been opposed by the BRU. Substantial pressures to approve the loan were brought to bear, however, including a letter to the Bank's senior management. The sub-loan was finally approved on the basis of additional undertakings by the intermediating bank, which were never fulfilled.

[30] Sberbank suffered a serious loss of deposits during the crisis, as the government's default on its bonds raised doubts about its ability to honor its deposit guarantee. In the event, CBR credits to Sberbank covered the temporary drain and perhaps prevented a run.

[31] See Cadogan Financial, "Rebirth and Development Perspectives for the Russian Capital Markets," December 17, 1999.

[32] Discussions pursuant to the restructuring of FIDP and ESP had begun prior to the crisis, as concerns rose about the precarious situation of many participating banks. It appears that the Bank itself may have been slow to react to Government initiatives toward that end. The process was interrupted, in any event, by the crisis itself. As noted by PCFP, the FIDP Task Force took initiatives to restructure the project in October 1998, and comment that it was primarily Bank red tape that delayed the eventual restructuring. ECA clarifies, however, that the Bank was waiting for the amendment of a Government decree, considered essential to the restructuring, which only occurred in December 1999.

aftermath of the crisis, the CBR and the Government have reportedly shown new interest in accounting reform, strengthening the legal framework for the resolution of failed banks, and upgrading and refocusing bank supervisory capacity and licensing criteria. Toward that end, CBR requested a coordinated program of technical assistance from the Bank, Fund, and other donors. In this context of intensified dialogue, the Bank and Russian authorities agreed to reallocate most of the remaining uncommitted funds of FIDP away from assistance to individual banks in favor of supporting the streamlining of bank resolution procedures, upgrading of bank accounting, and strengthening of bank supervision, the latter focused on a review of prudential regulations, licensing, consolidated supervision, loan classification, provisioning, and disclosure regulations.[33] Support is also being provided to strengthening the organization and operation of the newly created Agency for the Restructuring of Credit Organizations (ARCO), including support for the design and implementation of bank restructuring plans. Limited and sharply focused technical assistance is to be provided to a small number of restructuring banks in support, for example, of implementing international accounting standards, enhanced risk management, and meeting the higher regulatory standards being developed by CBR. The former formal accreditation process was discontinued, and eligibility for intermediating funds under the ESP is to be accorded to only the very few banks that may qualify, as determined by the MOF, in accordance with agreed financial performance criteria, and subject to a "no-objection" by the Bank.[34]

3.10 According to supervision reports, the MFTP has to date been the most successful project directed, at least in part, at the financial sector. It reportedly supported the training of a large number of both trainers and participants in finance, as well as the preparation of high-quality training materials and the introduction of new attitudes into the training profession. Its Implementation Completion Report (ICR)[35] describes these results as "truly impressive." Both ownership and the project concept itself proved "surprisingly robust" in the face of the political and economic instability that marked its implementation period. Both enterprises and banks showed themselves ready to pay for relevant and high quality training, and the Training Foundation established by the project was, by 1999, fully covering its operating expenses.[36] Nevertheless, and despite the MFTP's original conception as the first phase of a long-term program, the Bank did not respond to a request in 1997 for a second loan, nor did subsequent governments pursue the request.[37]

3.11 The two Rehabilitation Loans and the first two SALs ostensibly included support for financial sector development among their multiple programmatic objectives. The programs

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[33] This reallocation of resources to CBR was facilitated by a reversal of MOF's previous position, now allowing the repassing of FIDP resources to CBR on a grant basis.

[34] The addition to the process of a "no objection" by the Bank will strengthen the eligibility requirements for participating banks, of course, only if treated seriously by the staff involved. (See footnote 37 in this regard)

[35] Dated June 29, 2000.

[36] According to comments received from FCPF, banks participating in the ESP apparently did not participate in the training activities of MFTP. They cite this as evidence of lack of coordination of Bank projects. The author has no information regarding such cross-participation. The absence of ESP participants could also, of course, reflect a lack of interest on their part in improving banking skills.

[37] It may be that the shift in the Bank's focus by then to adjustment lending, and the ceiling imposed on overall lending by CAS "triggers," simply squeezed possible follow-up support out of the program. It should be noted, in any event, that the enhancement of banking culture and skills would have had to be reflected in and reinforced by supporting incentives within the banks to have led to improved banking.

supported by the SALs essentially repeated the objectives of the earlier rehabilitation and project loans, especially FIDP, but associated policy conditionality was weak. The assessment of progress and of government intentions in the financial sector presented in successive loan documents reflected the excessively rosy views described earlier. At the end, little of substance was accomplished in the financial sector by these operations, and their primary stated objectives are still being pursued. Although the financial sector received little attention in the formulation of SAL III, a major effort was undertaken in the aftermath of the 1998 financial crisis to renegotiate the program conditionalities to include major financial sector reform actions. This effort did not succeed, and the last two tranches of the loan were cancelled. Nevertheless, discussions with the authorities regarding the restructuring of SAL III, carried out in the context of joint Bank-Fund missions (see below), did serve as a vehicle for intensifying the dialogue on financial reform issues.

3.12 In summary, the Bank's diagnosis of the importance of financial sector development to the success of the overall reform process, and of the measures that needed to be taken for that development to occur, have changed little over the decade of its involvement in Russia. In this reviewer's opinion, that diagnosis has been basically correct, and has been backed up by good analysis and policy advice, although important elements of the analysis were ignored or sometimes badly applied, as in the case of FIDP and ESP. The constraints and risks have been recognized from the beginning, but were not fully integrated into the country dialogue or program and project design. Moreover, the difficulty and time required to overcome the constraints were underestimated, and the concrete progress reported as being achieved significantly overstated reality, as became evident in 1998. The "window of opportunity" that ostensibly encouraged a shift from project lending to adjustment lending was, at least in the financial sector, not readily apparent. Despite widespread implementation problems in the project portfolio, the policy objectives might better have been served by continuing to attack the fundamental issues at the nuts-and-bolts level, more rigorously monitoring and actively pressing the institution-building objectives of the FIDP, more active involvement of senior Bank Management when it became apparent that fundamental objectives were not being achieved, and following up the crucial training activities pioneered by the MFTP.

Strategic Gaps in the Bank's Approach

3.13 A significant gap in the Bank's strategy was its delayed recognition of the importance of restructuring and redefining the roles of the state-owned banks. Although this issue was highlighted in the 1995 report on the banking sector, it has only recently become an important element in the Bank's policy dialogue with the authorities.[38] The dominance of these banks in the financial system was significantly increased by the financial crisis, which dramatically reduced the size of the private banking sector, not because the state banks were better managed,

[38] The author's perception in this regard may reflect his unfamiliarity with conversations or other informal communications that have left no paper trail (see footnote 13). According to comments from the Bank's first Country Director for Russia, there were "extensive discussions" with the authorities on this issue in 1992-94, but the MOF and CBR made clear that there was no interest in dialogue with the Bank in this area. (I have seen no other reference to this discussion). The issue was revived by the joint IMF/Bank financial sector missions following the 1998 crisis, and, in November 2000, the Bank sponsored a conference in Moscow on the role of the state banks. A specific review of the role to be played by Sberbank was also launched. Both of these initiatives were financed by the restructured FIDP.

but because they continued to be supported by the CBR and the state budget. Little information is available about their financial condition, nor are their activities transparent. Meanwhile, many Russian officials and legislators continue to advocate and promote a major role for the state banks, including two newly created development banks, as pillars of the financial system.

3.14 It is also notable that, unlike the approach taken in other Central and Eastern European (CEE) countries, policy dialogues surrounding industrial restructuring and bank restructuring were not clearly integrated. The crucial issue of interlocking ownership and control was recognized in ESW and sector strategy papers, but the interrelationship emphasized in CASs and loan documents is described almost entirely in terms of the financial and governance inputs that privatized enterprises would require from the banking system. Separate treatment of enterprise and bank reform was perhaps considered justified by the smaller share of total enterprise financing provided by banks in Russia than in other countries, and by inflation having wiped out banks' bad portfolios. This detachment may also have contributed, however, to the overly sanguine approach taken in the FIDP to ownership and governance issues and the quality of bank lending.

3.15 Finally, on the basis of the documentation reviewed, it appears that the Bank could and should have been more forceful in expressing its concerns at a number of important junctures during the 1990s, when key financial sector decisions were being made. Principal examples were the damaging loans-for-shares program of the early 1990s, the unsustainable growth of the public debt during the mid-1990s,[38] and the deteriorating state of the banking system prior to the 1998 crisis.

Coordination with Other Agencies and Donors

3.16 The high importance given by Western governments to Russia's reforms was reflected in the many bilateral and multilateral programs mounted to provide assistance, including in the financial sector. The large number of internationally funded programs and the keen international political interests embodied in them, plus rivalries and frequently unclear delineation of responsibilities among Russian counterpart agencies, made coordination both crucial and difficult. In the financial sector, clusters of technical assistance financed from various sources were organized around Bank lending operations—in particular, the FIDP and ESP, which brought together the Bank, EBRD, the EU, and several bilateral agencies. Smooth coordination was difficult, however, and probably more time-consuming than project budgets allowed. Commitments from donors were not always firm in advance, and delays disrupted the timing of interrelated project elements. Implementation of the bank supervision component, in particular, was reportedly seriously compromised by the sudden withdrawal of support from a major bilateral donor.

3.17 Although apparently somewhat weak prior to the August 1998 crisis, coordination between Bank and Fund staff has been especially collaborative since then. By the end of January 2001, 14 joint financial sector missions had been carried out since the crisis, and this intensive

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[38] One interviewee has suggested that Bank concerns regarding the loans-for-shares program were muted in deference to IMF support for the program as a means of reducing the fiscal deficit. Expression of the concerns of some staff regarding the unsustainably rapid growth of the public debt may have been similarly inhibited.

effort was expected to continue. These missions have focused on spurring the long-sought reforms, made transparently necessary by the crisis, and enhancing the assistance offered by the international community through restructuring existing loans and technical assistance activities and restarting and achieving better coordination of the various donors' activities. The missions have made a systematic effort to explain and "sell" the reforms to a broader range of parties and interests than had previously participated in the dialogue, including the Duma and the judiciary. With strong leadership provided by the Bank and Fund, an Inter-Agency Coordinating Committee, chaired by CBR and including representation from the Executive and Legislative branches and from the Russian Banking Association, has been meeting since early 1999. It has reportedly made good progress in reaching a framework agreement for the provision of technical assistance and for coordinating and monitoring delivery of the commitments made.[39] The missions also successfully reached agreements with the authorities on the amendment of the FIDP, ESP, and CMDP, sharpening the focus, particularly of the first, to support for banking supervision, accelerating the adoption of International Accounting Standards (IAS), improving the legal framework and supervisory criteria for bank restructuring and liquidation, and strengthening ARCO. A substantial effort was also made to define financial sector policy conditionalities for a renegotiated SAL III. This latter operational objective was not ultimately achieved, but the discussions did contribute to an intensified policy dialogue.

3.18 IFC has generally maintained a cautious stance with regard to Russia's financial sector, which has accounted for only about 12.5 percent of its net investment commitments. In coordination with the Bank's efforts, its program through most of the decade focused principally on providing advisory services to the voucher privatization program and for securities regulation. It succeeded in mobilizing substantial donor grant resources in support of these activities.[40] Reported pressures to engage more directly in the financial sector were resisted for lack of sound investment opportunities, because of resistance on the Russian side to associate with foreign strategic investors, and because of lack of transparency of ownership, governance issues, and allegations of local sponsor engagement in criminal activity.[41] Several small credit facilities were negotiated with private Russian banks, at least one in collaboration with EBRD. Several others never disbursed either for lack of demand or disagreement over conditions, and four of eight mature institutions supported by IFC collapsed in the 1998 financial crisis. In general, the Corporation's investments in the financial sector performed worse than its investments in the real sectors. More recently, IFC has sought to develop technical assistance to local banks aimed at supporting SME finance and the development of leasing. Coordination with the Bank is described by both sides[42] as having been satisfactory. The Bank and IFC jointly prepared the 1999 CAS and the 2001 CAS Progress Report.

3.19 As noted above, the FIDP and ESP were both co-financed with EBRD. The relationship appears to have been somewhat problematic, however, partly because of EBRD's dual role as both equity investor in and lender to some of the participating banks, and partly because EBRD

[39] The Committee should also help to overcome the reported resentment of some donors that, on earlier occasions, they had been brought too late to the table and had, in effect, been faced with a *fait accompli* when asked to pledge their participation, weakening both their sense of commitment and their ability to ensure timely delivery.
[40] See Walter Cohn, "Evaluation of IFC Assistance to Russia," June 21, 2001.
[41] *Ibid*.
[42] In interviews.

also extended a separate credit line to the banks without any conditions regarding the latters' accreditation under FIDP. This gave rise to some frictions between the two institutions in the implementation of these projects, including the perception that information being made available to EBRD was not being shared with Bank staff. Similar concerns were raised in the overlapping relationships between the Bank, IFC, and EBRD.

Developmental Impact

3.20 Looking back over the past decade of Bank involvement in Russia's financial sector, it is difficult to conclude with any confidence that much would have happened differently if the Bank had not been involved. Although with hindsight a somewhat different approach was suggested above, any assistance strategy for the financial sector would have likely been overwhelmed by the enormous macroeconomic and political instability that has characterized the period.

3.21 How is the present situation different from the one that presented itself in the early 1990s in terms of the barriers, to the development of an efficient and sustainable market-based financial system? Improvements have been made in the payments system. The technical assistance and advice provided over the past ten years, particularly the intensive work of the past two years, have also broadened and deepened understanding in the responsible Russian agencies of the importance of the issues raised by the Bank and other agencies over the past decade, and the 1998 crisis has given credence to the need for action. At the same time, the legal framework has been substantially improved, and the technical skills and institutional capacities of the key regulatory agencies involved are incomparably stronger now than they were prior to the Bank's (and Fund's) assistance. ARCO has also benefited more recently from these institution-building efforts. Important foundations have thus been laid that can potentially make a major contribution to the future development of the Russian financial system and economy as a whole.

3.22 However, there has been little concrete application thus far of this enhanced capacity and no clear and consistent evidence of an intention on the part of the Russian authorities to apply it. Even in the aftermath of the 1998 crisis, CBR, RFCSM, and the authorities generally resisted the proposition that a radical restructuring of the banking system was needed, or that disclosure regulations and shareholder rights required aggressive enforcement. They have become gradually more receptive, at least on the surface, to Bank/Fund advice as regards the basic issues that had long been on the table, and have begun to take an active role in soliciting it. This greater openness and seeming agreement on the substance of financial sector reforms have continued to be accompanied, however, by reluctance of the authorities to push the necessary legal and other changes, or even to take effective action within the scope of already existing supervisory powers. The tendency consistently has been to dilute or delay action on recommendations, probably reflecting a combination of incomplete "buying-in" to the conceptual basis for the recommendations (despite rhetorical agreement) and powerful political resistance to their implementation. [43]

[43] The authorities' focus on banking reform has reportedly "intensified considerably in recent months…." On September 11, 2001, the CBR hosted a high-level seminar, with Bank participation, to discuss a joint CBR/Government strategy for reform of the sector. (Bank staff BTOR dated October 1, 2001).

3.23 Recent audit reports suggest that the banking system may have been even weaker financially in 2000 than immediately following the crisis, and that little change had occurred in the attitudes and practices of bank owners and managers. Resistance also continues strong within the government to the participation of foreign banks that could bring needed expertise, capital, and competition. Although IAS and their rationale are perhaps better understood, actual accounting standards and transparency have not significantly improved.[44] While prudential criteria and CBR's legal authority to enforce them have been strengthened, there is little evidence of their enforcement. Off-site supervision remains weak, and the skills and concepts acquired remain underutilized. The legal framework for failed bank resolution, albeit still with gaps, has been greatly improved. However, no bank, despite widespread insolvency,[45] had, during the period covered by this report, been liquidated, and asset-stripping by bank owners apparently continues unabated.[46] A bank restructuring agency (ARCO) has been created with adequate legal powers and an able staff, but its decisions thus far throw its independence from political pressures into doubt.

3.24 The volume of directly subsidized credits may have been reduced, but efficiency in resource allocation continues to be undercut by heavy subsidies hidden in the nonpayment system. The use of credit to administratively direct the allocation of resources remains a strongly entrenched ideal. The legal and institutional framework for capital market development has been improved, but the market remains small and is still inhibited by lack of transparency, inadequate and unreliable disclosure standards, weak corporate governance structures, and lack of protection for shareholders' rights. As in the case of CBR, RFCSM shows little interest in exercising the enforcement powers at its disposal. A similarly low level of development describes the non-bank financial intermediaries.[47] In sum, the financial sector continues to play a limited role, public trust in the system is low, and a significant share of "financing" continues in non-payment forms. The ultimate results of the Bank's assistance efforts and their sustainability thus remain to be seen.

4. Attribution of Bank Program Results

4.1 Although some aspects of the Bank's program might have been better designed, managed, and implemented, it is difficult to assert that the results would have been very different as a consequence. The strong external pressures on the Bank (and other assistance agencies) to provide rapid assistance to Russian reforms and to show quick results may account in some measure for flaws in design and implementation and for the excessive optimism of the

[44] In comments on the draft CAE, Anders Aslund has argued that the adoption of international accounting standards is now spreading rapidly. The most recent BTOR of the Bank's financial sector team describes this progress, however, as very modest indeed and still strong resisted by the large banks. It also notes little inclination by the authorities to push for IAS adoption prior to the designated starting date of January 2004.

[45] Whether insolvency should even constitute a criterion for bank closing is still an issue in dispute.

[46] The CBR did revoke the licenses of six large banks and commenced bankruptcy proceedings against them in mid-1999. Liquidation was delayed, however, by legal appeals or by opportunistic recourse instead to restructuring with financial assistance from ARCO. To the author's knowledge, only one (Inkombank) has since been liquidated.

[47] These were the subject of an informal ESW report prepared in 1996 ("Policy Note on Non-Bank Financial Institutions: Selected Aspects" [draft], June 30, 1996), which provided a good overview of the sector and constraints on its growth, although one of its recommendations was to apply to the promotion of the insurance industry the ISB model, that was showing "encouraging results" in the FIDP.

subsequent supervision reports. These early pressures, moreover, were not consistently followed up by Western governments and sustained in a way that would assure the coordination and timely availability of the resources needed to fulfill the mandates given.

4.2 External economic factors, particularly the eruption of the Asia crisis, also played a contributory role in triggering the 1998 financial crisis in Russia. The contribution of external shocks concerned timing, however, rather than fundamental causation. Macroeconomic management and the business decisions being made by Russian financial institutions, encouraged by distorted incentives and a weak legal and regulatory framework, had made the banks exceedingly vulnerable to any shocks that might affect the continued inflow of liquidity to the sector or alter asset/liability price relationships.[48]

4.3 Most important—and central, therefore, to any appreciation of the results achieved by the Bank's assistance program—was the situation within Russia itself. Arguably, in any country experiencing similarly extreme political and economic instability, efforts to promote the development of a sound, market-based financial system would be ill-advised and doomed to failure. It could plausibly be argued that the initial interventions from outside should have focused on stabilizing and rationalizing the state-owned banking system, while moving through dialogue, training, and technical assistance to build understanding of the basic concepts for strengthening the legal and regulatory framework, and more gradually to promote the private banks. This has been the tack taken in a number of other transition economies. However, such an approach would probably have been resisted by the Russian authorities and would have received little international support, given the heavy urgency being attached by the G7 to supporting private sector growth in Russia.

4.4 Moreover, the issues at the forefront of the effort to put the rapidly proliferating private commercial banks on a sound footing—i.e., transparency and honest disclosure, hard budget constraints for borrowers and lenders, prudential standards (including related and insider lending), failure resolution, owners' and creditors' rights, etc.—go to the heart of a country's political, judicial, and social processes for mediating conflicting interests. These have been and are contentious issues everywhere, and all the more so in a context of rapid shifts of economic and political power and major gaps in the structures of conflict mediation and resolution.

4.5 All of these factors were reflected in difficulties of access to information, frequent changes of counterparts to the policy dialogue and implementation of projects, and the sometimes abrupt shifts of policy positions and commitments from one meeting to the next. There was little consensus within the Government on many crucial issues, which in turn weakened the ability of counterparts to make a forceful case for needed action to a skeptical and often politically resistant legislature. Delays were frequent in preparing and presenting legislation to the Duma, and the process of getting laws passed once there was tortuous. Thus, it

[48] The fixed exchange rate policy, in the absence of fiscal control, also contributed by forcing up interest rates on government debt and providing both domestic borrowers and external lenders an illusory protection from exchange rate risk, thus encouraging the build-up of short-term foreign currency debt. A significant factor in the authorities' reluctance to devalue was undoubtedly the foreign exchange risk in the banking system from their heavy exposure, noted above, from forward contracts.

was often difficult, and may still be difficult, to know whether the dialogue was or is progressing or regressing.

4.6 This complex and often opaque context must be taken into account in assessing Bank performance. Assuming that the Bank could not and should not have sat on the sidelines until the situation stabilized, could it have done things differently? Yes. Would it have made a major difference in the status of financial sector development today? Possibly, but the case is not obvious. At a minimum, the Bank might have done more to carry a strategic vision for financial sector development (and its role in overall development) beyond the confines of its non-reactive direct project counterparts, and thus seek to inform a broader public debate of the key issues.

5. Agenda for Future Action

5.1 The thrust of the Bank's efforts to support Russia's financial sector development adopted since the 1998 crisis is essentially a correct one. The policy advice and technical assistance that have been provided have helped to create a promising foundation of laws and institutional capacity. What remains to be demonstrated is the determination of the Russian authorities to move forward from this foundation to provide the incentives necessary to sound financial intermediation and financial markets. The long-standing agenda in this regard has been well defined. The due attention now being given in the policy dialogue to the future role and restructuring of the state banks must also be intensified. Given their size and dominance of the banking system, and the strong political pressures to maintain and expand them, their operations, at least in the medium term, are likely to have greater impact on the stability and efficiency of the financial system than developments in either the private banking sector or in the capital markets. It will be important to ensure that the agenda for improving incentives in the private FIs is applied also to the state-owned FIs. This has not been easy anywhere, including in many Western industrial countries with state banks, but the alternative of privatization does not seem a likely option in the foreseeable future. In this intensified dialogue, the issues of hard budget constraint and the restructuring of state enterprises will surely have to be joined.

5.2 As it did throughout the 1990s, the Bank continued at the end of 2000 to be faced with the dilemma in its financial sector program of where to draw the line between (a) cutting losses (both for its own reputation and for Russia's debt burden) in the face of poor progress, and (b) its responsibility as a multilateral development institution to maintain a dialogue and the capacity to respond to opportunities to be of assistance. Given the crucial role that must be played by the banking system, the case for "keeping a foot in the door" remains a strong one. The case at this juncture for extending the CMDP seems to this reviewer a frail one, however. Without the will to enforce proper disclosure, accounting standards, governance and protection of shareholder rights, and lacking a sound banking system to provide credit and anchor payments and settlement, savers will rightly remain reluctant to enter, and will be well advised to stay out of, the market.

5.3 Adjustment lending has not proven an effective instrument in Russia for advancing the policy agenda in the financial sector. As the present dialogue advances, a more promising "window of opportunity" could open, but, in any event, technical assistance and advice will continue to be the essential tools of Bank assistance. By their nature, the provision of these services, whether financed by the Bank or by other donors, requires intensive supervision and dialogue, and, to be effective, the Bank will need to continue the very significant commitment made in the last two years in this regard.

5.4 Given the apparent success of the MFTP and the continuing need to develop modern banking and other financial market concepts, attitudes, and skills, the Bank should consider renewing support via a training project for bankers and bank supervisors at both the managerial and technical levels. Managers and staff of the state-owned FIs should be included in such training opportunities. While the ultimate results of such training will depend on changing incentives within the FIs, the latter may themselves be influenced by a rising consciousness at the staff level of what constitutes good banking.

5.5 Finally, the Bank has done little thus far to promote the development of sound micro and SME finance in either the urban or rural areas. This is understandable given weak property and creditors' rights and lack of real property markets that could provide security to lenders. Formal financial institutions, as in most countries, have also shown little interest in serving this clientele. IFC has begun to work with small local banks to development SME finance. Without having any concrete knowledge of the Russian situation in this regard, the reviewer suspects that there also exist in Russia, as elsewhere, informal private and community institutions providing elementary financial services to small savers and borrowers in the cities and rural areas. Taking advantage of the successful innovations that have been made around the world to reduce the costs and control the risks of providing these services, such institutions could offer a promising base upon which a sustainable developmental effort could be mounted, provided the central and local government authorities were willing to effect the enabling policy framework.[49]

5.6 On July 26, 2000, The Government of Russia adopted a Social Policy and Modernization Action Plan,[50] which for the first time set out as its own objectives in the financial sector—albeit with varying degrees of precision—virtually the entire financial sector agenda of legal, regulatory, and institutional reforms discussed above.[51] This is a promising development. Nevertheless, although the quality of the Bank's dialogue may have improved, it is clear that Russia, both within and without the government, is still far from having reached a consensus on crucial issues of financial sector reform.[52] In many cases, basic concepts are not shared. The Government's own commitment to the road ahead, and its political ability to walk that road, will require a growing convergence of understanding and views of the policy agenda and the directions of institutional change. As it has already begun to do, the Bank should increasingly seek and take advantage of opportunities to promote and inform the debate among both public officials and the general public regarding these issues. Progress in financial sector reform seems unlikely to accelerate from the snail's pace of the past decade, unless a consensus is built outside the bureaucratic interests and rivalries and the vested private interests that have heretofore confined and impeded the debate.

[49] In this regard, several reviewers of the draft CAE have pointed to over-regulation and bureaucratic harassment as more serious obstacles to SME development than the shortage of financing.
[50] Directive No. 1072-r.
[51] See also footnote 44.
[52] Notably absent in the Action Plan, for example, was any reference to the state-owned banks. It was also notable that President Putin's subsequent statement on development policy made hardly a passing reference to the financial sector.

6. Some General Observations

6.1 In addition to the above assessment of the Russia program itself, a few general comments are also suggested by the present review. A first comment has to do with the use of financial intermediary loans (FILs). Since the beginning of the 1990s, a central element of the Bank's policy toward such operations has been that, in addition to the transfer of resources to the economy, they should contribute conscientiously to the development of the financial institutions and system through which those resources are channeled.[53] Otherwise, the operation is likely to accomplish little more than a one-shot injection of funds with no lasting impact on future resource mobilization and allocation. One requirement of this policy has been that the intermediating institutions either have already attained financial soundness and viability, or that there be a feasible and monitorable program in place for achieving that institutional objective. This intention was clear in the conceptualization of FIDP and ESP, but, as described above, the design and supervision of the project fell far short of what was necessary to achieve it.

6.2 Although the reviewer has not been provided documentation for the other FILs in the Russia program, interviews and other materials suggest that financial sector and institutional objectives have been largely ignored in these operations.[54] Lack of concern for financial sector objectives and policies is also evidenced by the (apparently continuing) absence of participation of financial sector staff in the design and review of these operations in the ECA Region.

6.3 Also related to FILs, the Bank should, as was intended in FIDP and ESP, set quality and performance criteria on its intermediating FIs, and be satisfied that these criteria are being met, in order to ensure that proper credit assessment and risk management are applied in the use of its funds. The Bank, unlike IFC, however, does not take risk positions in the FIs that participate in the intermediation of its credit lines. If it takes the further step of publicly accrediting the soundness of such institutions for access to third-party funding, it inadvisably assumes an implicit moral obligation to anyone who relies on that accreditation to place his or her own funds with the FI.[55] Unless the Bank is willing to offer an explicit guarantee, it should not endorse an FI's creditworthiness to other potential creditors. It should rather promote accounting and disclosure standards sufficient to allow potential depositors/creditors to assess the risks for themselves.[56] (By the same token, the Bank should not, as it sometimes has done in other countries, certify sub-projects for financing by FIs, unless it is willing to offer explicit guarantees.)

6.4 A third comment is suggested by the timing, close sequencing, and frail conditionality of the Russia SALs. Perhaps a "window of opportunity" for achieving a significant policy reform breakthrough was visible in 1997. Even so, care should have been taken that such an abrupt shift

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[53] See the Bank's Operational Directive (O.D.) 8.30.
[54] See Bartoletti, *op.cit*.
[55] IFC itself cited FIDP accreditation in the documents supporting its own proposed credit lines for financial intermediaries.
[56] Two commentators have noted that the Bank cannot prevent banks participating in its FILs from advertising that participation to other funding sources. I agree, but I believe that there is an important distinction to be made between entering into an onlending relationship, in accordance with the Bank's own criteria, and joining in a public endorsement via an official accreditation process.

in the Bank's lending strategy not break the continuity of work already under way. Moreover, many observers were left with the impression that large-scale resource transfer was the primary objective of these operations. It is not unusual for the Bank to be expected by its owners to participate as a significant contributor of resources in a concerted support effort for a borrowing member. Such resource transfers may sometimes be a justified role for the Bank to play, but greater candidness, as in the case of rehabilitation loans, would be helpful to avoid undercutting the seriousness given by Bank staff, Board, and borrowers to policy conditionality.

6.5 Finally, it is necessary to comment on the poor quality of communication that appears to have prevailed between Bank staff and senior management.[57] Interviewees referred to intense external pressures on the Bank to provide quick assistance in support of private sector development in Russia, and to show quick results. Those pressures were apparently transmitted on a number of occasions directly from senior Bank management to the middle managers and line staff involved. It is not clear, however, how engaged management was afterward in evaluating and resolving the issues that arose as a result, nor how candidly staff reported upwards their concerns about problems they saw in the program, its implementation, and the evolution of events in Russia. One task manager at headquarters reported that memos expressing such concerns went unanswered, and another in the field alleged a general lack of support from Bank headquarters for dealing with concerns about, for example, the quality of intermediary institutions. Several interviewees related that staff had the impression that management did not want to hear "bad news". Whatever the facts, the politics of Russia and of Western assistance to Russia were highly charged, and staff undoubtedly felt under considerable pressure. As a general matter, it seems to this reviewer that it behooves Bank management in such situations to take a more hands-on responsibility in the decision-making process than seems to have been the case here. They should have reassured staff that it was accurate reporting and their best technical advice that was sought and appreciated, and that management would "take the heat" for decisions made either consistent with or contrary to that advice.

[57] The reader is reminded that these impressions are based on interviews and formal documents.

ATTACHMENT 1

DOCUMENTS AND INDIVIDUALS CONSULTED FOR RUSSIA: FINANCIAL SECTOR STRATEGY ASSESSMENT

Country Strategy Papers

- Country Assistance Strategy (incorporated in Oil Rehabilitation Project President's Report), May 26, 1993.
- Country Assistance Strategy (President's Memorandum), May 15, 1995.
- CAS Progress Report, February 29, 1996.
- Country Assistance Strategy (President's Memorandum), May 6, 1997.
- CAS Progress Report, December 1, 1998.
- Country Assistance Strategy (President's Memorandum), December 1, 1999.
- CAS Progress Report, November 1, 2000.

Loan Proposal and Supervision Documents [internal]

- **Rehabilitation Loan**
- President's Report, July 22, 1992.
- Project Status Report, June 15, 1995.
- Project Status Report, June 30, 1996.
- Implementation Completion Report, February 12, 1997.
- **Second Rehabilitation Loan**
  - President's Report, May 15, 1995.
  - Implementation Completion Report, February 12, 1997.
- **Financial Institutions Development Project**
- President's Report, April 6, 1994.
- Staff Appraisal Report, April 6, 1994.
- Project Status Report, September 2, 1994
- Project Status Report, May 31, 1995.
- Project Status Report, June 26, 1996.
- Project Status Report, January 10, 1997.
- Project Status Report, July 8, 1997.
- Project Status Report, June 25, 1998.
- Project Status Report, June 18, 1999.
- Project Status Report, December 15, 1999.
- Proposed Amendment to the Loan Agreement, May 26, 2000.
- Project Status Report, June 30, 2000.
- Project Status Report, November 13, 2000.
- **Enterprise Support Project**
- President's Report, June 1, 1994.
- Staff Appraisal Report, June 1, 1994.
- Project Status Report, December 9, 1994.
- Project Status Report, May 23, 1995.
- Project Status Report, December 14, 1995.
- Project Status Report, June 5, 1996.
- Project Status Report, January 15, 1997.
- Project Status Report, April 30, 1997.

- Project Status Report, June 25, 1998.
- Project Status Report, June 18, 1999.
- Project Status Report, December 29, 1999.
- Project Status Report, June 30, 2000.
- Project Status Report, December 5, 2000.
- **Capital Markets Development Project**
- President's Report and Technical Annex, May 6, 1996.
- Project Amendment, October 2000.
- Project Status Report, November 13, 2000
- **Management and Financial Training Project**
    - President's Report, November 23, 1994.
    - Staff Appraisal Report, November 23, 1994.
    - Progress Status Report, January 13, 1995.
    - Progress Status Report, June 30, 1995.
    - Progress Status Report, August 1, 1995.
    - Progress Status Report, October 25, 1995.
    - Progress Status Report, January 26, 1996.
    - Progress Status Report, June 28, 1996.
    - Progress Status Report, January 6, 1997.
    - Progress Status Report, June 9, 1997.
    - Progress Status Report, April 22, 1998.
    - Progress Status Report, April 16, 1999.
    - Progress Status Report, December 29, 1999.
    - Progress Status Report, June 30, 2000.
    - Implementation Completion Report, June 29, 2000.
- **Structural Adjustment Loan**
- President's Report, May 16, 1997.
- Project Status Report, July 7, 1997.
- Implementation Completion Report, July 15, 1999.*
- **Second Structural Adjustment Loan**
- President's Report, November 28, 1997.
- PID, December 23, 1997.
- Project Status Report, July 6, 1998.
- Implementation Completion Report, July 15, 1999*
- **Third Structural Adjustment Loan**
- President's Report, July 26, 1998.
- Project Status Report, May 25, 1999.
- Project Status Report, December 28, 1999.
- Project Status Report, June 28, 2000.

- BTORs of various financial sector missions (and attachments), 1998-2001.

ESW Reports, Working Papers, and Other Publications
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- World Bank. 1992. "Russia: Financial Sector Strategy – Issues Paper," September 14.
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W. Cohn. 2001. "Evaluation of IFC Assistance to Russia," (internal document) June 21.

OED and QAG Assessments [internal]

- OED, Evaluation Memorandum, Rehabilitation Program, June 24, 1997.
- OED, Evaluation Memorandum, Second Rehabilitation Program, June 24, 1997.
- QAG, Rapid Quality at Entry Assessment, SAL I, January 9, 1998.
- QAG, Quality at Entry Assessments, SAL II and SAL III (undated).
- QAG, Quality of ESW Assessment: "The Russian Banking Sector: Years of Stabilization," May 14, 1998.
- QAG, Quality of Supervision Assessment: Financial Institutions Development Project, July 12, 1999.
- OED, Performance Audit Report, Rehabilitation Loan and Second Rehabilitation Loan, September 29, 1999.
- OED, ICR Review, SAL II, November 1, 1999.
- OED, ICR Review, SAL I, March 3, 2000.
- OED, Evaluation Summary, Management and Financial Training Project, August 17, 2000.
- OED, Project Information Form, Management and Financial Training Project, August 24, 2000.
- OED, Performance Audit Report, SALs I and II (draft), November 14, 2000.

Government Plans

- Social Policy and Economic Modernization Action Plan (Directive No. 1072-r), July 26, 2000.

Persons Interviewed

By reviewer:
William Alexander, IMF, 1/8/01
Ken Lay, IBRD, 1/8/01
Cesare Calari, IFC, 1/8/01
Michael Fuchs, IBRD, 1/9/01 and 4/6/01
Jacques Toureille, IBRD, 1/9/01
Paul Siegelbaum, IBRD, 1/9/01
Ruben Lamdany, IBRD, 3/16/01
Walter Cohn, IFC (Consultant), 4/5/01

By others:

Michael Carter, IBRD
Lajos Bokros, IBRD
Ira Lieberman, IBRD

* Implementation Completion Reports for SAL I and SAL II were presented in a single document.