Cover Story

WTO Accession & Financial Services

How Near is Russia with the U.S. on an Agreement?

By **Dr. Jan-Hendrik Röver**, Managing Partner, Asset Capital Partners GmbH, Moscow/Munich

Russia has made great progress on becoming a member of the World Trade Organization, and membership is rightly on the top of the political agenda as President Vladimir Putin and Minister for Economic Development and Trade German Gref have expressed numerous times. WTO membership is key to achieving Russia's ambitious targeted growth rates, which require increased foreign and Russian direct investment and strong financial intermediaries.

In May 2004, Russia successfully concluded its bilateral negotiations with the European Union on WTO accession, but an agreement with the United States is still outstanding. Financial services are part of the negotiation agenda, but by no means are they the only issue, or the most important, to be resolved. The final bilateral agreement with the U.S. will balance all issues at stake – a point that should be borne in mind when discussing financial services.

The focus of international treaties dealing with trade liberalization is on the free trade of goods. However, in 1994 the member states of the WTO also adopted a document called the **"General Agreement on Trade in Services"** (GATS) and an **"Understanding on Financial Services"** (Understanding), both designed to increase the free exchange of services. Article XVI of GATS and the Understanding allow member states to take on "specific commitments" on services agreed upon in negotiations between member states. Within this context, Russia and the U.S. are discussing terms and conditions of market access for U.S. financial service providers to the Russian market.

The open structure of the WTO legal framework for all types of services is a reflection of the fact that services (and financial services in particular) are an area where states still have widely differing policy objectives, and, although liberalization is desirable in this sector, the degree and transition periods are a matter for negotiation.

The following are the **three areas of greatest concern to foreign financial institutions**, with the first being the sticking point in WTO negotiations with the U.S:

- The Russian position that foreign banks should not be allowed to establish their own branches in the Russian Federation. Currently foreign banks may only register subsidiaries or acquire stakes in Russian banks. In both situations, there is full supervision by the Central Bank of Russia
- Russian nationals must comprise at least 75 percent of the overall bank's staff and 50 percent of its management
- The issue of whether federal or regional governments should be the owners of a significant part of the Russian banking system

The issues must be viewed against the background of the current state of the Russian banking sector and two recent banking crises. The development of the Russian banking sector has clearly lagged behind the phenomenal development of Russia's natural resources industry and Russia's economic development as a whole.

The Russian financial system is characterized by two specific factors. First, it is dominated by banks such as Sberbank, Vneshtorgbank and Bank of Moscow, which are owned by federal or regional governments. These banks are estimated to control 40 percent of the sector's assets. Additionally, many of the country's most important privately-held banks are part of Russian financial-industrial groups (e.g. Gazprombank, Alfa Bank, EvrazBank, Interros and MDM) and are, therefore, mainly funding vehicles with limited functions. Furthermore, the banking system is unconsolidated (with 1,366 banks as of December 2005, only about 450 of which have an authorized capital of more than $6 million) with total assets of approximately $300 billion in December 2005. Even the major domestic banks have relatively low asset bases as compared to their Western competitors: Sberbank with assets of $50 billion in 2004, Vnestorgbank with assets of $11 billion in 2004, Gazprombank with assets of $7 billion in 2004, and Alfa Bank with assets of $6 billion in 2004.

However, simply describing deficiencies of the system only provides a static snapshot of the situation and does not reflect the steady improvement in conditions. The banking sector is consolidating, and the surviving banks are gaining critical mass to become serious competitors. British and Dutch banks are good examples of successful consolidations which can transform once ailing banking industries into global leaders.

The introduction in Russia of the **Depositor's Insurance Act** as part of a broader reform of the banking system in 2004 was a significant step forward in banking reform in Russia. Deposits are now insured for RUR 100,000, or about $3,300, in the event of bank insolvency.

Although it is still difficult to receive long-term financing from Russian banks (due to the limited inter-bank market liquidity), and loan terms are usually three to four years maximum, the general trend is toward longer loan repayment periods.

The market still reflects high loan margins for all creditors except first-tier borrowers such as Gazprom, Lukoil, Norilsk Nickel, Rosneft and Transneft, for whom margins have been reduced dramatically during the past two years; however, loan margins are generally declining for U.S. dollar, euro and ruble financings. The result is that Russian banks have become more competitive in the corporate lending market. Still, Russian banks have little experience with structured financings such as acquisition finance or project financing (which hardly exist in Russia), although there are signs that these financing techniques will be offered by Russian banks in the near future.

Russia is aware of the inherent weaknesses in its financial system, but its actions are also tempered by memories of two recent banking crises. The first, in 1998, was triggered by a crisis of public finances resulting in the default of the Russian state on its foreign debt and led to the insolvency of several hundred banks. It resulted in a serious shortfall in funds for Russian companies, even for blue chips, which are today the main targets of marketing efforts by international banks.

The second crisis, in mid 2004, was triggered by the closure of two small banks for violating anti-money laundering regulations and led to the closure of 11 banks. On a macroeconomic level the second banking crisis was not a serious event, but demonstrated the still shaky confidence of Russian customers in their banking system; despite apparently insignificant causes, customers rushed to their banks to withdraw deposits.

The current structure of Russia's financial system means that there are many financial institutions which are not looking forward to a liberalization process threatening their existence. The so-called Big Bang in the English banking industry, which took place in October 1986 and resulted in a restructuring of the London Stock Exchange as well as the introduction of the Financial Services Act, can provide a telling example. Century-old merchant banks, once the epitome of the City, were acquired by mostly foreign banks in a matter of a couple of years and disappeared from the scene after centuries of operations.

Additionally, until the mid 1970s, there was a widely held belief in Western Europe that competition between banks should be limited to protect the stability of the banking system. The difficult acquisition of the Italian Banca Antonveneta by ABN Amro in 2005 demonstrates that this belief still has supporters in some corners. It is, therefore, understandable that Russian WTO negotiators are trying to buy time for the liberalization of the Russian banking sector.

Eventually, however, the liberalization of the Russian banking sector will be of benefit to the Russian economy. One factor which is often overlooked in the discussion is the phenomenal development of the international banking industry in recent years. There is hardly another economic sector which is transforming so quickly. The development of financial structures (such as structured capital market products), of highly complex risk control systems or the ability to collect and invest large amounts of capital are evolving at breathtaking speed; it is almost unthinkable to match these recent developments in a strictly protected national banking sector. In addition, liberalization is widely held to lead to an increase in the quality and variety of banking services and a decrease in the cost of borrowing, to ensure public confidence in the banking system, and to increase profitability and thus banks' capitalization. Moreover, a functioning banking system is the most important tool for efficiently allocating capital within the economy.

In summary, although it is clearly desirable that liberalization come sooner rather than later, it is to be expected that Russian negotiators will hold a firm position on providing increased access to the Russian banking market for foreign competitors unless this position is overridden by gains in the liberalization of the trade of goods or other services. For sure, Russia will pay a price for preventing broader competition (particularly if it limits foreign banks' access to the market by not allowing foreign bank branches) and delaying modernization of its banking institutions, which economists may regret. Again the Big Bang in the English banking system can serve as a role model. Despite the dramatic changes in the English banking industry shortly after the Big Bang, the banking system as a whole benefited.

However, it is realistic to assume that Russia will fight for long transition periods and may even prevail in view of the strongly held belief in Russia that the Russian banking industry needs more time to become competitive. ■