A Regulatory Framework For Commercial Banking in Russia

Celeste E. Greene†

The Russian Republic presents a variety of investing opportunities as a result of the new free market economy. However, the success of economic reform and entrepreneurial endeavors depends on the strength and efficiency of the underlying banking network. The author of this article raises some of the difficulties currently facing the Russian banking system, indicates the sources of these difficulties, and proposes a regulatory scheme to address these concerns.

After examining the state of banking and bank regulation firsthand in Moscow, the author concludes that implementation of the Pierce Model of narrow banking would be beneficial. The positive and negative aspects of implementing this model are discussed. While there is currently an impetus for change, modification of the extant system is long overdue.

I.
INTRODUCTION

This paper proposes a regulatory model for the emerging banking system in Russia which addresses the challenges faced by the Russian banking industry as it moves from a command to a free market economy. In this period of transition, the success of Russia's financial institutions depends in large part on their ability to create a stable economic environment in the face of disruptive social and political pressures. The proposed model is not meant to be an optimal structure for facilitating commerce through Russian banks, but rather a reasonable means of avoiding collapse of the monetary system without compromising the development of industry expertise.

Russian regulators should not pursue an institutional approach to bank regulation, but rather one that focuses directly on bank monetary and financing functions. Commercial banks should be separated into two legally distinct entities—one focusing on monetary services ("monetary service banks") and the other on financial services ("financial service banks"). This scheme would place limits on the activities and permissible assets found within monetary service banks. Financial service banks, on the other hand, would be subject to the rigors

† J.D., Boalt Hall School of Law, University of California at Berkeley; B.S. in Commerce, University of Virginia. The author wishes to thank the Ford Foundation for research support. The author also thanks Price Waterhouse, Moscow, for their efforts in obtaining many of the reference works, statutes and documents referred to in this article. The author also acknowledges the advice and assistance given in preparation of this article by Professor Richard Buxbaum, Professor David Caron, Professor Edward Rubin, AIOC Resources Ltd., Moscow, and Evgeny Bershtein.
of market discipline. Banking literature refers to this arrangement as a "narrow bank."

James Pierce, writing in *The Future of Banking*, describes such a model (the "Pierce Model"). He asserts that separating the functions of a bank into monetary service and financial service entities does not undermine the safety and stability of the monetary system, nor does it reduce the availability of credit within the system. Elimination of both the asset-liability mismatch and any diversification standards helps to control inherent bank riskiness and improve capital adequacy standards. Deposit insurance addresses any residual risk in the system, while permitting the payment system to retain its stability. Further, the Pierce Model does not impair the stability and availability of credit as loan securitization channels funds from monetary service to financial service banks. Continuing its traditional role as lender of last resort, the central banking authority acts as final guarantor of system liquidity. Pierce's argument serves as the analytical framework for this paper.

Traditional Western models are inappropriate to conditions in Russia because they begin with two false premises: that Russian banking methods comport with Western banking methods, and that banks can be successfully regulated irrespective of cultural and historical peculiarities. The Russian economic and political situation cannot be approached from a Western analytical framework because the problems Russia faces are the product of its unique cultural and historic development. There are three major concerns. First, the Russian system resists change because the Communist administrative apparatus is not completely dismantled: communists remain in key positions in the public and private sectors. For example, loan grants are based on political influence rather than economically rational procedures and policies. Second, there is a lack of fundamental competence in the regulation of banks as well as in the operation of private banking. Western regulatory regimes presuppose not only regulatory competence but also strong institutions currently able to implement and enforce regulations. Present Russian institutions fail in both respects. This paper rests on the premise that the development of banking competence in the private sector will exceed that in government. For example, higher salaries attract college graduates to private banks instead of government agencies. Third, it is difficult simultaneously to develop and regulate a market economy. Policymakers must grapple with the design of a regulatory framework that will limit the potential for system failure while they create an environment conducive to the development of banking expertise.

2. See infra part III.
3. Interviews with Western international banking consultants, in Moscow, Russia (Nov. and Dec. 1992) [hereinafter Western Interviews].
4. Id.
These three difficulties can only be resolved by a framework which can adapt to cultural and historical peculiarities, or transcend these peculiarities. Most Western bank regulatory models can do neither because they are culturally biased; our institutions reflect our society's norms and tenets. The Pierce Model transcends culture, as its approach is functional and not institution specific. It is much too early in Russia's transformation process to pursue strategies aimed at optimal industry performance. Instead, the primary objective should be to avoid economic calamity while Russia develops a banking strategy based on its economic circumstances, history, and present opportunities.

First, this paper sets forth the current state of affairs in Russia and identifies emerging issues. Second, it analyzes the integrity of the Pierce Model and its fitness in current and future conditions in Russia. Third, it examines the transition to the Pierce Model in Russia while concluding that the current situation requires a regulatory scheme protecting the monetary system from collapse while providing Russian bankers and regulators time to develop expertise.

II. THE CURRENT STATE OF AFFAIRS

A. The Structure of the Russian Banking Industry

The number of commercial banks is growing at an exponential rate in Russia. In 1986 there were three state-owned banks.6 In 1988, the government formed three more banks for specific purposes: construction of housing, schools and hospitals, agricultural investment, and savings.7 In that year, the first commercial banks were also opened.8 These cooperative, publicly held banks were not state banks, although industrial ministries founded some of them.9 As of July 1992 there were 1,552 commercial banks, with a total of 2,625 affiliates operating in Russia.10 Founding capital for these banks totalled 57.5 billion rubles (U.S. $146.3 million at the October 27, 1992 exchange rate).11 During the first half of 1992, 245 new banks, or 15% of the total number of banks, were registered.12

Less than three percent (approximately 33 banks)13 of the total number of commercial banks are major players in the banking system.14 Each of these thirty-three banks has founding capital of over 200 million rubles.15 Combined,

7. Id.
8. Id. at 115.
9. Id.
11. Id.
12. Id.
13. Id.
14. Id.
15. Id.
these banks hold founding capital worth a total of 20.1 billion rubles, or 34.5% of the total founding capital.\textsuperscript{16} Seventy-one percent (1,099 banks) of the commercial banks have founding capital of less than 25 million rubles and control merely seventeen percent of total founding capital for all commercial banks.\textsuperscript{17} Despite the large number of banks, Russian banks can be divided into five categories: sector banks; specialized banks based in Moscow; specialized banks in the provinces; old independent banks; and new independent banks.\textsuperscript{18}

1. The Sector Banks

The sector banks generally have 200 to 1,000 clients. These banks are descended from former ministries or central agencies.\textsuperscript{19} Large companies of a particular industrial sector are the clients of these banks.\textsuperscript{20} As bank customers are customarily shareholders of the bank, these banks are also the financial tools of their shareholders.\textsuperscript{21}

Sector banks are characterized by expansive credit activity in an industrial sphere.\textsuperscript{22} They obtain resources from client accounts, and loans from both the interbank market and the Central Bank.\textsuperscript{23} In general, credit is concentrated in one client according to the influence of the client’s accounts on deposit.\textsuperscript{24} The paid-interest/interest-received ratio was above 40 percent in 1991 and increased significantly in 1992 because margins for interbank funds narrowed.\textsuperscript{25}

Banks retaining narrow sector specialization will experience limited growth in the future even if their range of activities is supplemented with international commercial transactions in the oil, timber, and non-ferrous metals industries, and privatization of major enterprises in their respective sectors.\textsuperscript{26} Some of these banks will not be able to overcome the bureaucratic “low dynamics of activity” from their ministerial origins.\textsuperscript{27}

\textsuperscript{16} Id.
\textsuperscript{17} Id.
\textsuperscript{19} French Firm Develops Guide I, supra note 18, at 19.
\textsuperscript{20} Id.
\textsuperscript{21} Id. Representative banks are AvtoVAZbank (descended from the car manufacturer) and Tokobank.
\textsuperscript{22} Id.
\textsuperscript{23} Id.
\textsuperscript{24} Id.
\textsuperscript{25} Id.
\textsuperscript{26} Id.
\textsuperscript{27} Id.
Banks that intend to expand their narrow specializations manifest that intent by considerable turnover in lending and in international and securities investment activities. However, if the proportions of influential shareholders remain considerable, this strategy will require substantial funding when resources become more expensive and difficult to acquire.

2. Specialized Moscow-based and Provincial Banks

Specialized banks were subsidiaries of the former state banks. The Moscow-based banks have at least 20,000 clients. Quite often, they have networks of branches in provinces which are evolving as specialized banks in their own right. Of the Moscow-based banks, Sberbank merits note. The Russian government plans to privatize Sberbank in the future, creating a network of private competing savings banks. Because Sberbank holds 90-95% of the public’s deposited savings, this privatization will have significant implications for the entire banking industry.

Specialized banks in the provinces occupy privileged positions by maintaining extensive contacts with major enterprises and networks in the regional centers and medium-sized cities. Inexpensive resources are available to these specialized banks through the accounts of their clients. Paid interest usually amounts to twenty percent, thirty percent of which is received. The assets of these banks contain credits to enterprises in distress, heightening their risk if they focus on activities in one region.

Strategically, specialized banks in the provinces must expand their number of clients and diversify their activities. Only the largest of such banks will be able to rely on self-financing to extend activities beyond the boundaries of their regions absent merger with major Moscow banks. These banks have the potential to cultivate the private sector by improving the quality of their services and reviewing their commercial lending policies.

28. Id.
29. Id.
30. Id. at 18. Examples are: Promstroibank, Zhilsotsbank, and Agroprombank. Id.
31. Id. at 19.
32. Id.
33. INTERFAX No. 44, supra note 10, at 4.
36. Id.
37. Id.
38. Id.
39. Id.
40. Id.
41. Id.
3. **Old Independent Banks**

The old independent banks, in existence for two to three years, specialize by region, customer, or both. They have considerable experience with private customers. Generally, these banks are successful, as evidenced by satisfactory profit-levels and clients numbering at least 15,000. Their success results from (i) a mixed or private capital structure, or (ii) specialization in strong areas (for example, hard currency operations and the growth in the new regions such as Bashkiria, Western Siberia or the Far East due to mineral reserves). These banks will require significant additional resources from operational revenues, shareholder funds, or new sources for further development. They will tend to draw closer together on the basis of complementary functions, geographic proximity and/or operational proximity. Some may become “business” banks or establish such banks as branches.

4. **New Independent Banks**

New independent banks are positioned to capture business from the emerging high-volume private customer sector composed of a variety of commercial enterprises and stock exchanges. Their clients number from 200 to 500. Representative banks include Delovaya Rossiya and Exchange Bank. Generally, new independent banks are characterized by both commercial dynamism and “rigorous” management. However, problems in acquiring resources and other important supplies hinder these banks’ operations.

An orientation toward new, private clients with greater demands for quality services is an important and potentially profitable strategy for these small and medium-size banks. However, the success of these banks, which generally have no subsidiaries, presupposes concentration on major clients with a considerable volume of transactions. Because new independent banks are not sufficiently diversified, a decline in credit margins would create a serious risk of harm for these banks. The future status and independence of these banks will depend on finding sufficient support from their present or future shareholders.
B. Appraisal of Russian Bank Management

1. Banking is Risky Business

The business of banking can be difficult even under predictable economic and political conditions. Banks act as intermediaries between lenders and borrowers by gathering funds from consumers and businesses, and then lending these funds to borrowers. As intermediaries, banks do three things: (i) gather funds; (ii) substitute their credit for that of the ultimate borrowers (i.e., they make credit judgments and assume credit risks); and (iii) assume interest rate risk by using short-term deposits to fund longer-term loans. Most banks seek to earn high profits by structuring their asset and liability maturities so as to earn extra profits by assuming additional interest rate risk. Judging conditions under which it is appropriate to do so requires vigilance and acumen.

A bank reacts not only to current conditions, but also attempts to predict the future and to position itself so as to maximize future earnings. In an environment characterized by volatile interest rates, far-reaching structural changes in financial institutions, and extant regulations, a bank must be managed by a competent team. Good internal communication, cooperation, and a clear view of the direction in which the bank should move are important. Strategies undertaken in different areas of the bank should coincide with management's overall objectives. Given a constantly changing economic environment, it is surprising that bank failure usually results from poor management rather than external factors.

A survey of problem banks and thrifts in the United States suggests that the main difficulties of these institutions is one or some combination of three factors. First, the institution has inept management that plays "bet the bank" and commits other management sins. Second, the institution is the victim of dishonesty. Third, misregulation drives an institution into a position in which its economic viability is threatened.

The objectives of bank management are to quantify the bank's constraints, determine the cost of those constraints, and measure the interest rate sensitivity of its balance sheet. A bank chooses a balance sheet that meets its goal of maximizing returns, while maintaining an acceptable level of interest rate expo-

58. Id.
59. Id.
60. Id. at 77.
61. Id. at 198.
62. Id.
63. Id. at 189.
64. Id.
65. Id.
66. Id.
67. Id. at 6-7. Constraints are limits on the amount of funds a bank realistically can buy in different markets, limits on its ability to add assets, such as loans, complicated tax constraints if it has international operations, a constraint on the degree to which it may leverage, constraints on the...
sure, credit, and liquidity. In light of the uncertainty inherent in managing these risks, experience is essential to success.

2. Russian Managers Have Limited Banking Experience

A banker must determine what is possible and prudent with the skills developed intuitively through lengthy operation in the market. Because commercial banking is relatively new to Russia, these bankers have little banking experience. According to the president of the Association of Russian Banks, many of the existing 1,500 banks "have started operations in basements and kitchens." The situation is worsened by the lack of any information infrastructure. In Russia, virtually no computer or telecommunications equipment exists. At a major sector bank the organization is replete with managers with little practical banking experience.

Because Russian bankers are bereft of experience, they engage in a variety of theoretical training programs of suspect efficacy; but practical training is desperately needed. Currently, training amounts to participation in a two or three month program in the West (usually England) during which Russian bankers "observe" Western commercial bankers at work. Western organizations have begun to sponsor training courses to give Russian bankers fundamental banking skills. Yet these short-term courses are unproductive. Training programs are needed which supplement theoretical knowledge with sound practical experience minimum amounts of certificates of deposits of different maturities it must write to maintain liquidity, and so on. Id. at 4.

68. Id. at 4.
69. Observations that follow result from the author's interviews with both Western personnel who have interviewed Russian bankers in connection with consultancy engagements as well as the author's direct contact with bankers. Due to the confidential nature of consultancy engagements, the names of banks and bank personnel interviewed have been withheld. With respect to the author's interviews, names are withheld because Russian bankers are rather secretive about their operations. They have neither a duty nor a desire to report particulars to anyone other than their shareholders. As most commercial banks are not publicly owned but rather owned by few shareholders, it is difficult to obtain information without the promise of anonymity.
71. EUROCONCEIL PROMOTIONAL GUIDE, supra note 18, at 4.
72. EUROCONCEIL PROMOTIONAL GUIDE, supra note 18, at 4.
73. Western Interviews, supra note 3. An international consultant appraised the sector bank in connection with a consultancy engagement. The consultant characterized the extant experience of bank managers as "woefully inept," citing as evidence the fact that the Credit Risk Department Manager had been in banking merely eighteen months after having been a foreman in a former car plant.
74. Id.
75. Several British organizations are engaged in providing training to Russian bankers in conjunction with the State Academy of Finance. These organizations include: The "Know-How-Fund" (through the British Embassy Commercial office), which does not run training courses but subsidizes courses arranged by others; the "GICAP Scheme" (through the British Council office), whose training programs, of two weeks in duration, are aimed at top management; and the "Chancellor's Scheme," which places the Russian banker at a British bank for a three to six month duration.
76. Western Interviews, supra note 3. According to a Western management consultant, the Russian visitor is rarely productive during this period, so the Chancellor's Scheme is very much a goodwill gesture.
mercial banking experience, provide real support from Western specialists with on-site coaching, and create correspondent relationships with Western banks.\textsuperscript{77}

Although banks appear to be profiting despite such difficulties, appearances are deceiving. The profitability as measured by bank stock prices is deceptive because commercial banks are taking advantage of the lack of legislative restrictions on their stockmarket activities.\textsuperscript{78} Likewise, although banks appear prosperous in terms of reported earnings,\textsuperscript{79} the integrity of their financial reporting systems does not conform to Western standards.\textsuperscript{80} Indeed, Western public accounting firms will not render opinions on the financial condition of banks, because the internal control systems are so poor.\textsuperscript{81} A great number of independent commercial banks have turned into monetary speculators and intermediaries preferring to issue loans to intermediary trading enterprises.\textsuperscript{82} Moreover, most banks contribute little to the Russian economy. Ninety-nine percent of the banks cannot satisfy the credit demands of a thousand medium and large-scale enterprises because of poor capitalization.\textsuperscript{83}

The absence of banking experience makes bank regulation difficult because regulators cannot rely upon bankers to manage risks prudently. Substantial human and capital resources are needed to develop the Russian banking system. It will take years to implement standards and build such expertise.

3. Russian Culture Frustrates Adoption of Western Standards

Irrespective of the lack of banking expertise, Russian culture and history render development of an efficient Western-style banking system in Russia difficult. "Russia," wrote Sergei Witte in 1905, "in one respect represents an exception to all the countries of the world; ... the people have been systematically, over two generations, brought up without a sense of property and legality."\textsuperscript{84} Since that time, three subsequent generations have been brought up under a government that prohibited private property and used the law as a weapon to enforce its political will.\textsuperscript{85} Democratization requires order balanced against the

\textsuperscript{77} This conclusion aims at improving training at the commercial bank level while, at the same time, providing policy oriented guidance. The Federal Reserve, in co-operation with the Financial Services Volunteer Corps, has agreed to a joint public-private sector effort that will provide broad-based technical assistance aimed at reform of the Russian banking and financial system, according to an announcement issued by the New York Federal Reserve Bank on June 19, 1992. The forum will provide on-going policy level direction and support for working groups of U.S. experts, which, in collaboration with Russian experts, will provide direct "hands-on" technical assistance and advice aimed at the creation of the basic elements of a market-oriented banking and financial system. Fed, Financial Services Group Agree to Aid Reform of Russian Banking System, 58 Banking Rep. (BNA) 1152 (June 29, 1992).

\textsuperscript{78} Banks and Stocks Doing Well, COMMERSANT, Sept. 22, 1992, at 8.
\textsuperscript{79} Id.
\textsuperscript{80} Id.
\textsuperscript{81} Western Interviews, supra note 3.
\textsuperscript{83} Id. at 4.
\textsuperscript{84} John Parker, Russia: The Sixth Wave, THE ECON., Dec. 5, 1992, at 3.
\textsuperscript{85} Id.
demands of self-interest. The Russian concept of order is rule, not consensus, for a cooperative purpose. In this regard, three prominent cultural attributes inhibit the adoption of a Western model of behavior: (i) dogged respect for and allegiance to theory as opposed to practice; (ii) impatience for solutions; and (iii) decisionmaking by a designated person rather than adherence to objective standards. These traits, combined with the legacy of communism, are injurious to the development of a sound and efficient banking industry.

Intractable respect for theory over practical experience obstructs training because banking requires judgment and does not lend itself entirely to mathematical models. For example, a banker may model her bank's growth-plan on an unrealistic mathematical model and theoretical strategy. Inevitably, she finds that no model works in practice as well as it does in theory. In addition, commercial dealings in Russia generally required compliance with orders, not the use of experience or judgement. Hence, bankers are reluctant to believe that there is no foolproof formula for successful banking.

This unrealistic belief in a right formula creates impatience for solutions. Bankers who employ Western management consultants attempt to impose strict recommendations intended as general guidelines. This practice has several disadvantages. First, the responsibility for the direction of the bank falls upon bank managers—not outside consultants. Second, it prevents the bankers from tailoring the recommendations to their organizations' strengths and weaknesses. Finally, bankers should not implement fundamental recommendations without making allowances for the strategic objectives of management in the overall direction of the bank.

Until Russian bankers learn to make strategic decisions and analyze their operations, they will be unable to manage their banks independently. In large part, recommendations are accepted as prescriptions because there is a desire to get ahead of the competition by any means rather than improving the strength of the bank. This attitude threatens improvement of Russian banking by creating an environment in which the quality of banking services is subordinated to the achievement of short-term competitive benchmarks.

Finally, the legacy of authoritative rulemaking in particular persons to the exclusion of objective criteria and demonstrated competence frustrates the de-
velopment of sophisticated banking. For example, a loan is granted according to the borrower's political influence,\textsuperscript{95} rather than the loan's potential profitability.\textsuperscript{96} Ordinarily, a "bank establishes credit standards to limit credit risk."\textsuperscript{97} A bank will attempt to meet the legitimate loan demands of any customer who fulfills these standards. Loans are a key source of bank profits; loan customers normally provide a bank with deposits and other business.\textsuperscript{98} When credit is granted without risk assessment, Russian bankers do not develop critical risk analysis management skills.

Most Western regulatory models are not suitable for Russia in light of the aforementioned cultural and historical peculiarities. Additionally, these models generally rely upon the rational pursuit of profits by bank management. Regulators assume that bankers will generally subordinate political (i.e., noneconomic) decisions in favor of profit-maximizing activities.\textsuperscript{99} The job of regulators is to keep individual bank risks within acceptable boundaries in order to insure industry safety.\textsuperscript{100} They do not replace a banker's judgment with their own. Rather, regulators defer to the judgment of the bankers with regard to the prudent management of bank risks within limited boundaries. When, as here, lending is conducted without regard to attendant risks and standard procedures, the trust relationship between regulators and bankers breaks down.

\textbf{C. Appraisal of Regulation at the Central Bank of Russia}

\textit{1. Regulation is Difficult Under the Current Economic Circumstances}

The Central Bank of Russia is not ready to regulate banks in a market economy. Since the nature of banking is taking risks by lending and maturity arbitrage,\textsuperscript{101} good regulators see their job as minimizing these risks.\textsuperscript{102} Although desiring a regulatory structure that eliminates bank failures, regulators must recognize that failure is a necessary aspect of banking in a free enterprise economy.\textsuperscript{103} Thus, the primary concern of bank regulation is to take preventive and corrective measures so that isolated failures will not induce a system collapse.

A predictable economic environment requires the delicate balancing of complex factors and control mechanisms. The primary policy tool available to a central bank is open-market operations, that is, the ability to create reserves in any desired quantity by monetarizing some portion of the national debt.\textsuperscript{104} In formulating policy, a central bank must first determine what macroeconomic

\begin{itemize}
  \item \textsuperscript{95} \textit{INTERFAx No. 44, supra note 10, at 3.}
  \item \textsuperscript{96} \textit{Id.}
  \item \textsuperscript{97} \textit{STIGUM \& BRANCH, supra note 57, at 73.}
  \item \textsuperscript{98} \textit{Id.}
  \item \textsuperscript{99} Shareholder obligations constrain bank management irrationality as well.
  \item \textsuperscript{100} \textit{STIGUM \& BRANCH, supra note 57, at 73.}
  \item \textsuperscript{101} \textit{Id.}
  \item \textsuperscript{102} \textit{Id.}
  \item \textsuperscript{103} \textit{Id.}
  \item \textsuperscript{104} See \textit{id. at 166.}
\end{itemize}
targets to pursue among a variety of choices: full employment, price stability, or a stable exchange rate for the domestic currency.\textsuperscript{105}

Of course, a central bank's decision as to which targets to pursue changes over time because "[e]xternal conditions [such as] the state of the domestic and world economies [are] in constant flux."\textsuperscript{106} Also, "central banking is an art form that is not fully understood. . . . [A] central bank's behavior at any time is therefore partly a function of its progress along the learning curve."\textsuperscript{107}

The efforts of the Central Bank of Russia to create a stable environment for banking have not been successful. Through the Central Bank the government is unsuccessfully pursuing a policy of controlled interest rates.\textsuperscript{108} The government planned a partial freeze on the assets of state enterprises which would decrease revenue to commercial banks, forcing yet another interest rate increase.\textsuperscript{109}

The practice of loaning enterprises money to pay old debts puts a strain on credit resources.\textsuperscript{110} In addition, the government's decision to assume the debts and control the assets of state enterprises prevents commercial banks from using these debts as collateral on interbank credits.\textsuperscript{111} Finally, the Central Bank has increased reserve requirements in order to "mop up" excess reserves that might be fueling inflation.\textsuperscript{112} The increase in reserves burdens the money supply, thereby exacerbating the recession.\textsuperscript{113}

Banks find it difficult to function in this environment. To attract more capital, banks increased interest rates on deposit by an average of 7.2 percent in June 1992.\textsuperscript{114} Several banks paid as much as 70-80 percent annual interest on deposits.\textsuperscript{115} As a result, in June 1992, banks issued more loans at a rate between 70-100 percent while in April and May of 1992, most loans carried interest rates in the 40-70 percent range.\textsuperscript{116} As interest rates increased, loan terms decreased.\textsuperscript{117} In June 1992, 96.6 percent of all loans were short-term and 68 percent were due in three months or less.\textsuperscript{118}

The high price of borrowed money carries over to interbank credits and loans auctioned on Russia's stock exchanges.\textsuperscript{119} While in early June 1992,

\begin{itemize}
  \item \textsuperscript{105}Id. at 167.
  \item \textsuperscript{106}Id.
  \item \textsuperscript{107}Id.
  \item \textsuperscript{108}Inflation Soars 52% in June, COMMERSANT, July 28, 1992, at 19.
  \item \textsuperscript{109}Average Interest Rate Tops 84% , COMMERSANT, July 28, 1992, at 14 [hereinafter Average Interest].
  \item \textsuperscript{110}Id.
  \item \textsuperscript{111}Id.
  \item \textsuperscript{112}FINANCIAL REPORT NO. 46, BANK OF RUSSIA ARMED WITH PLAN OF ACTION FOR 1993 (1992).
  \item \textsuperscript{113}See George J. Benston, Does Regulation Produce Stability? Lessons from the United States, in UNREGULATED BANKING: CHAOS OR ORDER 208-09 (Forrest Capie & Geoffrey Wood eds., 1991).
  \item \textsuperscript{114}Average Interest, supra note 109, at 14.
  \item \textsuperscript{115}Id.
  \item \textsuperscript{116}Id.
  \item \textsuperscript{117}Id.
  \item \textsuperscript{118}Id.
  \item \textsuperscript{119}Id. at 15.
\end{itemize}
Moscow stock markets sold credits at 96.6 percent on average, by the end of the month, credit prices increased to 102.9 percent per annum. Most credits were issued for terms ranging between two and three months. Deposit rates also jumped during June 1992 from an average 91.1 percent to 95.2 percent.

Under these circumstances a regulator must be skilled and experienced at managing in a chaotic environment; regulators at the Central Bank do not appear to be up to this challenge.

2. The Destructive Soviet Legacy Hampers Regulators

The Central Bank, consisting of 88 branches, is plagued by a shortage of personnel to supervise the activities of a rapidly growing number of commercial banks. Present employees often must work overtime. Many new employees are unable to undergo supervision training. Most young, Western-educated graduates attracted by high salaries and the opportunity to develop and implement new banking strategies are pursuing careers in private banking rather than regulation. Hence, bank supervisors are by and large former Soviet bureaucrats. It is extremely difficult to educate government bureaucrats to perform judgment-laden tasks because deeply ingrained habits formed under the old economic system resist alteration. Additionally, the task before them amounts to creation rather than reformation of an economic system.

Any economic system can be analyzed by looking at the decisionmaking hierarchy that defines the rights and responsibilities of various actors, the information system that links those actors to each other, and the incentive mechanisms that motivate those actors to function within the system. Within the economy, the market or the government acts as a resource allocator while the banking system acts as a conduit through which investment capital passes. The legal system specifies the rights and responsibilities of the various actors and the mechanisms for adjudicating disagreements that arise among them.

In Russia, the traditional economic underpinnings identified above are virtually absent. There are few computers or software, there is no computer network, and transactions are processed through the mail and hence subject to the

120. Id.
121. Id.
122. The Russian Banking System, supra note 34, at 6.
123. Id.
124. Interview with anonymous Central Bank employee, in Moscow, Russia, November, 1992 [hereinafter Russian Interview]. Although these young graduates are better educated their Central Bank counterparts, they still lack the requisite skills to be immediately productive in a commercial bank. After all, they were educated under a centrally controlled economic system.
125. Simonov & Slipagina, supra note 5, at 8.
126. See BIS Chairman Says Eastern European Banking Systems Must be Re-Vamped, 54 Banking Rep. (BNA) 1067 (June 18, 1990).
128. Id.
129. Id. at 15.
vicissitudes of the Russian postal service.\textsuperscript{130} The legacy of the centrally planned economy has proven detrimental to bank regulation for at least two reasons:

First, central planning [was] inaccurate as it [sought] through a bureaucracy working with limited information and limited analytical ability to make decisions about capital allocation throughout a complex economy. Second, central planning suffer[ed] from a deep moral hazard as it by definition divorce[d] responsibility for the consequences of decisions from control over the decisions, thus, providing incentives for undesirable action and disincentives for desirable action.\textsuperscript{131}

The destructive legacy of communist central planning has grave implications for bank regulation today. For example, during interviews with a Central Bank employee, it was suggested that rather than implement a government-sponsored deposit insurance program to diminish the likelihood of system-wide failure, if an individual bank failure were to occur, the Central Bank would merely back the failed bank’s obligations on a case-by-case basis.\textsuperscript{132} The Central Bank relies upon the “tradition of the State Bank of the U.S.S.R.”—which used “moral suasion” to regulate commercial banks.\textsuperscript{133} “Moral suasion” worked in the English banking system due to the sophistication of British bankers and relative simplicity of banking until the 1970s.\textsuperscript{134} However, in Russia there appears to be little evidence of banking sophistication.\textsuperscript{135} Given the absence of an ability to regulate itself successfully, the banking system has a manifest need for comprehensive regulations.

While the Central Bank is reluctant to manage the monetary functions of banks to improve their stability, it has no reservations about managing credit allocations.\textsuperscript{136} According to a Bank employee, the government should select certain firms to “channel investment activity” to desirable projects.\textsuperscript{137} Directing resources to socially desirable projects is a legitimate goal of regulation. However, in light of political instability as well as the heavy political influence in most state regulation, this goal will be subject to distortion.

\textsuperscript{130} Russian Interview, \textit{supra} note 124.
\textsuperscript{132} Russian Interview, \textit{supra} note 124. Subsequent to my conversation, the Committee of the Supreme Soviet of the Russian Federation for Budget, Plans, Taxes and Prices proposed deposit insurance as one of several reform measures. \textit{See} Law of the Russian Federation on Revision and Extension of the Law of the RSFSR on Banks and Banking Activities in the RSFSR, Nov. 10, 1992 (translated) [hereinafter RSFSR Law on Banks and Banking] (on file with the \textit{International Tax & Business Lawyer}).
\textsuperscript{133} Russian Interview, \textit{supra} note 124.
\textsuperscript{135} To illustrate, an international management consultant conveyed to me her utter frustration in trying to explain the concept of credit risk to the Manager of the Credit Risk department at a major sector bank! It seems that since there was no opportunity for loans to default in the former Soviet system, the concept of credit risk has yet to take root in Russian commercial banking. \textit{Western Interviews, \textit{supra} note 3.}
\textsuperscript{136} Russian Interview, \textit{supra} note 124.
\textsuperscript{137} \textit{Id.}
The reluctance or inability of the Central Bank to manage monetary functions has many disastrous implications. Consider the payments system for example. Currently the Center for Settlements at the Central Bank performs all settlements in the Republic. In the old Soviet banking system, every state bank had an "MFO" code with which to conduct settlements. The means of payment was simply an advice indicating the number of the account, the sum, and the MFO number. In 1989, emerging commercial banks were not part of the old Soviet banking system and thus did not have MFO codes. Accordingly they were and are shut out of the official settlement system. In response, commercial banks created a system of correspondent accounts with former Soviet banks.

The inability to accommodate commercial banks in the settlement system partially illustrates the challenge faced by the Central Bank as an effective regulator of the banking system. It is simple to propose that commercial banks be issued MFO codes in order to bring them into the payments system. However, it would be difficult to control the issuance of valid MFO codes because there is virtually no information system infrastructure. In order to issue such codes, Central Bank of Russia employees would manually have to create, log, and mail these codes to the banks. In this nonautomated environment, verification of a code appearing in a transaction would require a central bank employee to look up each code. Given the potential volume of transactions, it is doubtful that employees would consistently comply with this procedure. Since the system would be extremely vulnerable to this type of misfeasance, the Central Bank has not issued codes to commercial banks and hence has precluded them from direct participation in the government-run settlement system.

3. Extant Legislation is an Ineffective Regulatory Tool

Existing banking legislation is incomplete and fails to regulate the banking industry sufficiently. According to information obtained by the law firm of Clifford Chance, many commercial banks ignore existing legislation anyway. The law reflects the Russian attitude that law is neither uniformly applied nor internally consistent.

The law, fashioned after a traditional regulatory scheme, is not appropriate for the current state of affairs nor will it be proper for the banking industry as it matures in the future. The major substantive law on banking is The Law on the Russian Soviet Federative Socialist Republic on Banks and Banking, which constitutes the cornerstone legislation on banking. This law sets forth the gen-

138. Id.
139. Id.
140. Id.
141. Id.
142. Id.
143. The Russian Banking System, supra note 34, at 5.
144. Parker supra note 84, at 3, 4.
145. RSFSR Law on Banks and Banking, supra note 132, § I, art. I.
eral provisions for banking and standards for: establishing and liquidating banks; ensuring the financial stability of banks; defining the relationship between banks and their clients; and establishing the savings system in Russia.146

The law defines a bank as "a legal entity, which, according to this law and the license (permission) issued by the Central Bank of the RSFSR . . . shall have the right to attract monetary deposits . . . on conditions that such monies be returned and paid within a specified term, as well as to conduct other banking operations."147 Herein lies the first deficiency with this law: by linking depository functions with unspecified "other banking operations," institutions which engage in banking operations may avoid licensing and regulation by the Central Bank of Russia by not engaging in depository activity. While the law attempted to include credit institutions in its jurisdiction, the attempt is ineffective because the law does not define "other banking operations."148 As there has been no development of interpretive law, there are no standards by which activities may be tested. Due to clumsy drafting, the reach of the law is effectively a matter of choice for individual financial services institutions. Consequently, the law is not effective in preventing nonbank financial institutions from engaging in banking activities without a license.

In addition, the new law fails to provide for sufficient monitoring of the licensing procedure. For example, a bank may obtain a license by submitting an application, the bank's statutes, "economic substantiation," and "personal data" about the bank's management.149 In the West, on the other hand, a banker must demonstrate a good reputation, an irreproachable past, and be qualified to perform his duties.150 Moreover, in Russia, if a bank transgresses all or part of the law, it is difficult to revoke the bank's license.151 The grounds for revocation of a license do not set forth strict criteria defining infringement.152 One circumstance in which the Central Bank may clearly revoke a license arises when a bank conducts operations not stipulated by the license issued.153 This ground is effective only if the operations declared by the bank are stated in specific terms. However, there is no requirement that the intended activities be stated with any level of specificity.154

The law establishes few restrictions on potentially dangerous bank activities. Banks may engage in activities unrelated to finance when acting through subsidiaries.155 As there is no effective restriction on a bank's peripheral activities, its solvency could be impaired if its non-bank subsidiary suffered chronic losses. There are either no provisions limiting a bank’s ability to issue loans to

146. Id.
147. Id.
148. Id.
149. Id. § II, art. 12.
150. The Russian Banking System, supra note 34, at 5.
151. RSFSR Law on Banks and Banking, supra note 132, art. 18.
152. Id.
153. Id. art. 18(d).
154. Id.
155. The Russian Banking System, supra note 34, at 5.
related persons or existing provisions offering insufficient protection. Further, the limit on the maximum risk one borrower or related borrowers may bear is insufficient. Finally, banks are not required to provide security on bad debts and the legislature cannot introduce security requirements. Considering the large amount of mutual debts between Russian enterprises, such a requirement would entail ubiquitous provisions of banking security.

These failings of the Russian banking system may have been unavoidable. It is difficult to draft legislation without a common law foundation. Drafters employ clumsy language because they have no experience to draw upon nor access to words or phrases already subjected to judicial interpretation. While the law falls short of meeting fundamental requisites for a Western regulatory banking model, the model reflects the commercial environment in which it is drafted and implemented. Because the public's interests are not at issue here, efforts should be directed at identifying substantive problems inherent in drafting law under present conditions rather than identifying this law's shortcomings vis-a-vis other established models of regulation.

In the United States, regulation endeavors to protect the interests of depositors. Hence, bank activity is closely scrutinized to ensure the safety and soundness of a bank's financial condition to thwart potential bank runs. In Russia, however, depositors do not participate in the banking system. As protection of individual banks amounts to protection of financing tools of various enterprises, the inadequacy of extant legislation may not be a cause for alarm.

The Russian legislators are considering a draft amendment of the Law on Banks and Banking, which will result in significant reforms in the banking system. These reforms include:

a) re-registration of all banks with capital in excess of 200 million rubles, and simultaneous confirmation of all existing licenses to conduct financial activity;

b) development of a comprehensive licensing system for categories of banks as well as nonbank institutions, including requiring banks to maintain international standards;

c) increasing the minimum founding capital necessary to register a bank (from 5 million to 100 million rubles);

156. Id.


158. The Russian Banking System, supra note 34, at 5.

159. Id.

160. STIGUM & BRANCH, supra note 57.


162. However, if Sberbank, the state owned savings bank, were to go private, the protection of the public's deposits would become an issue. Interfax No. 44, supra note 10, at 4. Unless the public then takes its proper role as net surplus provider in the funds system, the chronic funds shortage will continue to hinder the maturity of the economy.

163. See generally RSFSR Law on Banks and Banking, supra note 132.
d) creation of a state deposit insurance system;
e) prohibiting loans by a bank to its founders or owners;
f) development of requirements to diversify "credit portfolios" and reserve requirements for risky loans; and
g) introduction of changes in existing legislation which would define the central bank's supervisory and inspection powers with regard to bank solvency.\textsuperscript{164}

While these amendments are a laudable step toward effective regulation, they do not address fundamental issues underlying the ineffectiveness of regulation. These issues arise from the discretion still accorded Russian regulators in the supervision of banks.\textsuperscript{165} The proposals suggest that making the laws more stringent is not enough. Rather, legislation should create a system of regulation that limits regulators' use of judgment and discretion to their competence level.

\subsection*{D. What About a Laissez-Faire Environment?}

Treating banks like any other industry in a laissez-faire environment could have disastrous effects for Russia. In a laissez-faire environment, financial firms would first search for the most desirable profit maximizing configuration.\textsuperscript{166} In the absence of explicit or implicit government guarantees, the process of calculated capital and effort could backfire, thus exposing a depository to the mercy of sources beyond its control and the potential for forced liquidations when depositors or other claimants pressed their legal remedies.\textsuperscript{167} In addition to a large number of bank failures due to inept management, a number of banks might fail under a laissez-faire system due to lack of regulatory control.

Deregulation would subvert the development of a Russian banking system because of the lack of expertise in the industry and the lack of public confidence in the now chaotic banking system. Approximately 1,500 commercial banks in Russia do not receive any funds from the population.\textsuperscript{168} Additionally, the system is chronically underfunded as banks resort to funds contributed by shareholders and other enterprises or banks.\textsuperscript{169} The population's savings are deposited with the state bank—Sberbank—which appropriates 70\% of its resources to finance the government's budget deficit.\textsuperscript{170} One consequence of the lack of funds in the system is that the demand for financing investments remains unsatisfied.\textsuperscript{171} Because banks lack long-term resources, such as time deposits, they prefer to offer short-term credit (94\% of the total assistance to their custom-

\begin{footnotesize}
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\item[\textsuperscript{164}] Interfax No. 44, supra note 10, at 4.
\item[\textsuperscript{165}] See Dubenetsky, supra note 82, at 27.
\item[\textsuperscript{166}] Lewis J. Spellman, The Depository Firm and Industry - Theory, History and Regulation 17 (1982).
\item[\textsuperscript{167}] Id. at 18.
\item[\textsuperscript{168}] The Russian Banking System, supra note 34, at 4.
\item[\textsuperscript{169}] Id.
\item[\textsuperscript{170}] Euroconceil Promotional Guide, supra note 18, at 3.
\item[\textsuperscript{171}] Id. at 4.
\end{itemize}
\end{footnotesize}
ers,\textsuperscript{172}) rather than long-term financing.\textsuperscript{173} Hence, without some intervention by a state authority in the system, the system will remain underfunded and will not develop a significant position in resource allocation within the economy.

Since the financial industry tends to be vulnerable to external shocks, the adverse impacts of which often reach beyond the depository, banking is especially prone to government intervention and regulation.\textsuperscript{174} As fundamental changes associated with Russia's transition to a free-market system occur, the vulnerability of the banking system cannot be overlooked or discounted. Banking, unlike other industries, is special because the failure of one bank has serious and far-reaching external effects.

The insolvency of one bank raises questions regarding the solvency of others, and when this cloud exists, deposit runs develop on what are otherwise solvent financial institutions. Since depositors have the right to demand cash, the depository firms are pressed to liquidate assets, as few hold sufficient cash reserves to withstand a general run. In a scramble to liquidate assets, loans are called, assets are sold at distressed prices, and there is often insufficient time to liquidate even sound assets on reasonably favorable terms in order to meet pressing cash withdrawals.

Steps are then taken by depository firms to expand sources of liquidity in times of general deposit outflows. Correspondent relationships develop among financial institutions with prearranged lines of credit; secondary markets for assets develop; private central banking or private gold or reserve asset pools with drawing rights for each contributing member emerge.

Despite these developments, many depository firms fail under the general run. Not only does the insolvency of one financial institution spread to others, but the failure of one financial firm in turn affects the business sector in which loans are called, credit extensions denied, and the liquidation of assets at distressed prices is forced in turn.\textsuperscript{175}

Government abdication of market-creating responsibilities could have expensive consequences as a result of this scenario. In Russia, the government does not have the fiscal wherewithal to take corrective action if such a situation developed. Therefore, the question is how to structure departures from a pure laissez-faire system.

III.
APPLICATION OF THE PIERCE MODEL TO THE RUSSIAN BANKING SYSTEM

Russia needs a regulatory regime that will permit its regulators to create a conducive environment for the development of the fledgling banking industry while protecting the monetary system from collapse as the industry develops competence. The proposed regulatory scheme must be sound in its own right, while conforming to current and future conditions. Under the Pierce Model,

\textsuperscript{172} Id.
\textsuperscript{173} Id.
\textsuperscript{174} SPELLMAN, supra note 166, at 18.
\textsuperscript{175} Id. at 18-19.
corporate separateness of banks can enhance the "stability of the monetary system by improving the safety of both checking accounts and the payments system."\textsuperscript{176} Considering the objectives of regulation, this model eschews an institutional approach to banking regulation in favor of a functional approach.\textsuperscript{177} The Pierce model was designed with a view towards streamlining regulation of complex regimes in industrialized countries.\textsuperscript{178} Despite its origin in the United States, the model contains no cultural bias and thereby can be applied to conditions in Russia.\textsuperscript{179}

In assuring the stability of the monetary system, the Pierce model does not overlook the implications arising from credit availability.\textsuperscript{180} First, Pierce observes that monetary and credit functions are less entwined today.\textsuperscript{181} "Most . . . bank credit is funded not by monetary liabilities but by time accounts and other nonmonetary liabilities . . . . Further, considerable business borrowing is conducted outside banks, using commercial paper, bond markets, and other sources of credit."\textsuperscript{182} As such, monetary stability does not necessarily lead to credit stability, and conversely credit stability does not necessarily imply monetary stability.\textsuperscript{183} As monetary and credit functions are at least partially independent, the regulatory goals of stable money and available credit each can be directly addressed separately.

The Pierce Model would be effective in Russia for three reasons. First, Russia's evolution will not parallel development in other countries. Russia will attempt to adopt internationally accepted credit markets such as bond markets and other nonbank sources of credit. Second, Russian banks are not currently a major source of credit to businesses,\textsuperscript{184} so the relative independence of money and credit already exists. Third, it is unlikely that most banks, as currently capitalized, will play a major role in credit allocation in the future. Because they are essentially financing tools of their major shareholders, they play a limited role in lending to the private sector. This disintermediation is the linchpin in the Pierce narrow bank concept.

\textsuperscript{176} Pierce, supra note 1, at 136.
\textsuperscript{177} Id. at 131.
\textsuperscript{178} See id. at 152.
\textsuperscript{179} For a discussion of legitimacy of the technical application of the model in Russia, see infra this section.
\textsuperscript{180} Pierce, supra note 1, at 130.
\textsuperscript{181} Id. This separation is distinct from years past in which the banking system was the primary source of credit to businesses. Notably, "the banking devastation of the 1930s involved the collapse not only of the nation's monetary system but also of the availability of credit to businesses. Because bank credit was funded largely by accounts payable on demand, the objectives of stability of money and of credit came to the same thing." Id. Disintermediation has changed all that.
\textsuperscript{182} Id. at 130-31.
\textsuperscript{183} Id. at 131.
\textsuperscript{184} Dubenetsky, supra note 82, at 4.
COMMERCIAL BANKING IN RUSSIA

A. Safety and Stability of the Monetary System

Pierce writes that "[i]t is not necessary to assure the safety and soundness of all the activities in which banks and thrifts engage in order to protect their monetary functions." The object is to isolate, insure, and protect monetary functions while eliminating insurance and protection for other functions. Under this scheme other businesses can provide monetary services as well.

Monetary services are provided by legally separate, highly regulated entities. These monetary service banks offer "federally insured accounts payable on demand at par." These banks must not lend to their owners. A monetary service bank can only "provide checking accounts and payment services to its owners on the same basis as other customers." Thus, the bank may be owned and operated by another bank, pay dividends, and receive capital injections, but it cannot lend money to the bank, buy certificates of deposit, or be involved in providing funds to the owner bank. "These restrictions eliminate conflicts of interest and help maintain effective corporate separateness that protects the banks against failure of their owners."

The scheme proposed by the Pierce model does not impair the ability to conduct monetary policy. In addition to supervisory powers, the central regulatory authority, here, the Central Bank of Russia, would impose reserve requirements on the liabilities of the monetary service banks just as it does for traditional banks. The Central Bank of Russia would be required to make its discount window available to these banks as well as to permit access to its check-clearing facilities.

In a traditional bank, accounts which are payable on demand can be used to fund illiquid, relatively long-term, and risky loans. In contrast to currency which is subject to erosion of purchasing power from inflation but not default risk, these accounts are the liabilities of private institutions and are not completely safe. Without "heavy government intervention, the severe mismatch between the character of liabilities and assets would make checking accounts unsafe and the banking system potentially unstable."

185. Pierce, supra note 1, at 131.
186. Id.
187. Id. at 133.
188. Id. at 131-32. Pierce calls these entities "monetary service companies." The title is really immaterial; I use the term "bank" for additional clarity.
189. Id.
190. Id. at 132.
191. Id.
192. Id.
193. Id. at 133.
194. See id.
195. See supra text accompanying notes 57-68 and accompanying text.
196. Pierce, supra note 1, at 128-29 n. 1.
197. Id.
discount window are invoked to make the situation viable. In order to make an unstable system stable, comprehensive regulation and supervision of banks are utilized.

However, regulators in Russia are not yet ready to take on such a task effectively. In this regard, any proposed regulatory scheme must not only address the inherent riskiness of banking but also acknowledge the virtual absence of competent supervision. The current state of affairs requires a regulatory scheme, such as the Pierce Model, that will limit the use of discretion and judgment in the regulation of banks without undermining the integrity of the monetary system.

1. Narrow Bank Concept is Subject to Refutation

The narrow bank concept is generally criticized as being difficult to implement. Specifically, Benston and Kaufman refute the practical viability of narrow banks. Asserting that thin profit margins give rise to "transaction balance substitutes" as other financial institutions offer lower fees or higher interest rates, they write:

A shift in funds to those institutions would reduce the relative importance of the narrow banks and increase the concern of the government for the safety of the institutions offering alternative transaction deposits. Thus little would have been gained at the cost of developing new institutional arrangements.

To combat such potential shifts from the narrow banks, proponents of the proposal have progressively broadened the narrow permissible investment opportunities to securities such as commercial paper and long-term Treasury securities, which subject the banks to credit and interest rate risk. . . .

As the proposed bank’s powers continued to be expanded, it would resemble today’s broad bank except that its assets and liabilities would be valued at market prices. Unless timely reorganization procedures were introduced simultaneously, today’s problems would not be solved.

Each shortcoming merits attention. First, since the government benefits from the relative safety of these narrow banks through reduced regulation, enhanced monetary stability, and elimination of potential tax bailouts of bankrupt insurance funds, it should provide direct subsidies to guard against flight of funds. The criticism does not take into account the depositor’s utility in having his funds in such an institution. Some depositors may be willing to forego additional returns in exchange for the peace of mind of having their money in a safer institution. Hence, competition on the basis of fees and interest paid on ac-

198. Id. at 128-29.
199. For a discussion of the incompetence of bank regulators, see supra notes 69-83 and accompanying text.
201. Id.
202. Id. at 74-75.
203. Pierce, supra note 1, at 139.
counts from nonbank institutions may not attract funds to the extent that Benston and Kaufman suggest.

Second, it is not clear whether criticism of investment powers is relevant. The authors seem to suggest that the expansion of investment powers to more risky and more profitable instruments causes banks to become troubled. Arguably, a decline in the market value of asset holdings is not the primary reason for bank failure. Indeed, Benston and Kaufman identify "fraud and gross mismanagement as... the primary causes of bank failures and large losses to the deposit insurance agencies." As fraud and gross mismanagement transcend the institutional structure of banks, restriction of investment powers in a narrow bank should not be identified as a reason to eschew narrow banks due to a putative tendency to make banks fail.

Third, the need to resolve a single bank failure is diminished because the failure of one bank does not have systemic implications if that bank does not perform monetary functions. Benston and Kaufman state that "regardless of how insurance premiums, capital standards, or investment powers are structured, unless failures are resolved in a timely fashion, the banking structure will continue to impose unnecessary risks and costs on the economy." Because the risk of failure is controlled through asset restrictions, that risk can be held to a manageable level sufficiently covered by deposit insurance. Moreover, optimum closure policy depends on a good monitoring system. Particularly in Russia, swift regulatory resolution of bank insolvency will not happen because it is unlikely that state institutions can "resolve economic insolvencies effectively and [inexpensively]." Institutional incompetence as well as a lack of clarity in the delegation and scope of agency authority would impede efforts to reorganize expeditiously. Finally, the lack of firm reporting requirements is yet another difficulty. In short, these ostensible deficiencies do not undermine the general application of the narrow bank concept.

2. Elimination of Asset-Liability Mismatch and Imposition of Diversification Standards Control Inherent Riskiness

The need for regulation flows from the asset-liability mismatch inherent in all traditionally structured bank balance sheets. Goodhart states that "the special feature of banks that requires central bank support is not their joint role as providers of payment services and holders of a portfolio of assets, but rather the particular nature of their asset portfolio." Central banks are instrumental in assuring the stability of the monetary system through regulation that prevents

204. Benston & Kaufman, supra note 200, at 83.
205. Id.
206. Pierce, supra note 1, at 152.
207. Paul M. Horvitz, Commentary to Regulating Bank Safety and Performance, in Restructuring Banking & Financial Services in America, supra note 200, at 103.
208. Id. at 75.
panic caused by depositors' doubts about the solvency of commercial banks.\footnote{210} When, however, the value of the standard bank portfolio can be ascertained at all times, simple reforms could virtually eliminate the possibility of such an occurrence.\footnote{211} Goodhart and Pierce propose an alternative scheme: incorporating structural improvement to stabilize a banking system and prevent runs, thus eliminating the need for a central bank, and restricting the set of permissible bank assets so that market value is always clearly ascertainable and usually stable.\footnote{212} This also eliminates the need for a central bank. Under this structure there would be only a regulatory "need for regular inspection and monitoring to prevent fraud."\footnote{213}

Elimination of the asset-liability mismatch inherent in all bank balance sheets is attractive in Russia because it greatly reduces the need for regulatory oversight. Taking its cue from money market funds, monetary service banks hold assets that are more compatible with their obligations than those of traditional banks. "With a much closer match between the character of liabilities and assets, the risk that a [monetary service bank] cannot meet its demand obligations at par is vastly lower than that for banks... today."\footnote{214} These assets include government securities, highly-rated commercial and finance company paper, and similar instruments.\footnote{215}

The efficacy of this arrangement may be undermined in Russia in light of the unavailability of securities and current illiquidity of the markets.\footnote{216} As diversification standards are required to buttress stability, there must be a variety of available instruments with varying attendant risks. There is a fledgling but steadily growing government securities market.\footnote{217} For instance, in an effort to dissolve the debt of the former Soviet Bank for Foreign Affairs, the Ministry of Finance may issue Soviet Vneshecombank hard currency bonds on the domestic market.\footnote{218} The total issue will amount to U.S. $10 billion for terms from one to fifteen years.\footnote{219} After the bonds are issued, the Ministry hopes to create a secondary market for hard currency bonds.\footnote{220} The plan to issue the bonds was developed in cooperation with major Western investment firms including Lehman Brothers, S.G. Warburg & Co. Ltd., and Deutsche Bank.\footnote{221} There is a potential for more activity of this sort as the Russian government continues to dissolve the obligations of the Former Soviet Union.

\footnote{210} E. Gerald Corrigan, Are Banks Special?, in Dynamics of Banking 290 (Thomas M. Havrilesky et al. eds., 1985).
\footnote{211} Id. at 1.
\footnote{212} Id. at 2.
\footnote{213} Id. at 3.
\footnote{214} Pierce, supra note 1, at 137.
\footnote{215} Id.
\footnote{216} EUROCONCEIL PROMOTIONAL GUIDE, supra note 18, at 4.
\footnote{217} INTERFAX, FINANCIAL REPORT NO. 37, MINISTRY OF FINANCE MAY ISSUE BONDS 6 (1992).
\footnote{218} Id.
\footnote{219} Id.
\footnote{220} Id.
\footnote{221} Id.
Liquid instruments other than government securities are rare because development of markets in Russia has been atypical. Normally, an economy first develops commodity markets. Out of these markets grow money markets, capital markets and stock markets, followed by foreign exchange markets. While Russia is developing elements of a currency market, the fledgling capital and stock markets are illiquid, controlled by issuers and nonpublic entities. Finally, extant legislation necessary to protect the interests of investors is inadequate.

Such a dilemma brings to the fore the interdependence of multiple factors in Russia. Privatization is a necessary precursor to development of a free market. Markets will develop in accordance with the development of privatization efforts, but privatization requires planning and institutions to absorb and direct the emerging securities. Therefore, it is desirable to have an apparatus in place that meets current regulatory abilities.

3. Capital Adequacy Requirements Improve Stability as Well

The issue in Russia is not whether minimum capital standards must be set but rather how much capital Russian banks need. Arguably, there is no satisfactory answer to this question. A well-managed and profitable bank can get along with an extremely low capital ratio, whereas no amount of capital will be sufficient to guarantee the solvency of either a poorly managed bank or an institution that operates in an environment rendering it nonviable. In both banking and industry, capital adequacy is an elusive measure. Perhaps the only real determinant of adequacy is the aggregate consensus of the marketplace—that is, leverage, or the inverse of the capital ratio, should be extended until the marketplace reacts adversely and reflects concern.

Capital adequacy standards have emerged as a central tool of bank regulators to address two overlapping goals. First, capital ensures solvency by adding to the resilience of banking institutions. Second, capital acts as an 

   223. Id.
   224. Id.
   225. Russian Interview, supra note 124.
   228. STIGUM & BRANCH, supra note 57, at 181.
   230. Id. at 375.
   231. Trachtman, supra note 131, at 167.
   232. Id.
institutional guarantee: it is the risk capital that compels shareholders' diligence and prudence. 233 "The smaller the capital at stake in comparison to the total funds of the bank, the greater the risks the shareholders, who together exercise control over the bank (subject to bank regulation), may be willing to take." 234

Regulators influence market perceptions by creating guidelines which set minimum standards and establish a definition of what constitutes capital. 235 Such a regulatory minimum then becomes an important benchmark for the marketplace's evaluation of adequacy. 236 However, some policy analysts have expressed reservations about the efficacy of capital-based regulation because many seemingly well-capitalized banks failed or were reorganized during recent years. 237 This criticism is misguided because it overlooks the fact that capital-based regulation will remove at least one dimension of regulatory discretion, thus diminishing the problem of weak supervision. 238

Risk-based capital adequacy standards have been introduced in Russia. 239 However, they are currently ineffective in controlling risk due to the adverse impact of inflation upon minimum capital targets. 240 Notwithstanding the ineffectiveness of capital requirements in a hyperinflationary environment, the most salient argument against using minimum capital requirements as a regulatory tool in Russia stems from the weakness of the banking industry. One commentator notes that possibly the greatest danger in imposing some minimum acceptable capital ratio on banks is that capital minimums undermine the institution's fiscal resilience. 241 This occurs because the portion of an institution's existing capital needed to meet the requirement is also unavailable to serve the key function of capital—namely, to enable the institution to withstand losses and thereby provide a margin of safety for the institution's creditors. 242 Requirements on liquidity or capital thus weaken an institution because the required amount is unavailable for use.

The counterproductive nature of externally imposed capital constraints becomes particularly evident when financial institutions lose significant amounts of capital as a result of prolonged industry-wide operating losses. 243 As the

233. Id.
234. Id.
235. Ehlen, supra note 229, at 377.
236. Id.
238. Id. at 1527-28.
239. Instruction on the Procedure, supra note 157.
240. Maintaining equity capital ratios, except through external infusion, is a mathematical function of four variables: (i) return on assets (profitability); (ii) level of dividend payment; (iii) existing equity-to-assets ratio; and (iv) the growth rate of assets. A decline in the equity ratio occurs when asset growth is higher than the rate of equity retention, or stated another way, when profitability is too low to support asset growth. Ehlen, supra note 229, at 375.
241. STIGUM & BRANCH, supra note 57, at 186.
242. Id.
243. Id.
banking industry matures, credit margins decline. One response of the regulators is likely to be a request for new accounting practices, such as deferred write-off of capital losses, to permit an institution to show a higher capital ratio than it would otherwise have under previous accounting practices. Regulators will not permit capital rules to bankrupt an industry, but if capital ratios are evaded there appears to be little justification for imposing them in the first place. Notwithstanding the inability of banks to use reserve capital for other purposes, the gains from capital requirements in terms of relief from regulatory discretion transform the debate from whether to have minimums at all to how much.

4. Deposit Insurance Addresses Residual Risk in the System

Should insolvencies continue to occur in banks performing solely monetary functions, deposit insurance would protect depositors against losses. Unlike deposit insurance in a traditional bank setting, here the premiums are held low because of the inherent safety of monetary service banks. Deposit insurance engenders public confidence and hence financial stability. Federal deposit insurance converts deposits from unsecured obligations of the bank itself into obligations of the federal government. On this basis, depositors feel secure and charge little or no risk premium to the bank. Thus, insured deposits generally constitute an inexpensive source of finance for banks due to this implicit subsidy. Yet deposit insurance gives rise to the need for protection of the federal treasury through powers, capital, and reserve regulation because of the moral hazard it creates when applied to traditionally structured banks. Indeed, current thinking is that wide-scale deposit insurance with de facto protection of all deposits is inconsistent with a healthy industry.

When the government stands behind the obligations of a private corporation, it takes responsibility for the management decisions of that private corporation. To accept this responsibility, the government must also increase its control over that private corporation, to moderate the conflict of interest that would otherwise arise from the divorce of responsibility from control. This divorce in responsibility gives rise to the moral hazard and may lead to a problem of re-regulation.

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244. Id.
245. Id. at 186-87.
246. Id. at 187.
247. PIERCE, supra note 1, at 132.
248. Trachtman, supra note 131, at 163.
249. Id.
250. Caesar, Note, supra note 237, at 1528. Augmenting the role of capital when the government provides deposit insurance is one means of increasing market discipline of bank activity. In such a context, capital operates in much the same way as an insurance deductible, which shields the insurance fund from the initial losses and counters the moral hazard of risk-taking associated with the insurance safety net. Id. at 1530.
251. Trachtman, supra note 131, at 168.
252. Id.
The re-regulation problem stems from the failure to decide whether banks are public sector entities or private sector entities.\textsuperscript{253} If banks are public sector entities, they should be managed by the government, and their profits should accrue to the public treasury.\textsuperscript{254} If banks are private sector entities, they should not benefit from the massive subsidy of deposit insurance and other aspects of the banking safety net, and should be permitted to make their own management decisions.\textsuperscript{255} Here, the moral hazard is avoided because corporate separateness prevents cross-subsidies. More importantly, deposit insurance can infuse public confidence into the system. Russia needs this social contract between the state and depositors because even under optimal conditions, depositors are not adept at assessing bank risk.

Under this scheme, the Central Bank of Russia would administer deposit insurance. As an alternative, one might consider a private insurance scheme, assuming that the attendant risks are low. However, private deposit insurance engenders systemic risk. That is, if depositors feared that private insurers could not cover their obligations there could be runs on a number of banks, and in the absence of federal intervention, prices of the banks' securities would collapse as banks rushed to sell them off.\textsuperscript{256} Given the level and prevalence of the public's distrust of private actors, such a scenario is very likely.

5. Payments System Not Rendered Unstable

Monetary service banks provide payment services including check-clearing and electronic fund transfers.\textsuperscript{257} The importance of a safe and efficient payments system is manifest. As an economy becomes more complex, the existence of money is not sufficient: an efficient mechanism for transferring money—a payments system—is essential.\textsuperscript{258} Monetary service banks operate their own private payment facilities "in order to provide a smoothly functioning and safe payment system."\textsuperscript{259} Further, monetary service banks eliminate most credit risk in the payments system.\textsuperscript{260} First, because all demand deposits at monetary service banks pay a market rate of return, organizations have less incentive to turn over their accounts at high speed, thus reducing the volume of transactions and aggregate risk.\textsuperscript{261} Second, because monetary service banks are not allowed daylight overdrafts, they may extend credit only through purchases of highly rated marketable securities.\textsuperscript{262} In order to make a payment to a third

\begin{itemize}
  \item \textsuperscript{253} Id.
  \item \textsuperscript{254} Id.
  \item \textsuperscript{255} Id.
  \item \textsuperscript{256} Pierce, supra note 1, at 139.
  \item \textsuperscript{257} Id. at 132.
  \item \textsuperscript{258} Horvitz, supra note 207, at 142.
  \item \textsuperscript{259} Pierce, supra note 1, at 142.
  \item \textsuperscript{260} Id.
  \item \textsuperscript{261} Id.
  \item \textsuperscript{262} Id.
\end{itemize}
party, the depositor must have funds on deposit with the monetary service bank before the transaction takes place.263

The payments system in Russia is currently controlled by the Central Bank of Russia.264 The Bank runs its own interbank payments system known as the Central Settlement Account.265 The system of payments between banks is a shambles, but Western computer and systems companies can do little to improve the process until the Central Bank decides on basic banking rules.266 The system is so disorganized that no one knows the volume of transactions that have occurred.267 A Central Bank deputy chairman admitted that the system is open to fraud because tens of trillions of rubles and millions of payment orders were simply lying around in sacks waiting to be processed manually.268

Several commercial banks are forming their own clearing and settlements systems to bypass the Central Settlements Account.269 The Central Bank has not stated whether such systems are legal.270 Following introduction of new accounting systems, the government may permit banks to open and maintain correspondent accounts either through similar means (the decentralized plan) or by creating regional clearing houses.271

The desirability of a private scheme is questionable as the allocation of risks is unsettled. In the United States, the check payment system has been firmly established in our legal system, which means that the allocation of risks in the system is well understood by all participants in the process. While this is easily taken for granted, the allocation of risks is not settled in all systems.272

In light of the above state of affairs in the government-run payment system, it is clear that the Russian government will not be able to implement an efficient payment system in the foreseeable future. Therefore it seems that the private sector may be relatively more competent to run the payments system. But in a private payments system, who will be liable for failures in the system? In addition to risks from failure of a participant in the system before settlement, there are also fraud risks of a generally unknown magnitude in wire transfer systems.273 The important feature of a government wire system is that it is the only element of the payment system in which all transactions are instantaneous and final.274 A bank receiving funds via this means knows that the transactions cannot be reversed because of the failure to deliver by any participant in the

263. Id.
265. Id.
266. Id.
267. Id.
268. Id.
269. Id.
270. Russian Interview, supra note 124.
271. INTERFAX No. 44, supra note 10, at 4.
272. Horvitz, supra note 207, at 147.
273. Id.
274. Id. at 146.
system. A central bank is the only institution that can make such a guarantee.

In a private payments system, some form of insurance would be needed to make the system work. However, it is difficult to obtain insurance protection in the absence of information on risk and without a clear understanding of the allocation of responsibilities of the various parties in case of failure or loss. In the case of checks, credit card transactions, and automated clearing house operations, risks must be allocated fully among the participants by contract, statutory law, or years of experience in which virtually every possible eventuality has been litigated and resolved. It is unclear who is responsible for fraud by means of a wire transfer.

It is appropriate for a government to establish a legal framework to protect payment system participants. In the United States, the Uniform Commercial Code does this fully with respect to the check system, and existing law spells out consumer rights with respect to a variety of electronic fund transfer systems. The relationships among the financial and communications firms involved in wire transfers can be resolved by contract among the parties, but there is a need for additional law. Accordingly, because the payment system is inherently risky and is central to the function of a modern economy, it cannot be left completely in private hands.

Within-day debt and credit positions will develop among the monetary service banks during the course of business, exposing creditors to the risk of failure by monetary service banks owing funds. The Central Bank thus must provide strong regulation and supervision as part of its oversight of monetary service banks. This will not happen soon due to the lack of an effective and modern information system. Nor will the lack of regulatory competence expedite this regulation. The Central Bank is also needed to guarantee delivery of funds transfers, without which the system is subject to failure, yet the Central bank has neither the expertise nor the information system infrastructure to implement effective control of the system. This illustrates the conundrum in which virtually all Russian financial services are mired. As such, the policymakers must resort to a scheme in which the risk of financial collapse is controlled as much as

275. Id. at 145-48.
276. Id.
277. This is the current situation in Russia. See Paul Klebnikov, A Market Grows in Russia, FORBES, June 8, 1992, at 78, 80. Since the old Soviet republics lack an official system of contract guarantees and enforcement, the commodities exchanges fill that role with regard to commodities trading activity. As clearing agent, the Russian exchange guarantees the delivery of the product and imposes penalties on the seller if the shipment is either late or defective. For its troubles, the exchange takes a 0.2% commission on the value of the deal.
279. Id.
280. Id.
281. Id.
282. Id.
283. Pierce, supra note 1, at 142.
284. Id.
possible until the fundamental requirements of a modern financial system are adopted.

Rather than attempt to develop its own system by fits and starts, Russia should adopt a model already proven effective which would not conflict with its cultural legacy. Since the stability of the payments system is nestled in the stability and solvency of the participating actors, the regulatory scheme should be directed foremost at assuring the safety of those actors. Utilizing monetary service banks to operate the payments system and guaranteeing the finality of payment makes it possible to have a payments system that is safe, efficient, and stable.  

B. Stability and Availability of Credit

The Pierce Model enhances the safety and stability of the monetary system without sacrificing the stability and availability of credit. Monetary service banks extend credit directly to businesses, and indirectly to the public, in forms that will protect financial service banks.  

Pierce writes:

When [monetary service banks] purchase short-term securities issued by finance companies, they are lending indirectly to consumers. When [monetary service banks] purchase commercial paper, they are extending credit to business, the same kind of credit that used to be provided by banks as prime loans. Similarly, when [monetary service banks] purchase the short-term marketable debt issued by nonaffiliated [financial service banks], they are extending credit to these institutions, allowing them to fund loans to businesses and consumers. Although this debt must be relatively short-term and highly rated to be eligible for [monetary service bank] purchase, it offers a large potential source of funds for well-managed [financial service banks].

Financial service banks provide a complete range of financial services, excepting insured monetary services, without the regulation and supervision imposed on traditional full-service banks. Financial service banks are subject to market discipline; they will be unable to attract funds from monetary service banks, other businesses, or the public at large unless they manage their risks prudently. They must disclose pertinent facts about their operations and creditors will insist upon receiving ratings for financial service banks to better assess risk. Well-managed financial service banks will have incentives to disclose their success in order to give them a competitive advantage over less effectively managed institutions. The discipline demanded by creditors will force these banks to protect themselves not only by limiting the riskiness of

285. Id.
286. Id. at 143.
287. Id.
288. Id. at 134.
289. Id. at 143.
290. Id.
291. Id. at 143-44.
loans and other activities, but also by adopting methods of effective diversification and retaining sufficient capital to cushion creditors.\textsuperscript{292}

To militate against the risk of a crisis, the Central Bank would act as the final guarantor of liquidity to otherwise solvent institutions.\textsuperscript{293} The Central Bank can engage in open-market operations to ease general liquidity pressure, and it can use monetary service banks as conduits for channeling funds to solvent financial service banks that are experiencing liquidity problems.\textsuperscript{294}

1. Market Discipline Controls Imprudent Risk-Taking

Some commentators question the desirability of a regulatory scheme incorporating market discipline as a social policy irrespective of favorable economic attributes. Some would espouse a "free market argument,"\textsuperscript{295} also called the "process-oriented" argument.\textsuperscript{296} Process orientation assumes that in judging the outcomes of social institutions, one should not concentrate on ethical considerations but instead on the institutional process through which these outcomes are determined.\textsuperscript{297} If the outcome was arrived at through mutual consent of all involved, it is justifiable because nothing that individuals enter into voluntarily is bad policy.\textsuperscript{298} This process orientation has led many social scientists to view social justice as a matter of the government establishing fair rules of social interaction.\textsuperscript{299} Once this is done, outcomes must be left unchanged.\textsuperscript{300}

Theoretically, there is a fundamental economic reason why society should want its economy organized along the lines of the free market.\textsuperscript{301} The market is the most efficient mechanism capable of processing the huge amount of disparate information necessary to coordinate the plans of individual economic agents.\textsuperscript{302} In such a market, information known only to specialists can also be exchanged at minimal cost.\textsuperscript{303} The rampant corruption of the Russian market undermines the efficacy of subjecting any social process to pure market forces,\textsuperscript{304} because its commercial processes are neither fair nor volitional.\textsuperscript{305} Rather, favoritism and political influence permeate these transactions.

\textsuperscript{292}Id. at 144.
\textsuperscript{293}Id.
\textsuperscript{294}Id.
\textsuperscript{295}Andrew Schotter, Free Market Economics - A Critical Appraisal 24-25 (1985). The "free market argument" rests upon two points: 1) the Fundamental Theorems of Welfare Economics, which state that a free enterprise system guarantees the generation of points that are Pareto-optimal (i.e., will never yield income distributions in the interior of the triangle); and 2) the ethical belief that any point on the boundary of the feasible triangle is justifiable if it has been arrived at through a process of fair play.
\textsuperscript{296}Id. at 4.
\textsuperscript{297}Id.
\textsuperscript{298}Id. at 5.
\textsuperscript{299}Id.
\textsuperscript{300}Id.
\textsuperscript{301}Id. at 40.
\textsuperscript{302}Id. at 40-41.
\textsuperscript{303}Id. at 41-42.
\textsuperscript{304}Western Interviews, supra note 3; Russian Interview, supra note 124.
\textsuperscript{305}Interfax No. 44, supra note 10, at 3. See Klebnikov, supra note 277, at 81.
Irrespective of social policy implications, the actual benefits of a free market are clear. The market has the flexibility to consider the bank's capital position, securities business, quality of management, and whatever other parameters may be relevant.\textsuperscript{306} The market has the vigilance and incentive to react quickly and accurately to changes in these parameters that may affect its decisions.\textsuperscript{307} A mature securities market has the quality of analysts and liquidity to perform these functions in a skilled and effective manner.\textsuperscript{308} While the decisions of the market are never perfect, they appear to have a better overall record than central planning.\textsuperscript{309} Incentives and disincentives tied to financial rewards influence human behavior, whereas state bureaucracies are slower to respond to administrative or political discipline.\textsuperscript{310} In short, centralized planning has proven to be a failure,\textsuperscript{311} while markets respond quickly to new banking information.\textsuperscript{312} For example, the market often signals problems with banks thirty-three weeks before regulatory agencies placed them on problem-bank lists.\textsuperscript{313}

Currently, in Russia there are virtually no organized exchanges in which market functions can be examined.\textsuperscript{314} This paper is based on the premise that as Russia moves toward a free market system, exchanges will develop and the competence of private actors will surpass that of regulators. This assertion is based upon the retention of planned-economy bureaucrats in key government positions and the drain of Western-educated college graduates to private enterprise. Thus, the lack of markets should not foreclose a prominent role for markets in setting forth a regulatory framework.\textsuperscript{315}

The real issue is whether, in the long run, market discipline and good information could reduce failures more effectively than regulators. The availability of information concerning the operation of financial institutions influences the effectiveness of market discipline; additionally, the costs and benefits of increased disclosure differ depending on the importance and form of market discipline.\textsuperscript{316}

Information is most important to stockholders.\textsuperscript{317} Stockholders make choices among investments based on their assessments of expected returns and risks. Inherent in this computation is stability in the legal framework within

\textsuperscript{306} See generally Trachtman, supra note 131.
\textsuperscript{307} Id.
\textsuperscript{308} Id.
\textsuperscript{309} Id.
\textsuperscript{310} Id.
\textsuperscript{311} Id.
\textsuperscript{313} Id.
\textsuperscript{314} Russian Interview, supra note 124.
\textsuperscript{315} For a discussion of the markets, see supra text accompanying notes 218-227.
\textsuperscript{316} GEORGE BENSTON, ET. AL., PERSPECTIVES ON SAFE & SOUND BANKING - PAST, PRESENT AND FUTURE 195 (1986).
\textsuperscript{317} Id. at 198.
which the enterprise operates.\textsuperscript{318} Information on the volume of past-due and nonperforming loans obviously should be disclosed, but it is less clear whether data on loans classified by examiners should be made public.\textsuperscript{319} The basic principle is that financial information useful for evaluating the true economic condition of the banks must be available.\textsuperscript{320}

2. Loan Securitization Channels Funds from Monetary Service to Financial Service Banks

Although the Pierce Model will not reduce the total amount of credit available in the system, it will affect which entities extend credit. In the Pierce Model, financial service banks will pay risk premiums and maintain larger equity positions as a result of the absence of government insurance for their liabilities.\textsuperscript{321} Accordingly, these banks will find loans that are not subject to securitization\textsuperscript{322} unprofitable.\textsuperscript{323} In a traditional bank setting, these loans are profitable due to federal deposit insurance subsidies and other guarantees.\textsuperscript{324} Without such subsidies, credit will not tighten "but will be directed increasingly into the securities markets."\textsuperscript{325} To the extent that financial service banks can develop low-risk, short-term securities backed by consumer loans and perhaps even business loans, they will find ready purchasers in monetary service banks.\textsuperscript{326}

The arrangement may exert upward pressure on interest rates for some business loans. Banks will continue to hold idiosyncratic business loans that cannot be securitized because they require too much information to be appraised by outsiders. However, these loans will probably carry a higher interest rate than loans of the same type in a traditional bank due to the absence of the deposit insurance cross-subsidy.\textsuperscript{327} In short, the redirection of credit from banks to the securities markets will foreclose the potential for credit shortages. Securitization of loans ensures that the public's funds will be channelled to financial institutions who may in turn lend them to borrowers.

\textsuperscript{318} Id.
\textsuperscript{319} Id.
\textsuperscript{320} Id. at 199.
\textsuperscript{321} PIERCE, supra note 1, at 145.
\textsuperscript{322} The term "securitization" refers to the packaging of loan assets for sale as securities in the public market. A true securitized loan issue is no different, except in the assets that form it, from the mortgage-backed instruments now customarily sold in the secondary markets in the United States. See e.g. JEREMY F. TAYLOR, THE BANKING SYSTEM IN TROUBLED TIMES: NEW ISSUES OF STABILITY AND CONTINUITY 92 (1989).
\textsuperscript{323} PIERCE, supra note 1, at 146. These loans include loans to households to finance consumer durables and homes.
\textsuperscript{324} Id.
\textsuperscript{325} Id.
\textsuperscript{326} Id.
\textsuperscript{327} Id.
3. Scheme Controls Risk of System Failure

To make market discipline work, financial service banks will be allowed to fail. However, the failure of one institution will not directly alter the viability of other banks.\(^{328}\) Pierce asserts that with recycling available from monetary service banks, and obligations ultimately backed up by the central banking authority, systemic risk is eliminated.\(^{329}\)

In a traditional bank setting, the failure of individual banks can affect systemic stability and economic well-being in two principle ways: reduction of the money supply and constraints on credit.\(^{330}\) The failure of one or more banks can result in a run on other solvent banks. However, if the withdrawn funds are redeposited in other banks, and if the average bank-desired reserve ratio does not change, then the money supply would not be affected.\(^{331}\) Failure of banks may result in a reduction in credit availability as the failed institutions are no longer sources of loans.\(^{332}\) This is not a concern if alternative credit sources exist.

The Central Bank of Russia should take care in its role as liquidity manager. In exercising this power, it runs the risk of expanding the money supply beyond the growth of the economy, thus causing inflation, with the attendant redistribution and waste of resources as people restructure relationships to deal with unexpected changes in the value of contracts.\(^{333}\) Prevention of systemic failure is paramount.

IV. TRANSITION OF EXTANT BANKING SECTOR TO MONETARY SERVICE AND FINANCIAL SERVICE BANKS

Current conditions are conducive to the adoption of the regulatory scheme articulated by Pierce. First, nearly all banks are small capitalization firms. Apart from the independent banks, commercial banks are closely-held and lend solely for shareholder purposes. Therefore, there would not be a great disruption in providing financial services to the general economy. Second, private banks do not yet have any real depository functions because 90 to 95 percent of the population’s funds are in Sberbank, a state bank. Thus, new private banks can become monetary service banks without much disruption and divestiture. Third, Russia will be unable to capitalize newly privatized enterprises from internal sources due to a general funds shortage, nonconvertibility of the ruble, and hyperinflation.

The Russian economy needs foreign money to capitalize fledgling industries. However, there is political resistance to foreign banks taking a large role

\(^{328}\) Id. at 145.

\(^{329}\) Id.

\(^{330}\) Benston et al., supra note 316, at 207-08.

\(^{331}\) Id.

\(^{332}\) Id. at 209.

\(^{333}\) Id.
in financing these enterprises.\textsuperscript{334} Accordingly, the government will insist on a role for Russian banks. New and old independent banks would be a good fit as financial service banks because of their experience with private customers, relatively diverse ownership, and their young, aggressive staff. Financial service banks would also have an incentive to cooperate and develop further banking expertise in order to obtain foreign capital. Western investors would be more effective monitors of bank risk-taking, and therefore soundness, than government regulators.

Capital markets must and will develop. As financial service banks augment and improve their activities, they will be able to offer relatively safe and marketable instruments that monetary service banks may purchase.

The key to creating a safe and efficient monetary system lies in the objectives of regulation. The objectives are to achieve a safe and efficient monetary system, and stable and reliable sources of credit, while avoiding undue risk-taking, financial instability, and exposure to potential government bailout. Russia lacks the competent institutions around which a regulatory framework can be built. Government institutions are left-over central control agencies which are not adept, in terms of professional competence or numbers of personnel, at monitoring complex financial services institutions. Because Russia lacks meaningful regulatory institutions, efforts must focus not on the specific types of financial services institutions requiring regulation, but rather on financial functions.

The regulator’s functions are two-fold: to protect investors from fraud and grossly incompetent management, and to protect the banking system from the effects of individual bank failures.\textsuperscript{335} While it is possible to overregulate, the Pierce Model controls the tendency to overregulate without sacrificing the monetary or financial system.


\textsuperscript{335} Sir Peter Middleton, \textit{Comment on Chapter 6, in Unregulated Banking: Chaos or Order}, supra note 113, at 240.