



# Regulation of Financial Conduct in Russia

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## Abstract

The chapter is devoted to evolution of regulation in Russian financial sector. In the first part, we describe the general evolution of regulation starting from the late 1980s when the country started transition to market economy to current situation. The system of regulation came through two large stages: 1989–2013 was a period of coexistence of several different regulatory bodies, and 2013–nowadays when Bank of Russia started to serve as a mega-regulator and took the responsibility over all financial sector. We examine positive and negative side of this evolution. In the second part, we describe several episodes of self-regulation of ethical

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**Keywords**

Financial markets · Stock exchange · Ethics · Regulation · Self-regulation · Russia

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**Introduction**

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There is little research devoted to evolution of regulation of financial sector in Russia. There is a book about financial regulation of emerging markets (Kawai and Prasad 2012), but Russia was not included. Another book covers just early years of development of financial markets in the Baltics and Russia (Knight et al. 1999). There also some papers about regulation of financial markets in Russia (Ezangina et al. 2016), problems of law enforcement (Pistor 2004), financial backwardness (Tompson 2000), but regulation of financial conduct is mostly not discussed. Some papers focus on particular aspects of ethical conduct like transparency (Farvaque et al. 2012).

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**Evolution of Regulation: 1989–2020**

When Russia turned to the market economy in the 1990s, the country was hardly ready for this challenge. USSR financial sector was dominated by one bank since 1930s – *Gosbank* (the State Bank) of the USSR which served as a central bank and savings bank for people. Gosbank did not have a profit motive and served as instrument of government policy. It provided loan funds to favored individuals, groups, and industries as directed by the central government and did not care about creditworthiness, reserves, and other “capitalist” concepts. Insurance market was also dominated by one company – *Gosstrakh* (an integrated system of state insurance organizations in all Soviet republics). Gosstrakh provided compulsory and voluntary insurance and offered a range of products like life and property insurance for people to harvest insurance for collective farms or cargo insurance for trade enterprises. The

problem of unethical behavior was not very relevant in these markets because the managers and directors of Gosstrakh and Gosbank did not have a profit motive which usually pushes their counterparts in the market economy to bend laws and moral norms.

In 1985, the communists announced *Perestroika* as a process of moderate “reconstruction” of economic system. The main idea was to increase decentralization to increase managerial and economic autonomy of enterprises (i.e., decrease shirking and other unethical behavior of people in overcentralized administrative system). According to this strategy, in 1987, the Soviet Government divided Gosbank into six major banks – the State Bank (“bank of banks”), the Promstroibank (industry and construction bank), which was engaged in lending to industry, construction, transport, and communications; Agroprombank (agriculture and industry bank), which credited the agro-industrial sector; Zhilsotsbank (housing and social bank), whose task was lending and servicing housing and social services; Sberbank (saving bank), serving the population; and Vnesheconombank (foreign economic bank), serving foreign economic activity.

In 1988, a revolutionary *Law on Cooperation* was adopted, which opened up opportunities for entrepreneurship in various fields including financial markets. People started to establish “cooperative banks” or “credit cooperatives” trying to fill a free niche in lending and raising funds. The first cooperative bank “Patent” was registered in Leningrad in August 1988, and then a whole wave of opening banks followed. By January 1, 1989, there were already 43 commercial banks, a year later – 224, and by the end of 1991 – 1357. The quality of these organizations was very heterogeneous. On the one hand, entrepreneurs in this area did not have experience, and on the other hand, many of them were adventurers or just scammers, so many of these banks soon went bankrupt and closed. It was obvious that banking activity required separate regulation, and at the end of 1990, two laws were adopted: the law “On the State Bank” and the law “On Banks and Banking Activities,” which determined the conditions for opening a bank, ways, and methods of control over them.

However, the further peaceful evolution of the financial regulation was disrupted by a severe economic crisis. The economic problems accumulated during 1985–1991 (state budget problems, deficit in goods market) led to *dissolution of the Soviet Union*. After acquiring independency, Russia decided to implement a faster transition to free market. In reality, it turned to be a shock therapy which undermined the trust of population to the government for many years ahead. High inflation in 1991–1992 wiped people’s lifelong savings in Sberbank accounts; high unemployment destroyed people’s feeling of economy security. This created a landscape of general mistrust and fear. Government started to create institutional base for a new market economy, but for many years, it was not very effective. Therefore, in the 1990s, the actors in many financial markets had to solve problems with misconduct themselves. Sometimes they were pretty much successful, and later governments formalized these.

Until 1993, there was only one regulator of financial markets – Central Bank of Russia (CBR) who inherited its staff and bureaucratic traditions from Gosbank.

Initially it was a weak institutional player like the Ministry of Finance. The main purpose of CBR in the 1990s was control of money circulation and commercial banks, and it did not pay much influence to financial markets or problems of unethical conduct.

In 1989 CBR with other participants of the market established the first currency exchange – *Moscow Interbank Currency Exchange (MICEX)* – to conduct currency auctions between banks. It turned to be a very active market, and its quotations were used by the Central Bank for a long time. In 1992, MICEX opened a *trading floor for corporate securities* and became the first stock exchange market.

At this time, the vast majority of enterprise were still owned by state, so no significant stock market was possible. However, it was going to change very soon – between 1992 and 1994, mass privatization was conducted by State Property Committee led by Anatoly Chubais. The main instrument of privatization was *voucher* – specially issued privatization certificate which every Russian citizen could exchange for a number of shares in any privatized enterprise or to invest in a specially established investment fund. These certificates could be freely traded and exchanged, which immediately created a highly liquid and speculative voucher market. However, majority of Russian citizens did not know what to do with vouchers, and many of privatization dealings were fraudulent or manipulative. As a result, it created considerable obscurity in the Russian corporate sector which lost attractiveness for decades.

## **FCSM in 1993–1999: FCSM and Harvard Consultants**

In March 1993, the first regulator of securities market was established – *Federal Commission on Securities Market (FCSM)*. The commission reported directly to president and was independent from CBR or government. In the beginning, FCSM followed advice of Harvard consultants and tried to build a version of an American market in Russia: a legal regulatory framework, clearing and settlement organizations, depositories, large investment banks, asset management companies, mutual funds, etc. Even the first name of FCSM (Securities and Exchange Commission) was borrowed from its American counterpart. Another important legal innovation recommended by Harvard consultants was the introduction of the concept of nominee holder into the Russian legislation. It was a bit unusual because Russian legal system was built on continental legal tradition, but the concept of nominee holder was borrowed from Anglo-Saxon tradition. This innovation had significant influence on the emerging Russian corporate culture. It made the stock market liquid because selling and buying shares became much easier and less expensive.

In 1994, after accumulation of experience in voucher auctions, 15 most active brokers decided to create an organized market where the shares of newly privatized companies would be more effectively exchanged. An organized market would have many advantages – general rules, general informational system, common registrar, etc. As a result, Professional Association of Stock Market Participants (PAUFOR) was established. In the same year members of PAUFOR developed the first version

of rules for the market which included the rules of making contracts, protection of fraud, etc. Victorov (2015) claims that PAUFOR was created by the initiative and guidance of FCSM, however, Alexey Savatyugin, a participant of this process, does not support this and suggests that PAUFOR appeared absolutely independently as self-regulation of market participants, and only later FCSM discovered that this new rules and regulations work good and decided to support them.

However, soon it became obvious that PAUFOR should be reorganized. First, the law prohibited to one organization to be a trading platform and a membership-based self-regulatory association. Second, PAUFOR was an association of Moscow brokers, but there were also three other regional associations of brokers (St. Petersburg, Ekaterinburg, Novosibirsk) who developed in isolation with their own rules and informational systems and traded mostly the securities of local companies. It was a mutual desire of all four associations to merge and create one trading for securities. Therefore, in 1995, PAUFOR was reorganized. *The Russian Trading System* (RTS) was established as a trading platform. *National Association of Stock Market Participants* (NAUFOR) was created by members of associations a national self-regulating organization of stockbrokers.

RTS had to organize a platform for over-the-counter securities market and decided copy the experience and even software of NASDAQ. The entire trading was founded on mutual trust between a narrow circle of brokers, and the trade took place mainly via telephone. Only large brokers participated in RTS (it was not available for small participants). The clients were foreign high-risk investment banks and hedge funds, and the settlements were done in offshore structures (partly due to tax consideration). The main purpose these investments was to purchase cheap Russian equity. The inflow of this money was highly nontransparent throughout the 1990s since it was not usually disclosed which particular investors acquired securities. These investors contributed much to the first stock bubble but were not interested in participation of management of enterprises.

At the same time, in 1995, large banks and investment firms were also developing a project of establishing their own association for brokers who were active at the securities floor of MICEX. In January 1996, they created National Financial Association with support of Ministry of Finance and CBR.

In March 1996, Russian Duma adopted *Law on Security Market* which formalized the rules which were developed spontaneously in the market. Following to American practice and Harvard consultants' advice, FCSM tried to delegated considerable self-regulating functions to associations of brokers. Chapter 13 was devoted to self-regulating organization of professional participants of security market who were delegated with responsibility control professional standards and professional ethics in the market.

In 1997, FCSM actually introduced an obligatory membership for all stockbrokers in NAUFOR. This was not accepted positively by the rest of Russian brokers because of dominance of the large brokers in NAUFOR, and it was cancelled in 2000.

Therefore, in the 1990s, the Russian stock market operated through two main stock exchanges RTS and MICEX and two main self-regulating associations NAUFOR (brokers) and NFA (credit organizations).

Unfortunately, the economic effect of stock market in the 1990s and in 2000s was quite limited. It remained a highly speculative environment. The first problem was general lack of trust to market mechanisms and to state protection of investments. There were unclear formal regulations, obscure privatization deals, corporate governance abuses, and especially informal networks of government officials and business leaders. As a result, the stock market was dominated for a long time by nonresident investors who were driven by short-term speculative motive. The main funds for stock market come from foreign high-risk capital, which was very sensitive to any political rumors or to oil prices. The second problem was insider trading which widely practiced in 2000s. There was no law against insider trading in Russia before 2011. The third problem was that Russian companies avoided using equity for financing because they were afraid of potential corporate raiders. If they had to use financial markets as a source of investments, they prefer to issue debt in the form of corporate bonds. That is why the corporate bond market in 2000s expanded significantly, but the stock market was not a major source of major investments for corporate sector.

The first speculative bubble happened with government short-term bonds between 1995 and 1998. Oil prices were low, and the government had to borrow lots of money to fill the budget deficit. Investments into these bonds became the main source of financial gains, but the series of bond emissions eventually turned into a financial pyramid. The bubble ended with severe economic shock, depreciation of ruble, and political crisis. However, Russian government did not respond with any restructuring of financial markets for several years (Thießen 2004 and 2005).

## **2002–2004: FCSM and Kostikov Reforms**

After the crisis, the head of FCSM was replaced to Igor Kostikov (a director of a large brokerage firm AVK Securities) – the first and the last businessman appointed to this position. He tried to conduct several reforms, but, surprisingly, he was very independent from other informal circles, and his activity was not very comfortable for major players.

In early 2000s, macroeconomic stability returned, and oil prices began to rise. A period of economic growth began which could mean development of a normal stock market. Surprisingly, RTS lost its position as the leading Russian equity market because it refused to introduce Internet trading. Liquidity as well as retail stockbrokers moved to the MICEX. RTS continued operations and was still under control of large brokerage houses which used this platform because of its informal network informal contacts and shared interests. In the same time, the MICEX actively developed Internet trade as well as corporate bond and repo markets. Internet trading gave birth to a new generation of discount brokers who could compete with the old

RTS brokerage houses. As a result, corporate bond market expanded rapidly in 2000s as the main source of finance to Russian companies.

However, the stock market grew very slowly. Mutual investment funds started to accumulate savings from the population, but it was mostly money of wealthy Russians, and no mass investors appeared in this decade. The stock market did not improve because of lack of trust and transparency in ownership and protection of stockholders' interests. This is why in 2002, Kostikov introduced a *Corporate Governance Code* to increase protection of investors and the transparency of the largest Russian businesses. The leading Russian companies who were preparing for internationalization actively participated in the code development.

However, activity of rather independent FCSM with Kostikov was a problem for Russian financial market. Victorov (2015) claims that Kostikov tried to play the role of independent and effective enforcement agency and major players (like largest brokers in RTS) had no influence of Kostikov, which was not usual and comfortable for them. Other experts say that the main reason was corruption in FCSM and the fact that Kostikov lobbied interests of his brokerage firm AVK Securities. Even the Bank of Russia was not very happy because Kostikov insisted on withdrawal of the CBR as the MICEX's shareholder. When in 2004 the President decided to renew the cabinet of the government Kostikov lost his position.

## 2004–2013: FSMS as Weak Regulator

After Kostikov's dismissal, FCSM was transformed into FFMS (Federal Financial Markets Service). The scope of its activity was significantly enlarged and now included almost all financial sectors (microfinance, credit cooperative, commodity exchange, and since 2011 insurance) except banking and auditing. At the same time, it was a considerably downgrading of the authority. Initially FCSM reported directly to president, but FFMS became an agency in Russian government. It became a weaker organization unable to effectively supervise the financial markets. First, it was poorly financed and could not pay competitive wages to attract best professionals. Low pay forced the FFMS employees to practice dual-income sources and have second jobs in broker firms and depositories, which created conflict of interests. Different informal networks (large brokerage firms, oligarchic groups, and state corporations) de facto controlled the FFMS and manipulated the agency in their interests (Viktorov 2015). The brokers were not interested in the strong regulator because in this case their business would become less profitable. At the same time, they did not want to remove FSMS completely because it transfers of its functions to CBR as mega-regulator.

In 2006–2008, the second speculative bubble grew in the financial markets. Partly, it was a consequence of global financial bubble (led by US mortgage markets). Russian banks abused access to cheap international capital and borrowed too much. The regulators (CBR and FFMS) failed to restrict risky speculative high-leverage practices used by the leading investment banks. This factor contributed heavily to the collapse of the MISEX's repo market, which triggered the 2008

financial crisis in Russia. During the crisis, leading private investment banks fell victim to their risky derivative operations. It ended with sharp drops in Russian stock indexes and equity prices. About one trillion of market valuation was wiped.

The Great Recession had a major impact on the regulation of financial markets abroad (Inderst 2009; Friedman and Kraus 2011; Porter et al. 2011; Ferran et al. 2012). However, the Great Recession was experienced not in Russia as severely as it was in the USA or in Europe, because Russia accumulated huge dollars reserves during several years of high oil prices, and now these money were used to cover crisis needs. Several large companies were saved from margin calls from western banks by Russian government loans. Experts say that this protection actually prevented a healthy process of market cleaning (similar to one which happened after crisis of 1998), and structural problems were conserved for the future crises.

## 2008–2013: Course to Integration

In 2008, the new President Medvedev announced an ambitious program to make Moscow an international financial center. The huge dollar reserves created confidence that Russia is powerful enough to claim a strong position in the global financial landscape. The decentralized regulation of financial markets was understood as a problem in this course. Many saw the problem in the diversity or dualism of regulation structures. There were two leading stock exchanges (the MICEX and the RTS) and two regulators (the FFMS and the CBR). There were no central depository and central clearing. There were a number of self-regulatory organizations of brokers and dealers made the institutional matrix of the markets too complicated and fragmented.

In 2011, under pressure of CBR, RTS merged with MICEX creating Moscow Exchange. The purpose was the reduction of the number of organizations with overlapping functions, the creation of a single platform for issuers, traders, and investors, and the reduction of transaction costs and easier trading.

In 2011, the law against *insider trading* was introduced it last. The problem of insider trading was relevant since the early 2000s, but the law was being developed very slowly because there were many hidden opponents of this law which benefited from insider trading. One of them was the Ministry of Economic Development and Trade – the former minister was personally involved in insider trading on several occasions, and the market knew which broker served his interests (Viktorov 2015).

In 2011, Federal Insurance Supervision Service was merged with FFMS. This made FFMS the regulator who is responsible for all nonbanking financial markets.

In 2012, FFMS introduced the law requiring establishing the position of *internal controller* in every professional firm of securities market who is responsible for monitoring unethical conduct. All customers' complaints are directed to a controller who has power to collect all necessary information, take actions, and report about this to the director of the firm.

In 2012, the government continued the task of making regulation more effective. The main problem was that FFMS was not powerful enough. So the government



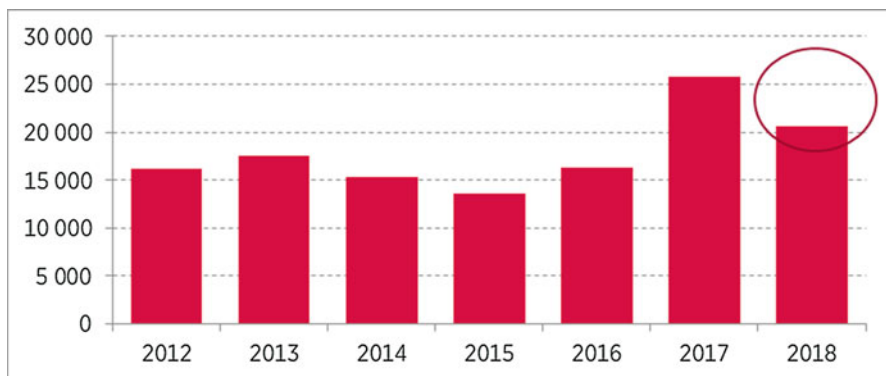
considered three options: (1) add more financial resources to FFMS, (2) create a special agency of financial markets in CBR, and (3) transfer all function of FFMS to CBR (Mwenda 2006; Buklemishev and Danilov 2013). Eventually, they chose the third option. There were several cultural and institutional reasons for Russia to choose mega-regulator model. First, there is a historical trend in Russia for vertical control both political and economic life. Russian government prefer to have large integrated corporations in any sectors, and one large regulator with one responsibility and chain of command fits well into this model. Second, in financial markets, there is the same model where large banks control about 60–70% of the market, and they can transfer into conglomerates (create their “ecosystems”): banking division, investment division, real estate division, collection division, etc. So a one sector regulator will have limited power dealing with such conglomerates, and it would be more effective to control them by one large mega-regulator.

### Since 2013: CBR as Mega-Regulator

On September 1, 2013, FSMS was abolished, and all its functions were transferred to Central Bank of Russia. A mega-regulator was created with enormous administrative and financial power. If CBR of the 1990s was mostly busy with money circulation and banking system stability, CBR of 2013 became a very different institution and had a much bigger goal – to protect investors and consumers of the whole financial sector. This protection is very important to increase confidence in the market and economic growth. In 2014, CBR established a special department – the *Service for Consumer Protection and Financial Inclusion* – whose purpose was to reveal and prevent unethical behavior in the market. They should monitor violation of financial services consumers’ rights protection, accept complaints, and appeals and draft of amendments to laws and regulations. After 2016, the Service is headed by Mikhail V. Mamuta, a former self-regulatory activist of microfinance market. The Service conducts regular research revealing unethical conduct in financial markets and makes a lot of effort to detect unethical actors and introduce new restrictions for unethical practices.

However, many experts claim that CBR as mega-regulator lagged behind the needs of its participants and in many cases is neither effective nor efficient. In 2019, ATON investment company conducted a survey of more than 100 professional participants of securities market. They mostly supported the positive effect of CBR regulation which increases the confidence and stability of the market but also provided some criticism to its relative inefficiency (Grekova 2019). This is the main points of their criticism.

*Large number of regulations.* Nowadays, there are about nine thousands of regulatory documents (letters or instructions of CBR which are issued to mitigate current problems). The number of regulatory documents in South Korea was almost the same some time ago (11 125), but after this, South Korea conducted the regulatory reform and reduced this number by 50%. At the same time market capitalization per capita in South Korea is 27,000 dollars and in Russia is only



**Fig. 1** Regulatory costs 2012–2018 (Grekova 2019)

4000 dollars. Therefore, a six times larger stock market can be regulated with 50% less documents.

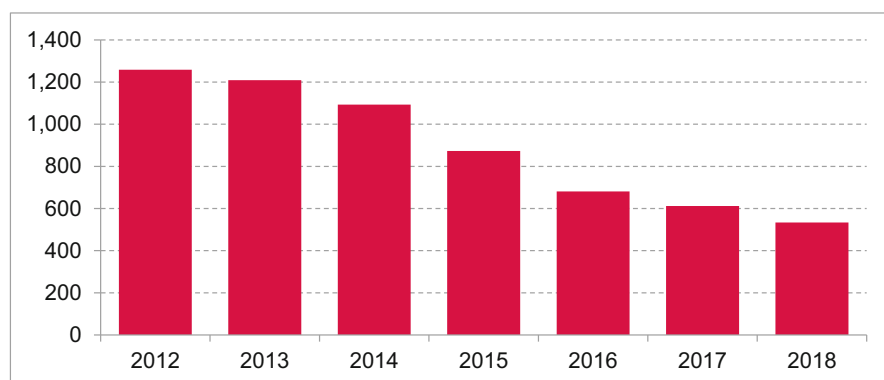
*Fast and unpredicted change of regulations.* Experts say that the rate of newly introduced standards is high, but they are not clarified sufficiently before introduction. Standards are constantly updated and often adopted without assessing the consequences of their implementation. Letters and instructions of CBR often replace the law, but their speed and variety make the process of compliance very expensive. For example, over the past 30 months, the Federal Laws FZ-115 and FZ-224 were modified 26 times.

*Lack of communication with the market.* Many financial companies complain on the low level of communication and interaction of CBR with financial market participants. Although there are 4–5 large financial conferences every year where CBR speakers come to participate in panels and plenary, many financial firms still do not understand the principles and ideology of regulation and complaint that CBR is death to their concerns in panel discussions.

*Untested regulations.* Experts say that there is no feasibility assessment of compliance costs of new regulatory actions. As a matter of fact, CBR first decides to introduce new regulation and after this starts to assess its impact and consequences. Of course, CBR has the right to decide whether a new regulation is needed, but it would be wiser to use some method of estimation of compliance costs before this regulation is introduced.

*Duplicating regulations.* Sometimes requests from various departments of the CBR are not systemic and redundant, and the deadlines for execution are almost unrealistic. Moreover, different reporting forms require the same data to be provided in different formats (e.g., forms 0409711 and 0409101).

*Low level of interagency cooperation.* Sometimes CBR does not harmonize its regulations with policies of other governmental bodies. For example, the amendments to Federal Law 54-FZ, which have obliged all noncredit financial institutions to invoice their services to individual clients and added significant regulatory burden



**Fig. 2** The number of professional participants of securities market (Grekova 2019)

to professional participants, are a vivid example for the inconsistent interaction between the CBR and the Ministry of Finance.

*Costs of regulation.* As we see in Fig. 1, the regulatory costs were constantly growing from 2015 to 2017. In 2018, they reduced, but the real factor of their reduction was decreased number of participants of financial market. Andrey Paranich, the deputy director of the self-regulating organization in microfinance market MiR, also provided evidence that CBR regulation led to serious additional cost of MFOs because they had to hire additional people to comply with regulations. As a result, the MFOs have to increase its interest rate for consumers which is a very sensitive issue for this market.

*Reduction of number of firms.* As a result of regulatory pressure, the number of professional participants was falling and reduced by 50% during the last 8 years (Fig. 2). This is viewed by many market participants as a dangerous trend aimed at reduction of competition in the market. For CBR, it is easier to control several large participants of the market instead of hundred small ones. However, small professional participants of financial markets are very important because they may serve interests of small customers. Large players (Sberbank, VTB, Gazprombank, Alfa Bank) mainly work with large companies and rarely deal with securities placements less than three billion rubles. Therefore, the absence of small professional market participants will make it difficult for small companies to access the securities market and negatively affect Russia's economic growth.

Regulation of banking market by CBR was also a subject of strong criticism. The main concern is that the market is regulated in the interests of largest banks who have direct access to CBR executives. There are even legal foundations for the conflict of interests because CBR owns shares in Moscow Exchange and Sberbank (the largest commercial bank in Russia). The pressure for CBR to sell these shares was discussed many times, but there was not movement in this direction until February 2020, when CBR at last announced the plan to sell Sberbank shares to the National Reserve Fund.

However, the problem is not only with Sberbank. After 2008, CBR several times provided special support for the largest banks but constantly increased pressure on the general banking system which was very sensitive to smaller banks. There were several reasons to increase these regulations. In 2010–2011, new Basel III requirements introduced for additional risk reduction, and CBR had to translate these regulations to the Russian banking system. At the same time, CBR introduces the criteria for distinguishing “systemically important” credit organizations which have rights for government support in crises. The whole system looked unfair and after 2016 CBR started to discuss introduction of “proportional regulation” where the banks would divide into two groups: (1) the largest with higher regulatory requirements but with more opportunities and (2) middle and small banks with reduced requirements but limited functions. In 2016, CBR suggested the term of “regional banks,” but many small banks did not like it, and the term was abandoned. In 2017, CBR finally introduced two types of banks: *universal* (more than 1 billion of capital, all types of operations, higher regulatory load) and *basic* (from 300 million to 1 billion, smaller capital requirements, limited number of operations, lower regulatory load). Banks with smaller capitals could be transformed into microfinance organizations. The purpose of this regulation was to reduce regulatory load of smaller banks and to reduce their costs to make them more competitive.

However, in 2015–2016, many acts of CBR made the competitive positions of small banks worse and worse. In 2016, many CBR orders restricted small banks opportunities to participate in serving budget money, participate in governmental programs of subsidies, etc. Besides this CBR conducted a policy “cleaning” – withdrawing license from banks who made some mistakes or had some problems with liquidity instead of curing steps. All these measures were interpreted by many experts as a result of lobbying by large banks.

In 2017 the *Association of Russian Banks* (about 400 members many of whom are medium and small banks) publicly criticized CBR for regulating the market in the interests of largest banks (limited competition) and hidden attempt to decrease the number of small banks and to limit competition. This criticism was very negatively met by CBR and the largest banks. In July 2017, seven biggest banks who represented 70% of all assets of banking system (Sberbank, VTB, Rosselkhozbank, Gazprombank, Alfa Bank, Bank Otkritie, and Binbank) announced their decision to withdraw from the Association of Russian Banks and join another banking association – the Association of Banks of Russia – who demonstrates a much more flexible position in relationships with CBR.

However, recently, CBR made significant efforts into preventing unethical behavior in the financial market. In 2017, CBR announced a new ideology of market regulation with strict distinction between *prudential regulation* and *conduct regulation*. Prudential regulation deals with stability of financial organization and prevents unwise decisions which may lead to defaults and crises. Conduct regulation deals with unethical behavior of financial organization toward their customers. CBR declared conduct regulation which would have reactive and proactive components. The reactive component is the handling of complaints – CBR created the hot line to

accept the complaints for all financial services. This helps to resolve complaints as such, but on the basis of analysis, two types of decisions were made:

- If there is comparatively low number of complaints for some financial product (e.g., 3 complaints per 1000 of contracts) but some organizations generate significantly higher complaints (e.g., 10 complaints per 1000 of contracts), then there is something wrong with the organization. CBR sends additional inspections and requires additional control. This allows to reduce regulatory load on other organizations who do not generate complaints above average.
- If there are a lot of complaints for some particular financial instrument (e.g., 100 complaints per 1000 of contracts), then CBR makes a conclusion that something is wrong with this instrument as such and develops systematic changes in this instrument regulation. For example, such instruments as foreign currency mortgage or microloans were severely limited on this reason.

The proactive component is the establishment of rules for how and to whom financial instruments are sold and how the interests of the citizen are protected in the financial market.

Recently, there were also some signs of reduction of massive regulatory pressure. In 2019, Russian government announced the idea “regulatory guillotine” – elimination of excessive and ineffective regulations, and CBR joined this initiative by creating several working groups. During several months, in 2019, they gathered about 700 suggestions from the market participants, and CBR already agreed to cancel first 100 obsolete or duplicated regulations. This is not much comparing to the total number of about 9000 regulations, but we may hope that this process will continue.

However, the recent policy of Central Bank is evaluated quite critically by some experts. For example, Alexey Savatyugin, who served a president for several financial professional associations (NAUFOR, NAUMIR and NAPCA) and now works as an auditor of Accounts Chamber of the Russian Federation (the parliamentary body of financial control in the Russian Federation) admits that since the Central Bank became a mega-regulator, it began to pay much more attention to the ethical behavior of all participants in financial markets. However, in many aspects this attention is too paternalistic and impose unnecessary limitations onto free market. At the same time, the Central Bank itself has many hidden opportunities for conflicts of interests and for corrupt behavior.

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## Self-Regulation of Conduct in Different Markets

In this chapter, we will describe several particular markets and will see how self-regulation of ethical conduct was developed. First, we describe the situation in consumer bank loans in 2008 when there were two unsuccessful attempts to introduce codes of conduct to reduce unethical practices. Second, we describe the evolution of microfinance industry and its unsuccessful attempts to introduce self-regulation ended by strong intervention of CBR. Third, we consider the debt

collectors market and their successful work of implementing self-regulation for many years before the law about debt collection was finally adopted by the state.

## Consumer Bank Loans

In the late 1990s, in Russia, banks and retailers started to offer consumer loans at the place of purchase – in home appliance stores, electronic stores, etc. The pioneer of this model was the bank Russian Standard. These loans had a high interest rate (about 70–80% per year) but were granted very quickly (within 30 min) and with a minimum set of documents (no guarantors, certificates of employment, etc. were needed).

In the early 2000s, the economy began to grow, and the demand for such loans was huge, and soon this business model attracted other banks. Many retail chains had 3–4 bank stalls into its trading floors, because consumer credit made it possible to significantly increase sales. The consumer lending boom began; the volume of loans increased significantly each year. For example, in 2004, the volume of consumer loans doubled compared to 2003 and reached 535.8 billion rubles. The share of sales on credit in chain stores reached 50–60%. The model was used most actively by the largest retail chains M-Video and Eldorado.

However, new business opportunities came with new ethical challenges. Not all buyers coped with the repayment of loans, and at the same time with the rapid growth of loans issued, delays and defaults also began to grow rapidly. State regulation could not manage this situation and only made everything worse. For example, if the bank brought the debtor to court, the latter, as a rule, required to repay only the amount of the principal debt and exempted the debtors from payment of accumulated interest, interest, and fines. Up to some extent, this resolution restored justice, since the consumers' debt was artificially inflated by tricky conditions of loan contracts (fines, etc.), but the complete exemption of interest and penalties had also bad consequences: (1) unethical borrowers began to use the court decision as a more profitable option than paying with the bank under the contract and (2) a large number of defaults lead to an increase in the interest rate for the entire market, as a result of which bona fide borrowers suffered. The failure of state regulation was caused in part by the fact that no specific legislation was provided for consumer lending contracts. It was regulated by general norms of the Civil Code of the Russian Federation and the law "On Protection of Consumer Rights" which did not take into account the real issues of consumer lending relationships.

In May 2005, the Federal Antimonopoly Service (FAS) and CBR jointly published recommendations on *disclosure standards* for consumer loans. The recommendations assumed reliable and complete information about the conditions for issuing, using, and repaying a consumer loan in a standardized form, allowing the consumer to compare the conditions of consumer loans of different banks and make an informed choice. Compliance with the standard was monitored by the FAS, who annually published a "white list" of about 50 banks successfully applied these recommendations.

However, this measure did not solve the problem. The amount of overdue debt continued to grow, and by the beginning of 2008, according to CBR, the total amount of citizens' debt on bank loans amounted to more than 100 billion rubles. Experts say that the real situation was about two times worse, because not all indebtedness was reflected in official statistics.

It was a good moment for self-regulation of the banking industry. There were two major banking associations: *Association of Regional Banks of Russia*, created in 1990 on the basis of regional Promstroybank branches and the *Association of Russian Banks*, created in 1991 as a result of the merger of banking associations in Moscow and St. Petersburg. In 2008, both associations adopted codes of conduct aimed at eliminating dishonest practices, but these attempts failed.

The initiator of new ethical code in Association of Regional Banks of Russia was a small foreign GE Money Bank, which appeared in 2004 as a result of the acquisition of Delta Bank by GE Capital (a financial division of General Electric). In 2006, rebranding was carried out, and GE Money Bank entered the market with a completely updated product line: consumer loans, mortgages, cash loans, etc. GM Money Bank announced the idea of responsible lending, which was the company's global strategy (GE Capital already implemented the responsible lending program in 55 countries). All details regarding interest rates, commissions, and lending conditions are communicated to the client. This allows our customers to make informed and independent decisions. According to Elman Mehtiyev, who at that time was the president of GE Money Bank, they were the first to introduce a number of self-restrictions, to which the vast majority of Russian banks were still very far away. For example, GE Money Bank was the first to limit the amount and terms of late payment penalties, introduced a strict policy of controlling the sale of additional products (borrower's life insurance), controlling the ratio of the amount of debt to the borrower's current income, etc.

At the beginning of 2008, GE Money Bank suggested the Association of Regional Banks of Russia to develop and adopt a "Code of Responsible Consumer Lending." According to Richard Gaskin, this code was to become a self-regulatory tool for ethical behavior of banks that preach not only the letter of the law but also its spirit. At the same time, it is important for the strategic development of banks, as ethical banks receive a long-term credit of trust from the population.

The code received support from the Association of Regional Banks of Russia. The president of the association, State Duma deputy Anatoly Aksakov, said that the adoption of a corporate code of ethical principles would help, through joint efforts, create conditions to prevent and combat unfair competition. According to Aksakov, this code of mutual trust and respect between a responsible creditor and a bona fide borrower was supported by the Bank of Russia, the Ministry of Economic Development and Trade, and the Federal Antimonopoly Service.

The code described in sufficient detail all the problems of unethical behavior that are encountered in the banking services market, although it did not specify exact criteria for determining ethical level for overdue penalties, maximum debt load, etc.

Moreover, the code did not describe any mechanisms for monitoring compliance with the code and punishment for violators.

In April 2008, the Association of Regional Banks of Russia invited all its members, as well as other Russian banks, to voluntarily sign this code. However, the code was signed only by GE Money Bank, and the remaining members of the Association of Regional Banks of Russia refused to do so. According to Elman Mehtiyev, at that time, Russian banks were not interested in using ethics as a marketing strategy, since overall competition was weak in the market. The main players relied on other strategic tools, and the code of responsible lending was not interesting to them. Another reason was rather passive support of the Association of Regional Banks of Russia, which formally supported the code but did not make any material steps to ensure that its members signed this code.

In the same year, the second major banking association, the Association of Russian Banks, launched a similar initiative and wrote *A Code of Ethical Principles of Banking*. This code was much weaker than the previous one, because it was formulated in too general words, e.g., “assist in the selection of services that best meet the interests of the client”; “charge fees according to volume, quality and complexity of your services”; “to provide customers with complete and reliable information about the conditions the loan.” Obviously, this general level of norms was not enough judge about real ethical dilemmas in this area.

A good side of this case was the mechanism of compliance with code – Commission for Monitoring Compliance with the provisions of the Code, which should consider cases of violation of the code and recommend, if necessary, to exclude a member from the association. However, no tools were suggested for detecting violations, which made the whole project unworkable.

In April 2008, the ARB congress approved the text of this code and recommended to its members to sign the code. During the same year, about 20 members of the association signed the code, and each subsequent year the number of signatories increased by about 20 more banks. However, this code remained a declarative paper, and there were no signs of its influence on the conduct of the banks. Too abstract norms, as well as the lack of a tool for monitoring performance, made this project initially useless. The only thing we can find about the effectiveness of the application of this code is the number of its signatories, which is available on the association’s website (now it is about 140 banks – about 80% of all members of ARB).

## Microfinance

For a long period, the Russian microfinance market developed completely without government regulation. In 1990, the law on Banks and Banking laid the foundations for regulating banks but did not mention microcredits. In 1994, the new Civil Code of the Russian Federation was adopted, which also did not mention microloans, but created a general legal basis for credit transactions which could be used by microfinance organizations. Initially, microcredits were mainly associated with loans to



entrepreneurs, and in 1999, the government even established the Russian Bank for the support of small and medium enterprises, which was supposed to provide such micro loans. The real growth of the microfinance market in Russia began in 2004, when the economic situation in Russia stabilized after the crisis of the 1990s. If in 2003 there were only 150 microfinance organizations (MFOs), by the end of 2008, there were already 2750 and by the end of 2011 – about 9000.

All this growth took place without any state regulation, but there were some self-regulatory organizations. In 2002, the *Russian Microfinance Center* provide educational and methodological assistance to those who would like to give and take microloans. It was financed mostly by foreign grants and organized many free seminars and events for participants in the Russian market. Its training program *loan manager* became a standard preparation of staff for MFIs.

In 2006, a membership-based association *NAUMIR* was created to unite all participants of the microfinance market with the aim of developing standards for microfinance activity with participants and new technologies for microfinance services, creating a positive image of microfinancing activities, and performing representative functions in the interests of its participants. NAUMIR was responsible for the “political” part of the organization of business events at the federal and international levels and ensured the interaction of legislative and executive authorities, public organizations, microfinance organizations, and their associations, as well as the media.

The law *On Microfinance Activities and Microfinance Organizations* was adopted only in 2010 – after 8 years of successful self-regulation activities. The law simply fixed the existing practices which have already developed by market participants. Many existing MFIs simply re-registered under the new law without any material change in their operations. At the same time, the law attracted new entrepreneurs to the industry who wanted to get quick profit. Surprisingly, this new wave of MFOs was demonstrated the lowest ethical standards.

One of the biggest ethical issues was the problem of excessive debt which resulted from high interest rate and overdue fines. Everyone understood that something needs to be done with it. In 2013, MiR together with NAPCA developed and published the *Code of Ethics and Standards for Work with Overdue Debts in the Market of Microfinance Organizations*. However, the code was mainly aimed at collecting overdue debts and did not do anything with the origins of the problem. It was obvious that MFOs and their associations will not be able to handle this task by themselves. So, CBR decided to take this responsibility and to change regulatory landscape in the microfinance market.

In 2015, the state adopted the law *On Self-Regulatory Organizations in the Sphere of the Financial Market*, which required all MFOs to become members of a SRO. However, this law was very different from the basic Russian law on self-regulatory organizations. Here microfinance SROs actually became the remote hand of the regulator since CBR got the right to approve their directors and their budgets as well as prescribe them development of particular standards of conduct. The law defined also the minimum size of SRO – at least 25% of total number of market participants, i.e., there could not be more than three SROs in the market.

After this law, three SROs were registered in Russia in the field of microfinance: MiR, Edinstvo ("Unity"), and Alliance. These SROs could develop their own standards for carrying out activities (risk management, corporate governance, internal control, consumer protection, etc.) and offer them to the Bank of Russia. If the standard was approved by the Bank of Russia, it became mandatory for all MFIs, regardless of their affiliation with a particular SRO. Membership of SROs was beneficial for MFIs because it allowed them to legally advertise their services, increase their reputation among clients, etc. However, some part of the market decided to stay in the shadow.

In May 2016, the Bank of Russia published a list of basic standards that microfinance SROs should develop: (1) a risk management standard, (2) the standard for transactions in the financial market, and (3) the standard for protecting the rights and interests of individuals and legal entities of MFO clients. In February 2017, the Bank of Russia published requirements for a basic standard for protecting the rights and interests of MFI clients (instruction No. 4278-U) listing the areas that should be described in this standard (e.g., the requirements for providing information to clients, restrictions to change the terms of the contract, advertising rules, rules for interacting with a client, rules for considering customer requests, etc.).

In accordance with these requirements, MiR has developed the Basic Standard for the Protection of the Rights and Interests of Individuals and Legal Entities – Recipients of Financial Services of Microfinance Organizations, which was approved by the Bank of Russia on June 22, 2017. This standard included many provisions aimed at protecting customers. Some of them were clearly worded and could be verified (e.g., ban on transferring MFOs to the credit history bureau with false information in order to prevent a client from concluding an agreement with another MFI), but some did not have any mechanism for monitoring (e.g., the ban on rewarding employees aimed exclusively at increasing the amount of debt) or clear criteria for recognizing violation (e.g., the ban of using advertising tricks to abuse the trust of the recipient of the financial service).

Unfortunately, this mechanism regulation was not able to prevent the main problem of the microfinance market – the issuance of loans to borrowers who are unable to resist a serious increase in the amount of debt. The debt volume continued to grow catastrophically, and this forced CBR to take tough measures to regulate this market through administrative pricing. On February 2018, CBR announced strict restrictions on the terms of microcredits: introduction of a standard product "10 thousand rubles for 15 days" with maximum amount of payment 3 thousand rubles (with all fines and penalties) or interest ceiling for other loans 1.5% per day (and 1.0% since 01.07.2019). CBR estimated that 30–50% of MFOs will be forced to leave the market under these terms and explained this as a normal procedure to remove inefficient MFOs who can survive only through severe exploitation of their clients.

## Debt Collection

The first professional debt collection agencies began to emerge in 2004–2006. The collection market was initially a completely unregulated area with a huge number of ethical issues. Collection was carried out by poorly trained or semi-criminal firms that used psychological pressure, threats, insults, and even physical violence against their clients (debtors). It was obviously that without any collective actions, this market cannot function.

In 2007, *National Association of Professional Collection Agencies (NAPCA)* was established by the initiative of three leaders in the collection services market: National Collection Service, Sequoia Credit Consolidation, and Financial Payments Collection Agency. The creation of NAPCA was supported by the Association of Regional Banks “Russia.”

Immediately after its creation, NAPCA began active work to improve ethical conduct at the market. The process of creating a code of ethics was not easy, since many issues of interaction between the collector and the debtor remained unclear. For example, is it necessary to indicate in a letter from the collector that the debtor may, if he wishes, complain about the actions of collectors in a professional association? In May 2008, NAPCA published the *Charter for Professional Collection Agencies of the Russian Federation* which should be signed by all its members.

In addition to developing a code of ethics, NAPCA has taken steps to establish a mechanism to identify violators. The main tool was filing a complaint on the NAPCA website about a specific agency. All complaints received by NAPCA should be carefully examined by a committee with disciplinary actions against violators of the code. This service played a huge role in motivating fair collection agencies to improve the quality of their collectors. After some contemplation, NAPCA decided to publish all complaints with the name of debt agencies to create public awareness about violators of the code. Currently, about 1000 complaints arrive every month, but only 10% of them are really substantive and require a reaction. Each complaint is dealt with by the Monitoring Committee, composed of representatives of NAPCA member agencies. If necessary, there is a trip to the agency, which received the lobby, and its audit is carried out. Fines, warning, or exclusion from NAPCA are used as punishment. An exception is a serious punishment, and everyone is afraid of it, because NAPCA means access to the largest customers of the market.

These actions were very timely, because in the summer of 2008, the collection services market experienced a boom. The financial crisis led to a sharp increase in loan defaults, and the total past due debt reached 122 billion rubles. Banks began massively use services of collection agencies.

However, the legal regulation of debt collection market was still absent. In 2009–2014, NAPCA made several attempts to submit a draft of a law on collection agencies, which could make the regulation more effective, but the government did not support this initiative for a long time. Only in 2016, the law was adopted under the title *On the Protection of the Rights and Legal Interests of Individuals in the Activities of Returning Overdue Debts*.

Currently, NAPCA has the status of an SRO and brings together about 40 leading companies in the collection market, representing more than 90% of the collection market. Many debt agencies remain in shadow, and it is these agencies which generate most of the scandals and unethical behavior in the market.

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## Conclusion

As we saw in this chapter, regulation of ethical behavior in Russian financial sector went through two main periods: coexistence of several different regulatory bodies (1989–2013) and Central Bank of Russia as mega-regulator (since 2013). In the first period, ethical aspects of behavior were mostly absent in the regulatory agenda. In the second period, CBR took the strong position for improving ethical conduct of financial market participants and introduced many important regulations protecting consumers in banking, microfinance, and other sectors. At the same time, self-regulation in many financial sectors does not work properly, because, by the words of Alexey Savatyugin, SROs in many sectors are essentially the “hidden hand of CBR” but not a genuine self-regulatory body. The only example of successful self-regulation in financial sector is NAPCA (association of collectors), but this area is controlled not by the CBR but by another government body – The Federal Bailiffs Service (an enforcement agency of Ministry of Justice of Russia). Self-regulation of ethical behavior in other financial markets is yet to be developed, but it requires a different role of CBR as a mega-regulator.

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## Cross-References

- [Ethics in Finance](#)
- [Financial Institutions, Codes of Ethics and Professionalism](#)

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