

Dr. Vasily Vysokov

Transformational Banking: made in Russia

**Rostov-on-Don
2014**

Dr. Vasily Vysokov

Transformational Banking: made in Russia

A Theoretical and Practical Handbook

***“Ma’am, it’s not just the toilet
that needs replaced, it’s the
whole system!”***

*Soviet plumber’s recommendation
for the financial market*

Rostov-on-Don
2014

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This book focuses on the pressing need for a new business model for the banking system. An overview of the main banking models is complemented by a thorough analysis of the transformational banking model and the effect it could have in providing sustainable solutions to today's development challenges. It is shown, by making reference to the experience of Center-invest Bank, that transformational banking methods can be applied in the Russian financial market. The impact of transformational banking on southern Russia's economy is also discussed. To conclude, the author presents a programme for the transformation of the financial markets. This work is aimed at a wide range of financial market participants, including regulatory authorities, as well as academics, researchers, university lecturers and students.

Reviewers:

O.G. Semenyuta Doctor of Economics, Professor,
member of the Academy of Economics and Entrepreneurship

V.S. Zolotarev Doctor of Economics, Professor, Honoured Academic
of the Russian Federation

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Chapter 1.

Transition to Transformation

1.1. 2013: Key Achievements and Results

*“When I was twenty-one,
it was a very good year.”*

Ervin Drake¹

Since its establishment in 1992 by southern Russia’s first privatised enterprises, Center-invest Bank has not only provided banking services, but has also helped the region’s population, companies and authorities to resolve economic and social problems. Center-invest Bank is known as a reform laboratory in southern Russia for its impact on economic processes in the region and its ability to combine modern theoretical knowledge with practical solutions.

Our 20th anniversary year was one of celebration and also very hard work. Despite the global crisis and the economic stagnation in Russia, our customers, i.e. businesses and the local population in southern Russia, were boldly tackling specific challenges. We met continually with our customers to help them find solutions, and our assistance was appreciated. In its anniversary year Center-invest Bank continued to develop its operations on the basis of a sustainable banking business model. The bank achieved balanced growth for its financial indicators and strengthened its positions in the regional and Russian markets, including for the following important parameters: SME lending (ranked 16th among Russia’s banks), reliability (ranked 35th by Forbes), and return on equity (ranked 19th by The Banker). In 2013, 83 children were born to Center-invest Bank employees.

1. “When I was 21, it was a very good year.” Ervin Drake. From the repertoire of Frank Sinatra.

Table 1.1. Center-invest Bank: Key Development Indicators, 2010-2017

	RUBbn							
At 31.12 of each year	2010	2011	2012	2013	2014	2015	2016	2017
	Actual				Strategy			
Capital	5.8	6.7	7.6	8.8	10.8	13.1	16.0	19.6
Assets	48.3	54.5	62.7	75.9	87.5	98.0	109.6	122.1
Net loans and leases	30.6	42.5	48.4	61.5	71.3	80.8	90.9	102.4
Deposits	33.8	39.0	44.1	49.4	57.8	64.0	71.2	78.7
Profit	0.22	0.91	1.10	1.4	2.17	2.64	3.23	3.95
CAR, RAS, % ≥ 10	14.7	13.3	12.8	12.4	12.7	13.3	14.2	15.8
CAR, IFRS, % ≥ 8	19.8	18.2	17.4	15.6	15.7	16.4	17.4	18.5
CAR, Basel 3, % ≥ 10.5	16.4	15.9	15.3	13.9	13.9	14.4	15.2	16.2
CAR Tier 1, IFRS, % ≥ 4.0	11.9	11.6	11.8	11.3	12.4	13.8	15.5	17.2
CAR Tier 1, Basel 3, ≥ 8.5	9.9	10.1	10.4	10.0	11.0	12.1	13.5	15.0
ROAA, %	0.48	1.77	1.88	2.03	2.63	2.85	3.11	3.41
ROAE, %	3.92	14.64	15.42	17.25	22.1	22.12	22.13	22.15
Children born to our employees	81	82	71	83				

Several events in 2013 were significant for our understanding of the development prospects of Center-invest Bank and the financial market.

Solution banking. In February, the bank signed an agreement with the International Finance Corporation (World Bank Group) for another credit line to support small business development in southern Russia. My meeting and conversation with World Bank President Dr Jim Yong Kim, who is trying to transform the World Bank into a solutions bank, gave fresh impetus to Center-invest Bank’s implementation of a sustainable development model.

In Russian, the same word, “resheniye” (решение), is used both for “decision”, which describes a future process (and is sometimes just so much hot air), and “solution”, which refers to decisions that have already been implemented and can be employed again. As Dr Kim says, “Millions of people are tackling a multitude of problems daily. International financial institutions should not hinder, but rather multi-

ply the best practice solutions that are already being used by people in different corners of the world.” Center-invest Bank applies this same approach in its own work.



President of the World Bank Group, Dr Jim Yong Kim, and Chairman of the Board of Directors of Center-invest Bank, Dr Vasily Vysokov

Sustainable banking. At the FT/IFC Sustainable Finance Awards held in June, Center-invest Bank received an award: Sustainable Bank of the Year in Eastern Europe.

 	FT/IFC SUSTAINABLE FINANCE AWARDS 2013
	<i>Center-Invest Bank, Russia</i> Special Commendation for Leadership in Eastern Europe SUSTAINABLE BANK OF THE YEAR
An event from FINANCIAL TIMES LIVE	

Sustainable banking entails environmental and social responsibility and operational efficiency based on: 1) organic growth (independent, without external support) and 2) a high level of profitability and risk management in accordance with national and international standards (Center-invest Bank is the only bank in southern Russia to have a Moody's Ba3 global rating, outlook stable).

Creative and responsible banking. In September, the bank held an International Conference on the Sustainable Banking Business Model, which was attended by key international development institutions (DEG, IFC, EBRD, BSTDB, EDB and Vnesheconombank) and Center-invest Bank partners. The German Investment and Development Corporation (DEG) was the event co-organiser, and Chairman of the DEG Management Board, Dr Bruno Wenn, presented a paper and moderated one of the conference sessions. The speeches and discussions positioned sustainable banking in relation to the other traditional business models (speculative, state-owned, and Islamic banking) as innovative and responsible.



*Chairman of the DEG Management Board, Dr Bruno Wenn;
Chairman of the Board of Directors of Center-invest Bank, Dr Vasily Vysokov;
Deputy Editor-in-Chief of the magazine "Expert", A. Ivanter*

Prepared for challenges. In November, the Board of Directors approved the bank's Strategy for 2014-2017 "The Global Competitiveness of Center-invest Bank's Customers". After thorough assessment of the new global and Russian economic challenges, the Board of Directors concluded that over the next four years Center-invest Bank could deliver 100% growth in key indicators. Each section of the Strategy clearly sets out the new challenges and the proposed solutions by function, product and business unit. In 2013 the number of entrepreneurs fell by 15% in the Russian Federation as a whole. The number also dropped in southern Russia, but by only 8-9%. Regardless of this, Center-invest Bank has retained its SME customer base, indicating that its new strategy is entirely realistic.

Transformational business. In 2014 the organisers of the FT/IFC Sustainable Finance Awards rebranded the competition as the Transformational Business Awards: Sustainable Solutions to Today's Development Challenges. This rebranding reflects new global business development trends. Analysis of best international practice in these trends forced us to look anew at the bank's work in the light of new challenges. Through this, we gained an understanding of new areas for the sustainable development of our own business, and our customers' businesses, and also for the outlook for financial market regulation.

1.2. Transition... to Transformation

After the long years of stagnation in the 1970s, followed by perestroika, which was incomprehensible to most Russians, in the 1980s concrete measures to change the economic and political systems were required. At that time it was considered an absolute truth that the transition should be from an administrative command economy to a market economy.

Transition to a market economy. In 1990, after the First Congress of People's Deputies of the Russian SFSR had adopted the Declaration on State Sovereignty of the Russian SFSR, I was tasked with heading the Market Transition Economic Support Centre, reporting to the Rostov Region Soviet of People's Deputies. The Transition Centre played an important role in

training managers, developing regional reform programmes², carrying out privatisation in southern Russia³, creating a securities market, setting up a bank that operated in compliance with international standards, addressing the problem of non-payments⁴, and modernising the production sector. This experience in market transition also proved useful during subsequent transformations⁵.

In recent years, the words “reform” and “transition” have acquired slightly negative connotations, both in Russia and elsewhere. The EBRD’s 2013 Transition Report was rather tellingly entitled “Stuck in Transition?”⁶ Its authors openly admit that despite the efforts made and the results achieved, income in the transition region has not converged with that of the EU-15. In some countries, reform has not been accompanied by the development of social institutions; new economic institutions have failed to prove themselves in crisis situations; and the level of engagement of the population in the new market relationships is low. As a result, structural transformations are not taking place quickly enough.

At the same time, IFC began rebranding its ideas about sustainable development as “transformational business” (Transformational Business: Sustainable Solutions to Today’s Development Challenges).

Thanks to my experience of working with these respected international financial institutions, and the results achieved by implementing their recommendations, I have developed a clear understanding of the subtle differences between the processes of transition and transformation (see Table 1.2.).

Table 1.2. Characteristics of Transitions and Transformations

Transition:	Transformation:
Goes from state A to B	Envisages movement from A to B and further...
Uses one method of transition	Requires examination of transition options
Occurs once	Becomes a continual process
Requires a sharp change in the social structure	Relies on a social structure that is ready for continual change

2. www.centriinvest.ru/ru/about/articles/3330

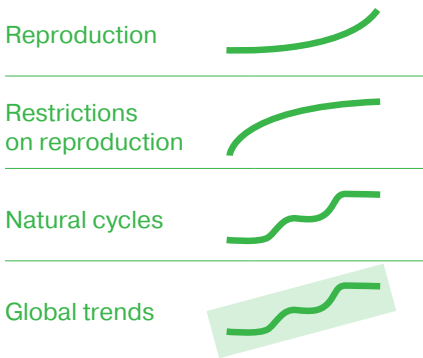
3. www.centriinvest.ru/files/articles/pdf/privatizaciyz-v-rossii.pdf

4. www.centriinvest.ru/files/articles/pdf/neplateji.pdf

5. www.centriinvest.ru/files/articles/pdf/CI_invest_privlek_English.pdf

6. www.ebrd.com/pages/research/publications/flagships/transition.shtml

The difference and interrelationship between transition and transformation are evident when we analyse long-term development trends. In the absence of restrictions, self-developing systems grow at a rate greater than 1. External restrictions slow growth rates; development follows an S-curve and tapers off as soon as the system achieves balance with the surrounding environment. If the growth rate becomes negative, the life cycle of the system is complete. One system comes to replace another on a cyclical basis, but when we take a broader view, we see that the development process remains continuous.



The separate stages of growth, saturation, and completion of the cycle describe the processes of transition. The term “transformation” refers to the continual replacement of one transition by another. In genetics, transformation is when a cell is altered through acquisition of a new DNA molecule. In linguistics, transformation describes the construction of new sentences on the basis of core sentences. We start talking about economic transformations when it is not only an organisation, method, or methodology that must change, but fundamental ideological principles⁷.

Sociology of transformations. The term “transformational business” refers to a continual process of change and implementation of innovative solutions, based on sustainable development principles and a creative and responsible approach, in response to constant new challenges. It refers not only to the new fields of technical and finan-

7. D. Ulyukayev. The Painful Transformation of the Global Economy. 2014

cial engineering, but also to social engineering: transformation of the knowledge, competencies and skills, and psychology of social groups.

The fundamental interconnection of society's technological and social structures is seen most clearly in transition periods: wanting to satisfy their new needs, the old elite starts changes in the technological structure, but a new technological structure requires a new social elite. This contradiction quite frequently hampers reforms and transitions, and is often resolved by radical social reorganisation. To maintain social stability amid continual change in the technological structure, the elite must focus on continual transformations rather than one-off transitions.

Based on my own experience of successfully effecting transformations during the years of stagnation and in the transition economy, I have devised a number of rules for achieving a result:

- *Success lies not in radical changes, but in consensus;*
- *The maximum speed for transformations is “half a length ahead”;*
- *A new environment must be created at the same time as transformations;*
- *Even the greatest success ends in a search for new areas for new transformations;*
- ***When you give an instruction, you should teach how to do it, supervise, and finally, do it yourself!***

The life cycle of transformations. In Soviet times, the lack of any ready formulae or clear definitions for “transformation” gave rise to several ironic descriptions of the life cycle:

I. “Sensation – commotion – punishment of the innocent – rewards for those not involved.”

II. “This cannot be – there is something in it – everyone knows this!”

Western colleagues⁸ describe the transformation life cycle in less ironic terms: Envision, Engage, Transform, Optimise. Combining best international and Russian practice, we could say that the transformation life cycle requires us to: envision oneself, engage everyone, transform everything, and optimise the result.

8. www.gowerpublishing.com/pdf/SamplePages/A-Handbook-of-Business-Transformation-Management-Methodology-CH2.pdf

Recognising the growing role of constant change, political leaders and senior company executives assure us that they are prepared for it. Many do progress along this trajectory successfully, but, more often, social barriers are encountered. With the old ways of doing things, an employer can tell his subordinates: “I am the boss, so let’s just see if you get to stay!” but with the advent of new approaches there is no guarantee that the boss will get to stay. A transformational business requires managers and leaders who are prepared for constant, sustainable, creative and responsible innovations. This applies to every sphere, including banking.

1.3. Out of the Crisis and Into...?

Stress test for regulators. At meetings of progressive organisations the floor is given to junior participants first. In bureaucratic organisations, meetings start with speeches by the most eminent participants.

In 2010 at a meeting of IFIs in the Hofburg Palace in Vienna, the first session was dedicated to producing recommendations for the next G20 summit. In the short time available after the official speeches and the scheduled coffee break, the moderator offered other participants the chance to speak. I took the opportunity to present a synopsis of the results of stress testing:





- In the post-crisis economy, banking will be split into payment systems and investment banking.
- Just as “Smoking Kills” is printed on cigarette packets, every page of an investment agreement should carry the risk warning “Investments Kill”.
- Stock exchanges must include the word “casino” in their names.
- Ratings agencies will be re-registered as bookmakers.
- The Basel Committee will become known as a construction company, “Tower of Babel 1, 2, 3 and so on”.

A deathly silence reigned in the enormous hall. Then the coffee break was announced. Bankers and financial experts from leading international banks with whom I was acquainted tried to avoid me during the break. However, bankers from regional European banks, whom I had not previously met, surreptitiously shook my hand and thanked me for my speech.

The market economy is not the cause of crises. Let us remember that the administrative economy was also unable to withstand a crisis. There have always been crises and there always will be. It is crises that most clearly reveal the mistakes made by market participants. And it is market regulators that lay the foundations of new crises by providing concessions to certain market participants over others, and by favouring certain growth indicators over the balanced development of other indicators.

The governments of various countries, business people and the general public are today trying to find a way out of the crisis. The problem is not “how to get out of the crisis”, but rather, “where to go next?” The diverse range of options for the banking sector is presented in Table 1.3.⁹

Table 1.3. Comparison of Banking Business Models

Banking model	State	Speculative	Sustainable	Islamic
Profit	Set by the government	Immediate	Long-term	Risks shared with customers
Human Resources	Based on ideological principles	Headhunting	Home-grown personnel	Educating personnel in Sharia traditions
Pricing	In accordance with the state plan	Market prices	In line with risks	Risk sharing
Branch network		Profit centres	Developing regions in which the bank operates	Supporting co-religionists
Planning		Aggressive growth business plans	Development Strategy	Promoting Allah
Client Relations	Financial control over execution of the plan	Promoting products	Supporting customers' businesses	Supporting customers' businesses
Activities		Buying and selling risks	Best international practice	Compliance with Sharia law
ROAA				
Regulation	Efforts to combat corruption	Over-regulation	Self-regulation	Compliance with Sharia law

9. http://www.centriinvest.ru/files/articles/pdf/ug_rossii_protiv_crizisa.pdf

It is clear from the table that, ultimately, the different business models differ by the phase and amplitude of fluctuations in the earnings yield (ROAA).

The immediate reaction of regulators to the volatility of speculative markets is to attempt to preserve these markets by introducing stricter requirements. The following questions arise: If these requirements are correct, objective, and backed up by research, then why did the regulators not use them earlier? Where are the guarantees that the new regulatory requirements will not lead to a new crisis? Attempts to improve regulations will ultimately repeat the history of “improvements” to the system of the Soviet State Planning Committee (Gosplan), which led to its collapse.

The shocking impact of the crisis has revived the popularity of government intervention in the economy, including in the banking sector. In many countries, government support is seen as a gift from the Gods, which the leader of the tribe distributes “fairly” among his fellow tribesmen. In developed countries the population understands that, using money from people who have been working effectively, government support is provided to protect the interests of people who have been working speculatively. The establishment and continuation of government supervision means that state-owned banks will start to engage in speculative transactions even more actively. Despite their bonuses being capped, managers appointed by the government will use the funds entrusted to them for speculative purposes and to implement the ambitious projects of the politicians who appointed them.

The privatisation of profit and the nationalisation of losses is a distinctive feature of Russian business, which is closely intertwined with the government.

In Islamic banking the prohibition on charging interest makes the risks to investors more transparent: income from successful investments is shared among the participants, and losses in joint investments are written off by each party (هل لا اءاش نا), Insha'Allah).

Given the volatility of speculative markets, the sustainable banking business model looks increasingly attractive.

The English word “sustainability” is translated into Russian as

“ustoichivost” (устойчивость). The word “ustoichivost” has more than one meaning: it can be applied not only to progress, but also to stagnation. In international practice, however, sustainability clearly refers to continuous development and social and environmental responsibility in the interests of current and future generations. The sustainable banking business model envisages a focus on ensuring long-term profitability, with due regard for current and future risks, rather than on maximising immediate, speculative profits. To be competitive in the financial markets, the sustainable banking business model must be innovative and based on best international practice.

The differences between the main features of the banking business models are summarised in the table below.

Table 1.4. Main Features of the Banking Business Models

	Irresponsible	Responsible
Orthodox	State-owned	Islamic
Creative	Speculative	Sustainable

Regulatory dead ends. Measures to overcome the crisis are essentially contradictory, since the search for solutions is conducted within the framework of outdated paradigms and stereotypes, with the preservation of an elite who seek to prove that these stereotypes are correct even in the new conditions. Psychologically, it is much easier for people to accept new ideas than to renounce old ones. Here are some striking examples of the dead ends that result from this:

Economic growth and regulatory requirements. After the dramatic downturn, politicians are doing everything possible to ensure economic growth. At the same time, they are promising that they will prevent new “bubbles”, and to this end they are introducing stricter regulatory requirements for banks. Caught in the vice of regulatory requirements, banks are then forced to refuse to finance economic growth. It should be noted that it is not by growing the old economy that the crisis will be overcome, but by changing its structure and

transitioning to new methods. Accordingly, we need to change the paradigm and methods for mobilising funds for economic modernisation, and also the mechanisms to ensure that these funds reach the real economy.

Cross-border transactions. In order to overcome the global crisis, all countries must pool their international efforts. Declarations on cooperation made at various political summits are undermined when regulators require national banks to reduce their activities abroad. Quite often national banks must comply with these requirements if they are to receive government support. It should be noted, however, that it is international trade and the sharing of technologies and know-how that delivers the fastest economic growth, not only for exporting countries, but for importers also.

Bubbles created by government support. Government support becomes more popular during a crisis. The government uses liquidity to cover not only the mistakes of bad management, but also strategic miscalculations by company managers and owners. Moreover, a new “business” for the “equitable” distribution of government funds emerges. Government support should always be accompanied by strict monitoring to ensure its effective and proper use. In addition, recipients of government support should be held criminally liable for its misuse.

As a striking example of government “support” I could mention the measures taken during the 2008-2009 crisis to stimulate the declining stock market, using taxpayers’ money.

On the one hand, taking bankrupt private banks under government control creates the illusion for customers that these banks have expanded the scale of their operations and become more reliable. Moreover, these banks then receive government support, i.e. cheap funding at taxpayers’ expense. On the other hand, state-owned banks incur substantial risks in lending to inefficient companies and ambitious projects under government support programmes.

A circular system of irresponsibility develops, whereby the economic bankruptcy of state-owned banks (their inability to meet their obligations without external support) could continue indefinitely, and it will be the whole population of the country who pay for this. It should be

noted that introducing strict timescales for the privatisation of banks requiring sanitisation would save a substantial amount of public money.

TOO BIG TO FAIL. The crisis led to a new, heightened understanding of the problem of bankruptcy of large banks. It has been assumed that the solution is to produce lists of systemically important banks and special requirements to regulate their activities. As a result, responsibility is spread out between the management of a large bank and the regulator. The regulator therefore develops a vested interest in prolonging the death throes of problematic large banks. This could be resolved if the regulator valued the bank's capital at the market price (MARK-TO-MARKET) and then used all the applicable ratios. To make the big players more socially responsible, we must switch to the rule "**TOO BIG? SO FAIL!**"

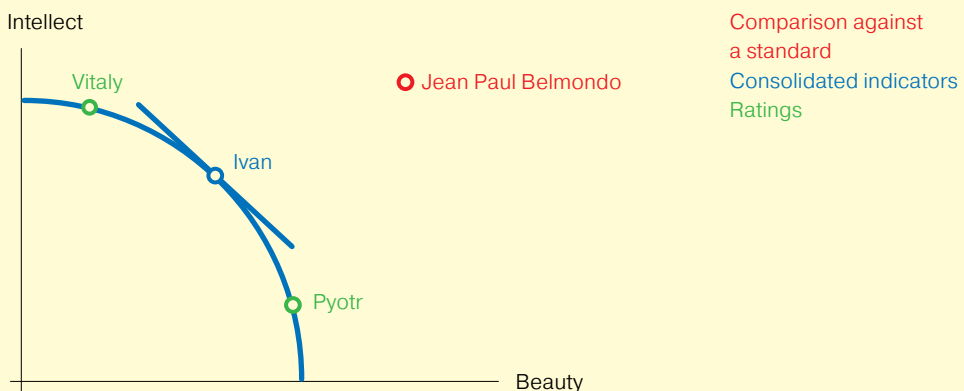
We should not make a fetish of ratings. The discrediting of Russian issuers by international ratings agencies spurred the creation of national and cross-national agencies. Many market participants might well appear more attractive in ratings produced by national agencies, but changing the unit of measurement does not alter the risk level. It should be noted that the task of calculating an "objective" rating belongs to the same category of mathematical problems as that of making the optimum choice of spouse: there is no unequivocally optimum solution.

Regulatory secrets. Lacking confidence in their knowledge and actions, regulators conduct "secret" stress tests, and demand the right to issue "substantiated" judgements in cases when the law or regulatory standards are open to interpretation. This type of regulatory instrument only makes market participants more nervous and causes them to suspect the regulator of corruption, incompetency, and aiding the competition. Letters from the regulator to Russian banks often end with the following, "Information sent to you, regardless of the form in which it is received, must not be disclosed (disseminated) without the permission of the holder of the information by whom access to this official information was restricted. You will be held liable under Russian law for disclosure of this information." Clearly, the regulator is protecting their wrongful actions from legal consequences. Transparency should apply not only to the work of financial institutions, but also to the work of the regulators.

The task of making the optimum choice of spouse. The work of ratings agencies comes under the category of vector optimisation tasks that do not have unequivocal solutions. To illustrate the attendant problems and manipulations, we can take the example of trying to make the best choice of spouse using just two criteria: intellect and beauty (For banks, liquidity and profitability can serve as analogies for these criteria.)

A. Choice of spouse. Let us look at a scenario where, from many permissible options, a bride-to-be is considering the three suitors presented below (Vitaly, Ivan and Pyotr). Depending on the predilections of the bride-to-be (the predilections of the ratings agencies' analysts), preference can be given to intellect (liquidity) or to beauty (profitability). It is also possible to choose a compromise or to make a comparison against a standard. The duality theorem, well-known in mathematical economics, does not leave any scope for the ideal choice: each candidate has their own criteria that allows them to achieve the maximum score among all the available options, and for each criterion an optimal candidate can be found. Increasing the number of criteria outwardly complicates the task, but does not fundamentally change it: there is no such thing as an optimal choice of spouse, just as there is no such thing as an unequivocal rating of banking operations.

Task: Making the optimum choice of spouse



B. Family advice. Ratings agencies love to refer to the collective opinion of their ratings committees. Continuing the comparison with the task of making the best choice of spouse, we can say that advice given by the family is analogous to such a committee, and we can show that there is also no such thing as an unequivocal choice in collective decision-making. This situation is demonstrated by the well-known Arrow's Theorem on the impossibility of aggregating individuals' preferences to establish community-wide preferences. Ratings committees, taking collective decisions, play the same role as a meeting of Native American shamans or the committees of three Bolshevik revolutionaries who signed piles of death warrants for innocent people.

Task: Collectively choosing a spouse

	Bride-to-be	Mother	Grandmother	Family advice
Vitaly	1	0	0	1
Ivan	0	1	0	1
Pyotr	0	0	1	1

C. Procrustean bed. It is mathematically more correct to try to classify different groups of suitors (banks) using pattern recognition methods. But this entails comparison of indicators from a large number of observations. And even in this case it is inadmissible to try to make the patterns so identified fit into the procrustean bed of symbol-based ratings classifications. Today, even royal families are relaxing their dynastic standards when it comes to choices of spouse.

D. Changing the order of terms. Contrary to the mathematical rule, changing the order of terms changes the rating. Attempts to split up criteria and use different weightings for different groups of criteria, and manipulations using combinations of weighted average ratings and comparison against standards, create the impression of thorough, thoughtful work. Yet it is actually the work of illusionists, as, in reality, criteria influence one another

and they can only be totalled using a table showing these influences. It can be supposed that beauty depends on intellect. But liquidity and profitability are two sides of the same coin, and as part of their operational activities, on an hourly basis, bankers assess the influence of one side on the other. Unfortunately, this influence is still under-researched even in statistics, and the associative rule remains valid only in the case of independent terms.

E. Who needs ratings? *Fulfilling approximately the same deciding role as matchmakers helping unconfident brides to make an unequivocal choice of spouse, ratings agencies have become popular among investors with a weak grasp on the complexities of the market. For the majority of investors, faceless investment firms, and banks with ill-defined objectives and strategies, ratings have become a convenient screen for the investor's lack of personal responsibility. Of course, in such a situation it is hard to find someone capable of saying, "The Emperor has no clothes!"*

In this way, ratings agencies, manipulating public awareness, try to demonstrate that there are solutions to tasks that are essentially unsolvable, and they serve as a means of concealing investors' irresponsible behaviour. Different stances can be taken on this, but most importantly we should:

- not make a fetish of ratings;*
- not consider them independent (they depend on the stereotypes of the originators of the ratings methodology);*
- require every ratings agency to cover at least 20% of comparable companies operating in similar markets;*
- use, alongside venerable agencies, simpler and more obvious methodologies, and issue public ratings of the ratings agencies themselves;*
- take responsibility for our investment choices, just as we take responsibility for our choice of life partner.*

To make a decision is to accept that some circumstances take precedence over others. Therefore, tasks for which there is no unequivocal solution require courage on the part of whoever is implementing the decisions. If, try as you might, you cannot resolve a contradiction using the old methods and approaches, you must apply a more creative approach and new methods.

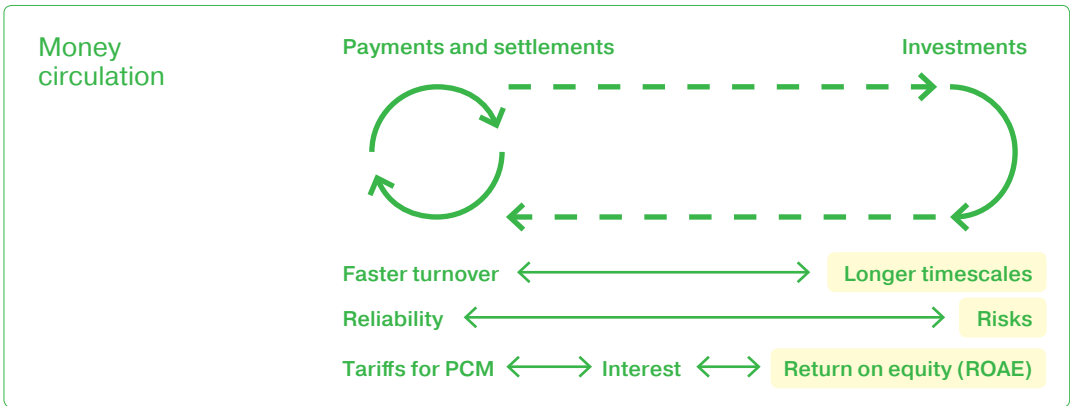
1.4. The New Banking Model

The old banking model has run out of steam. For lending, it relies on using temporarily available liquidity circulating in the settlement system. But modern payment and settlement technologies mean that money in customer accounts cannot be considered temporarily available liquidity for fixed term lending, and it is even increasingly difficult to cover customer cash shortfalls using intraday and overnight money. What until very recently was deemed virtuosic liquidity management is now seen as reckless, speculative behaviour.

If we look at the different banking activities of payments and settlements, lending, and investment, we see that money circulation differs in terms of the technologies, speed and timescales involved. Moreover, each of these activities has its own specific risks, and the form and amount of payment for these risks differs: tariffs for payments and cash management, interest rates for loans, and income for capital provided for investment. Because they understand these differences (especially since the latest crisis), regulators in a number of countries are more strictly separating out banking transactions relating to deposits, payments, lending, and investment. Big players in the speculative markets are staging a social protest about the regulators' innovations: they inevitably face a lot of work to reconstruct their business models, and the status of top managers could change. This social protest should be countered by changes in the mega-regulator's activities.

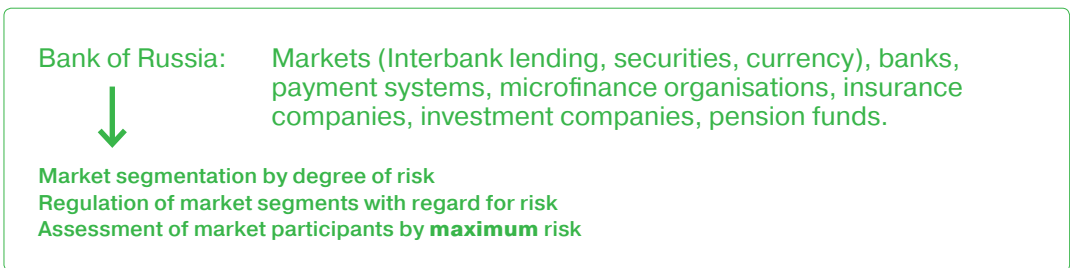
The future of the mega-regulator. The creation in Russia of a mega-regulator brought very different financial market participants together under the same umbrella: banks, stock exchanges, payment systems, microfinance providers, and insurance and financial companies. At first it was as though outdoor food markets had been amalgamated with markets selling all manner of other goods. However, in the measures that are being implemented decisively and consistently by the mega-regulator, and the events and processes underway on analogous foreign markets, we can glimpse the contours of the new rules of conduct for a single financial services market.

Fig. 1.1. Transformation of money circulation by financial market segment



Bringing all of Russia’s financial market participants under a single mega-regulator makes it likely that their activities will be delineated (segmented) by risk level and velocity of money. For this it would suffice to establish a rule for market participants that are operating simultaneously in different market segments: the risks and regulatory requirements and ratios for such market players should apply not to the mean values in their accounts for their consolidated businesses, but to the maximum risk level of their most risky financial activity. Six months after the introduction of such a rule, we would see a natural segmentation of market participants.

Fig. 1.2. Transformation of the functions of the financial markets mega-regulator



Another rule should be introduced to prevent market participants from being tempted to use the funds received in one segment for investment in segments with different maturities and risks: money flows between segments should take place on the open market only.

This will upset those market participants who are used to raising money under the one advertising slogan, while using the funds for different purposes. However, the system for attracting funds for investment from the general public will benefit, as ultimately, everywhere and always, the general public are the end investors.

New investment rules. On the one hand, the current deposit insurance system prevents panic and promotes social stability, but on the other hand, it encourages depositors to be somewhat irresponsible when choosing a bank. Ultimately, it is becoming a system in which effective banks pay for their reckless, thieving colleagues. With the transition to the new banking model, depositors will become investors. After allocating the required amounts to payments and settlements, depositors will then indicate for what purposes the bank should use their savings: to purchase blue-chip stocks, finance local companies' projects, build a stadium, a road, a car park, or finance their children's and grandchildren's start-ups.

In contrast to silent depositors, investors will themselves take decisions about the risks and returns of their investments, while banks and the banking system as a whole, represented by the Deposit Insurance Agency, will not assume excessive responsibility for the deposits and risks generated by the economy.

In the current situation it should be remembered that:

- In Russia, even long-term retail deposits are in effect call deposits: the depositor can withdraw their funds from the bank early, at any time (albeit they will lose the accumulated interest).
- Calls for investment are accompanied by stricter regulatory requirements for banks, which are increasingly forced to apply the first point of the Basel risk management recommendations: avoid risk.
- Government investment (money taken from the general public and businesses) has become a type of financial sporting competition: "to spend public money without facing criminal charges".
- Even reimbursing the losses of participants in "people's" IPOs has not restored the public's trust in investment experiments.

In these circumstances the population acts as a genuine speculative investor: Russians change rubles into foreign currency and then wait

for foreign investors to carry out restructuring in Russia. All they are doing, in fact, is stimulating the development of foreign economies.

With segmentation of the financial market, traditional banks will concentrate on payments and settlements and short-term lending for working capital. For their part, investment banks, financial companies and funds will attract genuinely uncommitted resources from the population for investment projects with various timescales, risks and returns. Moreover, instead of putting the population's money and investor risks on their balance sheets, they will act as investment analysts and intermediaries. It will be the end investor who should take responsibility for the investment decision, risks and results. Government supervision will gradually be replaced by supervision by investors and intermediaries who will help ensure that the population's money reaches those who require it for investment projects.

In all cases, regardless of the segment in which profit is generated (payments and settlements, loans, investments), financial market participants will have to make a public investment declaration about the risks they are assuming, the areas in which they are investing, and coverage of possible losses by capital. They must also disclose their governance approach and describe their liquidity management practices. The regulator will monitor the risks accepted by each market participant. If the regulator discovers that risks exceed those indicated in the investment declaration, it will revalue all the assets based on the maximum risk. If regulatory standards have been violated, the regulator will take steps to cleanse the market of unscrupulous participants.

1.5. Capital Markets

Shareholders: a family business or an IPO? In a market economy the highest recognition of a company's success is when it has an IPO. Hoping to attract as many new shareholders as possible, companies try to increase the liquidity of their shares and the size of their free float. However, by issuing shares on the open market, a company not only apportions its successes, but also shifts risks onto market participants. At the same time, if there are systemic interruptions, the company's own

capital is at risk. It is always convenient for managers of public companies to blame drops in share prices on market volatility. Soviet managers had a specific expression to counter such references to objective factors: every problem has its own name and surname. With a family business, these contradictions do not arise. But in joint-stock companies it is hard to identify the persons responsible for a company's sudden problems or indeed its collapse. Even in developed economies the government runs to the aid of large private companies that have gone bankrupt.

In a speculative economy, market quotes are considered the main criteria for assessing a company. Companies whose shares are not quoted on the stock exchange are seen as lacking strength, maturity and transparency.

In fact, as the number of owners increases and a vertical management structure acquires new levels, owner responsibility is diluted: a sole trader runs their business at their own risk and is liable with all of their property; in a limited liability company decisions are taken collectively and responsibility is limited to the participants' contributions to the authorised capital; in joint-stock companies the decision-making system is even more complex, and responsibility is spread out among all the shareholders. With a free float, this responsibility is replaced by market quotes, which market participants can manipulate in their own interests, without bearing any liability for these manipulations, let alone for the operations of the companies whose shares they are trading.

A growing company requires additional capital. Portfolio investors are willing to provide this capital; in return, they demand that their shares are liquid and provide a good yield. However, they are not willing to take responsibility for the company's sustainable development. Moreover, apart from increasing the transparency of the company's reporting (which is also important!), they often do nothing to improve its operating procedures. This sometimes results in unlucky portfolio investors becoming strategic investors, against their will.

On the one hand, companies raise capital from the market through IPOs, but the new minority shareholders can do little to make the company more efficient. On the other hand, minority shareholders rarely try to steer a company; they behave like holders of preference shares, looking

just for dividends. It is only in extreme cases when dividends are not paid out on time that they will use their vote to change the company's management. Given this, it would be logical to allow only preference shares to be issued on the market. But even then it would be essential to regulate the relationships between the shareholders who bear the main burden of responsibility and the owners of preference shares, so as not to lead into temptation the people responsible for the company's work.

Of course, allowing only preference shares onto the market would significantly limit opportunities to raise additional capital and the speed at which this could be done. It would, however, avoid the risk of a "people's IPO" becoming an "anti-people's IPO". This can occur when a mass marketing campaign raises funds from an enormous number of minority shareholders, but these shareholders still cannot be meaningfully involved in the management of a company that is becoming increasingly inefficient.

The second aspect of shareholder sustainability relates to the liquidity of shares. It is the fact that each shareholder has the option to sell their stake at any time, regardless of other shareholders, that makes participation in a joint-stock company attractive. But at the same time, shareholders are affected by the timescales for implementation of specific projects or the development strategy agreed by the shareholders. People who do not respect these timescales sacrifice income on which they had initially counted. It is fine if they find a market participant for whom the price, risks and project timescale are acceptable. Otherwise, a game of leapfrog begins with the shareholder's stake, which makes the other shareholders nervous. Therefore, if the aim is not to obtain a speculative share premium from an IPO or SPO, it would be best to select not just shareholders, but sustainable partners who are keen to ensure the profitability and liquidity of the company's shares for the generally agreed period.

In large joint-stock companies that are global market leaders it is hard to find the responsible shareholder. Investment funds holding shares in such a company are rarely able to take any responsibility for its operating activities, even with regular monitoring of its financial status. However paradoxical it may seem, large joint-stock companies,

for all their transparency, government regulation and strict oversight, are ultimately ownerless and become unsustainable if there is the slightest market fluctuation. Meanwhile, companies in which the founding family retains a significant stake, as strategic investors, remain liquid and profitable in the long term.

Risk management: how much capital is required? All investments contain a risk of losing money. These losses are generally categorised as “expected” (covered by provisions), “unexpected” (covered by capital) and “excessive” (there is nothing to cover them without external assistance or creating a “capital hole”). It is supposed that a company’s capital should cover its unexpected losses. The whole banking regulatory system is built on the idea that all banks assume standard risks, have standard operating activities, and should comply with standard requirements on risk and capital ratios. Whenever someone tries to force the diversity of the real world to fit within a strict regulatory framework it results in games to circumvent these requirements: we see new derivatives, hybrid capital creation schemes, and other schemes. This process is continuous: time and time again, the regulators introduce stricter requirements, and market participants think up new mechanisms to circumvent them. However strange it may seem, the parties to this game conceal information about their actions: the regulators almost never justify the specific values in their ratios, while market participants claim that the new instrument will mitigate the risks that were troubling the regulators.

The game would be different were it played with information that was made publicly available: the regulator would name different values for the different regulated market segments, and market participants could then choose the niche that best suits their business model.

Responsibility for investments. Changes in the way in which investment risks are managed and redistributed will take place on the basis of modern information communication technologies (ICT). Thanks to ICT, the general public and market participants have ever greater access to information and analytical materials and tools. This allows them to independently, deliberately and judiciously choose areas for investment. The interest margin from the classic banking business model will be

replaced by fees for the provision of advice and processing paperwork. A new industry for monitoring borrowers will develop, and it will be very different from the current ratings agencies. Numerous analytical agencies will emerge and they will make express recommendations to investors. The large number of small investors investing directly in company debt instruments will address the problem of the impunity of large market players. Depositors, with their blind faith in government deposit protection schemes, will be replaced by sensible investors. These investors will assess not only the returns, but also the risks of investment to finance working capital, modernisation projects, and ambitious long-term projects.

Naturally, new problems will arise: instead of deceived depositors, there will be deceived investors. But when a project fails it will not have a domino effect on the balance sheets of intermediary banks. Rather, the fallout will affect only the investor and the project that they chose to invest in. This process will be accompanied by an intensive natural selection of analytical agencies, for which the reliability of recommendations and business reputation will be paramount.

1.6. Money Circulation

Money circulation without money. Historically, money has fulfilled many functions: it is used as a measure of value, a means of payment, a medium of exchange, and a means of saving, and it can even be international money. When savings are converted into investments (a one-off transition), money acts as a means of payment. In the multiple transformations involved in the circulation of goods, money is a medium of exchange. The amount of money required for the circulation of goods (**M**) is directly proportional to: the prices (**P**) and the physical quantity of goods (**Q**) and inversely proportional to the velocity of money (**V**): **MV=PQ**. If the velocity of money continually grows, with the amount of products, goods and services remaining the same, demand for money will tend to zero.

While banks have traditionally attracted and invested money, to service the exchange of goods among their customers (“closed loop”),

they could do without money entirely and just use guarantees for the period of the production cycle.

NON-PAYMENTS. In the mid-1990s there was a payments crisis in Russia. To overcome the resultant bottlenecks, Center-invest Bank compiled a database of its customers' receivables and payables, created a self-contained chain of debtors, and issued a promissory note, which became the most reliable currency in the region. This resulted in the settling of more than 20 billion rubles in mutual debts. The vaults contained a promissory note with 150 endorsements.

If a bank uses money as a medium of exchange, it should be able to see not only the customer receiving the money, but also the whole chain that results in the money being returned to the bank. It is easy to picture this chain when it concerns the circulation of goods and services. However, when financing long-term projects it is harder to picture how the funds will return. Transformational banking does not simply allow, but in fact demands, that the investment process is seen in precisely this way. By using money as a medium of exchange, even for long-term lending, the risks of financing ambitious but ineffective projects can be avoided. If in the initial stage of making a loan, the whole sequence of transactions permitting repayment of the loan was clear and transparent for all the participants, money could be replaced by promissory notes, letters of credit, and other guarantees.

In addition to all this, it could have an anti-corruption effect, as any transactions beyond those agreed would seriously harm the project. Moreover, with non-cash forms of settlement it is much harder to use funds for anything other than the stated purpose.

Goods periodically put forward as a universal equivalent ensure the reliability and liquidity of means of payment and mediums of exchange. The fact that the composition of these equivalents has changed many times over the course of human history shows that the use of a common currency for payments and settlements is somewhat artificial. The parallel circulation of different currencies in different countries also forces us to question the magical powers of a given type of money. Extrapolating from this, it becomes clear that as mediums of exchange we could use debt instruments issued by any market participant. Depending on to

what extent they are trusted by other market participants, this means of payment could service any given payment transaction.

The budget system: circulating money supply. The budget is most often compared to the well-known exercise in school textbooks about the “swimming pool and two pipes”. In fact, the budget system works like a toilet cistern, whereby as it fills up, the accumulated water is released. From a technical point of view, it would not be difficult to make the budget work like a circulating self-supply system, with information technologies ensuring that each ruble of public money returns after its circulation. If all taxpayers and distributors and recipients of budget funds trusted one another, the circulation of money among them could be replaced by clearing of electronic entries. This would speed up growth in consumption and production many times over, in anticipation of each new release of money from the cistern.

The reforms in Russia in the 1990s were based on the monetarist views of members of the government. However, their fear of inflation, implanted back in their student days by Marxist lecturers, kept forcing them to limit not only the money supply, but also the velocity of money. This resulted in the barriers that underlie the unsatisfactory investment climate, and artificially constrained inflation still to this day prevents economic restructuring.

1.7. The Future of Regional Banks.

Listen!

If stars are lit

it means – there is someone who needs them.

*It means – someone wants them to be,
that someone deems those specks of spit
pearls.*

It means it is essential

that every evening

*at least one star should light up
over the roofs.*

Vladimir Mayakovsky, 1914

Who Needs Regional Banks? People have talked so often, and for so many years, about the inescapable fate of Russia's regional banks that it is absolutely clear now: these financial institutions will live for a long time, and indeed outlive many global players.

A scene from the Soviet film "Hot Snow" comes to mind. Looking through his binoculars at a field after a terrible battle, a general remarks with surprise, "This squadron should have died two days ago," and he sets off for the front line. Handing out awards to the surviving men, he feels a sense of guilt that the awards are not commensurate with the great feats achieved, and he says to each soldier, "All that I can.... All that I can..."

Regional banks rarely receive awards and they are discriminated against by regulators and ratings agencies. When problems arise, government funds to sanitise a regional bank are more often than not used for a hostile takeover. It is seldom recognised that many efficient regional banks have overcome all the crises and continue to operate in market segments where, due to their inertia, bureaucracy and unwieldiness, large federal banks cannot or do not wish to operate.

The explanation is: the effectiveness of decision-making, and opportunities to obtain objective information for decision-making, are inversely proportional to the distance and the number of steps from the end customer to the point at which the decision is made.

On principle, I do not participate in discussions about the fate of regional banks. I provide just a few examples from the distant past to explain my position.

Case study 1. At an international conference an official representative speaking from the podium compared the Russian banking system to faeces and regional banks to its liquid form.

In my own speech I put forward the following proposition, with which the audience agreed, including the previous speaker: "A regional bank is not about size, but about methods and approaches: a regional bank manages regional risks effectively."

Case study 2. At a briefing with customers in an agricultural district with a large Armenian population, someone asked me: “Why does the state-owned bank in our regional centre offer loans at lower rates?” Before I could answer, the person next to him responded emotionally in Armenian. In translation, he said: “Idiot! If Center-invest Bank wasn’t here, we would be grovelling on our knees and licking boots in the state-owned bank.” Well, I am proud that our customers do not grovel to anyone or lick anyone’s boots.

That was a long time ago. Center-invest Bank has since introduced new risk management technology and methods, allowing us to offer our customers some of the lowest interest rates on the market.

Type II error. People with a “centralisation” mindset see increased government control of the Russian banking system as a panacea for shocks to come. Consequently, regional commercial banks are perceived as a Type I error, casting doubt on the hypothesis that centralisation is advantageous. More skilled analysts view regional banks as potential sources of new ideas, products, methods and technologies, and therefore try to avoid the Type II error of also casting aside the best things that regional banks are already doing.

Case study 3. Behind the scenes at an international conference, the head of a large Russian bank was asked: “How long do you intend to use innovations generated by regional banks?” The well-informed competitor gave a good answer: “We have always learned and will continue to learn from the best regional banks!”

It is possible to compete successfully with large state-owned banks. For this, it is enough to bring out a new innovative product or service every quarter and ensure that you take good, timely decisions. An unwieldy federal bank needs two to three quarters to introduce an innovation; meanwhile, a regional bank can have brought out another two or three new products.

Markets in capital cities differ significantly from markets in the regions in terms of the local population's income, saturation with banking services, and risk appetite. Regional banks' knowledge and their effective management of regional risks allow them to remain competitive, despite the expansion of federal players into the regions. Aggressive competition forces regional banks to find new approaches and solutions, which in turn improves the competitive environment in the region and also the quality of banking services. Regional banks quite often protect regional markets from unscrupulous banking products (express loans, micro-loans), and set the benchmark for federal players operating in the regions. On the other hand, growing competition in the regions has meant a break away from the regional authorities' attempts to force customers to use banks that have their special blessing. (These banks went from having special mandates from the local administration to being sodden with debt and weighed down by losses.)

Segmentation vs. consolidation. Most retired financial analysts “worry” about the fate of regional banks, in the hope that their services will be in demand for acquisitions and mergers. There is a place for this market, especially if the new parent company is two or three times more efficient than the regional bank. If regulation of the financial markets were segmented, regional banks could choose from various options for their future development:

- To become an operator in the regional payments and settlements system (40% to 60% of all payments are intraregional);
- To become a microfinance institution (regional mutual aid fund);
- To become an investment company to raise funds and manage projects in the regions (including infrastructure projects).

In this way, the capabilities of regional banks ought to be used for intraregional payment systems, short-term lending and long-term investment projects. Instead of financial resources being taken out of the region and then redistributed, it would be better to straighten the real money flows within the region. Regional banks and financial institutions ought to address this task by using their advantages in terms of new technologies and methods, their knowledge of regional risks, and even their local connections, including contacts with local officials

and government bodies. Ultimately, in the long-term, the influence of administrative factors will change, but the superior methods and approaches of regional banks will multiply the local effect and best international practice.

The world will undergo continual transformation, and perhaps for the better. Regional banks, their customers, partners and employees must be prepared for continual changes earlier than other market participants. They must use their specific regional features to maximise their advantages in their niche segments and to compete with global market participants. A regional bank that is capable of transformation should know its own business, its customers, its markets and its advantages in these markets. It should also have a development strategy.

Transformational Banking: made in Russia

2.1. Creative Self-Regulation

The sustainable banking business model includes: a sustainable shareholder structure and corporate governance system; sustainable procedures for developing strategies and plans and managing assets, liabilities and risks; reporting under international standards; sustainable internal audit and operations management systems; a range of sustainable products and services; a sustainable system for managing customer and investor relations; and a sustainable human resources system.

Sustainable banking is caught between its own focus on long-term results, on the one hand, and the speculative risks of the market and stricter national and international regulatory requirements, on the other hand. As such, in order to succeed, a sustainable bank must constantly innovate and apply best international practice, both to its own operations and to those of its customers. Sustainable banking should be transformational, that is, it should be capable of continual self-development.

The sustainable banking business model was resilient in the face of the crisis, demonstrating its viability at a time of volatility on the speculative markets. While the ratings of many banks and even leading market economies were being downgraded, in August 2011, Moody's upgraded Center-invest Bank's long-term global rating to Ba3 and its national scale rating to Aa3.ru. It affirmed this stable outlook in 2014. At FYE 2013, ROAE was 17.2% and ROAA was 2.0%. These positive results

reinforce the argument that sustainable banking should be classed as transformational banking.

Center-invest Bank's position is reflected in its Sustainable Development Declaration. Crucially, the bank also has the necessary know-how to implement its sustainable development principles. It is this combination of practical solutions to today's challenges with a vision of the future that characterises transformational banking. In this section I will attempt to describe how:

- the transformational banking business model provides for a high level of profitability in the long term, irrespective of the growing risks in the operating environment;
- stricter self-regulation enables banks to find more innovative solutions and to apply more effective methods and approaches.

Sustainable Development Declaration

Center-invest Bank's Sustainable Banking Business Model

1. 1. Center-invest Bank's sustainable banking business model is a method of doing business that envisages that the bank's shareholders and personnel will voluntarily take decisions in the interests of current and future generations. These obligations have become a cornerstone of Center-invest Bank's corporate culture. They inform the bank's customer and partner relationships and provide a mechanism for successful business management even at a time of crisis.
2. The distinctive features of the sustainable banking business model are:
 - a high level of operational efficiency;
 - a long-term vision for the bank's own business and for the social, institutional and environmental setting in which it operates;
 - strict self-regulation, with due regard for national and international regulatory requirements and anticipated changes to these requirements;
 - rejection of speculative profits in favour of long-term profitability based on organic growth;

- application of best international practice to ensure the competitiveness of the bank and its customers.
3. By applying a sustainable banking business model Center-invest Bank is achieving: sustainable, balanced growth; a high level of competitiveness (including when compared to the speculative market); and high rankings in ratings of Russian banks, especially for the latest and most popular inclusive finance products.
 4. Center-invest Bank applies best international practice to improve its business performance. The following factors make our business model competitive in Russian and international markets and will ensure that it remains so in the long term: transparent procedures; a clearly defined corporate culture and unambiguous rules of conduct; independent risk management and internal control; a commitment to nurturing our employees; transparent and accessible reporting under national and international standards; a modern and constantly evolving information system; highly responsive liquidity management procedures; and technology, operations and product development.
 5. Center-invest Bank is the leading bank in southern Russia. In terms of efficiency, southern Russia lags behind developed countries and the rest of Russia as a whole. This creates scope to introduce best international practice, increase efficiency three- to fivefold in most sectors of the economy, and raise standards of living.
 6. Center-invest Bank is committed to helping maintain southern Russia's environmental diversity and to reducing environmental harm. The bank takes great care when selecting which agribusiness projects to finance, and we are a market leader for energy efficiency finance.
 7. The bank is a market leader for small business and youth enterprise development and for products to support women in business.
 8. Center-invest Bank sells products that enable the residents of southern Russia to improve their standard of living: consumer loans, mortgage loans and car loans. However, we do not provide express loans with extortionate interest rates. Instead, in dialogue with the customer, we assess the risks

relating to the loan purpose, factoring in the long-term interests of the customer's family and loved ones. We also look for opportunities to provide special purpose loans to enable customers to purchase energy efficiency technologies or carry out housing renovations (including to multi-family residential buildings). Drawing on its accumulated experience of introducing best international practice, the bank is broadening the scope of its lending on the basis of public-private partnerships (PPP).

9. Center-invest Bank's social and educational projects are designed to raise new generations of schoolchildren, students, entrepreneurs, civil servants and company managers who support the ideology of sustainable business development in southern Russia.
10. The bank helps businesses in southern Russia to expand their contacts with partners from the EMENA region and CIS and BRICS countries. For example, we have updated an online database of SMEs in southern Russia. We establish correspondent banking relationships with new partner banks abroad, and we hold training events where bankers from various countries can share experience of introducing a sustainable banking business model.
11. Center-invest Bank provides continuous staff training on new areas in banking, in line with the sustainable banking business model. We have established a positive corporate culture, with a creative atmosphere and employees who take responsibility for, and have confidence in, the successful implementation of the bank's own strategy and those of its customers. An important result of this is the high birth rate among our employees. We have every reason to be confident that all the members of our team are committed to helping the bank and our customers achieve new sustainable results.

President and Chairman of the Board of Directors,
Dr Vasily Vysokov



Chairman of the Executive Board,
Grigory Zhukov



Motto: Center-invest Bank is the Sustainable Bank for Southern Russia!

Southern Russia is a region:

- in which the staff of Center-invest Bank's 130 branches are fulfilling their civic and professional responsibility to work in the immediate and long-term interests of the region by promoting effective economic development, social stability, and environmentally responsible behaviour;
- in which Center-invest Bank effectively manages the regional risks associated with accepting deposits and lending to retail and business customers, the requirements of supervisory and regulatory bodies, the impact of global processes, and the specifics of Russian legislation;
- that, at a time of globalisation, effectively combines the advantages conferred by its geographical position, favourable climate, diverse natural and human resources, and infrastructure;
- that has long been populated by people of different nationalities, whose lives are enriched by the region's cultural diversity and tradition of enterprise, and who value their freedom and independence;
- that, with its economic diversity and high levels of entrepreneurship, serves as a model for the future Russian economy;
- in which salaries are 30-40% lower than the Russian average and five times lower than in European countries;
- that is experiencing a faster rate of economic recovery after the crisis, and slower growth in production costs, than the rest of Russia as a whole. This makes the region more competitive. Indeed, southern Russia plays the same role in the Russian economy as do the BRICS countries in the global economy;
- where SMEs are modernising successfully on the basis of best international practice.

Table 2.1. Southern Russia (Southern Federal District (SFD) and North Caucasus Federal District (NCFD) as % of Russian Federation

	2000	2005	2010	2011	2012	2013		
Territory	3.5							
Population	15.6	16.0	16.3	16.4	16.3	16.4		
Gross regional product / value of goods and services produced	7.6	7.1	8.6	8.5	8.8	8.8	SMEs ¹⁰	STs ¹¹
Fixed assets	10.2	9.3	8.6	8.5	8.4	8.4	10.3	17.92
Industry	—	5.6	7.2	7.6	7.3	7.2	11.5*	15.4*
Agriculture	18.7	22.6	24.4	23.2	23.6	23.4	9.4	15.1
Construction	11.4	9.5	13.2	14.5	14.4	15.0	23.1	37.4
Retail trade	9.8	11.5	13.8	14.0	14.2	14.1	10.0	16.9
Capital investment	11.6	9.4	13.2	14.5	13.0	14.0	10.2	12.3
Average monthly wage							*data as at 01.01.2013	
SFD	71.4	72.5	74.3	73.8	75.3	75.1	18	19
NCFD	54.5	55.9	60.0	59.5	63.1	65.2	80.4	—
Average per capita income (monthly)								
SFD	69.8	71.2	79.8	79.9	81.3	85.3	63.9	—
NCFD	49.5	56.0	69.9	72.5	79.3	74.1	—	—

At Center-invest Bank, sustainable banking means:

- an integral part of the corporate culture for its employees and customers;
- procedures to comply with the financial, procedural and environmental requirements of the bank’s IFI shareholders and partners;
- the bank’s experience in financing projects pertaining to energy efficiency, SME modernisation, and agribusiness, which have increased business efficiency three- to fivefold;
- increased operational efficiency on the basis of best international practice: transparent corporate governance, risk management and internal control procedures, advanced information technologies, and a new corporate culture;
- a risk management system based on a combination of data analysis methods that ensures high-quality and timely decision-making, the

10. Small and medium-sized enterprises

11. Sole traders

appropriate allocation of powers and responsibilities among the bank's business units and employees, and also sufficient capital and provisions for its risk exposure;

- a consistently strong financial performance that is persuasive not only for our sustainable development partners, but also for speculative market participants;
- increasing the competitiveness of the bank's customers and raising the population's standard of living by providing training in best international practice for a wide audience, including managers and other personnel, young people and schoolchildren.

2.2. Corporate Governance: From Rules to a Culture

In 1993 experts from the bank wrote and published Russia's first handbook on corporate governance (drawing on recommendations made by the Central Committee of the Communist Party of the Soviet Union for meetings of party organisations). The handbook contains recommendations for new shareholder companies on the procedures for holding shareholder meetings and adopting internal rules and regulations¹².

Despite the increasingly strict regulation of banking, many laws and regulations can still be interpreted and applied in various ways. Other countries had encountered this dangerous situation before post-privatisation Russia. Therefore, after a successful IFC survey, in 2002 Center-invest Bank readily accepted IFC's proposal that it pilot its programme to introduce best practice corporate governance in Russian banks¹³. In a short space of time, with the help of IFC consultants, we developed and approved all the requisite documents and policies for the bank to voluntarily undertake to observe best international practice in reconciling the interests of shareholders, employees, customers and partners. When the IFC programme officially began in Russia, we had already been through the advisory process.

Our initial aim in introducing a corporate governance system was to meet the requirements of our Western partners. This was with the goal

12. The Joint-Stock Company: Internal Rules of the Game, Rostov-on-Don, 1993

13. www.ifc.org/corporategovernance

of accessing long-term funding. In the process of producing the documentation, existing procedures were reassessed and more effective solutions and governance standards were proposed. By formalising its procedures, Center-invest Bank introduced more clearly defined rules on the relationships between shareholders, management, employees and customers. Ultimately, a **new corporate culture** was established.

Center-invest Bank has always acted in strict compliance with Russian legislation. Our work with international organisations has meant that we must also observe international standards. The main aspects of these voluntarily assumed obligations have been: clearly formulated corporate governance principles (in addition to mandatory principles), a transparent structure for the governance bodies, procedures to better guarantee the rights of minority shareholders, a transparent dividend policy, information policy standards, and a code of corporate conduct.

Nonetheless, many aspects of adapting best international practice to Russian conditions were particularly challenging. Indeed, many Russian banks are still to introduce proper corporate governance systems; it is still only recommended, not mandatory, for Russian joint-stock companies to have a code of corporate conduct. As a result, corporate wars continue, minority shareholder interests are ignored, and there is a constant threat of corporate raiding (stealing the company from the owners). In this environment, Center-invest Bank was bold in deciding to voluntarily adopt and comply with a whole number of obligations pertaining to: minority shareholder rights, transparency of the activities of the governance bodies, transparency of bonuses and salaries, clear obligations for the payment of dividends, internal control, strategic planning, management of risks, liquidity and lending, and reporting under Russian and international standards.

Under the speculative banking business model, it would be expected that all these additional obligations would mean additional costs. However, even in the early stages of producing the documentation, many procedures and rules were improved: they became simpler, clearer, more effective, and less costly. Ultimately, the corporate governance system brought genuine advantages for the bank's operating activities.

Instead of the anticipated costs, the introduction of a code of corpo-

rate conduct was an opportunity for the bank to clarify its rules and eliminate ambiguity, and to replace existing procedures with more effective ones. It also allowed us to change the team ethos and create an atmosphere whereby all employees have a sense of their personal responsibility for the bank's overall performance, and the bank works in the interests of its customers, shareholders and staff. Experience has shown that despite the possible costs, the voluntary acceptance of new corporate governance principles is justified not only from the point of view of investors, but also because it creates a new internal culture for a shareholder company.

The creation of a transparent governance structure was also important, with clear divisions between the competencies of the Meeting of Shareholders, the Board of Directors and the Executive Board.

Center-invest Bank's Corporate Governance System

1. The *Corporate Conduct Code (2002, 2008)*¹⁴ harmonises all of the bank's internal regulations (Articles of Association (2002, 2008), the Byelaws on the Meeting of Shareholders (2006), the Board of Directors (2006, 2014), the Executive Board (2006, 2012), and the Chairman of the Executive Board (2008, 2012). It has enabled the bank to clearly define the different remits and responsibilities of the governance bodies and the lines of reporting, and it provides a clear-cut decision-making process that is all the more important given the lacunae and ambiguities in current legislation. All of these documents allow the bank to avoid conflicts of interest and ensure that all decisions are well thought out and unanimous.

2. The *Corporate Ethics Code (2002)*, which enshrines our moral principles, enables us to address any conflicts successfully. For example, IFC withdrew its proposals about including a section on sexual harassment, as Center-invest Bank's procedures for examining disputes already contain a more effective way of addressing such issues. In addition to the bank's official documents on compliance with its human rights

14. The years in which the documents and their revised versions were adopted are given in brackets.

obligations and other social standards, it has developed a corporate culture that ensures effective risk management: every member of staff is entitled to address any question to any level of management, and they must receive a satisfactory explanation.

3. The ***Dividend Policy (2004, 2011)*** sets an upper limit on dividend payments (50% of net profit) and a lower limit ($\frac{1}{2}$ of the Central Bank of Russia rate). Observance of these rules has helped create shareholder confidence, thanks to which we obtained their agreement that the bank would not pay dividends in 2009, and that dividends for 2010-2013 would be 20-30% of net profit. Dividends have been paid annually on preference shares.

4. The ***Information Policy (2004, 2007)*** guarantees and provides access to non-privileged information and effectively protects trade secrets and insider information.

5. The ***Risk Management Policy (2002, 2009)*** ensures transparent and effective risk management. It is based on modern risk assessment methods using a wide range of risk assessment and data analysis tools and expert analysis.

6. The ***Lending Policy (2007)*** ensures that our lending procedures are transparent, effective, and properly controlled at all levels of the bank's operations.

7. The ***Internal Control Policy (2004, 2007, 2012)*** sets out a full range of measures to ensure compliance (IA&C) and prevent money laundering. The policy ensures compliance both with regulatory requirements and with best international practice. In addition to the oversight provided by the Internal Control Service, every bank employee is both entitled and obliged to inform management of any dubious transactions and to receive a full explanation. In 2013 the effectiveness of this policy was confirmed when the bank successfully passed all the inspections by various supervisory bodies, which, held concurrently, lasted a total of 1,336 days!

8. The ***Environmental and Social Policy (2004, 2010, 2011, 2012, 2014)*** requires the bank to promote the generally accepted principles of "environmentally sound and sustainable development" throughout

its banking operations, investments and technical cooperation, as a cornerstone of rational business management.

9. The **Liquidity Management Policy (2002, 2004, 2012)** and Liquidity Crisis Action Plan set out our decision-making procedures for liquidity management and the action to be taken in critical situations. Our policy has been proven to be effective: in 2008-2009 the bank met all of its obligations on time and in full. We have also conducted successful bond placements on Russian markets, attracted long-term funding from the international markets, and increased retail deposits.

10. The **IT Strategy (2004, 2008, 2012)** provides for the systematic introduction of modern software products. The effectiveness of our strategy was confirmed when we became a strategic partner for SAP AG's project to localise SAP for Banking 8 (SAP for Banking 4 is currently used in Russia). We also won tenders to service the accounts and plastic cards of regional divisions of the Central Bank of Russia, the Federal Tax Service, the Federal Treasury, the Pension Fund, and leading higher education institutions in southern Russia.

11. **Human Resources Policy, Remuneration Policy (2013)**. The Bank of Russia now requires banks to have these documents. In any case, we had already included in our corporate conduct regulations the main provisions on the payment of bonuses at different intervals and transparency over the remuneration of the governance bodies.

12. **The Information Security Policy (2004)** sets out rules and procedures providing for the reliable functioning of the bank's information systems, and allows for the development of information technologies, and the attendant risks.

13. The **Accounting Policies** and the procedures for reporting under RAS and IFRS for tax purposes are updated annually by the Board of Director's Audit and Compliance Committee to reflect changes in legislation.

Center-invest Bank's governance system. The governance of Center-invest Bank complies with Russian civil law and the recommendations of international organisations, in particular, the Basel Committee on Banking Supervision.

The *General Meeting of Shareholders* is the bank's highest governance body. It delegates strategic planning to the Board of Directors. *The Board of Directors' Committees for Strategic Planning, Audit and Compliance, and Appointments and Remunerations* may examine in more detail issues relating to the bank's activities and make prompt decisions as required.

The *Board of Directors* determines the bank's strategy: the main types of activities, permissible risk level, overall expenditure, anticipated financial results, and performance incentive scheme.

The *Executive Board*, headed by the *Chairman of the Executive Board*, and acting within its terms of reference, organises implementation of the approved strategy, business plans and budget. Pursuing its strategic mission, the bank introduces the most progressive forms of governance.

To further improve Center-invest Bank's corporate governance system, a transparent structure was established for its executive bodies. As a result, we have a transparent and effective governance structure that enabled us to minimise the financial crisis's impact on our operations. Our corporate governance rules and procedures, incorporating best international practice, ensured that during the crisis relations remained stable between the bank's shareholders, managers, employees and customers.

Due to ambiguities in Russian legislation on shareholder rights, to guarantee that all shareholders could participate in meetings, we had to introduce special provisions on the location and timing of meetings and the procedures for speeches and voting. To protect the rights of minority shareholders, independent directors are elected to the Board of Directors and the shareholder register is maintained by an independent registrar. There is a special procedure for considering and approving related party transactions.

Today, Center-invest Bank's corporate conduct system is not a static code; rather, it is a set of procedures and documents that is constantly

updated to reflect changes in legislation, best international practice, and the bank's own experience.

Sustainable shareholder structure. Although Center-invest Bank is a joint-stock company, it has a sustainable shareholder structure: EBRD – 27.5%, DEG – 22.5%, Dr Vysokov's family – 17.8%, Erste Group Bank AG – 9.8%, Raiffeisenlandesbank Oberösterreich AG – 3.6%, Rekha Holdings - 8.2%, Firebird Investment Fund – 9.9%, and the remaining shareholders - less than 1%. This structure has been maintained since 2009. Minority shareholders enjoy all the rights provided for by current legislation and the bank's Code of Corporate Conduct.

When the bank's founders persuaded development institutions to become shareholders, their participation not only increased the bank's capital, but also provided access to modern banking technologies and best international practice. The development institutions, while officially remaining portfolio investors, have transferred proven best practice methods and products to help Center-invest Bank improve its operating activities. Many of the development institutions' loan products that are traditionally used in transition economies (finance for SMEs, energy efficiency, agribusiness, mortgages) were first launched in Russia by Center-invest Bank. In effect, they became reference projects for other regional banks.

Fig. 2.1. Center-invest Bank's shareholder structure

As at 01.01.2014, % of voting shares



Center-invest Bank's transparent corporate governance procedures allowed it to respond promptly to the crisis: we adopted a new programme, "Southern Russia Versus the Global Crisis", and took measures to ensure

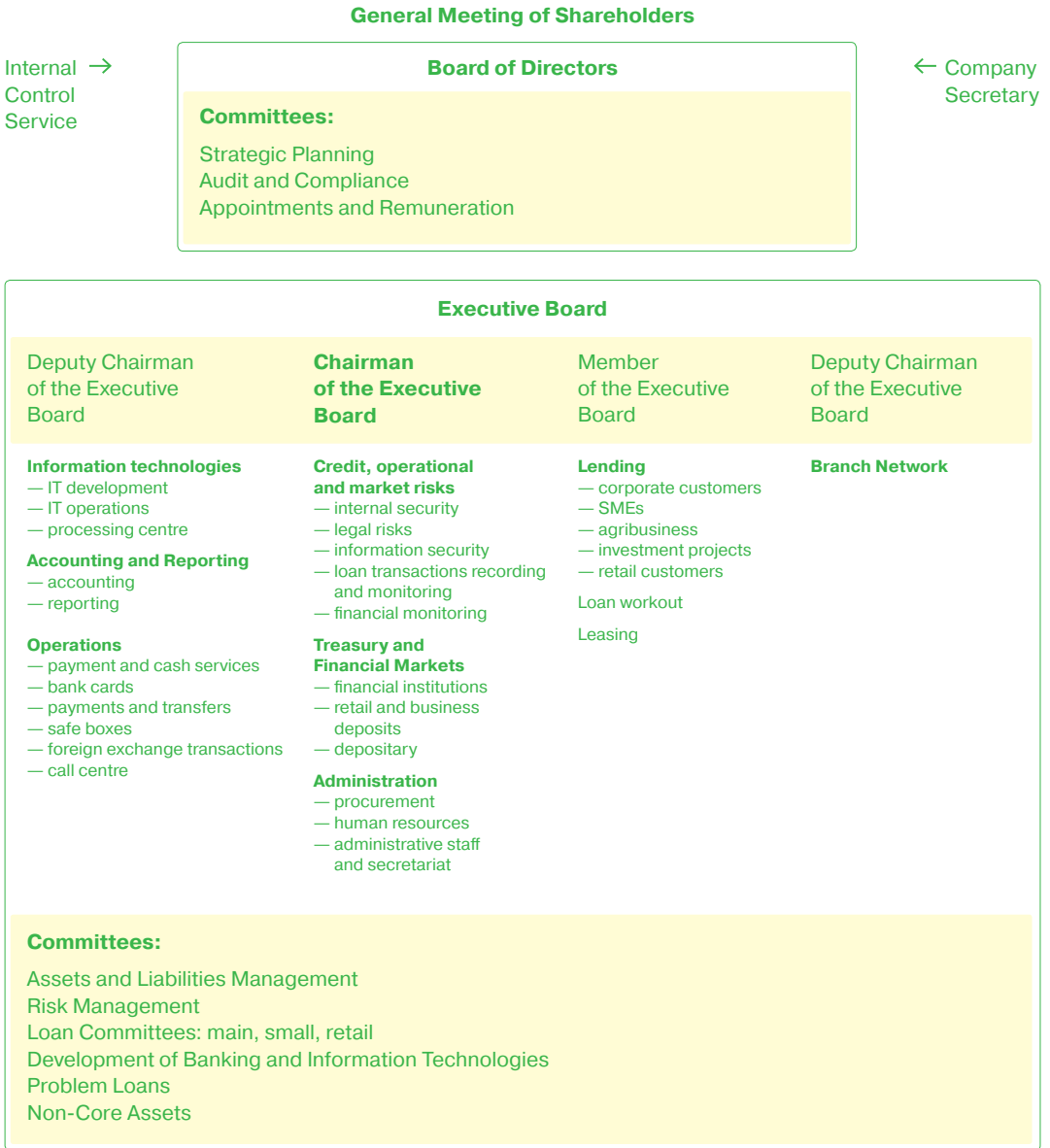
the bank's successful, sustainable development both during the crisis (2008-2009) and also in the post-crisis economy. To a large extent, it was thanks to shareholders, managers and employees openly discussing the situation that we managed, at every stage of the crisis, to mobilise and use all of our resources effectively to implement our post-crisis development programme.

All the decisions of the bank's Board of Directors are adopted unanimously. In contrast to the UN Security Council, this mechanism allows the bank to avoid conflicts, and guarantees that the proposals taken to Board meetings are properly elaborated and well founded.

The Board of Directors does not interfere with the everyday activities of the management team. The procedures for taking operational decisions can only be changed if the necessary amendments have been made to company policies.

Fig. 2.2. Center-invest Bank’s management structure

as at 01.01.2014



2.3. Transformational Planning

“You must not work without a plan that is designed for the long term and aimed at great success.”

Vladimir Lenin

Organisation of planning. Organisation of planning. Since its establishment, Center-invest Bank has used best international practice. This includes the best elements of the methodology, techniques and experience of Soviet planning. Center-invest Bank's planning system is based on clear organisational procedures that enable us to use an iterative process to agree the following:

- strategic plans, annual and quarterly business plans;
- development plans for individual products and business units;
- technology, data management, and human resources development plans.

All of the bank's business units are involved in developing these documents. This means that, using an iterative approach, solutions can be found and agreed upon, and employees can propose ways to make business processes more efficient. The main outcome of this dialogue is that every employee is aware of the bank's growth prospects, feels involved in its overall success, and views targets as personal objectives. Strategic and personal objectives are properly balanced in terms of resources, time frames and responsible parties.

In a stable economic environment, development prospects can be predicted on the basis of trends in economic indicators. In transition planning, a system of balanced indicators must be used, and optimistic, pessimistic and realistic scenarios developed. Transformational planning supposes the continuity and succession of strategic, tactical, long-term and current plans:

- In tactical plans, either the objectives or the resources are specified;

in strategic plans, both the resources and the objectives are variables, allowing a company to consider a wider range of options and select one that will provide for balanced development.

— In current plans, the outcomes for the end of the planning period are known; in long-term plans, the planning horizon is a variable.

— In transition planning, the methods for implementing the plan are known; in transformation planning, creative approaches are required to address the problems and challenges identified.

Planning methods. The transition to transformational banking increases the role of creative planning methods. The traditional methods of planning on the basis of trends and variant calculations for scenarios with varying degrees of risk assessment are increasingly being replaced by creative approaches: zero-based budgeting, SWOT and GAP analysis, Pro et Contra, identification of Type II errors, and portfolio and risk analysis. What sets these methods apart is that, as well as known, analysed interlinkages, they always consider alternative aims and resources for the plan, and look not only for harmonised solutions for the known links, but also for alternative combinations. Independent stress testing is an important element of strategic planning in a sustainable bank. Creative approaches use creative risk analysis methods: an overview of practice, Type I errors, risk mapping, at-risk expenditures, and expert assessments.

The financial indicators for the plans are calculated using International Financial Reporting Standards (IFRS) and Russian Accounting Standards (RAS).

Traditionally, many strategies are developed with a view to maintaining the status of the planners themselves. As a result, not only the best, but also the outdated elements of business models are retained and reproduced.

At Center-invest Bank the planning process is always iterative in nature: assumptions are changed, new solutions are generated, and the team looks for points of consensus. Moreover, almost every employee participates in the planning process, bringing their own personal perspective to the bank's overall strategy. Consequently, indicators sent down "from above" should be adjusted by proposals "from below".

Zero-based budgeting and creativity incentives may be used to ensure a successful iterative dialogue. Zero-based budgeting starts from scratch: it is assumed that the business unit has been liquidated, and that only the minimum, essential functions are to be restored. Creativity bonuses and crowdsourcing generate new proposals to save resources, increase sales and/or optimise processes.

Monitoring implementation of plans. The risk management and internal control systems track not only negative consequences, but also new opportunities arising in the course of plan implementation. The strategy and business plans set out the aims and objectives for developing:

- products (small business, agribusiness, energy efficiency, retail);
- services (payments and settlements, direct marketing, bank cards);
- the branch network (standardisation of products and services);
- operations (risk management, internal control, introduction of a new information system, management of human resources and equipment and technology).

The *planning system* is closely linked to the *risk management and internal control systems*, which take into account not only Russian and international regulatory standards, but also best international practice. The procedures for approving, monitoring and reporting on plans allow the Board of Directors to obtain quarterly updates on implementation of the approved strategy and annual business plan.

The bank's strategies have generally been produced for a four-year time period, using a model that takes into account the requirements of Russian legislation, international standards, the internal control system, and the risk management policy. For scenario development, it has been essential that the model includes global, Russian and regional economic development trends and parameters of market behaviour. Scenario development has also included forecasts by business units regarding product line development for various market segments in southern Russia. A sustainable planning system requires such a model, one that allows a company to rapidly assess the consequences of changes in different markets and the results of introducing new products and services.

Center-invest Bank uses the same model to produce its business plans.

The results of calculations are broken down by quarter. This allows the Board of Directors to examine reports on business plan implementation on a quarterly basis. The interlinkages between the bank's mission, strategy and business plans provide for its sustainable development, both in the short and long term. Discussion of the possible parameters of the bank's strategy and business plans by its shareholders, managers and employees at different levels of the organisation ensures that these documents are sustainable and that everyone understands the organisational structure, bonus system, risks assumed, and internal control system. This discussion enables not only shareholders, but also every employee to picture their future, and their place and role in the bank's sustainable development.

Mission. Identifying your mission in today's complex world is an important step for correctly understanding and positioning your business. Companies that lack a clear mission are left at the mercy of the waves in the free market sea.

Since its establishment in 1992 by southern Russia's first privatised enterprises, Center-invest Bank has been carrying out its mission to "provide the local population and businesses in southern Russia with a broad range of banking services on the basis of international standards and modern technologies".

Although ideas about standards and banking technologies have changed over the years, Center-invest Bank has always strived to introduce best international practice into its own activities and into the lives and work of its customers. With its experience in localising best international practice, Center-invest Bank has become a prime example of a Solutions Bank; the bank's approach is itself now cited as best practice by international organisations. Today, Center-invest Bank continues its mission as **the Sustainable Bank for southern Russia.**

The sustainable banking concept presupposes that banks will promote the development of their customers' businesses in the interests of current and future generations. Sustainable banking entails not only social and environmental responsibility, incorporated in banking methods and decision-making procedures, but also a focus on the long-term, effective development of a bank's own business and its customers' businesses,

rather than on immediate, speculative profit. Center-invest Bank has incorporated these principles into its operations.

Sustainable banking requires banks to help their customers introduce best international practice, including by means of technical, financial and social engineering. Center-invest Bank's experience has shown this approach to be both viable and effective. The numerous examples of projects achieving a three- to fivefold increase in business efficiency are giving impetus to new projects for the SME sector, agriculture and energy efficiency.

It should be noted that during the crisis Center-invest Bank did not raise interest rates on existing loans, nor did it pass currency risks on to its customers. Instead, we helped our customers to complete their equipment and technology modernisation projects and to become more competitive in the post-crisis economy. The bank regularly informs its customers and the general public about global and local development risks, presents its own situational analysis, and proposes solutions to the challenges that arise.

The bank also creates an eco environment for the implementation of its plans: it supports social and educational projects, provides incentives for the best students and young teachers in southern Russia, teaches the general public how to manage their personal finances, and introduces young people, students, schoolchildren and women to entrepreneurialism.

Center-invest Bank's Development Strategy. The mission statement should be concretised in specific figures in the development strategy. Center-invest Bank has always taken great care when developing its growth strategies. This has allowed us to achieve our targets ahead of schedule. The secrets to this success are:

- The numerical values for objectives and resources are calculated as variables.

- A wider range of options is included in the model, allowing us to look for balanced development scenarios.

- A SWOT analysis is conducted to analyse each option in terms of risks. This allows us to reinforce the positive aspects of a strategy and propose ways to compensate for the negative aspects.

— The strategy is not just a document for shareholders and senior management. All our employees are involved in discussing the bank's overall strategy and can see how they personally fit in to it.

— Calculations and discussions are iterative in nature, which allows the bank to coordinate the objectives, resources and persons responsible at all levels of the organisation.

— The strategy of a regional bank should be based on thorough analysis of trends, transitions and transformations in the global, national and regional markets.

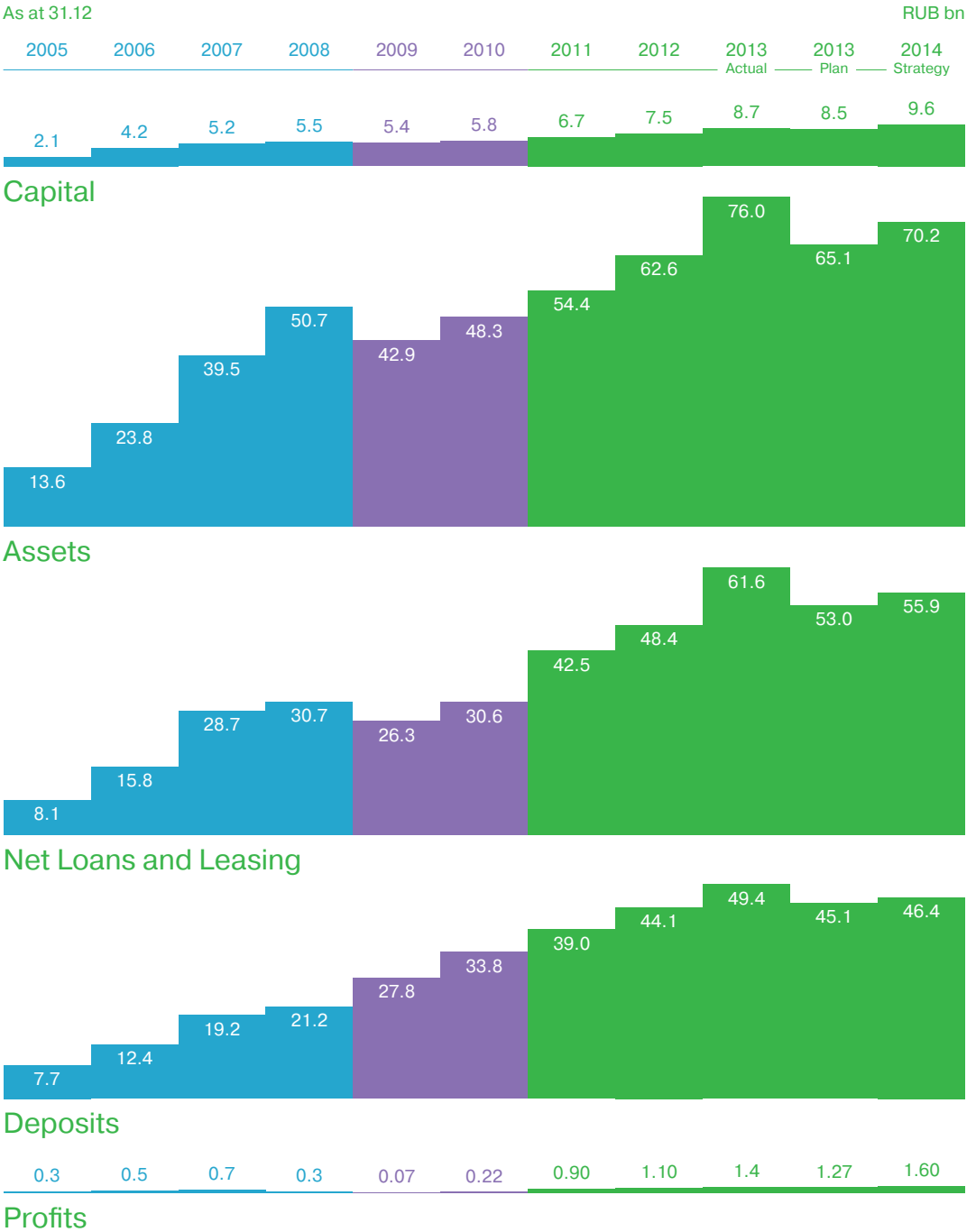
The implementation of a sustainable banking business model is supported by the interlinkage of strategic and current plans, risk analysis, and monitoring of progress with respect to specific tasks.

Case study 4. *The “South of Russia +” Strategy (2006–2008). In September 2006 Center-invest Bank’s Board of Directors approved the development strategy “South of Russia +” (2006–2008). This plan was a logical continuation of our development strategy involving the EBRD and DEG. These international financial institutions became Center-invest Bank shareholders in 2004 and 2005, respectively. The main outcome of the “South of Russia +” strategy and our work in the preceding period was the introduction in southern Russia of best international practice in banking:*

- *strategic planning, risk management and internal control;*
- *independent audit under international standards;*
- *backing of an independent international rating;*
- *participation in pilot projects run by international financial institutions (EBRD, IFC, KfW, DEG, FMO, BSTDB, OeEB) to promote energy efficiency and develop SMEs, agribusiness, trade finance and syndicated lending.*

Center-invest Bank achieved its key financial targets for the beginning of 2009 before the crisis even began.

Fig. 2.3. Implementation of Center-invest Bank’s strategies, 2005-2014



Case study 5. *The “Southern Russia Versus the Global Crisis” Programme.* Center-invest Bank presented this programme to its customers in October 2008 (http://www.centriinvest.ru/pdf/ug_rossii_protiv_crizisa.pdf and http://www.centriinvest.ru/pdf/vysokov2009_allbook.pdf). The programme set out a specific action plan appropriate to the crisis conditions, both for the bank itself and also for its customers. It was based on economic analysis, taking into account different economic theories. Its fundamental precept was that businesses could use the economic downturn during the crisis to increase their efficiency. As an indication of how well the programme was received, independent experts judged Center-invest Bank to be the most successful company of 2009 (<http://www.centriinvest.ru/ru/pr/3171>).

The bank regularly monitored different sectors of global, Russian and regional markets (http://www.centriinvest.ru/pdf/CI_invest_privlek_English.pdf, http://www.centriinvest.ru/pdf/ug_rossii_protiv_crizisa.pdf). This allowed us to decide on the best tactical approach for the crisis period, both for ourselves and also for our customers. The crisis confirmed southern Russia’s global advantages: its geographical location; its natural and climatic conditions; its relatively well-developed infrastructure; its experienced and skilled workforce; its diversified economy, producing goods that are competitive in terms of price-to-quality; and the sustainability of Center-invest Bank’s business model, with its focus on long-term rather than speculative profit. Center-invest Bank strengthened its customer base, took timely measures to manage risks during the crisis; met all its obligations to its partners on time and in full; and continued developing its operations in the new market conditions.

If we view the global crisis as an “objective” factor, then Center-invest Bank made full use of the “subjective” factor: it raised funds from its shareholders, partners and customers in good time. This allowed it to maintain a large liquidity cushion and to continue lending to its customers, concentrating on the most effective SME projects, agribusiness, energy efficiency technologies, and priority lending to bank depositors.

The time that has passed since the crisis began has underlined:
– the efficacy of Center-invest Bank’s business model, balanced in terms

of assets and liabilities, maturities, products, and geographical presence;
– *the bank’s ability to analyse in depth both the surrounding business environment and business processes; and*
– *the willingness of the bank’s team to mobilise all their energy and knowledge in the interests of professional and responsible work.*

Stress testing in a real crisis provided further confirmation that Center-invest Bank is right to incorporate sustainable development principles in its work:

– *Sustainable development starts with the personal belief of each individual that this path can provide for their own current and future needs and for those of their children and grandchildren.*

– *“Ideas are stronger when they are taken up by the masses”. Therefore, we must educate people in the ideas, methods and practical experience of introducing sustainability principles.*

– *Taking into account the risks, sustainable development models are more economically advantageous, especially if you view your business in terms of long-term rather than immediate profitability.*

– *Sustainable development requires a global approach by every business, an understanding of personal responsibility for global processes, and the application of best international practice in management methods and systems.*

Case study 6. *The Post-Crisis Development of Southern Russia (2011-2014). This strategy entailed the use of southern Russia’s competitive advantages to help the region adapt rapidly to change, during a challenging time of “W”-shaped economic recovery in different countries, regions and sectors.*

The bank’s successful work contributed to southern Russia’s dynamic economic growth and the region’s increased role in the Russian economy as a whole.

In the last ten years, southern Russia’s per capita exports and imports

have increased six- to tenfold. The structure of production and consumption in the region is approaching that of European countries, and this process is accelerating. For example, whereas there were previously four times as many motor vehicles per 1000 inhabitants in European countries as in southern Russia, there are now only twice as many. And the number of mobile phones per 1000 inhabitants is 1.5 times higher in southern Russia than in Europe. However, when it comes to introducing innovations, southern Russia lags eight times behind Europe, and local businesses are three to five times less efficient than companies applying best international practice. This creates good opportunities to finance our customers' projects.

Southern Russia's banking sector has been growing rapidly: branches of banks from cities outside southern Russia have replaced independent credit institutions, and the share of branches per capita now exceeds the Russian average. Southern Russia accounts for 10.5% of retail lending in rubles, 3.4% of foreign currency retail loans, 8% of business lending in rubles, and 5% of foreign currency business loans. These indicators have increased 50-100% in the last ten years and have good growth potential.

Despite the marked increase in the role of state-owned banks throughout Russia's banking sector, Center-invest Bank has managed to increase its share of the banking services market held by local banks and retain its market share among all the banks operating in southern Russia.

Table 2.2. Center-invest Bank's Share of the Banking Services Market in Southern Russia

		2005	2006	2007	2008	2009	2010	2011	2012	2013
Among all banks	Loans	3.5	4.2	4.8	4.1	3.6	3.7	4.3	3.6	3.7
	Deposits	3.2	3.6	4.1	4.0	4.0	4.0	4.0	3.9	3.8
Among local banks	Loans	18.9	24.5	29.8	31.1	30.8	36.3	38.1	36.6	37.5
	Deposits	18.2	19.5	20.8	23.3	22.8	29.2	29.7	29.4	28.5

The bank's track record of successfully resolving problems is a competitive advantage in the light of new challenges.

2014-2017 Development Strategy. The bank's new strategy has been produced at a time when there are no positive trends on the global, national or local markets. On the contrary, all the trends show that negative expectations have persisted or even worsened. The key indicators in the strategy have been calculated with due regard for the risks assumed by the bank, observance of sustainable development principles, and the competitive advantages offered by the progressive customer base cultivated by the bank.

The global setting: the crisis is over, but problems remain. Despite the assurances of the G20 leaders that the crisis is over, the prospects for the global economy remain uncertain:

- It is unclear which new scientific developments, and from which sectors, will create new technology platforms.
- Changes in financial mechanisms to transform savings into investments are not evident.
- There is a very wide range of possible scenarios for economic regulation, the legal framework for the economy, and domestic and international policy.
- Development in the countries that are part of traditional groups is heterogeneous; the gap between the leaders and the outsiders in each group is increasing.

Given this uncertainty, the optimum outcome is continued growth within the current economic trends, but with immediate receptiveness to any innovations in different spheres and regions.

Development of the Russian economy: stagnation is worse than a crisis. The scenarios for the development of the Russian economy assume that competitiveness will increase due to a slowdown in growth of primary energy and infrastructure costs and some redistribution of revenues in favour of manufacturing sectors.

Even these modest economic development rates will require major institutional reforms in Russia. Although such reforms are announced publicly, little is being done to implement them. Stagnation is worse than a crisis: there is a way out of a crisis, but stagnation can persist for a long time.

Southern Russia: even the deepest crisis is not universal. Thanks to its diversified economy, southern Russia adapts more quickly to any

changes on global markets: the region can be active both in purchasing high-productivity technology and equipment from developed countries, and in selling agricultural produce and manufactured goods on domestic and external markets. These same advantages hold true for the strategic positioning of southern Russia in relation to the other regions of the Russian Federation. Historically, development in southern Russia has been more dynamic than in the Russian Federation as a whole. This trend continues, even although the Russian economy officially entered a period of stagnation in 2013.

Small business in southern Russia continues to play a leading role in the region's economic development, pursuing active investment policies.

Development of the banking sector: in search of a new business model. Most analysts are anticipating that the banking sector's operational environment will worsen due to:

- lower economic growth rates and a slowdown in lending rates;
- stricter regulatory requirements;
- elevated risks in the business models of many market participants;
- domination of state-owned banks;
- the reduced asset quality, higher provisions and insufficient capital of many banks;
- the assets concentration of certain banks, including among borrowers affiliated with these banks;
- increased reputational risks in the sector due to criminal incidents involving certain banks;
- reduced profitability of banking;
- periodic liquidity problems of certain market participants;
- the additional risks and the conflict of interests involved in government support for borrowers and banks;
- risks of a run on deposits resulting from panic and disinformation campaigns;
- capital outflow due to armed conflict exacerbating the geopolitical situation.

Against this negative background, the Bank of Russia is resolutely taking measures to reform the banking system:

- cleaning up the banking sector by removing unscrupulous players

from the market;

- transition to regulation on the basis of Basel III principles;
- using special solutions to regulate certain products (express lending, deposits);
- forming a mega-regulator responsible for regulating banks, insurance companies, securities market participants, and microfinance organisations;
- reducing the number of Bank of Russia territorial departments, and implementing other organisational and personnel solutions.

Under the Strategy for the Development of the Banking Sector of the Russian Federation for the Period to 2020 (still to be finalised), the priorities for the banking system and banking supervisory bodies will include:

- ensuring that the activities of credit institutions are open and transparent;
- making bank reorganisation simpler and less expensive;
- creating the optimum conditions for development of a banking system that meets the needs of retail customers and SMEs;
- developing the microfinance system.

This is not the first time that such objectives have been set. However, implementation is fragmented and contradictory. This is reflected in the Main Areas of the Single State Monetary Policy of the Bank of Russia in 2014 and for 2015 and 2016:

- Efforts to control inflation are hampering economic growth.
- The lack of structural reforms is hampering the development of the banking sector.
- Inflation targeting is accompanied by transition to a floating exchange rate.
- Investment is being constrained by a lack of long-term sources of funding.
- The demographic situation is strained, and the risk of unemployment is increasing.
- Restrictions on tariff increases are reducing opportunities to modernise infrastructure.
- The rates of return on markets that have completed quantitative easing programmes are reducing investor interest in developing markets.
- Retail lending is attended by growing risks and likely restrictions on loan interest rates.

- Exports continue to be concentrated in the raw materials sector.
- Although a key rate has been introduced, auctions on the basis of this rate are not held regularly.
- The key rate and the refinancing rate will be harmonised only by 2016.
- At a time when banks are lacking capital, it is planned to introduce more stringent requirements on provisions and subordinated debt as part of capital.

Ratings agencies are taking a negative view of the prospects for the Russian banking sector:

- a slowdown in lending and economic growth rates;
- an increase in non-performing loans;
- higher mandatory reserves and exacerbation of banks' capitalisation problems;
- domination of state-owned banks;
- FOREX risks;
- capital outflow;
- reduced margins and profitability.

The reason for this negative assessment of the outlook for the banking sector is that the traditional banking model, requiring the use of temporarily available liquidity, has come to the end of its useful life. In many countries, the regulators have not only recognised this fact, but have already introduced legal requirements on ring-fencing customer funds from money for investment. There is much work to be done to educate the population about the new situation in the financial markets and to separate out payment and settlement services from investment services.

Center-invest Bank:

- knows the risks involved in the development of the Russian banking system;
- monitors best international practice in the development of banking;
- assumes only those risks that are in line with the parameters approved by its shareholders;
- effectively manages the risks that it assumes.

Solutions for challenges. The negative assessments and trends and the highly unpredictable operating environment forced us to apply a new approach when producing our 2014-2017 Strategy. We analysed the present situation in terms of products and services, operations, risk management, internal control, technical infrastructure and human resources. In each case we clearly identified the current challenges and proposed creative solutions.

Fig. 2.4. Solutions for the challenges in Center-invest Bank’s Strategy

New challenges	Center-invest Bank’s solutions
Analysis of the Present Situation	
Volatility of global markets Stagnation of the Russian economy Uncertainty about financial market reforms in Russia	Business based on sustainable banking business model, using the advantages of southern Russia’s diversified economy and entrepreneurial capacity
Product Strategy	
Small Business	
Surge of interest among speculative banks in working with small business	Modernisation of southern Russia’s small businesses, implementation of the “Start up!”, Youth Business Russia (IBLF), Business Loans for Women, and Enterprise for All programmes
Energy Efficiency (EE)	
Low energy efficiency of the Russian economy	Growth in lending for EE projects based on success stories
Uncertainty surrounding the setting of tariffs for energy resources	Financing EE projects that are invariant to tariff policy
Russian government declaration on new approaches to major housing repairs	Multiplying the number of success stories about EE lending in the housing sector
Low level of participation of the general public in EE programmes	Growth in lending for retail customers’ EE projects
Agribusiness	
Scope to increase efficiency in the agribusiness sector using its existing infrastructure and equipment has been exhausted.	Financing the modernisation of agribusiness
Low level of processing of agricultural produce	Localisation of loan programmes to increase the level of processing and improve value chains; promoting southern Russia’s agricultural produce

Chains & Organisations with Multiple Branches

Large counterparties have problems collecting payments (infrastructure, tax services, higher education institutions, public services).

Introducing modern technologies for payment collection and processing

Higher Education Institutions

Education reform in Russia

Payments and settlements for educational institutions; setting up financial literacy centres; managing Endowment Funds; educational projects for primary, mainstream and vocational educational institutions

Non-Governmental and Professional Associations

Non-governmental and professional associations are seeking to change their models and approaches.

Organisational and financial support for localisation of best international practice

Business Support for Customers

Customers are seeking to localise best international practice in their lines of work.

Organisational and financial support for the localisation of best practice

Service Packages

All areas of our customers' operations require modernisation.

Multifaceted organisational and financial support for the localisation of best international practice on the basis of service packages

Securities Trading

Reform of the securities market

Working with transparent products on the securities market to implement the bank's strategy

Retail Lending

The population is seeking to raise its standard of living by any means.

Promoting sustainable products to raise customers' standards of living

Payments and Settlements

New payment and settlement technologies

Leadership in the localisation of best international practice in payments and settlements

Operations Development

Products and services are continually updated.

Standardisation and optimisation of products and services

IT and Technical Services

Constant updating of software products and services

Developing the co-innovation partnership for the global updating of SAP for Banking to introduce best IT practice in product and service development.

Wide range of hardware options

Transparent competitive procedures based on price, quality and timescales

Risk Management

Constant changes in the operating and regulatory environment, banking products, services and delivery channels

Continually develop the methods and systems for decision-making and transaction monitoring based on international best practice

Internal Control

Increased complexity of transactions and regulatory requirements

Continually develop the control procedures with due regard for regulatory requirements and market conditions. Adopt decisions, make organisational changes, and revise regulations on the basis of the results of control activities.

Cross control by department and branch staff and participation in upgrading the IT system.

Human Resources

Higher demands placed on staff in a sustainable bank

Develop the corporate culture and transparent procedures for career growth based on employees' professional and personal qualities, continuous staff training, active social policy

External Communications and Social Projects

New information technologies and spaces

1. Fill the information space with content using new technologies and aggressive marketing of sustainable banking.
2. Implement social and educational programmes.

Raising Capital and Capital Structure

Shortage of resources on the financial markets and capital markets

Organic growth and raising funds from various sources in a balanced manner

2.4. Transformational Risk Management

Regulators issue detailed recommendations on calculating the risks in banking activities. However, these calculations will not in themselves save banks from risk. The transformation of risk management requires: substantive analysis of risks, a combination of risk assessment methods, interlinkage of all aspects of risk management, and a clear idea of the costs of risk management and the results that can be achieved. Moreover, in today's world, a transformational bank must manage not only its own risks, but also the risks of the external environment.

Managing risks: substantive analysis. All banks profess their commitment to risk management, but, as experience shows, such declarations will not save you in a crisis situation: a speculative bank will assume any risk that for the time being is covered by a large margin. Moreover, the mathematical tools used to manage risk on the basis of statistical methods often conceal a lack of proper understanding of how risks affect operating processes, including those in the banking sector. And in banking, risks are determinants.

Case study 7. *The Basel Committee recommends that data from a period of at least seven years be used to construct reliable parameters for a bank's performance indicators. This leaves the question: seven years before the crisis?...during the crisis?...or after the end of the crisis?*

Most of the statistical models for risk management used by banks assume a normal distribution of indicators and an infinitely large sample to calculate the parameters of these distributions. However, this assumption does not reflect reality, and so devalues and casts doubt upon the reliability of many risk management systems. This is especially true at a time of rapid change in the external environment, when random processes, even with a high degree of approximation, cannot be seen as static, and one event on the market can easily end all the mathematical games, unless they are backed up by an in-depth understanding of the situation and trends, and by stress testing.

To escape these contradictions, we have to use small samples and short-term data series, processed using special data analysis methods, as well as expert assessments by specialists with many years of practical experience. Calculations should be supplemented with substantive analysis using data from a large number of external sources.

Sustainable risk management requires a combination of formal and realistic procedures for risk calculation to be applied at all levels of the organisation when taking decisions, both in the planning stage and in day-to-day operations.

In addition to traditional statistical methods, focusing on large quantities of sample data, Center-invest Bank uses robust methods to obtain assessments based on small samples. Equally important are the expert assessments by the bank's own staff, as they know their customers and the risks in specific sectors!

Risk management at Center-invest Bank is based on transformational banking principles. It is not simply a means of overseeing the quality of the work of our divisions and branches. Rather, it is a comprehensive set of measures designed to protect the bank's assets and achieve the best possible risk/return ratio.

The main aims of the risk management system are:

- increasing the bank's assets with due regard for the risks;
- ensuring that risk exposures are covered with sufficient provisions and capital;
- managing risks and ensuring that they do not exceed the specified limits;
- supporting the decision-making procedures for accepting risks;
- optimising business processes with due regard for risks;
- developing risk management procedures and methods;
- protecting the bank's property interests and enhancing its image.

Risk management: integrated approach. Center-invest Bank's transformational risk management strategy envisages that:

- the bank will accept risks involved its business areas and products, with due regard for the risk/return ratio;
- priority will be given to developing lending because this is the type of risk that the bank can control most effectively;
- the market risks of assets will be minimised and regularly revalued;
- risks will be taken into account when evaluating performance in different business areas;
- capital and provisions will be managed effectively.

Center-invest Bank's risk management policy is approved by the Board of Directors and sets out: the risk management strategy and the procedures for its implementation; the areas and types of risks that must be monitored; and the procedures for interaction between business units in managing risks.

Center-invest Bank's risk management system covers the whole spectrum of risks arising from the different areas of our operations. It provides for:

- thorough assessment of borrower risks as part of the lending decision-making process;
- timely decisions in order to achieve the targets in the business plan at a time of rapid change in the external environment;
- prevention of NPLs and monitoring of collateral;
- effective work with problem loans and NPLs;
- assessment and management of market risks, including currency,

stock market and interest rate risks;

- monitoring and management of liquidity risks to ensure a balanced asset-liability structure and diversified sources of funding;
- monitoring and management of operational risks;
- anti-fraud monitoring;
- information security;
- coverage of risks with sufficient capital and provisions in line with the requirements of the national regulator and the Basel Committee for Banking Supervision.

The bank's risk management system exists independently of its business divisions. This means that objectively sound solutions can be found promptly, and the bank has the flexibility to make the necessary changes in its business areas.

Center-invest Bank's Risk Management Strategy has been approved by the Board of Directors. It regulates the bank's risk management procedures and reflects Bank of Russia requirements, Basel approaches, and our own *many years of experience in managing regional risks*. That is, it is based on a transformational banking business model and entails:

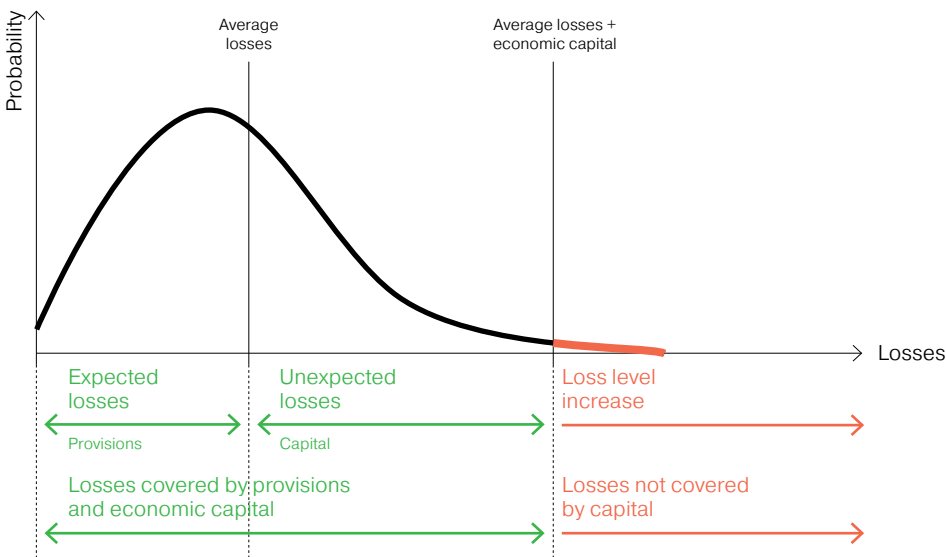
- minimising risks by rejecting speculative transactions in favour of lending to retail customers and the real economy;
- knowledge of markets and regional risks;
- promoting best international practice to develop our customers' businesses;
- effective decision-making procedures;
- the use of low interest rates, a broad product line and flexible lending terms to ensure the growth and quality of the bank's loan portfolio;
- priority lending to retail customers and SMEs on the basis of proven technologies and know-how, which ensure the optimum risk/return ratio;
- a wide range of products and services for different customer groups, with flexibility for customisation and bundling based on comprehensive risk assessment and risk optimisation;
- comprehensive application of a collateralisation system, setting lending limits, and monitoring borrower risks;

- the use of sustainable and diversified sources of funding;
- continual development of risk assessment methodologies, tools and technologies.

The bank studies global, national and regional economic trends in depth and analyses their impact on regional and sectoral risks. This has allowed us to minimise the systemic and strategic risks of our operations at a time when global markets are highly volatile, and to meet customer needs.

Coverage of Risks by Capital. Center-invest Bank’s risk management system ensures that both the bank and its customers develop sustainably and that shareholder and depositor investments are protected. The risks assumed by the bank are covered by sufficient provisions and capital.

Fig. 2.5. Coverage of risk by capital



With respect to the risks assumed by the bank, this means that probable, expected losses are covered by provisions created out of profits, and unexpected losses are covered by the bank’s capital.

Center-invest Bank’s capital is allocated between credit, market and operational risk. We use the following algorithm to allocate capital:

Operational risk capital is calculated and set aside using the basic indicator approach. The remaining capital is allocated between credit and market risks in accordance with the ratio set by the Board of Directors.

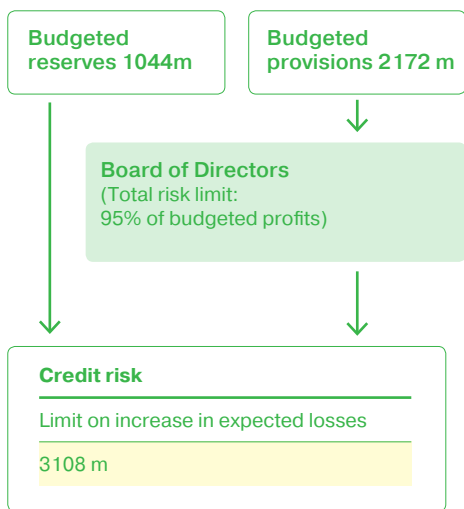
The calculated capital levels are then tested against the real credit and market risks.

The bank's focus on the real economy and its knowledge and effective management of regional risks are drivers of its sustainable, organic growth. The sustainability of the bank, within the framework of its chosen business model, is indicated by the risk-based capital ratio. This is calculated as part of self-regulation, using an internal methodology based on Basel II requirements.

Fig. 2.6. Allocation of capital by risk type

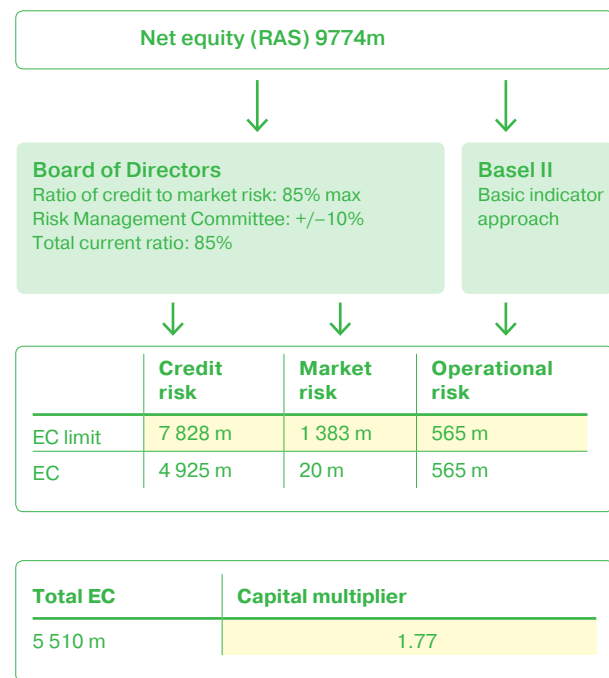
Aggregate risk

(Limit on the increase in expected losses covered by provisions)



Capital allocation

(Coverage of unexpected losses
Basel II economic capital (EC))



The bank *monitors and reassesses risks*. It uses the *full range of risk management methods* recommended by the Basel Committee: it refrains from conducting certain operations and transactions; it uses limits, collateral, insurance, hedging, and securitisation; and it covers its risks with sufficient provisions and capital growth.

Center-invest Bank: managing the main types of risk

The bank assesses credit, market and operational risks, and also liquidity risks. These are the main types of risk involved in its operations.

Managing credit risk. As has already been noted, given its chosen business strategy, the main risk to the bank is credit risk. Managing credit risks entails:

- Verifying information obtained from customers and other sources;
- Individual assessment of applicants for business loans;
- Observing the one obligor principle (Economic One Obligor);
- Creating and properly valuing a collateral base;
- Monitoring borrowers and their collateral;
- Using different decision-making procedures as appropriate for the product, sum and risk involved;
- Allocating sufficient provisions and capital to risks.

Managing market risk. The bank uses the following methods to manage market risks:

- Monitoring currency positions;
- Monitoring and managing the trading book;
- Assessing VaR.
- Interest rates GAP analysis;
- Assessing vulnerability of net interest income and cost of capital to interest rate changes;
- Stress testing;
- Allocating adequate capital to market risks;
- Maintaining the smallest possible open currency positions.

Managing liquidity risk. The Committee for Assets and Liabilities Management and the Treasury and Financial Markets Department are

the main bodies responsible for the bank's liquidity management. They use the following tools to manage liquidity risk:

- assets management, including creation of a reserve of highly-liquid assets;
- liabilities management;
- monitoring liquidity ratios;
- diversification of sources of finance;
- liquidity crisis contingency planning.

Managing operational risk. The bank uses the following mechanisms:

- Constant monitoring and improvement of processes and internal procedures;
- Identifying and classifying operational risks;
- Developing regulations and measures to reduce operational risks;
- Gathering and storing information on actual operational losses;
- Business continuity planning;
- Allocating sufficient capital to the bank's operational risks;
- Insuring operational risk;
- Verifying information and fraud prevention;
- Internal security procedures and operational environment safety;
- Internal audit and monitoring compliance;
- Information security and systems audit;
- Managing and training personnel in order to reduce personnel risks and potential human error.

Therefore, Center-invest Bank's risk management system:

- covers the whole range of risks arising from the bank's areas of activity;
- is appropriate for the bank's risk exposures;
- is consistent with international risk management standards;
- focuses on the risk/return ratio;
- can guarantee business continuity and allows for the bank's rapid growth and the expansion of its branch network.

Managing environmental and social risks. The bank includes environmental and social risks in its overall risk assessment of each project. The bank aims to finance projects that:

- are socially and environmentally sustainable;
- respect the rights of workers and the local population;
- are developed and implemented in accordance with regulatory requirements and best international practice.

To this end, the bank has operational procedures to:

- analyse projects;
- help customers develop measures to avoid or mitigate adverse social and environmental impacts;
- identify opportunities to obtain additional environmental or social benefits;
- monitor compliance with environmental and social obligations during project implementation.

The bank classifies the project by risk level. It does this on the basis of international standards for assessing environmental and social risks, and taking into account the sector, the loan amount and term, loan security, and the customer's experience. The risk level is then taken into account when making a loan decision. Relatively high-risk loans account for no more than 6-8% of the bank's total lending. The bank's Environmental and Social Policy includes an Exclusion List specifying the types of projects that we will not finance.

Center-invest Bank's credit agreements stipulate that borrowers must comply with applicable legislation. Moreover, the criteria in the bank's Environmental and Social Policy are applied when assessing all loan applications. Social risks are also considered, including observance of human rights. The obligation to observe human rights is stipulated in the agreements signed by the bank when it raises funding from its international partners.

The price of managing customer risks. Today, virtually no one views lending as the use of temporarily available liquidity. Bank managers love to say that they buy and sell risks. The global crisis clearly showed how this ends. It would be useful were there even a little genuine management of banking risks between buying and selling. Unfortunately, the arsenal

of risk management methods recommended by the Basel Committee is not very varied: rejecting risk altogether; using risk limits; taking collateral, which will devalue together with the asset in the event of default; using insurance to share risks; hedging; securitisation; paying for risks by creating provisions and covering risks with capital. What would the interest rate be if it included risks?

Consider the simplest situation when an asset carried in the balance sheet at its nominal value A_n may be lost with default probability p . In this case, the real (i.e. risk-adjusted) asset price A_p will be lower than its nominal value: $A_p = A_n(1 - p)$. Accordingly, the price of the risk-adjusted liability A_l will be higher than the nominal value shown in the balance sheet: $A_l = A_n/(1 - p)$. Presented in numerical form, the dependence of price on risks looks as follows.

Table 2.3. Impact of Risks on Price of Assets and Liabilities

Risk level, %	P	0	2	5	10	20	50	70	90	100
Nominal asset, RUBm	A_n	100	100	100	100	100	100	100	100	100
Risk-adjusted asset, RUBm	A_p	100	98	95	90	80	50	30	10	0
Risk-adjusted liability, RUBm	A_l	100	102	105	111	125	200	333	1000	∞

As interest r calculated on the nominal value is to be paid for obligations, the amount of interest can easily be found from the equation $An(1+r) = A_n/(1 - p)$. Hence the interest rate dependence on risk is: $r = p/(1 - p)$. In graph form, the interest rate increases as the risks increase, and it goes to infinity when the asset loss risk approaches 100%.

Table 2.4. Interest Rate and Risk

Risk, %	P	0	1	2	3	4	5	6	7	8	9	10	20	50	70	90	100
Rate, %	R	0	1	2	3	4	5	6	8	9	10	11	25	100	213	733	∞
Change in rate	Δ	0	1	1	1	1	1	1	1	1	1	1	2	4	9	64	∞

The current Bank of Russia key interest rate gives 7% risk for the Russian economy. The MosPrime6M¹⁵ rate (approx. 10%) corresponds to 9% risk for the Russian financial market.

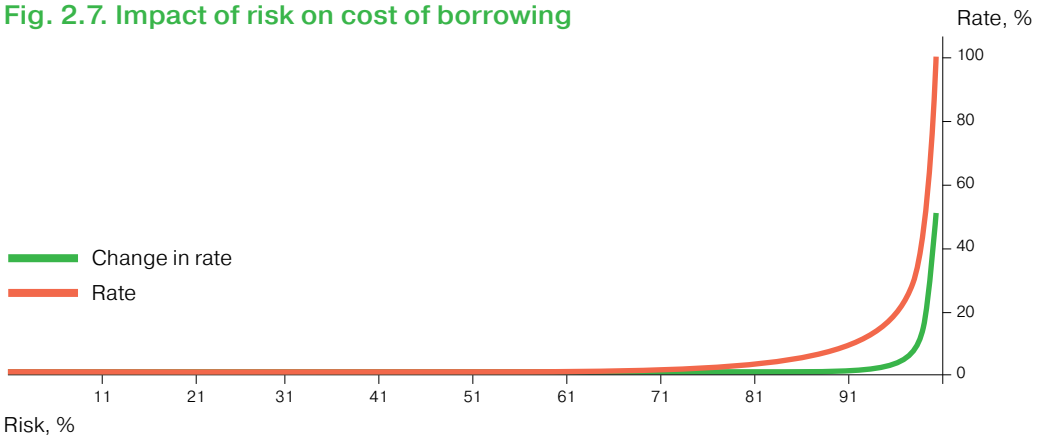
In speculative banking, the growth in risks is used as an argument

15. MP6M (MosPrime Rate 6 months) is an indicative rate calculated by the National Currency Association.

to increase loan interest rates. This is passive risk management: what you bought it for, you sell it for. In transformational banking, the creditor is willing to incur the costs of measures to reduce customer risks, for example, working through customer proposals in more detail. Crucially, with this approach, both the bank and the borrower win: by spending just a little on reducing risks, the bank can reduce loan interest rates for its customers, and it can also reduce its provisions, as lending to a properly prepared customer is less risky.

The diagram shows how risks affect interest rates (first derivative). The curve is flatter at the low risk end of the diagram, but then starts to rise sharply at the high risk end. Bankers are familiar with the latter situation: in the event of a customer default, the bank has to pay many times over for risks that were not previously accounted for.

Fig. 2.7. Impact of risk on cost of borrowing



In speculative banking it is hard to escape the spiral of “high rate – high risks – large provisions – higher rates for new borrowers”. However, in transformational banking, low rates increase demand. This allows transformational banks to select the best quality, lowest risk customers, who will use the funds for effective projects and repay their loans on time.

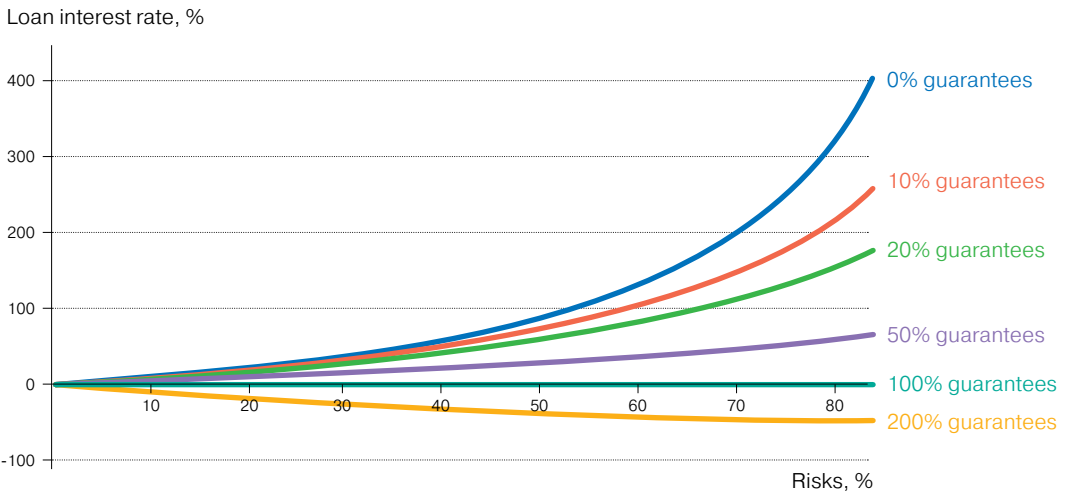
Loan interest rate dependence on risks and guarantees. In normal conditions, collateral reduces risks to $p' = p(1 - g)$, where g is the proportion of the risk that is covered. Accordingly, collateral should reduce the loan interest rate to $r' = p(1 - g) / ((1 - p)(1 - g))$. This relationship is illustrated below.

Table 2.5. Impact of Guarantees on Loan Price

Guarantees	0%	10%	20%	50%	100%	200%
Risks						
0%	0%	0%	0%	0%	0%	0%
5%	5%	5%	4%	3%	0%	-5%
10%	11%	10%	9%	5%	0%	-9%
20%	25%	22%	19%	11%	0%	-17%
50%	100%	82%	67%	33%	0%	-33%
70%	233%	170%	127%	54%	0%	-41%
90%	900%	426%	257%	82%	0%	-47%
100%	∞	900%	400%	100%	0%	-50%

It should be noted that quite often the real reason for the higher loan security requirements of speculative banks is that they want to seize the collateral. However, we should also remember that in crisis conditions, not only does the value of a loan fall, but so too does the value of the associated security (equipment, real estate, commodities).

Fig. 2.8. Guarantees and risks



Moreover, in a crisis, collateral liquidity falls sharply. This increases the time taken to sell the collateral, the costs of storing it, and the discounted value of money received after a long interval.

2.5. Transforming Products for Businesses

Center-invest Bank is a leader in Russian and regional markets for sustainable banking products: loans for SMEs, energy efficiency, agribusiness, and inclusive finance. In transformational banking, even excellent results and leading market positions are not grounds for complacency and self-satisfaction: new summits open new horizons, and this is reflected in the new objectives in Center-invest Bank's product strategy.

The sustainable lending business model entails considerable preliminary work to analyse efficacy and risks, and to help customers localise best international practice so that they can produce globally competitive goods and services. This preliminary work allows the bank to offer customers loan interest rates that they feel more comfortable with. It also reduces project implementation risks and provides for a high-quality loan portfolio.

The bank establishes strategic relationships with its customers. We continually offer new products to enable our customers to remain competitive in a changing economic environment.

We offer a wide range of loan products, including: overdraft facilities, credit lines, trade finance for imports of goods and equipment, project finance, leasing, bank guarantees, guarantees for customs agencies, and counter guarantees.

Small and medium-sized enterprises. Center-invest Bank has worked with small business since 1997. As well as "pure" banking products, we also offer our SME customers non-financial services: consultancy on accountancy, business planning, marketing and legal issues. Center-invest Bank's work has been commended by its customers, government authorities, development institutions and market participants. The bank has approximately 50,000 SME customers, accounting for 45% of its loan portfolio. Center-invest Bank is one of the top 16 Russian banks by volume of SME lending. We have successfully implemented all of the SME lending programmes proposed by our banking partners (the EBRD, IFC, KfW) and we work effectively with the SME Loan Guarantee Funds for the regions of southern Russia in which we operate.

During our many years of working with SMEs, we have managed to overcome many stereotypes and formulate a new ideology for small business¹⁶. We have also expanded on the latest thinking on the transformation of small business, whereby networks of small companies will replace transnational companies.

Small business: old stereotypes and new ideology

Stereotype 1. Small business is ineffective.

New ideology:

Small business growth is based on efficiency rather than increases in scale.

- Small business will exist in any economy.
- Small business is an equal business partner, not a small one.

Stereotype 2. Small business is part of the shadow economy.

New ideology:

- A shadow is cast on small business by bad laws.
- The nature of business is dictated by the nature of the government.
- The extent to which small business operates in the shadow economy is an indicator of the level of corruption.

Stereotype 3. Small business needs government support.

New ideology:

- The government needs the support of small business.
- If small business did not stand between the authorities and the people, the people would demand a change in the ruling power.
- The legalisation of small business is an economic growth factor.

Stereotype 4. Globalisation is destroying small business.

New ideology:

- Small business makes better use of the advantages of global technologies.
- International policy is increasingly taking into account the interests of small business.
- International projects subcontract work to small business.

16. http://www.centriinvest.ru/files/articles/pdf/start_up_don.pdf

Small business: the latest ideology

Market approach	Latest ideology
Removing the distinctions between big and small business	Exclusiveness of small business
Creating jobs	Creating new technologies
Competition between independent businesses	Cooperation between small businesses
Refraining from government support	Sustainable, socially responsible business
Reduced tax burden	Effective use of public funds

In the current climate Center-invest Bank will continue to promote:

- SME compliance with the law (through legal support, outsourcing accountancy services, and consulting);
- the use of Internet technologies and Internet consulting to accelerate our customers' business development;
- international cooperation among small businesses;
- the financing of energy-saving technologies.

Fig. 2.9. Center-invest Bank: Growth in number of SME customers and SME lending



In line with its 2014-2017 Strategy, Center-invest Bank:

— **reduces the risks of SME lending** by: 1) providing legal support, outsourced accountancy services, and consulting; 2) promoting the use of Internet technologies and Internet consulting to accelerate our customers' business development; 3) promoting training for entrepreneurs in secondary and higher educational institutions; and 4) promoting international cooperation between SMEs.

— **develops banking products and technologies to meet its customer requirements** for finance for modernisation projects based on best international practice; ensures flexible and prompt decision-making; conducts direct marketing of standard projects for target segments and groups; and aims to reduce loan interest rates through competent risk management.

— **is “raising” a new generation of entrepreneurs** through the “Start-up” programme; Youth Business Russia (together with the International Forum of Business Leaders – IFBL); business loans for women; engaging young people, students, and young academics; and the continued development of all forms of training for entrepreneurs, students and schoolchildren, including distance learning under the “Enterprise for All” programme (www.school.centrinvest.ru.).



Case study 8. Enterprise for All. *In its work with the SME segment, Center-invest Bank has always tried to not only multiply best international practice, but also to share and draw lessons from solutions that its SME customers have found for themselves. As part of this, the bank produced handbooks for entrepreneurs, civil servants, students and schoolchildren on the theory and practice of entrepreneurialism. These resources were published by the Rostov State Economic University with support from the bank.*

Over the years, new enterprise training centres have sprung up, where it is believed that the heavier the textbooks and the longer the classes, the better the quality of the provision. To counter this, Center-invest Bank distilled its own teachings into an online course. It set up a portal, “Enterprise for All” (www.school.centrinvest.ru), where every visitor can independently and free of charge study the key definitions and interlinkages in entrepreneurship, answer questions, and print off their own course completion certificate. In the first year alone, more than 6000 people from different countries and regions visited the portal, and more than 1000 people successfully completed the course. The bank also created an English version of the portal, which was commended by the international movement **Child & Youth Finance International**.

Case study 9. Khutor modernisation. *Historically, in southern Russia the word “khutor” (хутор) has meant a settlement that is not subject to external administrative control. From the perspective of the beau monde of Moscow, anyone living beyond the prestigious residential area of Rublevka is provincial. As for living in a “khutor”, well that is seen as almost no better than being “of no fixed abode”.*

In reality, to survive life in a khutor, you must be fit and healthy, strong in mind and body, capable of finding your own solutions to problems, and able to work without the need for party or government instructions. The main feature of khutor modernisation is that it is an independent process. People

are carrying out this process in their own ways, using their own capabilities, and despite government “assistance”. There is little media coverage of this modernisation, either in the press or on television. Khutor modernisers are not particularly interested in PR, and not just because they are used to counting every kopeck: they have already built up their businesses and will only decide to expand or advertise after very careful consideration. And of course, if they catch the eye of out-of-town “investors” or one of the numerous government inspectors, they risk losing a successful business. Modesty is a means of self-preservation. In many cases, a khutor moderniser will manage to preserve their business for the simple reason that their chosen path is a difficult one, a path on which there are no competitors. By virtue of this, Khutor modernisation should be not just a few per cent, but many times more efficient.

Outdated production equipment, facilities and methods are causing a bottleneck on the road to the modernisation of Russia. Khutor modernisation is helping to remove these blockages. Even if the equipment introduced in khutors is obsolete by international standards, it is still better than deserted khutors. Besides, the experience obtained by a new generation of khutor residents, who in recent years have had the opportunity to study abroad, creates scope for modernisation that does in fact conform to the rules of the global market.

“The khutor settlement system offers considerable technical advantages compared to the village-based system. It gives free rein to the owner’s individuality, allowing him to organise his farmstead as he sees fit, to quickly adapt to modern, changing market conditions, and to assimilate the new techniques offered by agronomic science.”

Brockhaus and Efron Encyclopedic Dictionary, 1907

Table 2.6. Center-invest Bank: SME Lending and Development Programmes

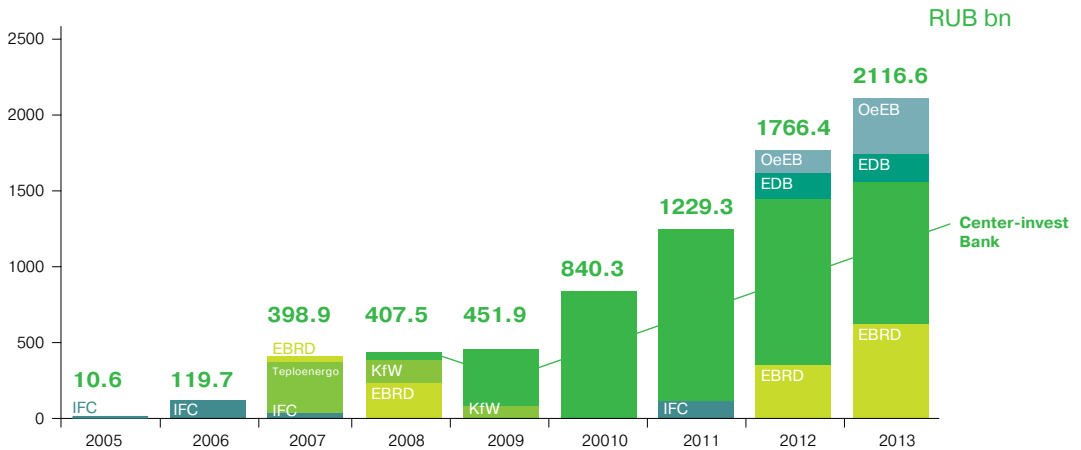
	2013	2012	2013 / 2012
Number of SME customers	49 530	44 300	+11.8 %
Number of active SME loan agreements	4 760	4 485	+6.1 %
SME loan portfolio, RUB bn	27.4	21.4	+28.0 %
Number of new loans made to SMEs during the year	4 866	3 123	+55.8 %
Value of new loans made to SMEs during the year, RUB bn	30.9	24.7	+25.1 %

Special loan programmes for SMEs	Number of loans		Value, RUB m		Number of loans		Value, RUB m	
	2013	2012	2013	2012	2013 / 2012	2013 / 2012	2013 / 2012	
“Start-up”, up to RUB3m, up to 36 months	181	116	265.7	155.3	+56.0 %	+71.1 %		
“Youth Business Russia” together with the International Business Leaders Forum (IBLF), RUB 300 000, up to 36 months	52	14	14.3	3.8	+271.4 %	+276.3 %		
Loans for businesswomen	125	78	120.0	61.0	+60.3 %	+96.7 %		
Loans in conjunction with regional guarantee funds	36	26	228.0	132.8	+38.5 %	+71.7 %		

Energy efficiency lending. The energy intensity of the Russian economy is five times higher than in developed countries. Cheap energy resources have done a disservice to the country’s long-term development prospects: outdated technologies can be used for a long time; the cost-based tariff system does not encourage suppliers to introduce new technologies; and we see corrupt schemes to manage financial flows in the energy sector. A traditional speculative bank cannot rise to these challenges, and leaves it to government bodies to address the problem. Transformational banking, on the other hand, does offer solutions to encourage customers to switch to energy efficiency technologies. These solutions are based on an integrated approach, combining technical, financial, environmental and social engineering.

Center-invest Bank has become the leader in Russia for financing standard energy efficiency projects. We work on energy efficiency programmes in partnership with IFC, the EBRD, FMO, KfW, OeEB and EDB. To date, we have financed more than 5700 energy efficiency projects in various sectors of southern Russia’s economy, with loans totalling RUB7.5bn (~ €160m). These projects have reduced CO2 emissions by 133,500 tonnes a year (equivalent to the emissions produced/absorbed by 78,100 light vehicles, 381,300 barrels of oil, or 5.3m trees). We have energy efficiency loan programmes for industry, agriculture, the service sector, homeowner associations and housing management companies, public sector enterprises, and retail customers.

Fig. 2.10. Amount of EE lending and sources of finance



Sources of finance: raised by Center-invest Bank from the market. and under its partners’ programmes: IFC. EBRD. FMO. KfW. OeEB. EDB

Case study 10. Modernisation of Teploenergo (Taganrog). In 2004-2011, together with the EBRD, the bank helped Teploenergo, the largest district heating company in the city of Taganrog, to implement a modernisation programme. The **technical engineering** component of the programme included: replacing 135 pumps, dismantling 26 old boiler rooms, constructing 12 new automated boiler rooms with remote operation, upgrading 3 central heat stations, installing 15 degassers, 3 water softening units, and 31 other pieces of new equipment. The company also upgraded and laid new heating pipes (about 50km in total), and brought into operation a 240KW cogeneration unit.

Fig. 2.11. Equipment modernisation freed up premises for a Center-invest Bank office.



The **financial engineering** component required that all the funds for leasing the new equipment be mobilised in the initial stage: overheads were reduced, and approximately RUB90m were obtained from economic development funds. The success of the project attracted the EBRD as a new investor. The EBRD contributed RUB133m to the company's capital and provided it with a ten-year RUB221m loan.

Environmental engineering. The new modern technologies reduced:

- specific gas consumption from 163.94 kg of equivalent fuel/Gcal to 157.85 kg of equivalent fuel/Gcal (**3.7%**);
- specific power consumption to generate 1 Gcal from 29.00kWh/Gcal to 15.74kWh /Gcal (**45.7%**);
- water consumption from 162,330 cubic metres to 65,250 cubic metres (**59.8%**);
- annual CO2 emissions from 489.099 tonnes to 367.66 tonnes (**25%**);
- staff numbers from 580 to 353 (**39%**).

Social engineering. Previously, payments for heating and hot water were made via municipal intermediaries, and Teploenergo received just 70% of the total money for the services provided. The company set up its own sales department, switched to direct collection of payments, and achieved a payment collection rate of 95%. With tariffs for heat based not on actual consumption, but total floor area in square metres, it appeared there was no incentive to use energy meters. However, the company explained the benefits to the local population, did the paperwork for 260 meters, and installed 76 meters.

Center-invest Bank develops loan programmes to enable customers to make energy efficiency improvements to their homes and purchase energy efficient household appliances (energy efficiency rating of A and above). Loans are available on preferential terms. The bank provides training for its employees and customers in all the regions in which it operates, and it actively promotes its experience among Russian and foreign banks.

Table 2.7. Center-invest Bank: Energy Efficiency Lending

	2013	2012	2013 / 2012
Number of energy efficiency loans made	3 563	1 412	152.3%
Value of loans made, RUB bn	2.1	1.8	19.7%
Annual CO2 emissions reduction	23 067	18 945	21.8%

Center-invest Bank’s experience of working with energy efficiency projects opened up a new promising area: providing loans for projects pertaining to “collective goods and services”: renovation of multifamily residential buildings, small infrastructure projects, and social projects. What is interesting about these types of project is that everyone needs them, but no one wants to invest in them personally. As well as modern technical solutions and clear financing arrangements, these projects require that the interests of the various stakeholders be reconciled.

Case study 11. *In 2011 Center-invest Bank made a loan for the renovation of a multifamily residential building. This required a decision of a general meeting of residents.*

When flats were privatised in Russia, it was not a requirement that the whole building and associated plots of land also be privatised. It was only a few years later that it became mandatory for residents to maintain shared communal areas in a decent condition (attics, basements, stairwells and entranceways). It is a paradox, but even after many years of being raised in the Soviet tradition, you will always find people who wish to obtain collective goods at the expense of others. After this first experience of obtaining a collective decision, Center-invest Bank went on to make loans for the renovation of 68 multifamily residential buildings. The bank became an expert for the Russian Ministry of Construction and Housing and Communal Services. It also participates in working groups and the public chambers of regional authorities, and works closely with the Association of Homeowners’ Associations and with companies managing multifamily residential buildings.

Agribusiness lending. Financial analysts consider lending to agribusiness a very high-risk activity. They are correct, if the risks are assessed in terms of weather conditions. However, sustainable banking is more interested in the climate than in the weather. The climate in southern Russia is favourable for the production of all types of crops and other kinds of agricultural produce. To reduce the risks, loans to agribusiness should be made for a minimum of five years, not just three years. In a three-year period, there could be two poor harvests, but over a five-year period, even two good harvests would be sufficient for the borrower to repay their loan.

The bank nurtures and works with the best customers in southern Russia's agribusiness sector. We help customers to use the advantages of the region's natural environment and climatic conditions and to introduce best international practice to modernise their operations. Projects include: acquisition of agricultural equipment, building and modernising production facilities and livestock farms, and purchasing livestock. Southern Russia accounts for 25% of the country's total agricultural output. At the same time, productivity of agribusiness in Russia is lower than in European countries that have comparable environmental and climatic conditions. This gap is due to the lack of modern equipment for producing, storing and processing agricultural products. With modern equipment and technologies, Russia's agricultural sector could increase its output by 50%-100%. In addition to new equipment, southern Russia requires qualified and skilled staff. This in turn requires rural areas to provide good housing, infrastructure, and access to professional training.

***Case study 12.** By introducing modern soil cultivation methods and leasing all the necessary agricultural equipment, our customers increased their grain yield by 30%, while also reducing the cost of production by 30%. With our help, customers have been able to purchase high-quality seeds and fertilisers and to apply agronomic knowledge, resulting in yields that are double the average for the region.*

Case study 13. A customer used a Center-invest Bank loan to revive a neglected apple orchard: new saplings were grown using Italian technology and an Israeli drip irrigation system was introduced. The yield increased threefold. The bank then provided the customer with a new loan to build a warehouse for storing and processing the fruit.

Case study 14. Using a loan from Center-invest Bank, a poultry factory introduced new automated technology for housing laying hens and for transporting and packaging eggs. This modernisation increased labour productivity eightfold.

The replication of these successes has enabled the bank to increase its cooperation with new players in the agricultural products market (including foreign players), and also to lengthen the value chain in the processing, transportation and packaging of food products.

Table 2.8. Center-invest Bank: Agribusiness Lending

	2013	2012	2013 / 2012
Number of borrowers in the agribusiness sector	667	600	+11.2%
Number of loans made	1 242	1 153	+7.7%
Value of loans made, RUB bn	9.2	7.5	+23.0%
of which, loans for investment purposes	1.9	1.2	+63.0%

Working with chains and organisations with multiple branches.

Although many chains are now controlled by Moscow offices, Center-invest Bank’s technologies and products have proved popular with retail chains, car dealerships, telecommunications, construction and transportation companies, and heat, gas and water suppliers. Our services include: payment collection and centralised settlements (“bank to bank”), factoring, loans for head offices and branches, and business promotion. The bank’s use of modern technologies for automated payment acceptance, centralised settlements, and online data

exchange and integration, gives it a competitive advantage. Chains are attracted to Center-invest Bank not only by its new technologies, but also by its extensive branch network. For example, any of a chain's establishments can now pay cash from the sale of goods and services into the one company current account, which is integrated with online accounting and the Bank-Client system. The bank also provides electronic settlements for the region's public sector organisations, and it can handle its customers' tax and customs payments.

Working with educational institutions. As educational institutions undergo reform, they require good banking services for the centralised management of their financial flows and organisation of payments and settlements between their subsidiaries, students and staff. As well as providing these services, the bank helps universities to set up their own small businesses. It also supports social and educational projects through the Endowment Fund for Education and Science in the Southern Federal District, Financial Literacy Centres, and a number of university faculties with which it works closely.

***Case study 15.** In 2009, together with the SAP University Alliance programme, the bank set up a SAP training centre at the Southern Russian State Technical University (Novocherkassk). The bank bore the costs of equipping the centre and connecting it to SAP AG's servers, and the university set up the training courses. In 2013, the centre was audited and became a certified SAP training provider.*

***Case study 16.** In April 2014, together with the Southern Federal University, the bank set up a Financial Literacy Centre for the general public. The chosen premises were renovated, given a modern interior, and equipped with new banking technology.*

Together with university lecturers, experts from the bank set up courses to train students in new banking technologies on the basis of sustainable development principles. Upon completing the training, the students themselves become advisors for their friends, acquaintances and local residents. They explain to members of the general public the risks and returns



for various financial instruments, and help them to understand consumer loans, mortgage loan terms and products, and mobile and online banking technologies.

A distinctive feature of a transformational bank's educational projects is that they are designed to train specialists not only for the bank itself, but also for other companies and organisations. We are always very proud when an employee of a large transnational company in another city, or even in another country, says they are glad they took part in one of our educational programmes or received a scholarship from the Endowment Fund for Education and Science in the SFD. In expressing their gratitude, people who have experienced transformational banking first hand are not simply reminiscing fondly about the past; they are showing a commitment to our common future.

Transformational Marketing. Like in a parable from the Bible, a transformational bank does not simply promote new products and services to “feed” its customers, but also aims to teach them how to continually transform their businesses themselves. To help us design new products to support our customers’ post-crisis growth, we regularly monitor Russian legislation and federal and regional programmes. In addition, we systematically hold briefings for our customers and advise them on important issues relating to legislation, taxation and business planning.

With a high level of market uncertainty, an inconsistent economic policy, and complex processes of transformation in various spheres of life, the bank must actively engage with government bodies and non-governmental and professional associations. The bank participates in events held by government bodies, committees, commissions and working groups in every region in which it operates. It tries to both explain the new challenges and also put forward its own solutions.

Center-invest Bank uses direct marketing to ensure that it reaches its customers and has the opportunity to finance their modernisation projects. We use leasing, combinations of structured and project financing (partly by attracting long-term funding from international banks and agencies), and the public-private partnership mechanism. The replication and sharing of customers’ experience of localising best international practice in southern Russia gives fresh impetus to continual innovation. It also allows the bank to spot new market niches early, to automate and offer its customers comprehensive business support, and to provide integrated solutions with new products and service packages.

International Trade Services. Center-invest Bank processes foreign currency transactions for its business customers who have international trade contracts. In accordance with Russian legislation, the bank holds “transaction certificates” as evidence that the transfer of funds is legitimate.

Center-invest Bank works continually to boost southern Russia’s import and export trade. We organise special seminars and networking meetings where Center-invest Bank customers can meet customers of

our foreign partner banks. Together with our partner banks, we arrange for our customers to visit trade fairs abroad in order to make new business contacts and sign new contracts.

Table 2.9. Center-invest Bank: International Trade Services

	2013	2012	2013 / 2012
Volume of transactions under international trade contracts			
USDm	335.0	281.0	+19.2%
EURm	55.0	63.7	-13.7%
RUBm	5 750.0	5 660.4	+1.6%



Center-invest Bank's awards from its partners: Citi bank and Commerzbank

Guarantees. One of the new trends in the transformation of banking products is that some customers are turning away from loans in favour of guarantees. Banks incur the same risks with guarantees as they do with loans; they set aside provisions for the contingent liabilities; and the income received is comparable to that from lending. However, in contrast to lending, guarantees do not require additional funding.

Table 2.10. Center-invest Bank: Guarantees

	1H2014		2H2013		1H2013		1H2014 / 1H2013,%	
	number	value	number	value	number	value	number	value
Guarantees issued	934	1 612.734	577	1 342.443	495	997.456	+88.7	+61.7
Guarantees in force	1 086	2 550.983	574	2 083.256	585	1 965.585	+85.6	+29.8
Income		31.3		28.7		21.5		+45.6

2.6. Transformational Banking for Retail Customers

Sustainable Lending. Personal income in southern Russia is 20-30% lower than the Russian average. Moreover, the provision of retail banking services in southern Russia lags three to five times behind the level of provision in European countries. However, this does not justify the use of “new” speculative express lending practices. While such practices enable a bank to build up its loan portfolio more rapidly, scratch below the surface and you will see deceitful, inflated interest rates, future defaults, and the personal tragedies of real people. In response to the drive by speculative banks to increase express lending, Center-invest Bank has had to work hard to increase the financial literacy of the general public.

The sustainable development business model assumes that a bank will have a balanced policy on accepting retail deposits, retail lending, and educating retail customers about modern financial products.

From the outset, Center-invest Bank has been very careful in its approach to retail lending. For our retail products (consumer loans, car loans, mortgages) we have standard mandatory procedures to assess whether the borrower and their family have a steady income, the interests of the borrower’s relatives, and the borrower’s own immediate and long-term plans. With all our loan programmes, both at the advisory stage and loan agreement stage, we inform customers of the total cost of the loan, including all possible additional costs for issuing and servicing the loan (such as compulsory insurance, the cost of valuing real estate, and annual service charges for bank cards).

Apart from our branch network, Center-invest Bank’s main advantages in this sector are: our use of plastic cards; our methods and techniques to promote our customers’ sustainable development; and the fact that we are ahead of the competition in developing standard products for retail customers in southern Russia. Among the top 100 Russian banks, Center-invest Bank is in 50th place for retail customer deposits and 44th place for retail lending.

Table 2.11. Center-invest Bank: Retail Lending

RUB bn	2013	2012	2013 / 2012
Retail loan portfolio	26 296.6	19 108.2	+37.6%
Consumer loans	14 718.0	10 383.9	+41.7%
Mortgages	9 528.7	7 469.7	+27.6%
Car loans	1 717.3	1 210.6	+41.9%
Bank cards	332.6	44.0	+755.9%

When we develop new retail loan products, we aim to make loan applications and loan repayments as simple and straightforward as possible for our customers. This is not an entirely easy task given the growing regulatory requirements. In addition, we have to factor in the risks of customer default, and also the risks in the real estate, car and consumer goods markets.

As a transformational bank, we use new technologies and approaches to address these problems. We are:

- working more extensively with credit history bureaus to reduce the risks of lending to unscrupulous borrowers;
- stepping up development of new banking products based on bank cards and mobile and Internet technologies;
- running programmes to increase the financial literacy of the population, for example, installing a credit calculator on the bank’s website;
- introducing personal finance management programmes for low- and middle-income customers.

Case study 17. By saving electricity, energy-efficient light bulbs also save money. As such, they could particularly benefit low-income families and pensioners. However, these bulbs cost more than ordinary bulbs, and so pensioners cannot afford them. On IFC’s recommendation, Center-invest Bank purchased 3000 energy-efficient light bulbs and set about developing a standard loan agreement. It turned out that the anticipated income would be cancelled out by the cost of all the paper needed to draw up the

agreements in accordance with regulatory requirements. So we decided to give the bulbs away free of charge to the veterans who bank with us. These elderly customers were delighted with this unexpected gift. Moreover, they became active proponents of energy-efficient light bulbs and energy-saving domestic appliances in general. Meeting on the benches outside their apartment buildings, the veterans set up mini “Speakers’ Corners” (like in Hyde Park) and discussed in public how to save energy and money. This drew the general public’s attention to the idea of loans to purchase energy-saving appliances.

In 2013 Center-invest Bank changed its procedures for agreeing bank card loans. Credit limits can now be agreed with just one visit to the bank. This generated a more than sevenfold increase in the value of the credit card loan portfolio.

Table 2.12. Center-invest Bank: Bank Card Loans

	2013	2012	2013 / 2012
Number of credit limits	14 493	1 213	12-fold increase
Value of limits agreed, RUB bn	1.2	0.1	12-fold increase
Outstanding balances, RUB bn	0.3	0.04	7.5-fold increase

Attracting Retail Deposits and Servicing Retail Customer Payments. The highly volatile and unpredictable markets, as well as unexpected decisions by the regulator, are causing the general public to disapprove of, and increasingly distrust, existing banks and financial institutions. Transformational banking must provide specific responses to these challenges and offer new solutions to transform retail customers’ savings into meaningful investments. In these conditions, Center-invest Bank is attracting retail deposits to finance effective projects in southern Russia (both retail and business customers’ projects). When retail customers see not only the interest on their deposits, but also the results achieved by a bank using these deposits to finance specific projects, they trust the bank more. However, process-based solutions are also required, which enable the bank to develop new products and

services based on transformational banking:

- segmentation of products for different depositor categories: parents, veterans, young people, entrepreneurs;
- flexibility to modify the forms and types of deposits: by term, interest rates, interest payment schedules, and purpose;
- use of new technologies: account management by distance banking, option to pay in money at terminals (ATMs), SMS notifications for depositors;
- ensuring a high level of service for all customer categories based on staff professionalism and multifunctionality, and modern customer care methods;
- increasing customer loyalty by holding regular surveys and prize draws, responding to customer requests, and educating customers from a young age.

For the people of southern Russia, Center-invest Bank is a reliable, stable, “home-grown” bank. The sales outlets for the bank’s retail products continue to operate with extended opening hours or on a 24-hour basis.

Table 2.13. Center-invest Bank: Retail Deposits

	31.12. 2013	31.12.2012	2013 / 2012
Retail customer funds, RUB bn	37.6	32.2	+16.8%
incl. deposits, RUB bn	32.7	28.1	+16.4%
Number of deposits (thousands)	525	479.3	+9.5%
Interest on retail customer accounts and deposits, RUB m	2 561.2	1 967.5	+ 30.2%

Center-invest Bank is expanding its use of modern devices and technologies (terminals, ATMs, mobile and online banking) for retail customer payments. For the benefit of its customers, the bank is also encouraging other suppliers (e.g. utility companies) to introduce online payment facilities and electronic documentation. It is also expanding its list of partners for money transfers.

The majority of payments are already made in real time and do not require customers to complete payment requests. To speed up the

process, the bank's system reads the barcodes on bills, and payment recipients are gradually switching to electronic documentation systems. Customers can use the bank's self-service terminals, ATMs and Internet-Bank system to pay 3rd party suppliers for various services.

Table 2.14. Center-invest Bank: Telecommunications Services

	2013	2012	2013 / 2012
SMS notifications, number of users	64 655	56 155	+15.1 %
Internet banking, number of users	19 765	3 994	+394.9 %
Internet banking, number of transactions	114 560	41 214	+178.0 %

2.7. Transforming Payments and Settlements

Modern technologies are speeding up customer payments and settlements and reducing opportunities to use temporarily available liquidity in customer accounts for lending. Center-invest Bank is systematically working to transform payments and cash management into an independent, effective business on the basis of modern technologies, product line development, optimum tariffs, its extensive network of branches and terminals, and by marketing its payment and settlement services. Specific measures include: facilitating C2C settlements, introducing clearing technologies, and running special promotions to increase payments.

Plastic cards. Center-invest Bank has been a principal member of the Union Card payment system since 1996, and in 2000 it became one of the first banks in the region to introduce MasterCard. In 2007 the bank set up its own processing centre, the only one in southern Russia. The bank became an associate member of Visa in 2004, and it has been a principal member of the main Russian payment system (United Payment System) since 2009. In 2012 Center-invest Bank became one of the partners for the Universal Electronic Card (PRO100 payment system). In 2014 the bank received certification for issuing and servicing PayPass contactless cards. The bank has also been a member of Western Union since 1997 and the Zolotaya Korona system since 2013.

The bank's modern infrastructure and its experience of working with

plastic cards not only make it more efficient, but also save our customers time. Our modern technologies make us more attractive for customers, and this creates opportunities to offer them new products and services: the bank can cross-sell retail banking products and related products from the non-banking sector. To this end, the bank works with federal treasury departments, tax inspectorates, public service providers, utilities companies, insurance and tourism companies, mobile telephone operators, and transport companies. The use of company plastic cards to pay for expenses in Russia and abroad (e.g. hospitality and business trip expenses) is increasing. The range of services for publicly funded bodies is being expanded, both on the basis of traditional payment and cash management services, and also using special corporate plastic cards.

It is definitely an advantage that we are the only bank in southern Russia to have a modern processing centre, as it means we can systematically build up the quantity of banking services based on bank cards.

A new loan product, “Universal Card”, was developed for people who receive their salary on a Center-invest Bank payroll card. It is now the main product in our range of bank card loans. In 2013 the bank also offered cards with a grace period to customers with a Center-invest Bank mortgage.

Table 2.15. Center-invest Bank: Plastic Cards

	2013	2012	2013 / 2012
Number of transactions (million)	40	30	+33.3%
Number of active cards	241 883	219 168	+10.4%
Visa International and MasterCard Worldwide cards issued	135 579	132 876	+2.0%
Volume of transactions (RUB bn)	46.1	34.8	+32.5%
Number of payroll card programmes	2 128	1 840	+15.7%
Number of cards to service the accounts of Federal Treasury departments	10 015	8 580	+16.7%
Number of ATMs	385	334	+15.3%
Number of goods and service providers using the bank’s card processing services	1 565	913	+71.4%

For VisaPlatinum cardholders, an additional benefit was added to the “Exclusive” package: the PriorityPass. This provides access to more than 600 airport executive lounges worldwide.

Companies participating in a Center-invest Bank payroll card programme can now issue cards with their organisation’s personalised design.

Center-invest Bank obtained full certification as an issuer and acquirer bank for EMV-standard MasterCard Worldwide cards. This means that we can provide customers with bank cards that have a higher degree of reliability.

As part of our distance banking provision, including via ATMs, customers can:

- obtain a printout of their bank account details from an ATM;
- register for the SMS-Bank service via an ATM;
- register/deregister a card for online transactions, which saves customers a lot of time as they do not have to go into a branch;
- use their mobile telephones and SME-Bank to receive notifications, make payments, and carry out other transactions.

By the end of 2013, under our ongoing World of Discounts programme, 186 goods and service providers were offering discounts for Center-invest Bank cardholders (2012: 105 companies).

By using business processes that support the introduction of integrated products based on bank cards and cross sales, the bank is able to increase its sales and reduce costs.

Table 2.16. Center-invest Bank: Bank Cards and the ATM Network

At 01.01.	2006	2007	2008	2009	2010	2011	2012	2013	2014
active cards	80 637	88 275	99 406	116 651	146 433	165 446	182 603	219 168	241 883
ATMs	35	60	108	177	226	257	285	334	385
Cash issue desks	38	58	75	97	97	99	114	128	128
goods and service providers	84	161	260	379	496	603	754	913	1565

Online banking for business customers. The bank continues to develop its distance banking channels to enhance the quality, reliability and efficiency of its payment and settlement services.

The *Center-invest-Client online banking system* allows customers to carry out transactions without having to install additional software. The system processes electronic payment documents, provides account information, and allows customers to submit applications for bank products and receive associated correspondence online.

The eToken PASS is a stand-alone device that generates passwords. Customers using this device will not have to ask the bank for one-time passwords for several years.

SMS notifications about financial transactions provide customers with timely information about their current account credits and debits.

2.8. Transforming Information Technologies

Experienced bankers say, “Modern banking is 90% IT, and 10% the smiles of the front office staff.”

In speculative banking, the main task when developing IT systems is to ensure speed and reliability. In transformational banking, this task must be addressed not only in terms of current needs, but also with a view to future business development. The problem is that information technologies change very rapidly. As a rule, everything that works today will be of limited use in the future, and those technologies that can actually be further developed will require adaptation. Rather than automating routine business processes geared towards speculative markets, transformational banks must automate sustainable business processes. These must take into account the interlinkages between bank products, sales department operations, customers’ sustainable development requirements, and risks.

The bank’s “**South of Russia +**” development strategy (2006-2008) required it to have an IT Strategy based on a centralised architecture for the IT system, integration of the core operating system with specialised solutions, a high degree of reliability, and high speed performance.

Assisted by EBRD consultants, the bank invited companies to tender to develop its information system. SAP AG won the tender. The key factors in our decision to choose the SAP for Banking system were:

- commercial productivity and scalability;
- division of business and accounting levels;
- built-in business process management capabilities;
- an open source code.

From the point of view of transformational banking, SAP for Banking offers scope for further development: it can be scaled up and business processes can be updated. The SAP technology is:

- modular and scalable;
- compatible with other systems and technical platforms;
- customisable, and it can be further developed;

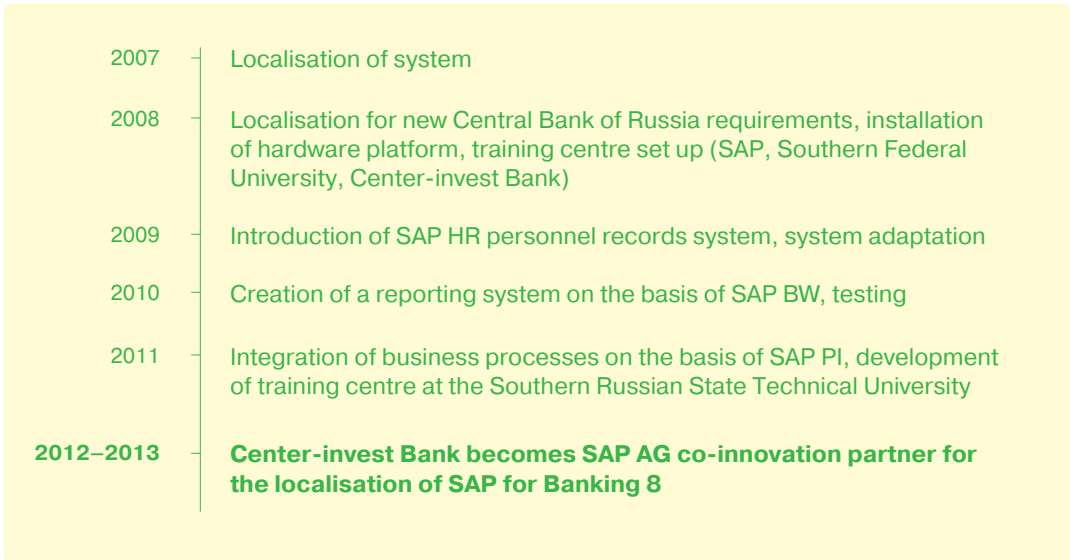
Moreover, the efficiency of business service provision is not affected by the accounting load.

SAP AG monitors best international practice in the development of banking, and it is proactive in offering its customers software updates to strengthen their competitive advantages. **A self-updating IT system** is important when trying to harmonise German software with constantly changing Russian legislation.

Of course, the bank's development strategy and IT strategy are inter-related documents. But, more than this, their co-development stimulates new creative solutions for bank products, sales techniques, the attraction of new customers, and risk management. While these interlinkages were previously supported by organisational solutions, in the new IT system they should be formalised, while still retaining flexibility.

Some people naïvely believe that the transition to a new IT system has an end point. In fact, developing an IT system is a continual process of transformations. The main stages in this process as it pertains to Center-invest Bank's work with SAP AG are shown below. The most important result of our transformational approach to developing our IT system has been an understanding that the bank's overall development and its IT development are continuous and interrelated processes. We have been pleased to discover that our partner SAP AG shares this view. In 2013 the bank became a co-innovation partner for the localisation of the new version of SAP Banking Services. This status provides early access to the very latest solutions for the automation of banking operations.

Fig. 2.12. Stages in the implementation of the IT Strategy based on SAP for Banking



Although developing the IT system is a continual process, the timescales for introducing new programmes must be respected. The transformational approach requires that projects be brought to a state of completion within the specified timeframe.

Another important aspect of the transformational approach to developing an IT system is that it allows for interfacing between different software developers' programmes. The core system is retained, and information is exchanged via special gateways.

For example, Center-invest Bank is successfully using Terrasoft CRM software together with SAP for Banking. The transition to a new version of this software, BPM 7.0, will speed up and simplify the process of handling incoming loan applications. The introduction of new ABBYY software to scan incoming customer documents and automatically transfer data to the bank's information systems will speed up document processing and reduce the risks of human error. The bank's experience of automating loan applications and end-to-end integration of loan application processing will allow it to replicate the automation of

business processes in other areas of its operations and to introduce a BPM Online system.

The bank will use the competitive advantages gained from its continual focus on IT development to introduce new services:

- switching its processing centre to direct interaction with international payment systems in order to reduce the transaction costs to the bank and its customers;
- within the CRM framework, using a centralised customer database will speed up new product and service development (including work on developing mobile banking, Internet banking, IVR, the contact centre and self-service devices);
- automated payments to government bodies through integration with the State Information System for Central and Municipal Government Payments on the basis of the SAP Process Integration platform.

Progress in transforming the IT system must be accompanied by the appropriate IT-based risk management methods: stress testing and monitoring the accessibility, reliability, security, and uninterrupted provision of the bank's services.

Standardisation of Products and Services. All of the bank's business units continually work on producing standard descriptions for products, business processes, sales techniques, customer relations, and risk management. We pay particular attention to:

- optimising our internal processes for the provision of banking services;
- simplifying, standardising and automating services;
- reducing the costs of promoting our products;
- increasing the capacity of our sales channels and the volume of sales;
- ensuring a high-quality service;
- our ability to respond promptly and effectively to customer needs, while minimising risks.

The centralised IT system allows the bank to develop its branch network through standardisation of the range of sustainable banking services offered in every branch, and also to optimise operational processes while retaining service quality and staff multifunctionality (universality) and substitutability.

Center-invest Bank's modern technical infrastructure guarantees the

reliability of its business processes. The bank continually upgrades the technical infrastructure of its business units on a planned basis, with due regard for the cost-reduction imperative. Technical equipment is purchased on a competitive basis. Transparent procedures are used to select offers with the lowest price, proven reliability and reparability, a long guarantee period, after sales servicing, and the shortest delivery times.

2.9. Asset and Liability Management: Transformational Approach

For its own sustainable development, a bank's asset-liability structure must be balanced in terms of amounts, maturities, risks, returns and currencies. Thanks to its carefully developed strategy and business plans, balanced asset-liability structure, and its effectively structured loan portfolio, Center-invest Bank maintains the different elements in the required proportions.

Liquidity refers to a bank's ability to fulfil its obligations on time and at competitive prices. Banks must monitor liquidity indicators daily and continually. In addition to the regulator's liquidity management requirements, a sustainable bank will clearly specify in its own rules that liquidity takes priority over profitability. At Center-invest Bank, the same liquidity management principles apply to the operations of each business unit as to the bank as a whole. Moreover, representatives from different business units are involved in the work of the Assets and Liabilities Management Committee. The bank's management sets liquidity limits for each business unit, and the Internal Control Service monitors compliance with these limits very closely. Transactions that would exceed these limits undergo additional assessment to check their impact on liquidity indicators. All of the principles and procedures are contained in the Liquidity Management Policy approved by the bank's Board of Directors.

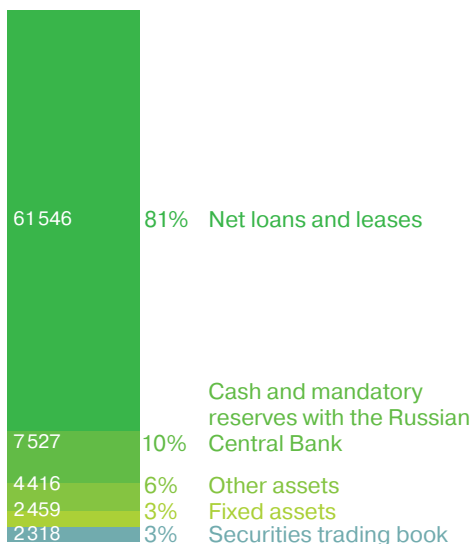
The bulk (81%) of Center-invest Bank's assets are loans and leases to the real economy in southern Russia. Customer accounts constitute more than half of the bank's resource base. Together with shareholders'

equity (12%), customers contribute 77% of the bank's total resources. Therefore, Center-invest Bank is using resources from southern Russia's population and business community for the region's sustainable development.

Fig. 2.13. The bank's balanced asset-liability structure

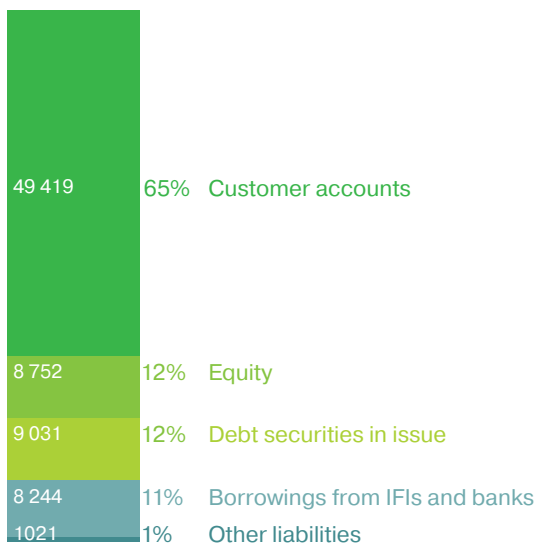
Assets, RUB m

75 947



Liabilities, RUB m

75 947



Liquidity management in transformational banking also involves monitoring customer liquidity. This takes place at the application assessment stage (the customer must indicate the funds for loan repayment), and also through monitoring of the loan portfolio (early risk diagnostics) and the customer's markets. As well as conducting its own analysis, a transformational bank must inform its customers about liquidity management methods, compliance with repayment schedules, and how to monitor the solvency of counterparties. Center-invest Bank has provided this support for many years now¹⁷, and we are pleased to note that it has been effective: overdue payments at companies in southern

17. NON-PAYMENTS! Managing Enterprises When Non-Payments are Common Practice. http://www.centriinvest.ru/ru/about/articles/3328/?sphrase_id=88351

Russia are 4.5-5% (approximately 3% in the Rostov region and Krasnodar Krai), which is lower than the Russian average of 5.5%.

Sources of funding. To implement its strategy, the bank pursues a policy of balanced use of different sources of funding:

- borrowing on the debt capital markets;
- attracting retail and business deposits;
- placing the bank's own debt securities on the open market (bonds and promissory notes);
- implementing projects with international development institutions.

The bank takes the view that by accepting customer deposits it is accepting responsibility for managing the assets of the people of southern Russia. As southern Russia does not have enough of its own long-term sources of finance for its accelerated development, Center-invest Bank attracts resources from the Russian and international markets. Aware of the regional risks and managing them effectively, we use our reputation as a transparent and reliable bank to provide access to long-term financial resources for businesses and the local population. We use the opportunities offered by international financial institutions and market mechanisms to encourage our partners to invest in successful business in southern Russia.

When we raise funds from the market, we always comply with the stringent requirements to meet our obligations to our partners on time and in full. In addition, the bank holds briefings to give updates on its loan portfolio, development trends in southern Russia, and the main risks and measures to manage these risks.

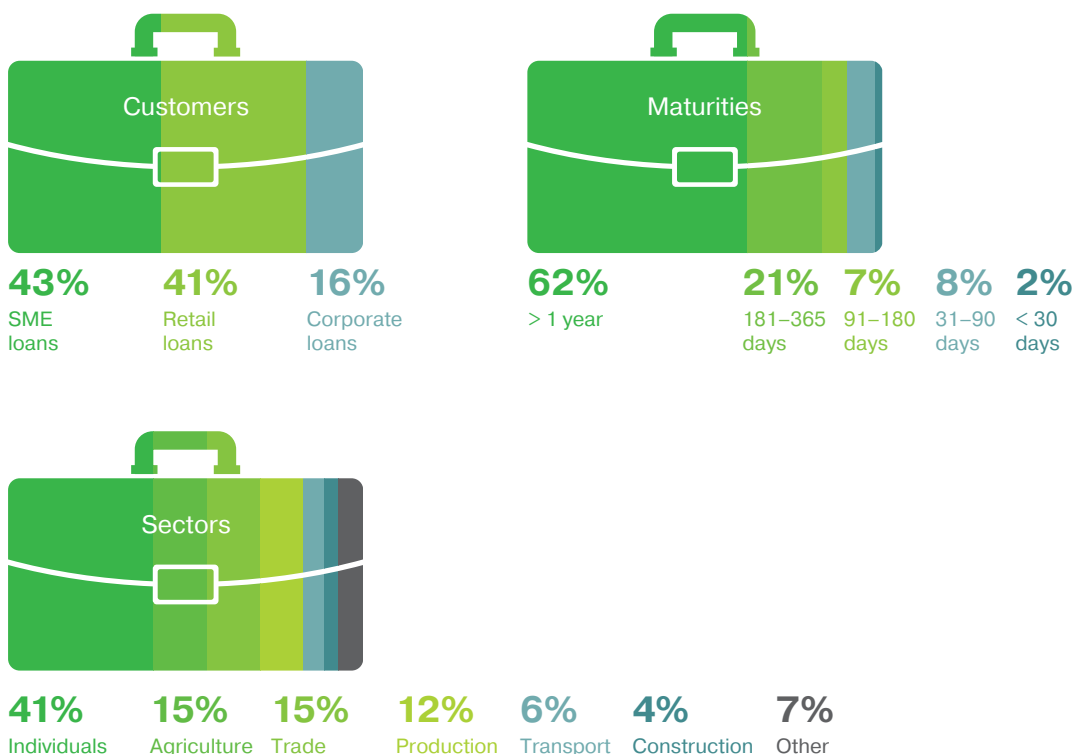
Asset Structure. Lending to the real economy accounts for the largest share of our assets. However, we are very careful to ensure that we maintain the necessary balance in our loan portfolio:

- We lend to SMEs and retail customers in roughly equal proportions (40% each). Loans to corporate customers account for less than 20%.
- Retail lending is divided almost equally among consumer loans, car loans and mortgages.
- The structure of the loan portfolio by sector avoids risk concentration and takes advantage of the diversification of southern Russia's economy.

— Thanks to our cooperation with international financial institutions and our sensible policy on attracting deposits, we are successful in making loans with a term of more than one year to retail customers, SMEs and the agricultural sector (more than 37% of the loan portfolio).

Our balanced loan portfolio enables us to select the best customers and maintain a high-quality portfolio. In the audited accounts for 2013 the proportion of non-performing loans under IFRS (NPL 90) was 3.95%. At 31 December 2013 the bank’s capital adequacy ratio calculated in accordance with Basel I was 15.6%, more than double the regulatory level.

Fig. 2.14. Balanced loan portfolio



Center-invest Bank's borrowing history

Date	IFI	Amount	Term, years	Purpose
May 2002	IFC	USD 2 m	3	Small business
November 2002	EBRD	USD 2 m	1.5	Trade finance
		USD 26 m	3	
August 2004	EBRD	USD 5 m	5	Small business
December 2004	KfW	EUR 6 m	6.5	Small business
December 2004	IFC	USD 5 m	6	Subordinated loan
		USD 5 m	5	Small business
April 2005	DEG	USD 7.5 m	7	Small business + mortgage lending
April 2006	IFC	USD 4 m	5	Energy efficiency
December 2006	National City Bank	USD 16 m	5	Retail
April 2007	BSTDB	USD 10 m	7	Subordinated loan
September 2007	EBRD	RUB 260 m	5	Small business
November 2007	EBRD + FMO	RUB 1000 m	5-7	Energy efficiency + small business + mortgage lending
April 2008	EBRD	USD 20 m	10	Subordinated loan
May 2008	DEG	USD 30 m	10	Subordinated loan
June 2008	KfW	USD 18.5 m	6.5	Small business + energy efficiency
April-June 2008	Russian Development Bank	RUB 350 m	3	Micro and small business
August 2008	EBRD	RUB 600 m	5	Agribusiness
April 2009	EBRD	USD 35 m	5	Small business
May 2009	DEG + OeEB	USD 10 m	5	Small business
		USD 10 m		
September 2009	EBRD	USD 18.2 m (limit)	-	TFP
November 2009	IFC	RUB 600+350 m	5	Agribusiness + energy efficiency
January 2012	EBRD	RUB 1125 m	3	SME + energy efficiency
June 2012	Eurasian Development Bank (EDB)	RUB 300 m	3	SME + energy efficiency
July 2012	Erste Group Bank AG	EUR 10 m	1	Senior Loan
September 2012	Austrian Development Bank (OeEB)	EUR 20 m	7	SME + energy efficiency
November 2012	MSE Bank (Russia)	RUB 500 m	5	SME
December 2012	EDB	RUB 150 m	3	Energy efficiency
February 2013	IFC	RUB 900 m	3	SME
March 2013	EBRD	RUB 1500 m	3	SME + energy efficiency
April 2013	EDB	RUB 150 m	3	SME
August 2013	responsAbility	RUB 130 m	3	Micro and SME
October 2013	responsAbility	RUB 175 m	3	Micro and SME
November 2013	responsAbility	RUB 180 m	3	Micro and SME
December 2013	BSTDB	EUR 20 m	5	SME
March 2014	IFC	RUB 600 m	1	Agribusiness
April 2014	EDB	RUB 300 m	1	SME + energy efficiency
May 2014	Erste Group Bank AG	EUR 7 m	0.5	Senior Loan
June 2014	EBRD	RUB 800 m	3	SME

Center-invest Bank's transactions on the national and international capital markets

Date	Transaction	Arranger	Amount	18 + 18	Number of participants
June 2006	First international syndicate	EBRD	USD 30 + 15 m	3 years	14
October 2006	Debut issue of ruble bonds	Rosbank	RUB 3 bn	12	
October 2006	Syndicated loan on the Russian market	MMB (now Unicredit-Bank)	RUB 1.5 bn	12	10
February 2007	International syndicate	Standardbank PLC Commerzbank AG	USD 80 m	24	37
March 2007	Debut CLN issue	TRUST Commerzbank AG	USD 175 m	5-7	more than 50
September 2007	Syndicated loan for: mortgage lending, small business and energy efficiency	EBRD + FMO	RUB 1 bn	12	EBRD + FMO
October 2007	Syndicated loan on the Russian market	CJSC Raiffaisenbank	RUB 1 bn	18	8
February 2008	Extension of 2006 EBRD syndicate	EBRD	USD 30 m	12	11
February 2008	Extension of 2007 international syndicate	Standardbank PLC Commerzbank AG	USD 145 m	12	37
October 2008	Syndicated loan	Standardbank PLC Commerzbank AG Erste Group Bank AG Raiffeisen Zentralbank Osterreich	USD 18 m EUR 30.8 m	12	8

Center-invest Bank's transactions on the bond markets

Bond issue	Placement date	Term, years	Status	Arranger	Amount, RUBm	No. of participants in the primary bond sale	Exchange
01	November 2006	3	Matured	Rosbank	1 500	23	MICEX
02	June 2009	5	Matured	Citibank, Renaissance Capital	3 000	4	MICEX
BO-01, BO-05	June 2011	3	Matured	Sberbank	2 500	39	MICEX
BO-02	April 2012	3	Trading	Sberbank, Bank Zenit	1 500	17	MICEX
BO-03, BO-06	March 2013	3	Trading	Citibank, Bank Zenit	2 500	45	MICEX
BO-07	November 2013	5	Trading	Bank Zenit, VTB Capital	2 000	30	MICEX
BO-10	May 2014	5	Trading	Bank Zenit, VTB Capital	3 000	38	MICEX

2.10. Internal Audit and Compliance

Banks usually view Internal Audit and Compliance (IA&C) as an expense. However, transformational IA&C offers a new solution to this challenge: it requires additional monitoring of compliance with best international practice, and the introduction of best international practice allows a bank to become more efficient. Assisted by international consultants, Centerinvest Bank created a practical internal control system, encompassing all of its governance bodies, business units and functional areas. The work of the Internal Control Service (ICS) is based on procedural regulations concerning the planning and organisation of inspections, monitoring and reporting. Internal control does not just reveal violations of rules and procedures; it also generates proposals as to how these rules can be improved.

In terms of organisational structure, the internal control function should be separate from operating activities. There are standard requirements for an internal control department: it should be independent, it should be answerable to the bank's Board of Directors (represented by its Audit and Compliance Committee), and it should report to the Board of Directors on a quarterly basis. The Board of Directors determines the structure and composition of the ICS and is responsible for appointing and dismissing the head of the service. The ICS's remit extends across all areas of the bank's activities and includes inspecting the work of all business units and employees.

In transformational banking, internal control is also part of the corporate culture, whereby every employee, every customer, and every shareholder is entitled to check any transaction and to ask questions and receive a comprehensive response. If a response does not properly answer the question asked, it is the first sign that something is amiss. Moreover, employees are obliged to ask questions when they believe that a transaction violates, or is at variance with, rules and regulations. The person responsible must not only answer the employee's question, but also take measures to ensure compliance with rules and procedures and to prevent such issues from arising again.

Case study 18. *An employee responsible for the sale of non-core assets was for a long time unable to submit a report on changes during a given period. The Internal Control Service conducted a repeat check of the loan file and discovered a conflict of interests in loans previously made by this employee when they were working in a regional branch. We informed law enforcement agencies not only of this employee's conduct, but also of that of their colleagues, who had failed to notify the bank of the violations when making and monitoring loans.*

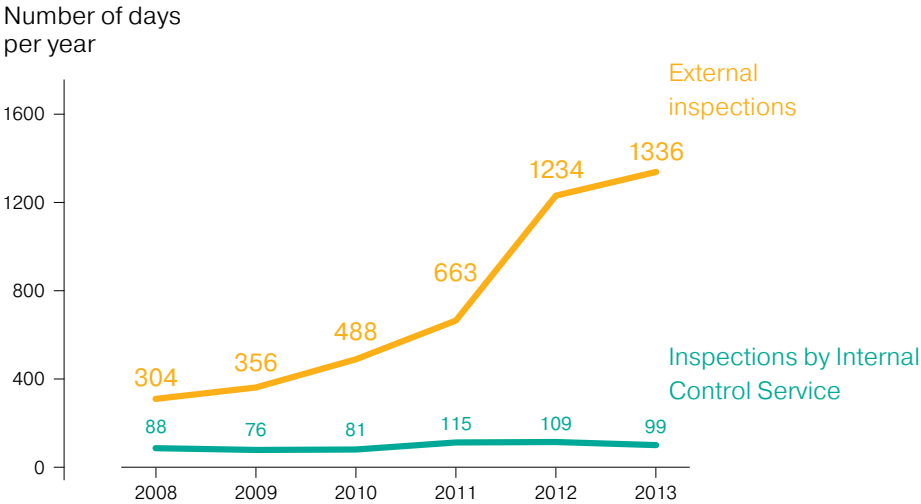
At first sight, a comprehensive compliance control system entails additional risks and costs. But at a time of stricter regulatory requirements, it is by using such a system that we can provide full and complete answers to any questions asked by external inspectors.

Case study 19. *An inspector, referring to his work with other banks, insisted that we allow him to have an unofficial look through folders of payment documents. When we categorically refused to violate our information policy, the inspector filed an official request for submission of 40 lorry loads of documents. After the first lorry containing copies of documents had been dispatched, the heads of the inspecting body withdrew their illegal demands.*

Of the 365 days in a year, 250 are working days. In 2013, held concurrently, the inspections of Center-invest Bank by external bodies lasted a total of 1336 days. This means that every week the bank was checked by at least five inspectors.

With such transparent and comprehensive control, operational risks are reduced, but the risk that inspectors will make requests in bad faith increases. In each specific case, the bank's decision is governed by the following rule: information is disclosed in accordance with the law, while also protecting the interests of other stakeholders.

Fig. 2.15. Total time spent on inspections



A transformational bank monitors compliance not only with regulatory requirements, but also with best international practice. Therefore, managers and their subordinates are informed both of any violations identified during an inspection and also about best practice and approaches to prevent such violations from reoccurring.

A transformational internal control system is based on the sustainable development concept, and is organically incorporated in all business processes. It continually updates the control procedures to reflect changing risks, market conditions, regulatory requirements, and best international practice; uses automated control procedures; and is integrated with the risk management system.

The Internal Control Service also uses best international practice when planning its work: inspection schedules are correctly balanced in terms of functional areas, business units and resources. Moreover, the inspection reports must include proposals on how to resolve the problems identified and prevent their reoccurrence.

At a time of market volatility and stricter regulatory requirements, the further development of Center-invest Bank's internal control system will entail:

- an Internal Control Service audit of all areas of the bank’s activities in the light of the changing economic conditions;
- timely organisational changes in accordance with regulatory requirements and market conditions;
- continual monitoring of external regulations and the bank’s compliance with these requirements; timely revision of internal regulations;
- introducing and improving control procedures for business processes; making inferences from the results of checks and inspections; informing the appropriate level of management about findings so that the necessary decisions can be taken;
- involving staff from the bank’s departments and branches in cross control;
- participation of the Internal Control Service in work to upgrade the existing automated banking system and introduce the new automated banking system based on SAP, which is aimed at increasing the efficiency of business processes.

Table 2.17. Center-invest Bank: Activities of the Internal Control Service

	2013	2012
Comprehensive audits of branches and sub-branches	16	31
Checks of cash and valuables	20	14
Investigation into customer complaints	1	1
Audits of specific aspects of the work of business units	62	63
Audits of professional activities on the securities market	4	4

2.11. Accounting, Reporting and Ratings

IFRS and RAS. International Financial Reporting Standards (IFRS) and Russian Accounting Standards (RAS) are different methods of classifying banking transactions. Center-invest Bank has reported under IFRS since 1997, with its accounts audited by PricewaterhouseCoopers. As IFRS and RAS are constantly amended and updated, we repeat-

edly demonstrate that the work of a sustainable bank is invariant to the accounting system.

Working with IFRS has taught the bank to evaluate every product and operation, not only in terms of Russian and international standards, but also in terms of tax accounting. We are obliged to use RAS for the Central Bank of Russia and IFRS for shareholders, international partners and ratings agencies. Naturally, this creates additional expense, but the bank has sufficient experience to ensure that it operates efficiently regardless of the accounting system used. Supervisory bodies, financial institutions and Center-invest Bank's foreign partners have rightly praised our consistently high performance indicators under IFRS and RAS. In 2007 the Rostov Region tax authorities awarded the bank a Gold Confidence Certificate for the high quality of its tax accounting.

The bank's Accounts Department submits the annual report and accompanying notes to the government authorities by 31 March each year. In accordance with the law, the bank must publish its audited accounts (prepared under Russian and international standards) on its website within 4 days of receipt. Therefore, as a result of stricter regulatory requirements, the submission of the report to the meeting of shareholders is becoming something of a ritual: the information to be approved by the shareholders has already become public. It is, however, in the interests of the bank, investors and markets that meaningful information about the bank is distributed. The volume of information is continually increasing, and it must be properly processed. This is the task of sustainable and integrated reporting.

Sustainable and integrated reporting. In 2012, the bank published its first sustainable development report applying the G3.1 reporting guidelines and financial services sector supplement¹⁸. In producing this report, the bank took into account the experience of other banks and criticism of the costs of preparing special reports.

In many respects, the main sections of a sustainability report overlap with the contents of a traditional report (strategy and analysis; characteristics of the organisation; governance, obligations and relationships with stakeholders; main and additional performance indicators; manage-

18. <https://www.globalreporting.org/reporting/G3andG3-1/Pages/default.aspx>

ment approach; sectoral indicators). In addition, the sustainability report has included sections on economic and social aspects (human rights, society, product responsibility).

As part of its reporting under IFRS and RAS the bank regularly discloses information about its corporate governance and management methods. Sustainability reporting has enabled the bank to give a fuller account of itself as an organisation operating in the real economy (86% of the bank's income) in the interests of the local population (26% of the bank's distributed income), its partners (25%), shareholders (24%), employees and the state (20%).

As part of sustainable reporting, the bank conducted the first gender analysis of its operations. This confirmed that the bank has young, intelligent, competent, accomplished, and financially secure female employees. In addition, sustainability reporting allowed the bank to collate information about how its activities are helping to address social and environmental problems in southern Russia.

Center-invest Bank observes current international business principles (Equator Principles, UNEP-FI Declaration, Global Compact) under its agreements with IFIs (IFC, EBRD, KfW, DEG, FMO, OoEB, EDB, BSTDB).

We have seen that the sustainability reporting guidelines are not set in stone. The new G4¹⁹ standards were introduced in 2013. The new standards are intended to be more universal for all companies and all users, but some flexibility in their application is permitted. Therefore, Center-invest Bank decided to publish an integrated report for 2013²⁰, combining a traditional report with reporting on economic, environmental and social aspects. The new report covered in more detail the risks to the bank of operating in the new global environment, and the bank's impact on socioeconomic development in southern Russia.

It is hard to believe that investors and regulators will want to switch between different forms of reporting. Transformational banking requires a transition to integrated reporting with disclosure of all aspects of a bank's activities. Much work remains to be done in this respect²¹.

Independent ratings are another means of obtaining an aggregate assessment of a bank's performance. Ratings agencies assign their ratings by analysing all of a bank's operations and the quality of its

19. <https://www.globalreporting.org/reporting/g4/Pages/default.aspx>

20. <http://www.centriinvest.ru/files/about/reports/byyear/2013.pdf>

21. <http://www.theirc.org>

loan portfolio and governance system, including internal control and risk management.

In 2006 Center-invest Bank was rated B1 stable by Moody's. In 2007, the agency strengthened this rating, assigning it a "positive outlook". When international ratings agencies assign ratings to companies in developing countries they consider the general situation in the national economy, including the actions of regulators and government agencies. Consequently, when Moody's downgraded the country rating for Russia, Center-invest Bank's outlook was also adjusted, first in October 2008 to "stable" and then in May 2009 to "negative". However, the change in outlook did not affect our relationships with our partners.

Then in 2011, at a time when the ratings of leading economies and Russian banks were being downgraded, Moody's upgraded Center-invest Bank's global rating to Ba3 and its Moody's Interfax national rating to Aa3.ru, outlook stable. This rating is affirmed regularly.

The bank's Ba3 rating permits it to be included in the list of banks whose guarantees are accepted by the Bank of Russia, the Federal Customs Service and the Finance Ministry. This gives Russian customers, the local population, and government authorities extra confidence in Center-invest Bank, especially as it is the only regional bank in southern Russia to have such a rating.

Sustainable Banking Mirrored in Ratings. Among all Russian banks (more than 900 as at 01.05.2014) Center-invest Bank is in 76th place for capital and 70th for value of net assets. The bank operates efficiently and ranks in 62nd place for profits. Center-invest Bank enjoys the trust of the local population (50th place for volume of deposits) and actively lends to retail customers (44th place for volume of retail loans).

The bank is proactive in lending to business (55th place in Russia); moreover, it has a high-quality business loan portfolio (101st place for non-performing loans). Funds for lending come from customer deposits and from long-term funding raised by the bank on the bond market (26th place).

In addition to regular monitoring, some agencies produce rankings for specific bank products. These show, for example, that based on performance in 2013 Center-invest Bank ranks 16th by volume of SME lending.

In The Banker's Top 100 Russian Banks rating, Center-invest Bank is in 19th place for return on equity, 31st place for return on assets, 64th for Tier 1 capital adequacy, 57th for assets, and 72nd for Tier 1 capital.

The Expert South magazine ranked Center-invest Bank the top bank in southern Russia by loan portfolio value.

As well as ratings, there are also awards that reflect the bank's position in various market segments. In 2011 the bank won a prestigious award from Citi Bank for excellence in international payments. In 2012 the bank won the banking services category of the nationwide competition "The 100 Best Goods of Russia". In 2013 it received a Special Commendation for Leadership in Eastern Europe in the FT/IFC Awards, and also a Commerzbank "Relationship Award 2012".

In ratings for modern services and technology, Center-invest Bank fares well for online banking.

Center-invest Bank introduces modern banking technologies, develops its own operational environment, and provides high-quality banking services. With its own processing centre, the bank ranks 38th among all Russian banks for number of ATMs, and 32nd for number of active bank cards and sustainable customer base (38th for number of newly issued cards and 21st for number of previously issued cards).

We should be aware of the risks of less conventional ratings. For example, a small bank that had simply changed owner appeared near the top of a regional ranking based on media activity.

Transformational banking proceeds from the premise that there are no ideal indicators that could fully encompass a bank's multifaceted operations. Therefore, Center-invest Bank uses an integrated system of indicators to measure performance against its profitability, growth and risk management targets. The system is sustainable with respect to Russian and international regulatory requirements, the new Basel rules, the requirements of auditors and ratings agencies, and our agreements with partners and regulators. All the indicators are calculated in a dynamic model using data from SAP BW. The bank's website provides information about its corporate governance procedures, its mission, strategy, business plan, financial results, main products and business units.

Center-invest Bank also uses additional indicators to measure its sustainable, organic capital growth, increased operational efficiency, capital adequacy under IFRS and RAS and the Basel requirements, modernisation of internal business processes, continuous staff training, and the number of inspections by regulatory and supervisory bodies.

2.12. Transforming Personnel Management

Nurturing personnel. Speculative banking focuses on “headhunting”, but actually, it is the “heads” that hunt the banks: they promise a lot, deliver little, and then move on to their next victim.

In contrast, a transformational bank concentrates on nurturing personnel by applying the following principles:

- competitive selection based on the professional and personal qualities of applicants and the bank’s corporate culture;
- career growth with due regard for employee performance and potential;
- continuing professional development for every employee, and involving employees in providing staff training;
- reserve personnel, competitive selection, training, and horizontal rotation of staff;
- continuous training programme, including international training courses;
- inviting in consultants and specialists in areas of particular importance to the bank’s development;
- implementation of an active social policy;
- gender equality and non-discrimination policies.

Every year more than 200 students have work placements at a Center-invest Bank branch. As well as studying the bank’s processes and procedures, they also soak up its corporate culture. The bank’s reputation for innovation attracts creative people; the rigour of its rules and procedures teaches them to combine this creativity with a disciplined approach. After completing their placement, 30 students stay on to work with the bank, while the others easily find employment, either with the bank’s customers, or with its competitors. Having been “schooled” by Center-invest Bank, these people take with them a high skill level and

an understanding of the bank's corporate culture, which facilitates communication between the bank and its customers.

More than 30 of our employees have postgraduate qualifications and an academic rank. Every year at least two employees submit a doctoral thesis.

As we develop our branch network, we must continue to improve the competitive selection process for branch managers, as well as their training and retraining on the basis of horizontal rotation. We send our employees abroad for training, and we also invite consultants and experts to talk about the latest issues in banking.

All of the bank's employees regularly receive various types of training: on the job training, in-house seminars, and external training courses and placements. In 2013 the bank held 2007 seminars, which were attended by 1471 employees. Participation in training was not dependent on gender or age. On average, each employee received five hours of training. In 2013, through external courses and placements, 88 employees received training on the following subjects: SME lending, and innovation in banking technologies, credit risks, security, investment and international policy.

Southern Russia is a multi-ethnic region. With a tradition of respect for the older generation, the population also attaches importance to motherhood, childhood and the younger generation. Checks conducted by IFC have confirmed that Center-invest Bank's procedures and corporate culture ensure gender equality and that a separate policy on gender equality is not required. Almost three quarters of the bank's employees are female, and more than half of all employees are under the age of 35. These same ratios are seen in the indicators for staff turnover (less than 10%), staff training, and the number of managers. However, the main result of our corporate culture is that the birth rate among our employees is 45-55%, which is almost five times higher than the average rate in Russia.

Remuneration. Although we value our employees immeasurably, limits do have to be imposed on remuneration: it is dependent on the bank's income and its allocation between current needs and future sustainable growth. Therefore, employee remuneration comprises

both a fixed amount and a bonus. Bonuses are based on an employee's individual performance, and on that of their department and the bank as a whole. The payment of bonuses to employees who take decisions involving risks may be deferred for up to two years.

The remuneration for the members of the bank's governance bodies is specified in by-laws approved by the General Meeting of Shareholders and depends on net profits, asset growth and asset quality. The wages of the bank's employees are in line with the market conditions in southern Russia and reflect the skills and experience required.

Occupational health and safety. The bank does not have any workplaces with hazardous working conditions. However, for many years now it has voluntarily paid for medical insurance for its employees. There have not been any workplace injuries at the bank. At our head office we have a sports hall and a Wellness Centre for yoga, Pilates and other forms of exercise, which employees can use free of charge. Teams from different departments and branches regularly compete in tournaments held by the bank, including football, ping-pong, basketball and volleyball (26 teams in 2013). Every year the bank holds contests as teambuilding exercises.

2.13. Transforming Customer and Investor Relations

The information policy sets out the procedures and channels for presenting and distributing public information about the bank. It also details commercial confidentiality measures, defines insider information, and sets out our advertising requirements and the procedures for the submission of information to the bank. As part of our information policy we use traditional mass media, new information resources, and direct contact with our customers through our branch network's front offices. Using all these various channels, we distribute information for the 14 million residents of southern Russia. In addition, the bank works with international media channels and publications: Bloomberg, CNBS, The Banker, Euromoney, and the Financial Times. By regularly informing the general public of its progress. Center-invest Bank has become a newsmaker in southern Russia.

It is important to understand that a real achievement lies behind every news story from Center-invest Bank.

The bank regularly updates its shareholders, Board of Directors, the general public, and its customers and partners about its sustainable development activities. It works with all parties and NGOs to implement environmental and social policies.

At a time of growing market volatility and uncertainty about economic policy, the bank's customers and partners require timely and reliable information about the current situation. The bank has therefore been even more proactive in holding seminars, meeting face-to-face with customers, investors and ratings agencies, and participating in regional and international conferences. The bank provides meaningful, objective information on a timely basis and in a friendly manner. As a result, even during the crisis, the bank was able to encourage both its customers and its partners to work together with Center-invest Bank to develop their businesses.

As well as providing customers and society at large with timely information about development trends and risks, a transformational bank should also promote best international practice in technical, financial and social engineering; advisory services; mentoring; educating customers, professional associations, and government authorities about new banking technologies, products, services and management methods; and cooperation with non-governmental and professional associations.

Transforming information. Modern information technologies have sharply increased information flows. At the same time, they have turned these flows into "noise". All company websites include links to their social networking pages. To help people navigate the growing volume of information, new methods of presenting and processing information have emerged: slogans, logos, links, "likes" and pictograms are squeezing out text.

The transformation of information flows has led to a new paradigm of information requirements: everything that happens in the outside world affects the bank, and everything that the bank does affects the outside world. The main thing is to extract the important impacts from the information noise.

The transformational approach requires banks to develop and apply sufficiently sustainable data processing methods. When using classical statistical methods to work with data, the following applies: “what you can do, the way you should do it.” However, applied statistics allow us to use a wider range of options, so it becomes, “what you should do, the way you can do it”. Data analysis, based on processing all kinds of information, allows us to see the surrounding world in a new way.

Without going into data processing methods in detail, an important sequence for achieving the end result should be noted: events should be supplemented by indicators, and then identification of risks for viable actions. The same is true of diplomacy: however long the negotiations last, what matters are the actions that follow. Therefore, obtaining information is being replaced by monitoring of the information sphere; review of statistical indicators is being transformed into data processing aimed at obtaining a sustainable image (pictures, key word, slogan, pictogram); the risks of using the image so obtained are assessed; and specific actions are taken based on the results of data processing.

This general scheme works for both the “input” and “output” levels in banking: in its advertising, financial information disclosure, and descriptions of events, the bank should make its customers and partners aware not simply of its new image, but also of the specific actions that they should take.

An important difference compared to speculative banking is that the moral framework of transformational banking means information cannot be used to the detriment of a customer or partner. Therefore, the bank discloses complete information about all of its financial products and the risks associated with their use. It also informs its customers of how they can reduce these risks and protect their property rights. The bank always complies with Russian legislation on full information disclosure when advertising financial products.

The bank complies with all the laws, standards, programmes and voluntary codes relating to marketing communications, including advertising, promotion and sponsorship. The relevant procedures are contained in employee job descriptions, and compliance with these procedures is monitored as part of internal control. The bank examines



Live interviews with CNBC and Bloomberg

customer complaints and claims, as well as customer opinion surveys and customer feedback.

At the same time, as access to information continues to increase, the bank must use all lawful methods to prevent information disclosure that could be detrimental to third parties.

2.14. Impact of Transformations: Environment.

There is a large body of literature detailing the consequences of negative environmental impacts. There are also some well-founded arguments against these apocalyptic portrayals²². One of the most significant arguments is as follows: the fact that natural resources are finite is used to promote new technologies under the banner of environmental protection, but these technologies are not always the most effective.

From their own experience, Center-invest Bank and its customers have some fairly compelling evidence that the payback period for investment in environmental protection and pollution reduction is too long. However, if you take into account not only natural resource savings, but also a comprehensive assessment of the modernisation of production and communal infrastructure, the picture changes: even just the initial measures can save energy resources and also reduce labour, materials and other production costs. For example, one of our customers replaced old boilers with modern, more expensive ones. The reduction

22. V.A. Pozdyshev, Protocols of Kyoto Wise Men. — Moscow.:Algorithm, 2011

in specific gas consumption was insignificant (3.7%), but the company was able to half its electricity and water consumption (by 45.7% and 59.8%, respectively), reduce its headcount by 39%, and cut its annual CO2 emissions by 25%.

We should also remember that resource savings must be calculated for the whole production chain, from primary resource extraction to end consumption. And there is another important point: natural resource consumption cannot be reduced ad infinitum. Once the most important environmental protection measures have been implemented, subsequent steps work out more expensive, while the effectiveness of these measures diminishes until the next technological breakthrough.

A transformational bank does not make a fetish of saving natural resources and reducing harmful emissions. Rather, it helps its customers to find solutions for environmental problems, while at the same time ensuring the financial viability of their project. This generally involves the use of new technologies and new arrangements for repaying the investment. Any technological innovations entail social change. Once the initial social shifts and changes in mentality have occurred, the process becomes sustainable and requires only minor improvements.

Center-invest Bank has run an energy efficiency finance programme since 2005. It provides businesses and retail customers with loans to introduce modern energy-saving technologies and measures. The results for the programme in 2013 are provided in the table below.

Table 2.18. Center-invest Bank: Energy Efficiency Lending

Energy efficiency projects	2013	Bcero
Number of projects		5 800
Value of loans made, RUB bn	2.1	7.4
Annual reduction in CO2 emissions	23 067	134 736
Equivalent to emissions: motor vehicles	79 000	78 800
oil, thousands of barrels	385	384.9
trees for absorption of emissions, millions	5.5	5.4

The bank's financing of energy efficiency projects has already been covered above. I will now touch upon the bank's internal procedures relating to environmental impact.

By working with IFIs, the bank obtained access to a list of proven energy-efficient and environmentally friendly technologies. This meant we could be confident when talking to customers about purchasing new equipment and technologies. The next important development was that we embedded environmental and social risk procedures into the loan decision-making system. New, more effective technologies were generally reducing not only environmental risks, but also the overall project risks. Therefore, all the credit committees were quite quick to adopt the new procedures as guidelines. The final touch in creating an environmental impact system was that we started producing a regular environmental report, indicating the volume and results of energy efficiency lending. A commitment to environmental protection has become an integral part of the bank's corporate culture. Therefore, even measures designed to reduce costs are now also assessed in terms of natural resource savings. This proved useful when producing the sustainable development report and integrated report.

Despite its sustainable growth, the bank is still achieving small, but continual reductions in its energy consumption. In 2013, it reduced its gasoline consumption by 28%.

Table 2.19. Center-invest Bank: Energy Consumption

Energy consumption	2013		2012		Change, MJ	
		MJ		MJ		
Gasoline, tonnes	210	6 735 680	292	9 344 000	-2608320	-28%
Gas, thousand m ³	468	15 912 000	448	15 232 000	680000	4%
Electricity, kilowatt-hours	4742000	17 071 200	4328000	15 580 800	1490400	10%
Total		39 718 880		40 156 800	-437920	-1%

Center-invest Bank uses centralised water supply and water withdrawal systems. It uses 66,000 tonnes of water annually for its own needs, which comes from municipal suppliers. In addition, it consumes 6,000

tonnes of drinking water. The bank does not recycle or reuse water, as the used water goes into the sewage system.

In 2013 the bank used 163 tonnes of paper. It does not use recycled waste.

By introducing electronic document management and holding credit committee meetings by videoconferencing, the bank saved the equivalent of 26,452 trees in 2012. (The bank used less paper, and also reduced CO2 emissions by transporting fewer documents). By expanding the use of new payment and settlement technologies based on bank cards, the bank saved 130 tonnes of paper in 2013. Applying Greenpeace's methodology, this is equivalent to 6,000 hectares of forest.

The bank does not operate in any protected areas. It does not have any impact on biodiversity or protected species. The bank's employees regularly participate in activities to restore natural habitats. The bank regularly holds seminars and advises its customers on the environmental impacts of their activities and the use of new technologies to reduce negative impacts.

2.15. Impact of Transformations: Society

Not only is Center-invest Bank the leading bank in southern Russia, but, as was mentioned at the start of the book, it serves as a "reform laboratory" for the region. On the basis of its own experience, the bank demonstrates the use of best international practice to address socioeconomic challenges in the region and in Russia as a whole. The regional community, federal government bodies, and Center-invest Bank's partners in global markets all place a high value on the bank's accumulated knowledge, experience and intellectual resources. The bank demonstrates a high standard of business conduct, which government bodies, NGOs, state-owned banks, and other private banks should take heed of. Indeed, the bank's business culture requires it to set an example for other companies and to show that profitability should be based not on short-term speculation, but on a long-term view; businesses should be socially responsible and consider environmental and social risks; and they should know how to implement best international practice. By applying a transformational banking business model, the bank ensures not only its own sustainable

growth, but also that of its customers, employees and partners.

The bank has proven the viability of the transformational, sustainable banking business model in the extreme conditions of state dominance of the economy. State-owned banks are using preferential funding, dumping, government-funded marketing campaigns, and priority legal protection in courts. Many foreign banks have left the Russian market. The bank explains and promotes transformational banking, and uses its own experience to show that transformational banking is competitive not only for glamorous proponents of sustainability, but also in a speculative market and in a state-dominated market.

Center-invest Bank sets a benchmark not only for local players, but also for banks from other regions, and foreign banks. The general public, businesses, government bodies, and even our competitors in southern Russia know that Center-invest Bank is always the first to introduce best international practice for banking services, retail lending, small business lending, energy efficiency technologies, and agricultural modernisation. Moreover, they know that we are the best at this. Rather than engaging in market division, the bank nurtures and multiplies new sustainable customers. We help them to find and implement best international practice projects to increase their business efficiency three to fivefold and become globally competitive.

As a result of Center-invest Bank, business people, non-governmental associations and government bodies pooling and multiplying their efforts, small business in southern Russia is continuing to grow rapidly, surpassing the average rates for the rest of the country. Our retail loan programmes have successfully retained demand among the population of southern Russia and limited the scale of risky lending. Our experience in granting loans for major repairs and renovations to multifamily residential buildings provides a good example on which to build an alternative to the current system, both in southern Russia and nationwide. Center-invest Bank's work on introducing electronic transfers for Federal Treasury departments has been used to roll out a new system across Russia. Our social and educational projects are helping to increase the prestige of education and form a new, literate and creative generation. Center-invest Bank's 1675 employees believe,

and indeed demonstrate through their own work, that people's lives and the environment in southern Russia can be improved and made more stable. This requires: a focus on the long-term, application of best international practice, and support for the younger generations, who one day will become Center-invest Bank customers or employees. From international conferences we know that there is demand for Center-invest Bank's experience in applying a transformational banking business model and that it is replicable by banks in other countries, including in G7, G20, CIS, BRICS, and EMENA countries.

The bank takes measures to ensure that it maintains prudential ratios for its contractual obligations. The precautionary principle is included in the bank's risk management procedures and must be applied in decision-making. Although the bank has not formally signed the following documents, it subscribes to and applies their main principles in accordance with its agreements with IFIs (IFC, EBRD, KfW, DEG, FMO, OoEB, EDB): The Ten Principles – United Nations Global Compact (2000); OECD Guidelines for Multinational Enterprises (2011); United Nations Guiding Principles on Business and Human Rights, implementing the UN “Protect, Respect and Remedy” Framework (2011). As adherence to sustainable development principles is not a regulatory requirement, the bank assumes its sustainable development obligations voluntarily, and it enjoys competitive advantages from pursuing a sustainable banking business model.

Speculative and state-owned banks rarely miss an opportunity to use their political connections and sway. Transformational banks would rather forego profit than break the law. This resolute stance actually has its competitive advantages, even in a challenging investment climate.

In Russia, it is socially irresponsible politicians who most love to hold forth on socially responsible business. Center-invest Bank's track record is very important in that we have used sustainable development not as charity or to “bypass official financial channels”, but as investment in southern Russia's sustainable post-crisis development.

Involvement in criminal, corrupt and other illegal actions is anathema to transformational banking. But at the same time, transformational banking must suggest new, more effective solutions within the existing legislative framework.



A business breakfast for businesswomen

Gender Products: Women's Happiness. One of the stereotypes of gender finance is the primitive view that we should be lending to more women. Center-invest Bank's experience shows that what matters is not the number of loans, but that the loans make women happy.

Russian women live 12 years longer than Russian men, but 8 years less than women in developed countries. Russian women are 15 times more likely to die in childbirth, and the infant mortality rate is double that of European countries.

The main tragedy for Russian women is that they are very popular in their younger years (up to the age of about 30), but they are alone in old age: Russian men have not adapted so well to the country's investment climate and their life expectancy is 10 years less than for women. Women earn 35% less than men, but pensions are equally meagre regardless of gender.

It is women who run Russia: there are 2.5 to 3 times more women than men working for government bodies, and in judicial bodies and

procurators' offices there are 3.8 to 5 times more women. In truth, the Russian justice system has a female face.

The gender situation requires Russian women to take responsibility for the health, safety, living standards and education of their whole family, and in many cases, to set up their own businesses so that they can meet these responsibilities. Therefore, all banking products should reflect that the ultimate beneficiaries are women. More often than not, women come to the bank as depositors (57%), but the percentage of women applying for loans is increasing and already exceeds 45%. Women are quicker to master online banking (52%).

Women are more reliable borrowers for the bank because their appetite for risk is generally lower and they assess project indicators more thoroughly. This allows us to offer businesswomen lower loan interest rates. The bank launched its **Loans for Businesswomen** programme in 2012 as an early gift ahead of 8 March²³. It has since become a permanent product, and we have already made **155 loans for a total of RUB 158m**. As well as finance, businesswomen receive free consultations on all issues concerning their businesses. Under the **Start-up** programme, women who are setting up their own companies can obtain a loan product with preferential terms for business banking, a grace period, free business advice, and free connection to the online Client-Bank system. We have made **272 loans** for a total of **RUB318.5m** under this programme.

The bank also arranges special networking events for businesswomen. These provide a forum for women to share their experience of implementing social projects and to join forces to expand them. Projects have included: setting up private nurseries and schools, and providing assistance for orphans and children with special needs.

Case study 20. *In 2008, at the EBRD's AGM in Kiev, member of Center-invest Bank's Board of Directors Tatiana Vysokova received a Women in Business Award. Accepting the award, Tatiana gave a short speech, ending with the words, "The main success factor for women in business is love!" She received a standing ovation!*

23. On 8 March Russia celebrates International Women's Day.

Looking after the older generation. More than 2000 veterans are depositors with Center-invest Bank and enjoy access to special products. Center-invest Bank's products for pensioners include: loans on preferential terms, growth deposit accounts for pension savings, and convenient deposit accounts for paying in and withdrawing pensions and other welfare payments. In 2013, 50 customers were winners in the bank's special prize draw for pensioners. Every year the Second World War veterans among our customers receive a Victory Day commemorative gift from the bank and we also organise a celebratory concert for them.

Social and educational projects. Center-invest Bank plays an active role in shaping the next generation. We run educational programmes for schoolchildren, students and entrepreneurs.

Schoolchildren. Center-invest Bank has sponsored *free Internet skills training for more than 3,000 schoolchildren*. Thanks to financial support from the bank, since 2004 more than 80,000 schoolchildren have received *free entry to two exhibitions*: "Treasures of the Don Steppes" at the Rostov Region Local Studies Museum (about the history of settlements in the Rostov region from the 3rd century BC to the 5th century AD) and "Southern Russia's Artistic Heritage" at the Regional Museum of Fine Art.



Children at the exhibition in the Local Studies Museum

Teachers in the region's schools use a *textbook written by Center-invest Bank experts to impart knowledge about the basic principles of entrepreneurship.*

For a number of years now, Center-invest Bank has provided *awards for the winners of the regional "Don Teacher of the Year" competition, including a special prize for "Best New Textbook".*

At the *School for Young Bankers*, which the bank set up for its customers' children and grandchildren, experts explain banking transactions, new products and banking technologies to youngsters in an accessible way. More than 100 schoolchildren from Rostov-on-Don, Semikarakorsk, Bataisk and Azov visited Center-invest Bank during *Doors Open Days* as part of a long-term programme to increase financial literacy.

In autumn 2013 Center-invest Bank opened a *children's bank branch in Kidburg*. This is a miniature town where youngsters can find out about many different kinds of jobs. At the Center-invest Bank branch, children can learn about being a teller, cashier, senior cashier, cash-in-transit officer, and even an assistant branch manager.

Students. Every fourth student in the region receives their *grant on a Center-invest Bank card*. The bank has been running payroll programmes for southern Russia's leading higher education institutions since 2004. The schemes are based on bank cards with *preferential terms* for educational institutions.

Center-invest Bank opened Russia's first *bank café* at its head office. Created specially for young people who are on the go, the facility combines access to modern banking technologies and services with excellent customer care. Customers can avail themselves of the full range of banking services in a pleasant café atmosphere.

More than 3000 students have used a *Center-invest Bank loan to pay for their studies.*

Endowment Funds. At FYE 2013 the capital of the Endowment Fund for Education and Science in the Southern Federal District, set up by Center-invest Bank, exceeded RUB100.5m. The Fund is used to further develop social and educational projects for schoolchildren, students, young academics and teachers in southern Russia. For over eleven years now, every December, the bank and the Endowment Fund for



Presenting awards to winners of the scholarship competition

Education and Science in the SFD have awarded RUB20,000 scholarships to more than 300 of southern Russia's top students. The annual scholarship fund exceeds RUB6.5m.

Case study 21. "My name is Natalia Oleinikova, and I am a medical student. I would like to share an extraordinary story with you. This academic year, I won a scholarship from the Education and Science in the SFD Endowment Fund. My joy knew no bounds when I received an invitation to the award ceremony! But I did not yet know that this evening would turn my life upside down and make me the happiest girl on Earth. The event began with a formal address by Vasily Vysokov, and I will recall his words for a long time. I don't know whether he was joking or not, but he said that the chaps should not be shy that evening; they should go straight up to a girl that they like and ask for her telephone number. As for the girls, he told us that we should make a small concession for these young men, begging just a moment of our time. I was on tenterhooks all evening: the guy sitting in front of me wasn't paying much attention to what was happening on stage; instead, he was looking straight at me. At the end of the event, this intriguing guy asked if he could introduce himself. It turned out his name was Kirill Kobzev and he was a postgraduate student at Don State Technical University. And so it was on that day, 18 December 2012, that our beautiful relationship began. But the most amazing thing is that at 10.30 on 24 May 2013 we will get married. You can imagine our surprise when we received a letter to a meeting of scholarship holders, to be held at exactly that same time! There was surely some kind of magic in the air. Of course, after our own event, we will be delighted to revisit the place where our relationship began. But this time we will be going as husband and wife! Thank you, Center-invest Bank, for supporting students, postgraduates, and young lecturers. And a special thanks for introducing us to each other, and on such a splendid and wonderful day you are also with us!"

From a letter by a winner of the Education and Science in the SFD competition.

More than 2,500 students enter the competition every year. They present the results of their academic and community-based work to introduce new approaches and technologies in southern Russia's economy, environment and society. After the winter session examinations, the students themselves nominate their institution's best young lecturers to receive a grant of RUB75,000. For many of the participants, these awards are not just about the money, but also about personal achievement.

The bank's experience of implementing best international practice makes it an effective partner for the region's universities. Representatives of the bank are on the boards of the Endowment Funds for the Southern Federal University and Don State Technical University, and the boards of trustees of Southern Federal University and the Southern Russian State Technical University.

Enterprise for All. On the basis of its own educational materials, the bank set up the "Enterprise for All" online portal to provide free online training in the basic principles of entrepreneurship (www.school.centriinvest.ru). More than 6,500 people have registered for the course, and more than 1,200 users have already successfully completed it. The portal has been included in Child Finance International's online library (<http://childfinanceinternational.org/>).

Youth Business Russia. The bank runs this programme together with the International Forum of Business Leaders (IFBL). Following assessment of their business proposals by an expert panel, young people can obtain unsecured loans of up to RUB300,000 at a rate of 12% per annum. In addition to consultancy services, the entrepreneurs also receive mentoring from some of the bank's most experienced business customers. The programme is just gathering pace, but already **62 loans** have been made for a total of **RUB17m**.

For students who are in paid employment the bank offers loans of up to RUB50,000 on preferential terms: no requirement for loan security or guarantors, terms of up to three years.

Every year, more than 600 people attend free training seminars on

taxation and accountancy held at the bank's Advice Centres (Rostov-on-Don, Volgodonsk, Shakhty, and Taganrog).

Financial Literacy Centre. Together with the Southern Federal University, the bank has opened a Financial Literacy Centre. Aided by modern technology and assisted by specialists, students learn about deposits, investments, lending, and mobile and online banking.

After completing the course, the students act as advisors for their relatives, acquaintances and other visitors to the centre.

Working with faculties. Together with SAP CIS, under the *SAP University Alliance Programme*, the bank set up training centres at Southern Federal University and the Southern State Technical University (Novocherkask). In 2013, the Novocherkask centre was certified by SAP AG for training specialists and developing programmes.

The bank regularly supports events held in universities to promote knowledge and research into entrepreneurship and the acquisition of entrepreneurial skills. In 2013, thanks to financial support from the bank, a Festival of Science was held in southern Russia for the fourth consecutive year. Every year, grants are awarded to the seven young university lecturers who win the "Best Young Lecturer" competition, organised by Center-invest Bank and the Endowment Fund for Science and Education in the SFD.

International Training Programmes. Together with IFC, the bank set up an *Energy Efficiency Centre*, which trains IFC partners from Belarus, Ukraine and other regions. As part of the "Partnership for Modernisation Programme", Center-invest Bank and its partner banks organise events for entrepreneurs from Austria, Italy, France, Germany, India, and China. The bank has held a lecture series on the Modernisation of SMEs in Southern Russia. This year, the bank arranged free training for new entrepreneurs.

The bank was a co-organiser of the first Russian Forum of Youth Enterprise Leaders, which brought together experts and heads of European and Russian youth enterprise programmes, including representatives of the Rostov Region.



With a grant from Chairman of the Board of Directors of Center-invest Bank, Dr Vysokov, students and postgraduates from the Southern Federal University published a book, “The Experience and Cooperation of the BRICS Countries and Their Regions”. The book was presented to Sergei Katyrin, Chairman of the Russian Business Council and President of the Russian Chamber of Commerce and Industry, and Gennady Chizhikov, Chairman of the Ukrainian Chamber of Commerce and Industry²⁴.

Cultural Activities. By participating in cultural projects, the bank promotes culture in southern Russia. In 2013, the bank:

- supported a Melpomena Theatre Festival;
- held a festival of French song (together with the Alliance Française);
- supported a classical concert conducted by Michael Kats;
- organised its traditional concert to commemorate Victory Day;
- held its traditional Christmas operatic concerts at head office for its customers and partners;
- for the tenth year in a row, funded free entry for schoolchildren to exhibitions at the Rostov Region Local Studies Museum and the Regional Museum of Fine Art. To date, more than 80,000 schoolchildren have participated in this project.

Participation in community life. The bank’s solutions based on best international practice have strengthened its standing and influence, and this allows it to actively engage with civil society organisations

24. http://центр-инвест.рф/pdf/опыт_i_sotrudnichestvo_stran_BRICS_i_ih_regionov.pdf

and government authorities. The bank conducts all of its operations in southern Russia in close cooperation with the local population, business community, civil society organisations and public associations.

Center-invest Bank is a member of, pays subscriptions to, and participates in the work of the following associations.

- Association of European Business (AEB) (Chairman of the Board of Directors of Center-invest Bank, Dr Vasily Vysokov, is the chairman of the Rostov sub-committee);
- Rostov Region Chamber of Commerce and Industry (Dr Vysokov is Vice President);
- Russian-German Chamber of Commerce (Deutsch-Russische Auslandshandelskammer);
- German-Russian Forum (Deutsch-Russische Forum);
- Krasnodar Krai Chamber of Commerce and Industry;
- Rostov Region Employers' Union; Russian Union of Industrialists and Entrepreneurs;
- Rostov-on-Don and Bataisk Councils of Directors.

Center-invest Bank board members and employees have been elected to the following public bodies:

- The Rostov Region Public Chamber (Dr Vysokov is chairman of the Commission for Economic Development, Enterprise and Innovation);
- The Public Chambers of the following bodies: North Caucasus Internal Affairs Directorate (Transport) (Dr Vysokov, member), the Rostov Region Ministry for Information Technologies and Communications (Yury Bogdanov, board member), the Rostov Region Ministry for Property Relations (Tatiana Vysokova, member), the Rostov Region Inspectorate of the Federal Tax Service (Dr Vysokov and Pavel Shvarz, members);
- Boards of Trustees of Southern Federal University, Don State Technical University, Southern Russian Technical University, Rostov State Economics University (Dr Vysokov is a member of all four boards);
- Boards of Trustees of the Endowment Fund for Education and Science in the Southern Federal District (Dr Vysokov, chairman; Tatiana Vysokova, board member), the Southern Federal University Endowment Fund (Tatiana Vysokova, board member), and the Don State Technical University Endowment Fund (Dr Vysokov, board member).

The bank also works with the Association of Russian Banks, the Association of Regional Banks of Russia, the Association of Rostov Region Municipal Districts, and the Rostov Region Association of Homeowners' Associations.

All of the bank's business units actively engage with local communities. The bank holds seminars and briefings for municipal bodies in southern Russia on current issues in banking, economic development, entrepreneurship, and housing and communal services.

The bank refrains from operations that would have a negative impact on local communities. In a timely manner, the bank communicates its anti-corruption policy and procedures to local communities and informs them of the impact of external risks. In accordance with Russian legislation, the bank informs law enforcement agencies of any incidents of corruption and breaches of the law. The bank refrains from financing political parties and it does not receive payment for its advice to political and non-governmental organisations or for its participation in the public chambers of a number of government bodies.

All of the bank's new products and services are assessed for their potential negative impact on society. The bank does not provide any products or services that could potentially have a negative impact on society, affect health and safety, or contravene regulations. It voluntarily and intentionally develops and sells products and services that help its customers to raise their standards of living and run sustainable businesses. It regularly and purposefully informs customers of its products and services through all forms of mass media. Using the latest information technologies, the bank enables customers to select for themselves the most suitable terms on which to receive services. By analysing customer feedback and using mystery shoppers, the bank monitors the compliance of its products and services with regulations and voluntarily assumed obligations. No significant deviations from regulations or voluntary obligations have been found. The bank continually develops its products and services, taking customer views into account. It also responds to customer queries.

Working with government bodies. The bank informs government bodies of possible corruption risks and the legal consequences of deci-

sions taken in the interests of corrupt parties. The bank regularly holds seminars, conferences and meetings for various civil society organisations, government bodies, business people, and the general public to share with them best practice methods of achieving objectives without resorting to corruption.

The bank does not make any financial or in-kind contributions, either directly or indirectly, to political parties, politicians, or related institutions.

In compliance with its corporate procedures, none of the bank's business units or employees will conduct any operation involving corruption risks. If corruption is identified, the bank will terminate the operation. When necessary, the bank asks the Federal Anti-Monopoly Service to check whether a counterparty, competitor or partner is infringing competition law.

Prospects for developing the branch network. Center-invest Bank ranks 36th in RosBusinessConsulting's rating of the top Russian banks by number of branches at 2013 year end. Our branch network comprises 130 branches in southern Russia and a representative office in Moscow. In 2013, the expansion of our work with the Federal Treasury departments for the Rostov and Volgograd regions and Krasnodar Krai occasioned the opening of three new branches. Six unprofitable sites were closed down and merged with larger business units. Our Aleksandrovka and Leventsovsky sub-branches in Rostov-on-Don moved into new buildings and can now provide services to more customers.

Together with its twenty years of experience, Center-invest Bank's well-developed branch network allows it to continually deliver sustainable, lasting growth in its key indicators. At FYE 2013 the bank's branches accounted for 82% of the loan portfolio. Our training and development programme for branch staff increased work productivity by 17%.

Center-invest Bank's extensive branch network in southern Russia gives it a competitive advantage in the implementation of its strategy. Our branches provide a full range of modern banking services and products, including: payments and cash management, various loan programmes, leasing, deposits, money transfers and business advisory services. They work with a wide range of customers in southern Russia: large companies, SMEs, self-employed individuals and retail

customers. The system for managing the branch network is founded on close cooperation between functional and regional managers, based on modern technologies and methods.

Creative Banking. The bank's mandate and agreements with its shareholders (EBRD, DEG) and partners (IFC, KfW, OeEB, FMO, EBD, BSTDB) prohibit it from having equity interests in its customers' businesses. The bank provides services based on best international practice and the latest banking technologies. As well as banking services, we provide customers with advisory services (increasing financial literacy, advice on tax and accountancy, business planning and marketing). We are the only bank in southern Russia to have our own processing centre and a modern IT platform based on SAP for Banking, the new version of which we are localising with SAP. Our technological capabilities allowed us to win tenders to service the accounts and bank cards of regional offices of the Federal Treasury, the Bank of Russia, the Federal Tax Service, and the Pension Fund of Russia.

Center-invest Bank established a "self-modernisation" programme for its customers, which is still successful today. The bank helps its customers to acquire world-class equipment and technology to produce globally competitive goods. As local companies are three to five times less efficient than businesses using best international practice, the bank finds integrated solutions based on a combination of technical, financial and social engineering to enable them to overcome this gap: assistance with identifying foreign suppliers and establishing contacts with international partners; arrangements combining trade finance, leasing, and special approaches to risk sharing; and training. The programme has been particularly successful in introducing energy efficiency technologies, increasing agricultural yields, financing the renovation of multifamily residential buildings, and modernising many SMEs operating in various sectors of the economy (including assistance with selling products into retail chains).

By constantly studying best international practice, Center-invest Bank brings out a new product every quarter, while other banks require two to three quarters. We therefore create new markets: we were the first to develop and implement strategies for working with small business, and

the first to finance energy efficiency projects. We have developed techniques and the ability to: finance young entrepreneurs, provide special products for businesswomen, finance renovations to multi-family residential buildings, collect utility payments from retail customers, service the payments and settlements of public sector organisations, and facilitate the introduction of universal cards. We constantly apply innovation in our own operations: we were the first in southern Russia to introduce a corporate governance system, best practice in risk management and balanced business planning, a comprehensive internal control system, and methods to develop home-grown talent and cultivate customer and investor relations.

The bank actively promotes its own experience of applying a transformational banking business model. Together with IFC, the EBRD and KfW it organises special training events for other banks. Center-invest Bank also actively participates in seminars and conferences organised for CIS, EMENA and BRICS countries and in international forums.

In accordance with the RIO Principles, the bank exercises the right to development for its own business and its customers' and partners' businesses, its shareholders, its employees, regional and national communities, and the environment, at both the local and global level. It does this in such a way as to meet the needs of present and future generations. The bank recognises its responsibility to promote sustainable development principles based on the application of best international practice and standards. The bank adheres to an Exclusion List, specifying the types of projects that it will not finance, and it takes a cautious approach to innovations that potentially pose environmental and social risks. Center-invest Bank observes current international business principles (Equator Principles, UNEP-FI Declaration, Global Compact) under its agreements with IFIs. The requirements of these principles are enshrined in its procedures and policies. Given the comprehensive nature of its agreements with IFIs, the bank does not need to adopt separate provisions for each new international initiative. The bank monitors new sustainable development initiatives and updates its internal documentation in a timely manner.

Chapter 3.

Transforming Southern Russia

3.1. The Region's Global Advantages

Southern Russia was formerly the northern point of the Great Silk Road. Today, it is the northern border of the United States. On old English maps, the southern part of Russia encompasses many areas that are now independent states. These areas bordered the former Austro-Hungarian and Ottoman empires. In the current territorial configuration of the Russian Federation, southern Russia comprises the Southern Federal District and the North Caucasus Federal District.

Transformational banking means always taking creative responsibility for one's customers and partners and for the transformations that they undergo. For many years now, Center-invest Bank has followed the processes of transition and transformation in southern Russia with care, love and a sense of responsibility. The changes that occur in the region give fresh impetus to the bank's own development through the localisation of best international practice, and successful localisation itself then becomes an example of best international practice.

Southern Russia: where is it? In Russia, people in official circles began talking about the crisis at the end of September 2008; by early October, Center-invest Bank had already devised a post-crisis development programme for its customers. The response from company owners and managers was positive:

“Yes, difficult times lie ahead, no one will be buying haute couture, but everyone will be buying the jeans made by my factory!”

“I shouldn’t count on any new boats being built, but they’ll be repairing their old ones in my yard!”

“Only 40% of meat packing factories will survive, but those that do will be buying my casing to make their sausages!”

In 2009 I was invited by Bloomberg to their morning television show, which for several months had been broadcasting a “thriller” about the global crisis. At Bloomberg, there are screens everywhere, showing the latest news. After my live interview, the journalists crowded into a small room with questions for me, and one request, “Please tell us, where exactly is this southern Russia?”

The strategy of any company working in Russia should take into account specific regional characteristics. This can reduce the risks to the company and quite often enable them to make more money. I decided to describe in more detail the processes underway in southern Russia so that our customers and partners can better understand the opportunities, risks and trends in the environment in which Center-invest Bank is pursuing a transformational banking model.

Trends. Southern Russia is a region with a “low starting point”: the gap between southern Russia’s indicators and the average figures for Russia as a whole creates considerable potential for dynamic and effective growth. And it is specifically this kind of region that is of particular interest to investors.

Climate and location. Southern Russia’s annual average temperature is 5°C higher than that of Moscow, and this is crucial to the region’s ability to produce many agricultural crops: sunflowers, high-quality wheat, fruit and vegetables. The unique combination of natural and climatic factors creates an inimitably diverse landscape: areas of semi-desert, expanses of steppe, alpine meadows, snow-covered mountain tops, and Black Sea subtropics. Foreign visitors acquainted with the region wholeheartedly agree that, “Moscow is Russia’s centre, but the south is its pearl!”

Southern Russia is located in the triangle of land between Russia's largest rivers, the Volga and the Don, and the Caucasus mountains. It borders the Caspian Sea, the Black Sea and the Sea of Azov. Long before our time, the trade routes of various peoples passed through this territory and the region had what we now call free trade zones. These days, southern Russia is an intersection for water, air, road, rail and pipeline transport routes between the Caucasus and central Russia, and the Urals and Europe. The region's transport infrastructure is well developed: road and rail density is three to five times higher than the Russian average, and in recent years extensive work has been carried out on upgrading roads, airports, stations, and river and sea ports.

The population and the economy. The multi-ethnic population that we see today in southern Russia has emerged over the centuries, influenced by the region's location at the intersection of trade routes. This multiethnicity is reflected not only at an official level, but also in everyday life, with the interweaving of different cultures, customs and traditions imparting a unique character to local literature, music, painting, and even cooking.

Living at the fringes of great empires, the people of southern Russia became bold, freedom-loving and independent of spirit.

With their long tradition of trade and enterprise, southern Russians have created a market economy that, according to former EBRD president Jean Lemierre, provides a good model for the development of the Russian economy as a whole. The south does produce oil, gas and coal, but these sectors do not dominate the regional economy. Southern Russia plays an important role in the production of grain, sunflowers, vegetables, meat, milk and wool. The following sectors have survived and are flourishing in the region: transport, agricultural machine building, ferrous and non-ferrous metallurgy, construction materials production, textile manufacturing, and food production and processing. Southern Russia (the Black Sea Coast and the Caucasus Mineral Waters in particular) continues to be the country's main tourism and recreation destination.

SMEs. Southern Russia's economy is diversified not only by sector, but also by enterprise size: 10% of all Russian SMEs (excluding micro enterprises) are based in southern Russia. Although it was these enter-

prises that “shrank” the most at the start of the crisis, by upgrading their equipment and technology, they also began to recover more quickly. It is unsurprising that southern Russia accounts for almost 20% of all investment in Russian SMEs. When visiting areas of southern Russia located far from large towns and cities, foreign partners are pleasantly surprised to see farmers using German technology in their fields, apples being grown using Italian methods, and companies producing goods that are sold to transnational companies. By using modern equipment and technologies, companies are achieving a three- to fivefold increase in production efficiency. Increasingly, SMEs in southern Russia are being run by young managers who have been educated abroad and who are fluent in European languages.

Foreign trade. As a border region, southern Russia plays a modest role in foreign trade. At the same time, the region accounts for 25-30% of Russia’s food exports, more than 7% of its textile and footwear exports, and more than 10-15% of its imports of metals and minerals. Southern Russia already has the necessary infrastructure to develop its foreign trade: large seaports, rail services, water transport routes, and regular flights by European airlines. Logistics centres are being built at the intersections of major highways. The customs agencies in southern Russia provide the same range and quality of services as their counterparts in the central region. Today, as much as 65% of Russian grain is exported via ports in southern Russia. However, due to the traditional centralisation of foreign trade in the Russian Federation, progress in redirecting trade towards southern Russian channels is slow and requires European companies operating in Russia to adjust their business strategies. For example, following the successful modernisation of boiler houses in the city of Taganrog, a European boiler supplier opened a new dealership at the local heating company. All the major car manufacturers and suppliers of general-purpose manufacturing equipment have dealerships in southern Russia. Moreover, dealerships are gradually becoming service centres and facilities for component assembly. Many companies are introducing energy-efficient technologies and increasing their imports of energy-efficient equipment.

Despite the zigzags of Russian reforms, the sustainable growth of the real economy in southern Russia has attracted attention. Returns are achieved through the higher efficiencies resulting from modernisation of equipment and technology.

Business and the authorities. The regional political leaders in southern Russia display a healthy level of ambition, as do all southern Russians. There is an unspoken competition among these politicians to achieve the best results for a range of indicators, including: the amount of construction work, investment, the harvest, and repairs to housing and roads. From a roughly equal starting point, each of the Federation members in southern Russia is trying to attract investors by offering more favourable conditions for doing business. Almost every Federation member has created an Investment Promotion Agency, which provides support for large projects involving foreign investors, and these agencies are fairly successful. Participants in large projects can obtain tax concessions from the local authorities, and even co-financing for the infrastructure components of projects. A number of the Federation members in southern Russia have designated zones for intensive development. Investment projects in these zones benefit from simplified procedures for land allocation and the creation of infrastructure.

For small projects it is best to find a local partner who knows how to overcome the barriers presented by Russian legislation and its application at the local level. With a local partner, a simple explanation of the content of the project and a public signing of a memorandum of intent is usually sufficient. Although it is not mandatory, it is welcomed when agreements include social obligations to support sport, education and culture.

Business infrastructure. Almost all the large banks, insurance companies, legal and consulting firms, and recruitment agencies, including those founded abroad, have offices in southern Russia, and competition among companies offering business services is strong. Modern business centres, with office premises for rent, have opened in large towns and cities. The commercial and residential property markets are sufficiently transparent and a wide range of properties is available. Many Russian and foreign investors prefer to set up production facilities in small towns that have railway stations, river ports and

access to federal highways. By purchasing existing enterprises in small towns, investors benefit from simpler procedures for land allocation and connection to utilities. However, such a step generally requires the complete reconstruction of buildings and production facilities.

Chambers of Trade and Industry and various industry-specific business associations are active in all the regions of southern Russia. The South Regional Committee of the Association of European Business brings together foreign companies already operating in southern Russia. Members of the committee work together with the authorities, promoting best management practice, including corporate conduct, social responsibility, and public-private partnerships. They also provide advice on an informal basis to anyone wishing to set up a business in southern Russia.

Southern Russia's innovation potential and modernisation. Despite inadequate R&D funding, the number of undergraduate and postgraduate students studying in southern Russia is fairly impressive, and a considerable number of patents are registered. However, when it comes to introducing new equipment and technology for production, southern Russia lags six to seven times behind average European levels. Given this specific configuration of southern Russia's innovation potential, the optimum strategy for the region's modernisation is for its companies to purchase modern equipment and technology on global markets and then become expert in the efficient production of products, goods and services that can compete on these markets.

3.2. Southern Russia's Sustainable Growth Trends

Anti-crisis stress test. Not only did the global crisis underline southern Russia's advantages (its climate, geographical location, diversified economy, and entrepreneurial culture), it also demonstrated the sustainability of the region's socioeconomic model in the face of external crises:

- As personal incomes in the south are lower than the Russian average, the local population could not afford to speculate on the stock or property markets.
- The population used savings accumulated before the crisis to purchase goods that they had longed for even before the crisis.

— With its diversified economy, southern Russia was able to level out the slump in production, avoid serious social shocks and unemployment, reduce costs, and adapt production more quickly to the new post-crisis environment.

— In many sectors in southern Russia the fall in output was less than the average for the same sectors elsewhere in the country. At the same time, by reducing their prices in the early stages of the crisis, southern Russian companies managed to retain their positions in contracting markets and then increase their market shares as these sectors recovered.

During the crisis, the general public, the business community and the authorities in southern Russia all demonstrated a strikingly high level of social responsibility: businesses endeavoured to pay salaries even at the expense of profits, employees agreed to redundancies and compulsory leave without unnecessary conflict, and the authorities tried to find people new jobs. This crisis was not the first, nor will it be the last; it is just the latest one. The anti-crisis vaccination received by southern Russia and the methods that it mastered during the anti-crisis stress test once again demonstrated the region's advantages as a sustainable, transformational region.

Southern Russia's post-crisis development: new challenges and new opportunities. Situational analysis has shown that whatever the developments on global markets, southern Russia adapts quickly. Under all scenarios, southern Russia's sustainable development will continue along its current trajectory:

— Economic recovery in developed countries will allow these countries to invest more in modern equipment (fixed assets) and additional demand will be created for the Russian regions that produce energy resources and food products;

— Accelerated growth in developing countries will increase their demand for food products;

— Fluctuations in market prices for raw materials will only affect growth rates in a number of industries in southern Russia;

— Southern Russia is becoming increasingly attractive for participants in global markets. In terms of labour productivity, the efficiency of production, including energy efficiency, and the time taken to imple-

ment projects, southern Russia lags three to five times behind European countries. This disparity creates a basis for the formation of a “new industrial space” between European countries and southern Russia.

Pre-crisis economic growth created unmet demand among both the general public and businesses in southern Russia. Southern Russia's entrepreneurs are determined and independent people, who recognise the benefits of new technologies and understand how to access sources of finance for small projects. Combined with the ambitions of the region's politicians, this creates scope for constructive dialogue between the authorities and the business community, and creates a competitive environment for the introduction of modern equipment and the production of competitive goods on a new technological basis.

Southern Russia is increasingly becoming an arena for the reference projects of European equipment suppliers, and for replicating experience of modernising different economic sectors. For example, bringing agricultural yields and productivity in southern Russia up to European levels will require an eight- to tenfold qualitative and quantitative improvement in the technology and equipment used by the sector. Bringing the provision and standards of housing up to European levels will require a tenfold increase in residential construction. Road construction needs to increase by the same amount. According to World Bank calculations, approximately seven billion dollars will be required for energy efficiency programmes in the Rostov region alone. At least a threefold increase in investment in the sector will be required to ensure that SMEs in southern Russia can provide the same level of employment as their European counterparts.

Successful cooperation with European companies to modernise southern Russia requires an integrated approach, including technical, financial and social engineering. By using modern equipment and methods, as well as trade finance, leasing and factoring, and by introducing best management practice and a system for establishing contractual relationships, southern Russia can multiply the effects of investment in the region. Southern Russia has a particularly acute need for European rules of the game in the utilities and communal services market, and international financial institutions (EBRD, IFC and KfW) are actively supporting pilot projects in this area.

3.3. Southern Russia: Trends in 2013-2014

Growth amid stagnation. Despite the Russian economy entering a period of stagnation in 2013, southern Russia has demonstrated significantly higher economic growth rates:

- Industrial output increased by 3.8% in the Southern Federal District and by 7.4% in the North Caucasus Federal District;
- Construction output increased by 10.1% due to the building of new factories, offices and housing in the Rostov region;
- Investment increased by 8.7% due to the completion of facilities for the Winter Olympics in Sochi and new factories and offices in the Rostov region.
- Trade (+4.9%), wages (+13%), income (+15%) and retail sales (+4.9%) continued to grow at faster rates in southern Russia.

Although the gap between incomes and wages in southern Russia and the rest of the country is shrinking, previously unmet needs continue to stimulate demand. Lending per capita in southern Russia is two times lower than the average for the country, and this is just one indicator of the potential for growth in consumer demand.

Companies have also started to act more cautiously: the proportion of overdue debt is half the average level for companies in Russia. The capital accumulated by small companies in the preceding periods and their experience of working through the crisis give grounds for cautious optimism.

Table 3.1. Southern Russia: Main Indicators, 2013 / 2012

	RF*	SFD*	NCFD*	KK*	VR*	RR*	SK*
Industry	0.3	3.8	7.4	0.1	0.1	4.4	1.3
Agriculture	6.2	4.4	11.6	6.9	9.2	-1.6	21.9
Construction	-1.5	10.1	1.3	0.2	3.9	20.7	1.5
Freight moved by road	4.2	12.3	-5.9	4.6	15.9	23.6	-11.6
Investment	-0.8	8.7	-0.8	7.8	-8.5	14.0	1.5
Trade	3.9	4.9	5.2	5.7	3.5	3.8	2.8
Real income	3.7	9.2	4.5	12.5	5.7	8.2	9.2
Wages	12.4	13	16	13.8	13.5	11.1	12.4
Income	9.1	15.1	15.3	17.3	8.4	16.7	10.9

* RF — Russian Federation, SFD — Southern Federal District, NCFD — North Caucasus Federal District, KK — Krasnodar Krai, VR — Volgograd region, RR — Rostov region, SK — Stavropol Krai.

New model for foreign investment. Foreign investors have become less active in Russia and they have still not recognised southern Russia's potential: while the region accounted for 13.9% of total investment in Russia, the percentage of foreign investment in the region in 2013 was just 2.1% (2012 - 7.7%).

Per capita, the number of companies in southern Russia with foreign investment is only just over half the Russian average, and employee numbers and turnover are almost three times below the Russian average. On the one hand, rather than put hard work into the real economy, foreign investors prefer to seek speculative gains on stock exchanges in capital cities. On the other hand, business people in southern Russia know the value of the riches that God gave the region, and they are in no hurry to part with them. This does not mean that the economy is closed to best international practice and equipment and technology imports: southern Russia accounted for 3.8% of total exports in 2013 and 4.6% of total imports. Moreover, southern Russia accounts for 30.6% of the country's total food and agricultural raw material exports and 5.5% of its exports of machinery and equipment.

The new model for foreign investors in southern Russia stems from khutor modernisation²⁵, whereby southern Russians are studying and implementing best international practice themselves. Importers of modern equipment and technology should try to find customers in southern Russia themselves. For this reason, the number of representative offices and dealerships in southern Russia is increasing. It is 30% cheaper for a Center-invest Bank customer to go directly to a manufacturer of modern European equipment, as there are no intermediaries. Moreover, Center-invest Bank's participation in the trade finance programmes of the EBRD and other development institutions has allowed its customers to avoid diverting working capital from their day-to-day activities.

Russian investors, including entrepreneurs in southern Russia, prefer to implement new projects, separating them from their existing business: investment is channelled into new legal entities and in the official statistics it appears under "other sources of investment".

25. Khutor modernisation is explained in Chapter 2.

Table 3.2. Southern Russia: Scale and Structure of Investment

	RF*	SFD*	NCFD*	KK*	VR*	RR*	SK*
as % of Russian Federation							
Investment	100	10.8	3.1	6.8	1.0	1.8	0.9
Foreign investment	100	2.0	0.1	0.6	0.2	1.2	0.03
as % of total							
Sources of investment	100	100	100	100	100	100	100
Equity	46.1	34.0	28.7	35.6	57.7	23.2	48.2
Government investment	18.8	20.7	44.4	23.1	15.6	19.9	20.7
Bank loans	9.2	8.8	7.4	10.8	3.8	8.9	7.3
Investment by the general public	3.0	1.9	1.0	0.9	2.8	5.2	0.1
Other sources	22.9	34.6	18.5	29.6	20.1	42.8	23.7

Under the sustainable banking model, the challenges of finding a local partner, and conflicts between investors and local communities, are both addressed by providing training and encouraging the future participants in an international investment process to share information on best international practice.

How does southern Russia compare to European standards? Southern Russia’s place in the world can be assessed by comparing its standard of living and labour productivity indicators with those of other countries. In terms of its size, population²⁶, geographic location and climate, Austria is very similar to the regions of southern Russia. Southern Russia’s economic structure is closer to that of Austria than to that of the Russian economy as a whole. Southern Russia’s transport infrastructure is more developed, and in terms of car and mobile phone ownership, southern Russia is steadily catching up with, and in some cases surpassing, European standards.

Table 3.3. Austria and Southern Russia: Geographical Location and Climate

	Austria	RF*	SFD*	NCFD*	KK*	VR*	RR*	SK*	
Territory, 1000 km ²	84	17098	421	170	76	113	101	66	
Population, million	8.4	143.0	13.9	9.5	5.3	2.6	4.3	2.7	
Urban population, %	68	73	63	49	53	76	68	57	
Latitude °N	48°	55°	47°	43°	45°	48°	47°	45°	
Average temp.	January	-0	-7	-4	1	2	-7	-4	-2
	July	+21	+19	+23	+21	+23	+23	+23	+20
Precipitation, mm	January	37	37	31	28	81	22	40	22
	July	71	85	33	44	40	18	54	53

26. Here we refer specifically to those areas in which Center-invest Bank operates

* RF — Russian Federation, SFD — Southern Federal District, NCFD — North Caucasus Federal District, KK — Krasnodar Krai, VR — Volgograd region, RR — Rostov region, SK — Stavropol Krai.

Table 3.4. Innovation

Per 1 000 people	Austria	RF*	KK*	VR*	RR*	SK*
GDP/GRP (USA=100)**	86	45	35	29	25	20
Exports, USD million***	17	36.6	1.9	1.3	1.2	0.4
Imports, USD million***	18	2.1	1.0	0.5	1.2	0.3
R&D spending as % of GDP/GRP	2.8	1.2	0.3	0.7	1.1	0.5
Patents issued****	135	157	70	94	148	74
Percentage of organisations:						
— carrying out innovations	48.8	9.1	5.5	6	8.1	7.8
— with websites	83	38	37	27	33	48

At the same time, there are also differences, which indicate the economic development priorities for southern Russia and stimulate positive change. For example, in terms of productivity, southern Russia lags two to three times behind Austria. While this is undoubtedly significant, just five to seven years ago, this gap was approximately six to seven times.

Austria is a notable player in international trade. Southern Russia's regions, meanwhile, are still establishing their foothold in trade with the external world. Southern Russia's per capita imports and exports are more than ten times less than Austria's. Yet, it should be noted that while Austria has seen its imports double since the beginning of the 21st century, southern Russia has seen a six- to sevenfold increase.

Although the share of R&D spending in southern Russia is half that of Austria, in individual regions, particularly in the Rostov region, the number of patents issued is comparable with the figures for Austria.

The most perceptible lag is in the practical implementation of innovations. Companies in southern Russia lag six times (five years ago, eight times) behind their Austrian counterparts, where every second company is bringing in innovations. Only a third of southern Russia's companies use a website, 2.5 times fewer than in Austria.

The structure of production in southern Russia is closer to that of Austria than that of Russia as whole. Industry's contribution to value added production in southern Russia is 10% lower than the average indicator for Russia, but roughly the same as for the Austrian economy.

* RF — Russian Federation, KK — Krasnodar Krai, VR — Volgograd region, RR — Rostov region, SK — Stavropol Krai.
 ** 2012, *** per 1000 people, **** per 1 million people

Agriculture plays a key role in southern Russia’s economy, accounting for 11% of gross regional product. However, the main crop yields and livestock productivity are 30-50% lower, and the level of processing of agricultural produce for sale outside southern Russia is low.

Table 3.5. Austria – Southern Russia: Structure of Production, as % of Total

	Austria	RF*	SFD*	NCFD*	KK*	VR*	RR*	SK*
Agriculture	2	4	11	13	10	10	11	11
Industry	23	32	21	13	14	35	24	19
Construction	8	7	12	13	16	5	9	8
Transport & communications	6	11	13	9	16	11	10	10
Trade, hotels, restaurants	17	19	19	25	20	16	21	24
Finance	24	13	9	5	8	8	10	7
Social sphere	11	9	10	17	8	10	10	14
Other services	10	7	8	13	7	7	8	11
Total	100	100	100	100	100	100	100	100

In southern Russia, the share of services relating to transport, recreation, and geographical location is higher than the Russian average. However, the share of the financial services and real estate sectors is three times lower in southern Russia than in Austria. To a large extent, it was thanks to this that the blows of the financial crisis were less painful for southern Russia. The structural changes underway in southern Russia’s economy are bringing it closer to the Austrian economic structure, and the process is not happening so quickly as to jeopardise its chances of success.

Although railway and road density in southern Russia is higher than the Russian average, road density in southern Russia is 75% lower than in Austria, and the number of cars per capita is 50% lower. In contrast, in terms of the number of mobile phones per capita, both Russia and southern Russia are overtaking Austria. This clearly shows the “backward advantage”, whereby the country or region lagging behind does not incur the same risks and costs as the forerunners, and it also has immediate access to more modern solutions.

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Table 3.6. Infrastructure

	Austria	RF*	SFD*	NCFD*	KK*	VR*	RR*	SK*
Density (per 1000 km ²)								
Railways	60,3	5,0	154	123	277	143	182	139
Highways	1341	49	171	356	389	127	161	196
Per 1000 people								
Number of cars	536	242	244	166	262	218	244	231
Number of mobile phones	1612	1827	1803	1316	2018	1719	1645	1538
Number of students	42	45	40	36	33	40	47	46
Number of doctors	48	51	50	42	42	50	40	45
Percentage with Internet access								
Households	79	55	52	38	48	61	51	53
Workers	43	24	20	21	19	20	19	21

As for social conditions, while southern Russia's birth rate is higher than Austria's, so too is its death rate. Life expectancy and housing provision are lower in southern Russia, but southern Russia has proportionately more doctors and students. However, in these areas also the indicators are converging. Let us look now at data on the structure of consumption. It should be borne in mind that in terms of purchasing power parity, per capita GDP in Austria is almost double that of Russia. The data for Austria is for 2011, and for comparability, the net purchases abroad for the Russian Federation have been added.

The population is the end user and the end payer in the economy. With less money than other Russians, the people of southern Russia spend a higher percentage on food. They also spend more on household goods and appliances, aspiring to a better standard of living. As the climate is more favourable, southern Russians spend less than other Russians on clothing and footwear, but, surprisingly, they spend more on housing and communal services. Having one's own car is a national tradition for the descendants of Cossacks and horsemen. Therefore, households spend less on public transport. As they have their own unique recreational spaces and historic monuments, southern Russians also spend

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Table 3.7. Austria & Southern Russia: Structure of Household Expenditure in 2012, as % of Total

	Austria	RF*	SFD*	NCFD*	KK*	VR*	RR*	SK*
Foodstuffs and non-alcoholic drinks	8	28	32	38	34	26	35	31
Alcohol and tobacco	3	3	3	2	3	3	3	3
Clothing and footwear	5	10	9	12	11	7	9	10
Housing and communal services (utilities)	18	11	11	10	12	9	12	11
Household goods, appliances, and cleaning products	5	6	7	7	7	6	7	6
Health	10	3	4	3	4	4	5	4
Transport	11	17	16	11	12	30	9	12
Communications	1,7	4	3	4	4	3	4	4
Leisure and cultural activities	10	7	5	5	4	5	6	6
Education	8	1	2	1	2	2	2	2
Hotels, cafes and restaurants	10	3	3	3	3	2	4	5
Other goods and services	13	6	5	5	6	5	5	6
Net purchases abroad	-3	1,9						

less on leisure and cultural activities, cafes, restaurants and hotels. It is important for the development of ICT that southern Russians' expenditure on education and communications has come into line with the Russian average.

When I am abroad, I often catch myself wondering, "Why is it that they work less than us, but they live better than us?" The simplest and most honest answer to this question is: "They don't do rubbish work!" Developed countries also have administrative barriers, corruption and bureaucracy, but they waste less energy on fighting one another. Consequently, they have plenty of energy left to work together for their mutual benefit. If we in the Rostov region also pool our efforts, using our region's advantages to the full, the effect obtained will be truly remarkable, with an impact that extends to global markets.

The realisation that in terms of its development the Rostov region lags behind Europe, and indeed Russia as a whole, should give commercial organisations, non-governmental associations, government bodies and

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local authorities a powerful incentive to work smarter. This realisation should be the focal point around which the whole Rostov region unites in order to maximise the region's competitive advantages, guided by best international practice.

The anabiosis²⁷ of small business²⁸ . Despite efforts to support small and medium-sized enterprises (SMEs), their share of the Russian economy contracted in 2010-2012: their share of total product sales fell from 28.5% to 26.5%, and of total investment from 6.3% to 5.8%. Salaries at medium-sized enterprises are traditionally 20% lower than the average salary in Russia, while salaries at small and micro enterprises are 30-40% lower. Despite this, the sector's share of total employment increased from 26.2% to 27.5%.

How can we attract new workers to small business when the state dominates all sectors of the economy? What induces Russians to start their own businesses when they know that the salaries are low? How can small business react not to empty words, but to the real economic situation?

Institutional transformations. The anabiosis of small business after the crisis can be seen in the following:

- Medium-sized enterprises have closed.
- New companies, primarily micro enterprises and sole traders, have emerged on their ruins.
- The new companies' employees include people who used to work in other sectors, as well as people who are just starting their working lives.
- As a result, there has been impressive growth in the total number of SMEs, while the number of employees and turnover remains almost the same, but capital and assets have increased sharply.

As to why a low salary is not off-putting:

- Firstly, not everyone receives "the average salary for Russia".
- Secondly, in the segments giving rise to the new ranks of entrepreneurs, even the average salary is lower than the national average.
- Finally, and this is hard for officials and people lacking in imagination to understand: creative people start up their own businesses simply because they are looking for ways to use their skills and knowledge. At the very least, they want to organise their labour more efficiently.

The number of medium-sized enterprises has fallen by more than

27. Anabiosis — (Latin, anabiosis - revival, from Ancient Greek ἀναβίωσις "returning to life, reanimation") an organism's state whereby vital functions slow dramatically (suspended animation), which helps it to survive in difficult conditions.

28. Based on "Small and Medium-Sized Enterprises in Russia. 2013. Compendium of Statistics", Moscow: Russian State Statistics Service, 2013 – 124p

50% in the wholesale trade, the communications sector, the restaurant business and construction. This is due to large chains moving into these sectors. The same trend is seen in employee numbers: after all, behind each new trend in the SME sector there are not only structures, but also people. And people are the most important component of any economic transformation. It is entrepreneurs who get back on their feet and create new businesses on the ruins of old ones. Small business has a unique ability to be a gene for continual reproduction of entrepreneurship and the economy.

Investment in SMEs. In 2012, federal government investment accounted for an astonishingly low percentage of total investment in the SME sector – just 0.69%. The fastest increase in investment was in production infrastructure and social infrastructure. Small business is quicker to respond to market demand and consumer needs, and at “unblocking” bottlenecks. Already, more than half of all investment in the SME sector is for modernisation, a goal that large companies have started to mention less.

Table 3.8. Change in SME Indicators, 2012 / 2010

	RF*	SR*	SFD*	NCFD*	KK*	VR*	RR*	SK
Number of SMEs								
Medium	-45	-37	-37	-36	-44	-46	-25	-39
Small	22	14	12	21	-3	2	51	-1
incl. micro	24	17	15	24	-1	2	44	-2
Sole traders								
Number of active sole traders	36	44	46	40	64	0	53	11
Revenues	86	152	108	264	97	70	115	140

Sole traders. A real entrepreneur, even if they have lost everything, will always be ready to start over again. This explains the sharp increase in 2011 in both the number of active sole traders (29%) and their revenues (+72%). In 2010, the fastest growth was seen in the number of sole traders working in the retail trade, education, and the extractive industries: entrepreneurs were clearly keen to retain their retail skills, transfer their knowledge to others, and make use of natural resources.

* RF — Russian Federation, SR — Southern Russia, SFD — Southern Federal District, NCFD — North Caucasus Federal District, KK — Krasnodar Krai, VR — Volgograd region, RR — Rostov region, SK — Stavropol Krai.

Small-scale farms. Small-scale farms (“peasant” farms) in southern Russia account for more than 22% of all land under cultivation, and for about 10% of cattle, but they produce just 13% of the crops and 4-5% of the animal products.

Regional profile. Southern Russia (the Southern Federal District and the North Caucasus Federal District) accounts for 9% of all Russian companies and organisations, 13% of medium-sized enterprises, 10% of small and micro enterprises, and 23% of sole traders.

Table 3.9. SMEs in Southern Russia as % of the Russian Federation

	RF*	SFD*	NCFD*	KK*	VR*	RR*	SK*
Medium	100	9.8	3.4	3.6	1.6	3.4	2.0
Small	100	8.0	2.6	3.0	1.4	3.0	1.2
incl. micro	100	7.6	2.5	2.8	1.3	2.8	1.1
Number of sole traders	100	15.5	7.5	7.0	1.8	4.9	2.8

Southern Russia’s SME sector has undergone institutional changes similar to elsewhere in Russia, but the trends have been more pronounced in the south: people who previously worked for medium-sized enterprises have found they can apply their knowledge and abilities as sole traders.

Institutional changes have had a positive effect on the whole SME sector. The remaining “medium-sizers” in southern Russia have become stronger, while the new recruits at small and micro enterprises are doing their best to uphold the region’s strong tradition of entrepreneurship: in 2012 southern Russia accounted for 19% of total investment in micro enterprises. However, the highly volatile financial performance of southern Russia’s SMEs remains a weakness of the sector, and net profits are growing at a slower rate than the Russian average.

Small businesses in southern Russia are retaining their positions in the food service wholesale trade, where they have 40-50% of the market. However, SMEs account for just 25% of southern Russia’s food retail industry, as chains are squeezing out small businesses.

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Practical conclusions. Anabiosis is a very healthy reaction by small business to the changed economic situation, with growing state domination and a slowdown in economic growth rates. The need for loans and investment for large and medium-sized enterprises looks ever more questionable. Meanwhile, providing support for start-ups (both to young people and to entrepreneurs who have already gained business experience in previous jobs) looks increasingly attractive and viable.

New start-ups should be competitive and they should be created in those sectors that have the biggest problems and where there is demand. At the same time, the technology, methods and solutions proposed by start-ups must be three to five times more efficient. Only then will consumers, whose incomes are being squeezed, agree to pay for new goods and services. There needs to be more caution when setting up a business on the base of an old one: the previous company has already exhausted its potential. There will be little demand for land under industrial enterprises for some time to come, while restoration of land for new construction will entail additional expenditure, including on upgrading utility lines.

Southern Russia's agricultural sector needs to move away from the notion that small-scale farms can only be used to provide employment; small farms in southern Russia should become start-ups, embracing new agricultural methods and technologies.

Instead of special quotas for public sector contracts, it should be mandatory for all large companies awarded such contracts to use subcontracting to channel at least 15% of the funds received to SMEs.

Faced with economic stagnation and an inevitable budget deficit in Russia, we must be bolder in switching to partnerships between municipal authorities and small business as an alternative mechanism for financing the development of production and social infrastructure.

Stereotyped thinking about grey income. There is a stereotype that the shadow economy dominates in southern Russia, since almost one third of the income of southern Russians is undeclared income²⁹.

29. http://www.gks.ru/free_doc/new_site/vvp/metod.htm

**Table 3.10. Income Structure of the Population in 2012,
as % of Total Household Income**

	RF*	SFD*	NCFD*	KK*	VR*	RR*	SK*
as % of total							
Income from entrepreneurial activities	8.6	12.1	17.5	12.7	15.2	10.3	13.9
Wages and salaries	41.5	32.3	22.3	30.8	35.4	32.2	31.9
Welfare payments	18.5	19.8	18.3	16.9	23.6	21.9	20.7
Income from property	5.2	3.2	1.0	3.7	2.7	3.1	2.3
Other income (including undeclared income from the sale of currency, money transfers, etc)	26.2	32.6	40.9	35.9	23.1	32.5	31.2
Total	100	100	100	100	100	100	100
as % of Russian Federation							
Income from entrepreneurial activities	100	114	151	135	123	93	118
Wages and salaries	100	63	40	68	59	61	56
Welfare payments	100	86	73	84	89	92	82
Income from property	100	50	14	65	36	47	32
Other income (including undeclared income from the sale of currency, money transfers, etc)	100	100	116	125	61	97	87

The picture looks different if we compare southern Russia with the rest of the country by type of income: in southern Russia, income from entrepreneurial activities is higher than the Russian average, while salaries, welfare payments, and even income from property are lower. Other income is money from Russians who holiday in the south. And may there be more of this money, in all the regions of Russia!

ICT in southern Russia. An analysis of the results of monitoring the government programme “Information Society 2011-2020”³⁰ allows us to assess the current level of use of information communication technologies (ICT) in southern Russia, and opportunities to use ICT for the region’s development. In southern Russia:

- People use ICT and recognise its importance, but they are unwilling to take the lead in developing ICT.
- ICT is used more actively in the social sphere (culture, medicine,

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30. <http://www.centrinvest.ru/files/articles/pdf/ikt.pdf>

education), in business, and by households, than by government and municipal authorities and research organisations.

— Due to the low incomes of the population, the level of provision with personal computers and telephone landlines is lower.

Therefore, something of a vicious circle has developed in southern Russia: low incomes prevent the use of ICT to increase incomes, and they also limit the use of ICT in public administration and academia, where it could have the most positive impact on incomes.

Southern Russia's position as an "outsider among leaders" should be used as a "backward advantage". Here, the following factors should be taken into account:

— The region's diversified economic structure means that ICT can be used in all economic sectors and in the social sphere. Given the scale of the potential market, the use of ICT in agriculture, construction, small business, and also to boost foreign trade, is of particular interest. A fairly rapid effect could be obtained from teaching people with low incomes how to use ICT.

— If services to analyse consumer goods markets were set up, the population could save time on purchases and select the best prices. To reduce costs to an optimum level, equivalent services could be introduced in respect of communal services (utilities), management companies, educational institutions, public health, consumer services, hotels and restaurants.

— Regarding consumption trends in southern Russia, it is anticipated that spending on housing and communal services will increase, and that the overall structure of consumption will shift in favour of services. The proportion of spending on communication services will reduce, while spending on education, health, recreation and culture (including with the use of ICT) will increase.

— Although southern Russia still lags fairly far behind European standards, it is quickly catching up. For example, mobile phone ownership per 1000 people is already higher in southern Russia than in Austria. The percentage of households with Internet access is only 30% lower than in Austria, while the percentage of workers using personal computers and the Internet at work is just 20% lower.

Table 3.11. Trends in Socioeconomic Indicators for Southern Russia's Regions

	RF*	SFD*	NCFD*	KK*	VR*	RR*	SK*
Per capita gross regional product							
2000	100	59	35	68	59	51	50
2011	100	63	36	74	61	56	45
Average per capita income							
2000	100	70	50	69	69	72	62
2012	100	81	74	91	70	78	73
Average nominal wage							
2000	100	71	55	76	76	61	65
2012	100	74	63	80	70	72	69
Percentage of the population living below the poverty line							
2000	29			44	35	33	45
2012	13			14	14	13	14

Southern Russia is a large region that is rapidly catching up with the rest of Russia and Europe. It has a diversified economic structure, a population that aspires to raise its standard of education and is willing to pay for communication services, and it is an outsider among leaders with respect to ICT use. This makes the following objective both very important and achievable:

to use ICT to give a new boost to the accelerated development of the economy and entrepreneurship.

However, the region still lags sufficiently far behind European standards for there to be good prospects for business development in the ICT sector. Expanding the scale of the application of creative software and search engines should create the conditions for transition to new management methods based on more modern software for management systems.

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Table 3.12. International Comparison of ICT Indicators

	Austria	RF*	SFD*	NCFD*	KK*	VR*	RR*	SK*
Number of mobile telephone subscribers per 1000 people	1612	1827	1803	1316	2018	1719	1645	1538
Households with Internet access (%)	79	55.1	52.0	37.5	48.2	61.2	50.7	52.7
Organisations using ICT (% of total number)								
personal computers	99	94	90.8	96.3	96.1	84.8	90.2	99.9
Internet	98	86	84.1	87.8	89.3	77.0	83.8	97.3
Broadband	91	79	74.8	79.8	80.0	66.8	74.5	89.6
have a website	82	39	32.7	36.4	36.5	26.7	33.0	48.2
Workers using ICT (as % of the total number)								
personal computers	51	36.9	32.25	33.8	30.7	32.6	30.4	35.4
Internet	43	23.5	19.75	20.6	18.9	20.4	18.5	21.1

Network integration. ICT should integrate an organisation’s internal management processes with the external environment. While some success has been achieved in this (60% of organisations use electronic document management systems), the process of integration has begun to stall. This is because many electronic documents, produced in accordance with strict rules and instructions, are now gradually being replaced by the more accessible email. With emails, the format and the content of documents need to be reconfigured to be compatible with the information systems of government bodies.

ICT for the end user. If current trends continue, it will be eight to ten years until every household in southern Russia has a computer and Internet access. As the region lags two years behind the average level in Russia, eight to ten years is not actually such a long period. On the contrary, given the “low starting point”, which allows the region to use pioneers’ experience, we should already be preparing to work with the new end user. Our sales techniques should allow for increasingly intensive ICT use by households. This is no mean task, given that in terms of website development, organisations lag two to three years behind household needs.

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Table 3.13. Household ICT Use

	RF*	SFD*	NCFD*	KK*	VR*	RR*	SK*
Proportion of households with a personal computer							
2011	60.1	56.1	47.5	53.9	68.1	49.8	51.2
2012	66.5	65.6	54.6	66.0	71.5	61.2	64.4
Internet access							
2011	50.2	47.0	30.8	43.8	59.8	41.7	42.2
2012	55.1	52.0	37.5	48.2	61.2	50.7	52.7

Southern Russia's diversified economy provides a good testing ground for the introduction of best international practice. The use of ICT by the general public, government bodies, business, and public sector institutions should help to boost the positive trends in the local economy.

The level of education in the Rostov region is at least as high as the Russian average. Almost all educational establishments have their own websites, and more than 60% of universities have distance-learning programmes. Whereas it was previously a case of providing the adult population with additional training in ICT, we are now seeing a new culture of everyday use of ICT from an early age. The fact that the population is embracing ICT is conducive to the development of all areas of ICT in southern Russia. For this, rather than specialists with a narrow focus, we need applications engineers who are capable of deploying ICT to develop various areas of the economy.

ICT use has not improved the quality of public administration. Government bodies must share more widely their experience of using ICT to improve their operations. Central and local government bodies require new rules, procedures and methods for the effective use of ICT.

Companies are now actively employing ICT to grow their businesses. They are not just using search engines to find out about legislation; they are also using ICT to develop their business processes for production, marketing, financial, and personnel management, and to create collaborative networks between all market participants, consumers and government bodies.

At first sight, the use of ICT in healthcare is impressive: almost all institutions use personal computers, local computer networks and

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the Internet. However, this is having little impact on the morbidity and mortality rates.

The development of ICT is fundamentally changing the activities of cultural organisations: demand for traditional approaches is declining, but as yet the new methods are not in high demand.

Mobile network penetration and increased access to ICT services in rural areas is creating new markets and new opportunities to take advantage of ICT.

Lessons from the Olympics. As is to be expected with any ambitious project, the Winter Olympic Games in Sochi gave rise to both a sea of delight and a squall of reproof, with talk of corruption and unprofitable facilities. Most probably, much of the infrastructure needed to be built regardless of the Games, and it will be hard to ensure that all of the sporting facilities will be used properly in the future. But it was a shock for the regional authorities when investment completely dropped off after completion of the Olympic facilities. However, the experience obtained in implementing large projects allowed them to maintain the positive trend and their focus on attracting new investors to the region.

The Ukrainian crisis. It is not only foreign journalists who have trouble with geography. For every thousand Muscovites there will always be at least one who, upon hearing that I live in Rostov, will say with all sincerity, “Ah, Rostov, that’s Ukraine!”

Albeit not in the best of circumstances, recent events have drawn attention to southern Russia, as well as Ukraine. The artificial deceleration of transformation processes resulted in not only a political crisis, but also an armed conflict in a neighbouring country with which we have traditionally had a fraternal relationship. The task of the transformational approach is to implement changes without a civil war.

Sanctions. When sanctions are imposed, it is actually the companies whose products are embargoed that benefit the most: they obtain advantages on the domestic market, their European competitors avoid any new projects in the Russian market, and import substitution boosts their growth. At a time of political tension and a constant threat of international sanctions, it should be remembered that any sanctions:

- always have a boomerang effect;

- stimulate opaque schemes;
- provide additional income for intermediaries.

In these circumstances, the sustainable banking business model proposes the formation of a new generation of participants in international activities, and the sharing of information, knowledge, methods and approaches among young people and students.

The transformation of southern Russia. With important competitive advantages (its geographical location, climate, developed infrastructure, diversified economy, and entrepreneurial spirit), southern Russia is today developing successfully in accordance with the “backward advantage” model: it is using best international practice to make local companies as efficient as their European competitors. This “game of tag” will retain its appeal for investors for the next five years. Southern Russia must use this period to master the techniques of localising best international practice so that they become automatic. We must also learn to formulate our own creative solutions from the combinations envisaged by best international practice.

Using the European terms for the different transformation phases (Envision, Engage, Transform, Optimise), southern Russia must optimise the results achieved from the localisation of best international practice and start preparing for new transformations: it should present a new world and begin mobilising for new transformations.

The table below contains recommendations made by Center-invest Bank to ensure the global competitiveness of its customers. It is pleasing to see that many customers have not only assessed their position in the global world, but also implemented transformations, ensuring their rightful place in global markets. Optimising this phase requires a transition from self-evaluation to constant monitoring of best international practice, sustainable access to all sources of investment, and a development strategy that appeals to a broad range of investors. The people in charge of regional government budgets must learn to co-finance effective projects, including projects in the social sphere. A government guarantee will sometimes be sufficient, but in other cases a public-private partnership will be more effective at achieving a multiplier effect.

Case study 22. *The Rostov's Region's enterprise development programme is funded both by the government (approximately RUB0.8bn) and also by bank loans for SME development (RUB113bn). To multiply this experience, it will suffice to require officials involved in other projects to report not only on government funding, but also on their success in attracting private sector funding.*

The Olympic Games in Sochi and the preparations for the FIFA World Cup have provided invaluable experience of promoting the region on global markets. To optimise the transformations that have already been carried out, we must win the recognition of global markets to obtain financing for other projects in southern Russia. Projects in southern Russia are sufficiently effective and profitable. Due to barriers created by federal legislation, construction projects have become more expensive. However, procedures for expert review and bringing new infrastructure into operation are now being simplified. In combination with a greater onus on officials to attract money from the private sector, the removal of barriers will strengthen southern Russia's investment appeal. Southern Russia should become one of the most attractive regions for infrastructure investment. This will require the elimination of barriers, the creation of suitable schemes for project co-financing, and a long-term tariff policy.

The demographic situation and the challenges of global modernisation require a workforce that is capable of providing transformational responses to these challenges; a workforce that can find and implement sustainable, creative solutions. To this end, students must be taught the basic principles of entrepreneurship and given the skills to use ICT to monitor best international practice. In addition, clusters should be created for the implementation of modernisation projects. It is a competitive advantage for southern Russia that such clusters can be created in all sectors of the economy and in the social sphere. When young employees join Center-invest Bank they gain invaluable experience of introducing best practice, which gives them a competitive edge in global markets.

The global trends of higher prices for dwindling natural resources make environmental protection projects more profitable. At the same

time, technological progress constantly generates new, more effective solutions, which reduce demand and prices for resources that were previously scarce. Transformational price setting must allow for these divergent trends and for switching to different price setting mechanisms as new risks and opportunities appear. Instead of blindly following transient price fluctuations, we must determine common rules and include in them a procedure for changing the rules.

Economists who advocate institutionalism believe that in a transition economy it is important to create the “correct” institutions: to limit the responsibility of the authorities, to create markets in the place of monopolies, and so on. In a transformational economy, as well as creating new institutions, it is important to liquidate obsolete institutions and their functions at the right time. So they can take practical steps, businesses and organisations should identify their rightful place in the new institutional environment. Knowledge and the ability to localise best international practice already give a competitive advantage in this respect.

Case study 23. *The Public Chamber of the Rostov Region has shown that civil society organisations should neither substitute for, nor replace, new opportunities and new threats in our rapidly changing world. Instead, they should alert society to these developments. Since the outset, the high level of professionalism and the experience of the Chamber’s members have set the bar high for efforts to address social problems on the basis of best international practice. The Chamber’s mission is to make sure that the Rostov region uses its globally competitive advantages. Moreover, this concerns advantages not only in the economic sector, but also in culture, art, science, education, public health, social welfare, international relations, environmental protection, and even mass media practices.*

This approach was not initially universally accepted. However, it was partly thanks to the results of the Chamber’s work that the authorities set the following transformational objective: “Rostov region - the leader!” and proposed the seven “I”s as a means of achieving it: Intellect, Initiative, Institutions, Infrastructure, Investment, Innovation, and Industrialisation.

Table 3.14. Interlinkages of the Measures Involved in Localising Best International Practice to Ensure Your Own Global Competitiveness

	Plans and projects	Lending	Finances	Marketing	Social protection	Prices	Institutions
Plans and projects	Self-assessment of your global competitiveness	Search for all sources of investment	Increase in budget income from investment	International marketing of infrastructure projects	Producing a globally competitive workforce	Using the difference between domestic and global prices	Local clusters and networks for modernisation
Lending	Submission of business plan	Finance for effective projects	Loan guarantees	Attracting investment from global markets	Insurance for social programmes	Risk sharing when lending	Competition between global banks in local markets
Finances	Analysis of options for financing projects	Combining different lending arrangements	Long-term equilibrium between income and expenditure	Financing the marketing of all projects	Guaranteed minimum financing for social obligations	Managing price risks when budgeting	Reducing the redistribution of public money
Marketing	Infrastructure development projects	International lending standards	Public-private partnerships	Developing modern infrastructure	Developing social infrastructure	Transparent tariffs for infrastructure services	Infrastructure managed on competitive basis
Social protection	Expert review of environmental and social impact of projects	Loans for education	Growth in income from modernisation	Modernising social infrastructure	Assimilating best international practice in the social sphere	Regulating speculative price variances	Transparency of infrastructure companies
Prices	Managing project risks	Loan products for international trade	Obtaining income from imports of goods and services	Increased SME participation in international trade	Subsidising prices for vulnerable social groups	Focus on long-term price trends in global markets	Competition between trading platforms
Institutions	Modernisation of diversified economy	Replacing loans with investment from the market	Increased income due to profitability	Creating competition in infrastructure	Competitive selection of personnel at all levels of management	Market-based pricing in all segments of the economy	Rightful place in global market networks

Transforming the Financial Markets

Center-invest Bank is a regional bank with a global outlook. Our many years of cooperation with international financial institutions and foreign partners have enabled us to study best international practice, including its limitations. (Even the very best practice has its limitations.) We have also been able to assess opportunities to adapt best international practice to specific local conditions.

International financial institutions, specifically IFC, the EBRD, FMO, KfW, OeEB and the EDB, have used Center-invest Bank to test their pilot projects for Russia in the areas of energy efficiency, agribusiness, corporate governance, risk management, internal control, and banking operations development. Moreover, the testing ground is a region where personal income is just 70% of the Russian average. Center-invest Bank sets a positive example for the Russian financial community, demonstrating that sustainable development in the banking sector can be both socially useful and commercially advantageous.

However, the reason we have been so successful is that, at first intuitively, and now consciously, we have been augmenting sustainable development principles with transformational banking approaches: we have not been afraid to respond to the continual challenges, and to turn our responses into solutions. Center-invest Bank will continue to grow its own business by applying the principles of business transformation. We will also continue to encourage our customers, government authorities, and civil society organisations to adopt the principles of transformation. We will take a range of public measures to promote transformational banking as a framework for post-crisis global and national financial markets. The next

step will be the implementation of transformational banking principles for other market participants:

► The unification of the financial market will require an inventory of the methods for regulating the different financial market participants: payment systems, banks, financial and insurance companies, stock market players and microfinance institutions. The aim will be to devise a common approach to the instruments for regulating capital adequacy, liquidity, risk concentration, and affiliated parties. This list will then be added to, but changes will be introduced systemically, rather than piecemeal for individual participants. Ultimately, the numerous laws regulating various market segments will be systematised in a Financial Markets Code.

► In parallel to the unification of the financial market, banks should be segmented by risk exposure. This process should be based on the unified approaches to the different financial market participants. However, the general principles of unified regulation should differentiate between banks that are engaged in consumer lending, mortgage lending, financing working capital, investment projects, and playing the securities market. If a participant operates in several segments, their aggregate risk should be based on the maximum risk level and the corresponding ratios applied to all of their activities. Once differentiated ratios have been introduced, banks will themselves determine their maximum risk exposure. If the regulator discovers that these risks have been exceeded, it will revalue all the assets at the new level. If the market player's capital is insufficient, the regulator will remove it from the market.

► After the unification of approaches and the segmentation of market participants, a transparent regulatory system must avoid non-disclosed "substantiated" judgements and instead require all "judgements" to apply to all market participants. This will avoid the regulatory system being constantly suspected of bias and corruption, and will mean that only truly professional judgements can be made. Representatives of the regulator will be exposed as unprofessional at the first sign of an "individual approach". The principles of proper corporate conduct for regulatory and supervisory bodies should require employees not only

to comply with the law, but also to refrain from any actions that could be construed as an intention to break rules and standards of conduct.

► A National Payment System (NPS) should above all be a payment system. It should be sufficiently globally competitive that it can go beyond pedestrian ideas about universal control and accounting (recording transactions) and realise the “Cash-Free World!” dream of international payment systems. Payment systems will not be highly profitable, but they must be highly reliable. Market competition between payment systems will be based on the technological advantages of information and communication systems. The profitability of payment systems will depend on their scale, the number of participant banks, and the range and quality of additional payment and settlement services. The system should be able to connect and interact with any international and local payment systems. The NPS should become a system for circulating money, and it should service the circulation of goods quickly and effectively so that ultimately the state can do without gold and currency reserves. Once the appropriate services have been created, the authorities could help by banning cash payments in all public transactions and most of the private sector’s transactions. Cash will be used for criminal transactions only; it should be considered a crime for officials and politicians to have their hands on cash.

► The redistribution of financial resources between market segments should take place on the open market only. Central bank auctions will create a transparent basis for the price of liquidity in settlement systems, payment for using customer account balances, and rates on loans for current transactions.

► Ratings agencies must publicly disclose information about their methods for compiling ratings, and also highlight all areas where their analysts make subjective judgements. The regulator and market participants have the right to point out publicly the risks in subjective judgements. Every market participant is entitled to have their own criteria for selecting ratings agencies, should they wish to use ratings in their work. Market participants using ratings must bear genuine responsibility for decisions taken with the aid of ratings and independent judgements. The activities of ratings agencies will be directed primarily at assess-

ing investment projects and products, rather than financial institutions. There should be several independent assessments for every project and product, and these should be based on analysis of at least 20% of the market for analogous products.

► Accounting and reporting systems will retain their national and methodological differences, but, thanks to information technologies and software, they will be able to automatically generate reports for any system that aggregates data on banking transactions. Regardless of which system is used, bank reports will be made public.

► When a politically exposed person (PEP) is a member of a financial market participant's governance body, the most stringent of the accepted forms of regulatory impact will be applied automatically in respect of that market participant.

► As well as their financial accounts, financial market participants must publish their strategic plans and forecasts for the segments in which they operate, indicating the strengths, weaknesses, opportunities and threats. The planning system should include planning documents that have various time horizons and that address the different business units, networks and types of operations and products. Transformational banking requires banks to develop not just long-term plans, but also strategic plans, which view both the objectives and the resource limitations as variables, and take into account environmental, social and legal risks.

Banks will conduct a creative analysis of a wider range of options, risks, and possible responses to challenges. There should be procedures in place to ensure both continuity and succession in planning: the long-term plan includes a description of the main processes after the strategic objectives have been achieved, and current plans are reviewed as each stage is accomplished. Iterative procedures for developing plans for individual business units, products and transactions should be embedded in the planning process, and they should involve employees from every business unit, not just senior management. When there is a real dialogue, it allows banks to select more effective product strategies, and to obtain additional benefits by providing comprehensive services, bundling its products and services, reducing the costs

involved in agreeing procedures, and improving the quality and flexibility of the services offered.

▶ The plans of financial market participants should be coordinated with their customers' plans. This entails holding briefings and seminars for customers, the business community, and local political and non-governmental bodies. Although this information exchange requires additional expenditure, it is a good marketing channel for disseminating information about the bank's plans in specific market segments.

▶ The accounting and reporting system for financial market participants should include analytical accounting for the funds raised, broken down by risk. The risk management system will become an integral part of the operations of all market participants. Risk management procedures will not simply demonstrate the capabilities of mathematical statistics and computer systems, but be complemented by specific, substantive analysis, building up quantitative and qualitative analysis like a layer cake. The risk management system must be transparent and public.

▶ Financial market participants must have properly approved Rules of Corporate Conduct that clearly set out decision-making procedures for matters not covered by legislation on the rights of shareholders, employees and customers. Given the shortcomings of market mechanisms, government regulators, and independent assessments, financial market participants must openly explain the nature and the point of their activities. In addition to clearly delimiting money by maturities, the usual set of obligations voluntarily assumed by financial market participants seeking to raise funds includes: independent ratings and audits, and rules and procedures for corporate conduct, risk management, planning and internal control, and personnel management. The regulator must demand that financial market participants have these documents and that they are publicly available. At first sight, the voluntary assumption of additional obligations looks like self-torture, a source of additional expense. However, transformational banking allows banks to obtain real competitive advantages from these obligations, and not just fodder for marketing materials. By revising existing procedures, various options can be compared, best practice identified, the cost of cooperation reduced, ambiguity in decision-making avoided, and

decisions standardised. Ultimately, the new business processes are transformed into a new business culture. As the number of regulatory and supervisory bodies, independent auditors, and ratings agencies continues to increase, transparency is more financially advantageous than restricting information. Even the risks that information will be misused are reduced if a bank is firmly committed to transparency.

- ▶ Financial market participants should adopt, implement and report on a social and environmental policy. Social and environmental reporting should be integrated with standard bank reporting and demonstrate the market participant's impact on external processes.

- ▶ Financial market participants are obliged, on a regulatory basis, to inform users of their services and society at large of assessments of their financial status, the strengths, weaknesses, opportunities and threats of the companies for which they have raised funding, and to what extent investor risks are covered by capital.

- ▶ Individuals and organisations must disclose income received from financial market participants; otherwise, this income should be seized and added to the public coffers or given to the Deposit Insurance Agency.

- ▶ Personnel management will be based on employment legislation and the principles in international agreements. The interests of every employee will be taken into account when developing internal regulations, strategic development plans, and investment projects and programmes. Specialists will be selected when they are still in the earlier stages of their development. They will be given the opportunity to combine theoretical knowledge with practical work, and to study best practice and its implementation. Knowledge acquired will be passed on to the next generation. For the employees of financial market participants, a “ban on practising” (debarment) will be introduced for violation of regulatory requirements and/or current legislation in any sphere.

- ▶ As well as being the task of internal control departments, internal control will become a work principle for all of a bank's employees. Any employee may demand an explanation for non-transparent actions, and they must also inform their colleagues of any such actions. Every manager must explain any transaction of the bank. In such a system, every transaction will be checked not only against current bank instruc-

tions, but also against the best practice of other colleagues and business units. Moreover, actions and transactions will be checked for compliance both with legislation and best banking practice.

► Operations development after payment systems have been separated from lending and investment will stimulate the continual introduction of new information and telecommunication technologies to improve the quality of payments and settlements, without increasing the risks that short-term financing will be used for long-term projects.

► The number of participants in the investment financing market will increase, and they will compete with one another to use available funds to finance projects with various timescales and returns. Lending and investment will be exclusively on a fee basis. Market participants will be obliged to warn customers of their responsibilities and the risks in their investment decisions. It will be recorded in every investment agreement that the investor has been warned of the risks they are accepting and that no guarantees will be provided by the government or society, with the exception of the standard anti-fraud measures provided for by criminal law. The professionalism and reputation of market participants will become the main stimuli for operations development in the investment sphere. Government agencies will be freed from unnecessary and ineffective supervision and regulation, while market participants will themselves become motivated to disclose in detail all kinds of information about investment projects. Instead of perfunctory reporting to government agencies, investment companies and banks, in their competition with one another, will voluntarily include information about their environmental and social responsibilities in their issue prospectuses. Similarly, investment companies and banks will choose their customers and partners more carefully, giving consideration to whether they observe environmental and social principles. As a result, the investment financing market will be re-established on a new operational base, and due attention will be given to the impact of investment projects and programmes on the all-encompassing, balanced development of territories, the environment and the social sphere. The role of investment in local public-private partnerships will grow. In the consumer sector, extortionate express lending will be replaced by the tried and tested

arrangements offered by credit cooperatives.

▶ Every “silent” depositor will be obliged to state clearly how they intend their funds to be used. Otherwise, their money will be recorded in balance sheets as “call deposits” and no one will have the right to calculate any revenue on the balance of these funds (i.e. they will not be paid interest).

▶ Payment systems will not be permitted to place the uncommitted funds of “silent” depositors for investment anywhere except in deposits with central banks. Banks can cover temporary cash shortfalls by buying short-term funds in central bank auctions.

▶ Investment banks will be able to attract long-term money directly from investors or from other intermediaries, but only if the banks have the right to manage this money for a correspondingly long period of time. Short-term funds can be used to finance investments, but only on the basis of auctions held among payment systems. When investment banks bid in these auctions, there should be a limit on the risks of investments undertaken by the participants in the auctions, but the price of the funds for the investment banks will be based on the cut-off price of all the bids submitted both by investment banks and also by settlement banks.

▶ The division of banking into payment and settlement systems and investment will not create an impenetrable wall between these two markets. On the contrary, the division of bank balance sheets into short-term payment and settlement operations and investment financing should be accompanied by a strengthening of market mechanisms for the flow of funds between short-term and long-term money markets.

▶ International anti-crisis marketing should halt attempts to hide from the global financial crisis behind national borders, and encourage countries to use the advantages of globalisation to overcome the crisis. Opportunities for demand growth have been virtually exhausted in most developed countries. At the same time, in developing countries, there is both a need and a demand for proven technologies. Given that developing countries lag three to five times behind the developed world in terms of technological efficiency, investment will yield returns even when the local population’s income is low. As a result of the recession,

developed countries now have a surplus of engineers, designers, builders and equipment suppliers. Moving these freed up resources to other regions would have more of an impact than governments propping up internal demand. In addition to responding to the gap in technological efficiency, it is essential for national and global economic growth that barriers between countries be cleared away: customs, borders, and legislative barriers. Whenever political leaders meet, in the interests of reviving the global economy, it should be mandatory for them to discuss measures to simplify customs and visa procedures, expand contacts between SMEs, and reinforce the rights of citizens to free movement. For tolerance between different peoples, nations have to mature psychologically. The economic conditions have to be right and the necessary legal and regulatory frameworks in place. We must view the future global economy as an uninterrupted whole, without any additional external restrictions imposed by individual states. Then the potential of each country can be used in the most rational way. When countries impose external restrictions, it is generally for the benefit of the ruling bureaucratic elite, rather than in the interests of the rest of the population. The free movement of resources, goods and services between countries and regions is in everyone's interests. By comparing the levels of infrastructure provision in different countries and the availability of different types of resources and products, we will be able to identify growth areas, both for investment and for international trade. We will see the material flows that require investment and loans.

To build the post-crisis economy, banks and financial institutions must initiate international trade and propose financial arrangements for transactions between different countries.

Political and legal risks should be compensated for by international financial institutions, and macroeconomic risks should be compensated for by international agreements and state guarantees. National governments should remove customs, tax and bureaucratic barriers standing in the way of new flows of goods.

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Vasily Vasilevich Vysokov
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Editor: Natalia Alyabieva

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