

# Modern Banking Sector in Russia: Trends of Development, Control and Supervision

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## Abstract

**Objectives:** To describe the trends in modern banking sector and the system of State control of the activities of credit organizations in Russia, highlight the advantages and risks that threaten the sustainable development of Russia. **Methods/Statistical Analysis:** Methodological basis consists of conceptual provisions in the area of institutional foundations of development of banking, monitoring and supervision. The systematic approach considering Russian commercial banks as part of financial market of the country. The following methods of scientific knowledge were applied: Comparative analysis and statistical research. **Findings:** More than half of the banks operating in Russia are concentrated in the Moscow region, while in the Far East, North Caucasus, the Urals, Siberia, Southern and North-Western Federal districts, their proportion is below 10%. It has been found that the process of bank enlargement in Russia entails a sequential monopolization of the country's banking sector. It is manifested in the constant increase of the importance of some of the largest state-owned banks in the economy. If in 2007, five leading banks of Russia held 42% of industry assets; by 2016 this figure had risen to 77%. It has been proved that an overall reduction in the number of banking institutions and their affiliates was not caused by compression of the sector, but resulted from its rapid centralization. The authors conclude that excessive bureaucracy in the control of the Bank of Russia hinders the development of the banking sector. It is necessary to generate new thinking focused on formation of professional opinions of supervisors and increased responsibility for results. **Application/Improvements:** The results presented in this paper may be used in further scientific research in this area.

**Keywords:** Banking Risks, Control, Inspection, Monopolization, Supervision

## 1. Introduction

Among many financial institutions operating in the Russian market, the leading position is occupied by banks. Accumulation, redistribution and regulation of cash flows carried out by them directly influence the development of the stock market and the real sector of the Russian economy. Due to the involvement of a large number of economic agents and monetary means of payment into the banking system of Russia, the development of the economy is impossible without its efficient functioning.

It should be noted that despite the fact that the age of

modern banking system of Russia is only 25, its structure has become in many ways up to international standards, existing for hundreds of years. At the same time, the Russian banking sector is experiencing a number of problems hindering the economic development of the state.

## 2. Concept Headings

One of the main problems faced by the modern banking system is the excessive concentration of banking in large credit institutions (Table 1).

**Table 1.** Existing credit institutions (banks) grouped by federal districts of Russia

Federal districts	1.01.15		1.01.16		1.04.16		1.07.16	
	number	as % of	number	as % of	number	as % of	number	as % of
	of banks,	total	of banks,	total	of banks,	total	of banks,	total
	units		units			units		
Central District	504	60.4	434	59.2	413	58.4	393	57.8
including the Moscow region	459	55.0	392	53.5	374	52.9	355	52.2
Northwestern District	64	7.7	60	8.2	58	8.2	57	8.4
Southern District	45	5.4	42	5.7	41	5.8	40	5.8
North Caucasian District	28	3.4	22	3.0	21	3.0	21	3.1
Volga District	92	11.0	85	11.6	84	11.9	82	12.1
Ural District	35	4.2	32	4.4	32	4.5	31	4.6
Siberian District	44	5.3	41	5.6	40	5.7	38	5.6
Far Eastern District	22	2.6	17	2.3	18	2.5	18	2.6
Russian Federation	834	100.0	733	100.0	707	100.0	680	100.0

Source: Banking Supervision Department of the Bank of Russia

As follows from the data in Table 1, more than half (57.8%) of all operating credit institutions are concentrated in the Central Federal District of Russia. The proportion of banks located in the Far Eastern District, North Caucasus, Urals, Siberia, South and the North-Western Federal District is above 10%.

The current stage of development of the domestic banking sector is characterized by the rapid process of monopolization, which has led to the formation of so-called “systemically important institutions”, the activity of which was one of the causes of financial crisis of 2008-2009.

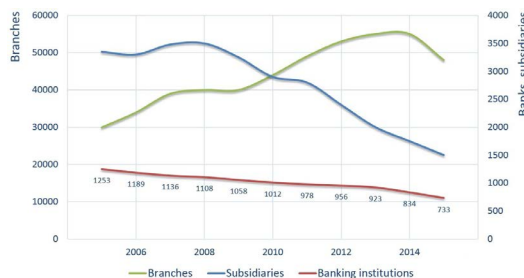
The study showed that the monopolization of the banking sector is typical for most developed economies in the world. In<sup>1-3</sup> monopolization trends often lead to a one-sided assessment, when it is called a serious threat to the modern economy. The<sup>4</sup> scientific literature says that the existence of monopolistic structures leads to various negative consequences for society and makes it impossible to take full advantage of the market mechanism. Scientists often call for a compulsory reduction of the level of monopolization of today’s economy as a necessary condition of formation of a favorable business climate<sup>5</sup>.

Such an approach to the assessment of the process of monopolization clearly does not take into account the existence of certain objective laws of social development, narrows the horizon of the analysis and does not make it possible to examine this issue in a consistent manner. Monopolization should be considered in the context of the historical development of the economy as an objective tendency to become a monopoly as the economic

structure, a complex element of the institutional structure of society. By virtue of this, it is incorrect to give a one-sided assessment of this phenomenon.

### 3. Results and Discussion

As part of this work, we will try to describe the tendency to monopolize the Russian banking sector, to identify the benefits of this phenomenon for the functioning of the country’s economy and its population, as well as to highlight the risks that threaten the sustainable development of Russia. Let us begin with considering such an indicator as the number of banking institutions in the Russian economy (see Figure 1).



**Figure 1.** Changes in the number of banks, their branches and subsidiaries in the Russian economy units.

Source: Compiled by the authors on the basis of the Bank of Russia data<sup>6</sup>.

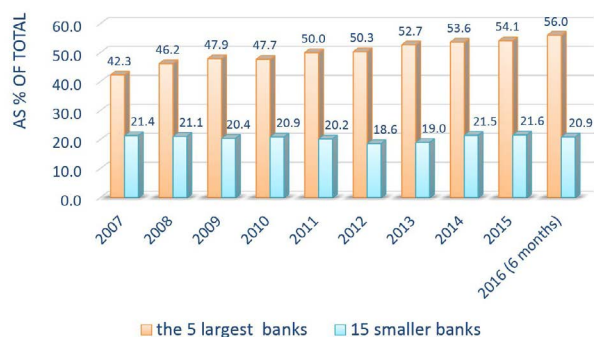
The first thing that attracts attention is a sharp and prolonged decline in the number of banks since 2008, while in the preceding 3 years, it was within a narrow corridor amounting to 1100-1250 banks. From 2008 to 2015 the number of banks decreased at an average by

almost 55 units per year, reaching by 1 January, 2016 the value of 733 credit organizations. The decrease in number of subsidiaries of credit institutions was at even a greater rate since 2008: From 3470 in 2008 to 1389 in 2015. It means that in that period, 260 subsidiaries were closed per year, at an average. At the same time, there is an expansion of the banking network, resulting in a progressive increase in the number of Russian banks' branches, including loan desks, stand-alone cash desks and mobile cash transaction units. If in 2005, the number of Russian banks' branches was equal to 29.6 thousand, by 2014 54.2 thousand of branches were opened (Figure 1).

This fact indicates that the overall reduction in the number of banking institutions and their subsidiaries was caused not by the compression of the sector, but by its rapid centralization accompanied by its active expansion.

Reduction in the number of banks was due to, on the one hand, the increasing incidence of bankruptcies, especially in the late 1990s (Default of 1998) and on the other hand, by growing number of mergers and acquisitions. But there is a third party: A consequence of the consistent work carried out by the Bank of Russia to implement the law on counteraction to laundering of the income received by the criminal way. We will consider this aspect in details hereafter.

The study revealed that the process of bank enlargement in Russia entails a sequential monopolization of the banking sector of the country. It is manifested in the constant increase of the importance of some of the largest state-owned banks in the economy. If in 2007, 20 leading banks of Russia held 63.7% of industry assets, by 2016 this figure had risen to 76.8%. But among the strongest ones the concentration is uneven. 5 leading banks (all of them are state-owned) in 2007 held 42.3% of assets and at the beginning of 2016 it was already 56.0% (Figure 2).



**Figure 2.** Dynamics of proportion of assets of the largest banks in the Russian economy, %.

Source: Compiled by the authors on the basis of the Bank of Russia data<sup>6</sup>.

As a result, 5 state banks in Russia on January 1, 2016 possessed assets of 44.9 trillion rubles, which is equivalent to more than 50% of the country's GDP.

The processes of monopolization of the economy, being an objective phenomenon, have a positive impact in terms of economic development for the benefit of the whole society and negative effects, manifested in a number of risks<sup>7</sup>.

Let us highlight the positive aspects of monopolization. The process of concentration of banking capital can positively influence the profitability of the industry and as consequence to increase tax revenues to the state budget. Due to the consolidation of players as a result of an active policy of mergers and acquisitions and other factors, the increasingly important role is played by scale economy and synergy effect, manifested in saving on fixed costs, greater loading of informational and analytical infrastructure. Similar to industrial enterprises, banks demonstrate the ability to save, not always though, through their own enlargement.

Analysis has shown that the process of concentration and centralization of the banking system provides the following benefits for society as a whole<sup>8</sup>:

- Enlargement of financial institutions could lead to a general reduction in the cost of borrowed resources. Large banks have cheaper funding of their operations, which makes it possible to set a lower rate on loans for enterprises and population.
- Consolidation of banks entails the growth of credit multiplier and as a result, the expansion of the money supply. Due to a more diversified customer base, large banks can maintain a lower level of their own liquidity. In certain situations, it can help to speed up the country's economic growth.
- Reduction of the level of competition in the industry leads to the fact that banks are starting to implement less risky policy without trying to get a new borrower at any cost, despite his doubtful reliability. Otherwise, as many times shown by the practice, a fierce battle for customers can cause the appearance of toxic assets and inflate "bubbles" in the credit market.
- There is a more efficient allocation of financial resources on the market. Large institutions have an informational advantage over smaller competitors due to the possibility to conduct deep industry monitoring and optimally allocate resources.
- Industry concentration provides the possibility for more efficient and cheaper supervision by the state.

The monopolization disadvantages. Along with the advantages the process of monopolization of the banking sector has a number of drawbacks, which threaten the economy development beneficial for the public.

First, the actively enlarging banks are guided by a natural desire to maximize profits, begin to use their dominance to reduce interest rates on deposits and increase credit rates. This leads to an increase of the cost of production, prices hike together with a decrease in household income and consequently, to a slowdown in economic growth.

Secondly, the large financial institutions that have more information about the market and groups of borrowers, in their desire to minimize their risks are prone to credit rationing. This leads to the situation when more risky projects are cut off from credit resources. In the long term this can lead to a decrease in innovation activity and a slowdown in economic and technological growth.

Thirdly, the bankruptcy of a major bank would imply high costs of its resolution and protection of the interests of depositors. So<sup>9</sup>, according to some estimates, in the US bankruptcy of any of the top five banks with a further compensation of depositors' loss would mean the complete exhaustion of the Bank Insurance Fund, especially bearing in mind the massive scale of the banking epidemic in the crisis years.

Fourth, bank consolidation leads to increased systemic risk. In our opinion, it is the largest risk associated with the monopolization of the industry. It became one of the causes of the financial crisis of 2008-2009, having demonstrated that excessive systemic risk is associated with the rapid process of monopolization in the banking sector. A new term has been introduced, meaning financial institutions becoming enlarged: Too big to fail. Such institutions are so large and firmly interrelated that their failure becomes disastrous for the economy. Therefore, their support is necessary for the State in the case of financial turmoil.

Systemic risk is the risk that consists in the following: The bankruptcy of one of the market participants will have in the future negative consequences for the other participants due to the strong interrelation of all players in the market. In<sup>10</sup> other words, the risk of a situation when the economic shock (for example, bankruptcy of a financial institution or its substantial downfall in the financial market) leads to massive bankruptcies of financial institutions, markets fall, large losses of subjects

of the financial system. Ultimately, this will adversely affect the cost of capital, its availability and lead to a sharp increase in volatility in the financial markets.

During the 2008 crisis, regulators decided to save large banks in order to prevent further deterioration of the financial system condition. But in fact, such actions have contributed to undermining of market discipline. Banks have become able to buy any assets. If they bring income, the bank will increase its market share, in case of a loss the bank will be saved by regulators. All this will lead to negative consequences in the form of business cycles with greater amplitude, with increasing damage and increased frequency of occurrence of the crisis events.

The feeling of impunity of owners of systemically important banks has created a new phenomenon in modern society, called by a former US Senator T. Kaufman too big to jail. In<sup>11</sup> emphasized that in recent years no major banker, whose questionable financial activities has led to a severe financial crisis, has been punished. Today, the banking monopoly capital is in fact endowed with political power. State authorities often fail to initiate legal prosecution of bankers, as it may cause panic in society and lead to significant shocks on the market.

In this regard, there is one of the most important questions for the global financial system in modern conditions: What should be done with systemically important institutions and the processes of banking monopolization in general? Implementation of systemic risk will not only have a negative financial impact for its members, as well as in case of other financial risks, but will have also a negative impact on society as a result of increasing unemployment and decreasing incomes of population.

Analysis has shown that systemically important banks are not interested in creating a competitive environment and the development of new banking products. They use benefits obtained by default, that make them possible to maximize profits at the expense of credit financing of sectors with quick return of capital; lobbying of relevant interests; distribution for its own benefit of government subsidies, grants and special powers.

In addition to the insufficient level of development of the competitive environment, the weak points of the Russian banking sector may also include today the capitalization that still remains low, poor diversification of assets, speculative investments, reliance of the largest credit institutions on the state support in situations of economic shock.

A big problem, from our point of view, is the excessive bureaucratization of the state apparatus of supervision and control of credit institutions and, above all, the Bank of Russia, which has become since 2011 a major regulator<sup>12</sup>.

In our opinion, the Russian banking sector could more rapidly overcome the existing lag behind developed foreign financial institutions in key aspects in the case of the political will to reduce the burden on credit institutions, which is determined by the usual practice of implementation of the requirements and control and supervision mechanisms of the Bank of Russia.

Being relied on the Basel Accords, the Central Bank of Russia forces the banking institutions to introduce standards followed in international practice in the shortest possible time, regardless of the losses incurred by Russian banks. Being brought by the Bank of Russia into the strict framework of requirements, credit institutions have to find easier ways to generate revenues.

Back in December 2012, the Russian President in his message to the Federal Assembly focused the attention on the need to change the principle of the supervisory bodies' work, emphasizing that there is an unreasonably large number of experts working in supervisory bodies: "There should be a reporting procedure in order to know what the spending on finance and human resources was and see whether it was at all needful to have this inspection carried out", said the President.

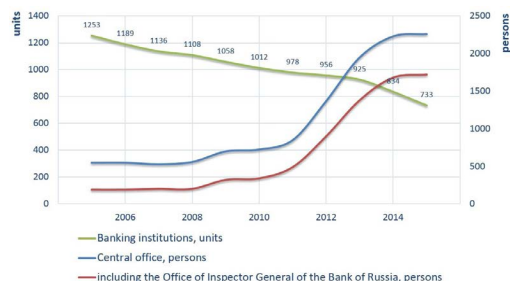
Let us refer to the banking statistics. According to official data, for the period of 2005-2015 together with reduction of the number of credit institutions from 1253 to 733 units, the number of the Central Bank of Russia head office staff grew almost fourfold: From 556 to 2186 persons and the number of specialists of the Office of Inspector General increased more than tenfold: From 156 to 1647 people (Figure 3). This means that the leadership of the Bank of Russia has in fact ignored the order of the President concerning the optimization of the staff of this supervisory body.

An important place in the work of the Bank of Russia is occupied by the prevention of the involvement of the supervised credit institutions in money laundering.

Theoretical studies of problems related to the legalization (laundering) of proceeds of crime, as well as the basics of building of a system of countering this phenomenon were considered in the works of Russian scientists<sup>8,13,14</sup> and others.

The works of Russian and foreign authors have proved that money laundering disturbs normal market

relations and promotes the growth of corruption. Modern economic and financial possibilities, new technology and communication facilities provide ample opportunities to conceal the origin of proceeds from illegal activity in criminal world. It has become possible to actively use a variety of methods, such as instant transfer of funds from one country to another, inappropriately use corporate tools for the purpose of disguising the identity of the true owner of the funds, etc<sup>15</sup>.



**Figure 3.** Changes in the number of banks and employees of the Bank of Russia.

Source: Compiled by the authors on the basis of the Bank of Russia data<sup>6</sup>.

It is practically impossible to determine the actual extent of money laundering in the world due to the high latency of such crimes, as well as due to the difficulty of obtaining of reliable data. Meanwhile, according to estimates of the International Monetary Fund, the amount of money laundered in the world is about 2-5 % of the world gross domestic product, which means from 0.9 to 2.4 trillion US dollars per year<sup>16</sup>.

This raises the question of the need for measures to improve the efficiency of the banking system in the field of combating money laundering, taking into account domestic and foreign experience.

The study of economic literature has made it possible to determine that the development of legislation aimed at combating money laundering was launched in the late 1980s. It was assumed that the creation of legal barriers preventing the laundering of proceeds from criminal activity would reduce the growth of the crimes themselves and would make it impossible to reinvest 'dirty' money in legal activities. However, the legislation counteracting money laundering implemented in a number of economically developed foreign countries did not take into account all aspects of the crimes, being not always related to the economy.

Problems arose in the late 1990s, when many countries with high tax burden have introduced criminal liability for

tax evasion, even in the case of minimizing the taxation of income from legal activities. It was there that a partial substitution of the objectives of legislation against money laundering took place. The well-known analyst Giancarlo Cervino<sup>17</sup> noted: "...ordinary optimization of taxes of the income from the legal activity has been relegated to the level of the laundering of 'dirty' proceeds from the really criminal activity. However, enforcement of legislation against money laundering in cases of purely tax crimes is simply incorrect at best".

The authors adhere to the position of scientists and experts who believe that tax evasion is not always money laundering. Many transactions are made by entrepreneurs who are customers of banks, in order to reduce tax burden in a lawful manner. It is not correct to relate this type of activity with money laundering or the financing of terrorism, because, in our view, it is not related to illegal activities. At the same time, as it is actively practiced in Russia, the banks are punished by the regulator and the Federal Financial Monitoring Service according to the reason of their participation in the withdrawal of money from legitimate money turnover.

It should be noted that with the adoption in 2001 of the Federal Law on Combating Money Laundering and Financing of Terrorism (hereinafter, the CML/FT)<sup>18</sup>, Russian banks have been entrusted with a huge responsibility and a considerable load. In addition to the mandatory daily supervision as per the law, credit institutions must present within the shortest time to the Federal Financial Monitoring Service detailed information on suspicious customer transactions.

It seems that in the CML/FT Russian legislation still assigns a rather passive role to credit institutions. Being developed and agreed with the Bank of Russia and the Federal Financial Markets Service, the internal control rules as per the CML/FT provide for the procedure for registering, storing and transmission of information to an authorized person. However, the role of a "filter" in processing and analyzing information from banks about operations of mandatory control and suspicious transactions is assigned to the Federal Financial Monitoring Service, which stands between the banking system and law enforcement agencies.

President of the Russian Association of Regional Banks, Anatoly Aksakov<sup>19</sup> noting the national importance and necessity of the work on combating money laundering, drew attention to the fact that it has a side effect. According to him, the government is forcing

commercial banks to carry out in fact a fiscal work. The bank should not be a supervisor for its customers. "The legalization of illegal income is nothing less than a crime. We should counteract the crime by using public instruments and not by forming" vigilante groups" of bankers", said the President.

As shown by the study of international experience in this area, adopted legal acts in most countries do not provide for operations related to the mandatory control at all or provide for some constraints regarding certain types of operations. For example, in the US practice, there is a mandatory inspection, but it includes only transactions with cash in the amount of more than 10 thousand US dollars, which allows banks to identify them without any technical problems. Time limits for sending by commercial banks to authorized persons of compulsory control reports consist 15-25 days from the date of transaction. With regard to suspicious transactions, there are no strictly regulated time limits for report sending, they are only specified as "reasonable periods of time"<sup>20</sup>.

The analysis has showed that the number of reports to the financial intelligence authorities about suspicious transactions sent by foreign banks is lower than those recorded in Russia. For example, in the US, one of the first countries, which faced the problem of shadow capital turnover, the banking sector, which currently includes 5.8 thousand banks sends to the Secret Service 1.0-1.2 million reports per year; in the UK, currently having about 400 banks, the average amount of reports sent to the authorized person per year is 0.15-0.2 million messages.

To avoid the immediate and harsh consequences from the side of the Bank of Russia, domestic banks have formed a habit to report to the Federal Financial Monitoring Service not only about operations related to mandatory control and suspicious transactions, but also literally about everything. Already starting from the third year of the functioning of the legislation against laundering, Russian banks have sent to the authorized body more than 5 million reports about questionable transactions. In some years, the number of reports was about 9 million per year, which means that the Federal Financial Monitoring Service within one calendar day was receiving not less than 20 thousand reports. As a result, the Russian financial intelligence is constantly in a state of enormous information overload.

It should be noted that the legislation leaves a fairly wide possibility for justification of measures against credit institutions, violating the requirements of the CML/FT.

Depending on the qualification of the work performed in this area, the assessment of the degree of involvement of banks in servicing the illegal activity of their customers, credit institutions and their leaders will inevitably carry serious administrative responsibility.

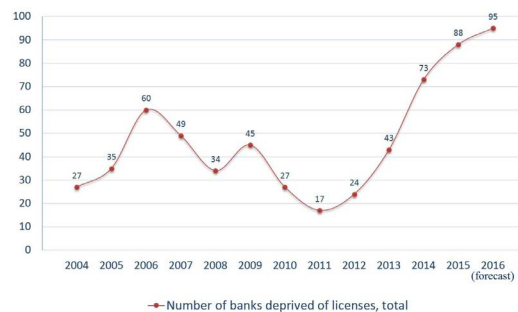
Among the measures taken toward banks violating the legislation against money laundering in 2006-2011 were the following: Preventive measures – bringing to the attention of management of information about the shortcomings in the activities (1753 cases); enforcement measures - requesting the corrective actions (1220 cases); imposition of fines (908 cases); imposition of restrictions or prohibition to perform certain types of banking operations (542 cases)<sup>16</sup>.

It can be stated that the Bank of Russia has launched in fact an unprecedented campaign to revoke commercial banks' licenses for banking operations, in connection with the violation of the requirements stipulated by CML/FT law. Focused on the control of compliance with the requirements of the law against money laundering, the Central Bank, according to its own experts, has diminished the traditional banking supervision. As rightly pointed out by<sup>21</sup>, President of the “Russian Financial Corporation” bank, the control of activities of banks regarding the implementation of CML/FT law has become one of the main functions of the Bank of Russia and at the same time the reason for the sharp conflicts between commercial banks and the regulator.

Historically, the launching of the campaign was initiated as early as in 2004. The years 2006 and 2007 were especially “fruitful” for the domestic banking sector in terms of revocation of bank licenses for violation of legislation against money laundering. During those years, licenses were revoked from respectively 60 and 49 commercial banks. Later, in 2008-2012, there was a discernible trend to reduce the number of revocation of bank licenses from 34 banks in 2008 to 24 banks. However, with the appointment of Elvira Nabiullina to a post of the Head of the Russian Central Bank (June 24, 2013), the Bank of Russia has begun the second phase of the active “cleaning” of the banking market. Revocation of licenses from operating banks mainly among the smaller banks in Russia has become very common in the last 2-3 years, becoming in fact a system (Figure 4).

Over three years of working of E. Nabiullina as Head of the Central Bank, licenses were revoked from 246 banks, mainly small ones. But along with the small banks, several known large banking institutions have lost their licenses

as well. Among the episodes of 2016 (during the period from January 1 to June 31, 58 credit institutions lost their licenses) we can mention six major Russian banks from the top 200: “Vneshprombank” LLC, “INTERKOMMERTS” LLC Commercial Bank, “BFG-Credit” LLC Commercial Bank, “First Czech-Russian Bank” LLC, “FIA- BANK” JSC and “Alta-Bank” CJSC Commercial Bank.



**Figure 4.** Changes in the number of Russian banks with banking licenses revoked in the 2004-2016. Source: Compiled by the authors on the basis of the Bank of Russia data<sup>22</sup>.

In our view, whatever the banks were, large or small, the fact of revocation of a commercial bank license will inevitably lead to impairment of the rights of shareholders, creditors, customers and depositors, collapse in confidence in the domestic banking system.

According to the study, there is another problem now: The mass exodus from small and medium-sized banks, including regional banks, to state-owned banks considered to be reliable due to state support. In these circumstances, the law-abiding banking institutions sometimes find themselves in the extremely heightened atmosphere. Even those banks that have always worked very conscientiously and successfully are frightened. Some of the credit institutions are taking preventive measures to reassure depositors and customers. In anticipation of hard times, good-faith banks augment liquidity and capital in order to increase stability. The capital adequacy of many banks, reaching 25%, is significantly higher than the 10% threshold required by the Central Bank.

This situation dissatisfies both the society and the country's leadership. These data can serve a proof of the fact that the implementation of federal legislation in the field of CML/FT is carried out mostly on a pro forma basis; in fact there is a simulation of money laundering counteracting.

Russian legislation and our legal practice related to the implementation of the Law have set quite vague criterion for information recording operations: For example,

transactions of “confusing” or unusual nature, that have no evident economic sense or apparent lawful purpose, etc. That is, the regulatory documents have already provided the ground for the high subjectivity in decision making.

## 4. Conclusion

It seems appropriate to review in the Russian legislation the interpretation of the grounds for sending reports to the authorized body taking into account the legislation of Western countries, to increase the time-limit for the mandatory reporting by banks up to 10-15 days from the date of the transaction. Also it is important to define in the legislation an exhaustive list of grounds for revocation of the license, ensuring thereby the implementation of the principle of proportionality of crime and punishment.

The further development of the national CML/FT system and the enhancement of its efficiency must be based on the principle of providing banks with greater rights and privileges emanating from the priority of the content aspect of the work over the formal one. The banks, in our view, should be given the right to suspend or refuse to conduct operations in the event of doubt as to their legality. Taking into consideration the development of the banking system, the growth of its complexity, the importance of the modernization of the Russian economy, there is a need to improve methods of combating money laundering; legislation against money laundering should take into account the modern international experience and be flexible enough.

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