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# EVOLUTION OF CORPORATE GOVERNANCE IN RUSSIAN BANKS

## Abstract

The paper examines corporate governance and control in Russian banks. We focus on real interests of stakeholders - bank regulators, owners, investors, and top managers. Anglo-American concept of corporate governance, based on agency theory and implying outside investors' control over banks through stock market, is found to bear limited relevance.

## 1. Introduction

In this paper we stick to the 'narrow' definition of corporate governance (hereinafter "CG") as a set of instruments and institutional mechanisms for protecting the rights of company owners and shareholders. Three aspects will be tackled: (a) consistency of CG in the banking sector with the 'national model' of CG; (b) adequacy of the current model of CG for Russian banks; and (c) implications for investors and bank regulators.

## 2. Ownership, control and governance in Russian banks: *Status quo*

What makes CG a topical issue for Russian banks is the existence of a vast national sector (87%) *not* integrated into multinational structures, which is no longer the case in other transition economies in Europe. Since early 1990s Russia adopts a broad set of formal institutions and mechanisms of CG, including codes of corporate conduct, mechanisms of protection to minority shareholders and small investors, information disclosure, elected boards of directors, independent non-executive directors, and control over conflict of interest in corporate decisions. The adoption of the Code of Corporate Conduct might be interpreted as regulators' attempt to implement the American style of governance (Shiobara, 2006).

Essential features of CG are similar in banks and in industrial companies: insufficient separation of functions of corporate ownership and management; high concentration of corporate ownership and control; prevalence of 'insider model' or 'blockholder model' (Kapelyushnikov, 2005) of governance; extraction of income through control over cash flows rather than dividend payments.

Insiders played the leading role in the privatization of banks in 1990s. Officially reported data might suggest that ownership structure is changing in the direction of broader participation of outsider investors, but nominal shareholding does not reflect real control, and focus on 'final owners' and 'true owners' gives a better idea about ownership and control (Avdasheva *et al*., 2006). The gap between legal form (joint-stock company) and the actual control structure (private company or partnership) denotes the formalistic adoption of institutions of CG. Enforced transformation of state-owned enterprises into open joint-stock companies (OAO) created tens of thousands of fictitious public companies that do not need external investors and permanently generate corporate conflicts (Yakovlev, 2003). 65% of the Russian banking industry consists of OAO (IFC, 2007), but some of them have just 1 or 2 controlling shareholders, are not listed on stock exchanges nor have shares in free float. Each

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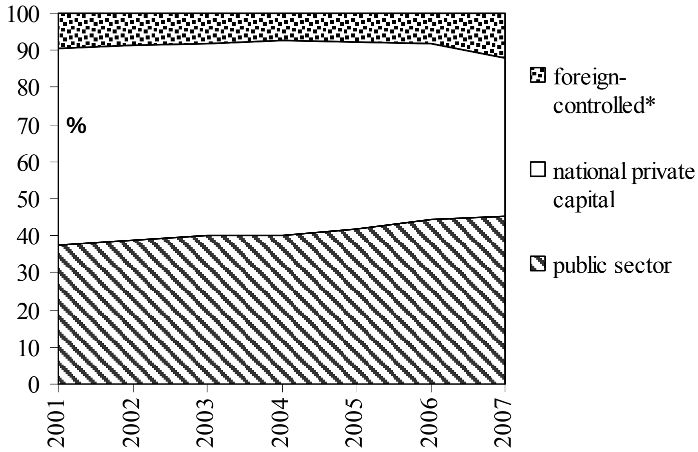
of top 30 Russian banks has a blockholder who concentrates decision-making. Concentration of ownership and control tends to exceed 75%. CG is similar in banks of different legal status (OAO, ZAO, OOO), size, type of ownership, and location.

We see *specific features* of CG in banks as compared to industrial companies: (a) obligatory disclosure requirements make bank ownership structure more transparent to the regulator and general public; (b) a business is associated with a legal entity to a greater degree than in industrial sectors where business groups emerge as an essential unit for analysis of corporate relations instead of individual companies (Avdasheva *et al.*, 2006). In banking groups the existence of independent entities bears a transitory nature in the course of consolidation or divestment. More demanding bank licensing and supervision neuters some of the advantages of running several banks as a single business group. Each bank is regulated on a stand-alone basis with respect to taxation, minimum statutory capital requirement, capital adequacy, observance of prudential ratios, composition of management bodies, etc.




* foreign ownership exceeding 50% of charter capital

**Breakdown of the Russian banking sector by ownership,** as percentage of total banking assets by January 1
Source: own calculations based on CBR data

Evidence supports both theories describing relations between state and business, i.e. 'state capture' and 'business capture' (Hellman *et al.*, 2000; Yakovlev, 2006). A strict classification is difficult, as one can find elements of both strategies working in a combined fashion and in parallel rather than in sequential order (Yakovlev, 2006). Bank owners often pursue political carriers, while civil servants support and patronize banks in exchange of a share of profit. Growing weight of the public sector heralds a return of the 'Big Brother': the share of public sector banks in total assets exceeds 45%, overcoming the share of domestic private banks (Figure; for classification details see Vernikov (2007)). Tens of banks not formally owned by the state remain under decisive influence from state bodies and/or individual officials, especially on the regional and municipal levels. Business capture is facilitated by the fact that many of Russia's private banks grew on windfalls from the state and started with shady transfers of public funds and capital to bank insiders. The state directly or indirectly reclaims some of the assets over which it lost control in 1990s or those now deemed 'strategic'.

### 3. Upgrading corporate governance in Russian banks: *Cui bono*?

Out of a broad range of stakeholders we single out the main groups of interest that promote 'mainstream' concepts of CG in Russian banks: financial intermediaries and consultants, including international institutions; foreign lenders and minority investors; controlling owners of Russian banks; and bank regulators.

**Financial intermediaries, consultants and international institutions** abundantly supply advisory, technical assistance, teaching and coaching in the field of governance. CG advisory is 100% politically correct, carries insignificant costs and no measurable risks, does not allow for accurate cost-benefit analysis by the recipient, triggers no responsibility in case it goes wrong or yields no result, and open doors to prospective clients looking for investment banking services (e.g. IPO arrangement). International institutions pursue their own agenda.

**Foreign lenders and minority investors** would like to see greater transparency and better governance at Russian banks to increase the scope of profitable lending and investment. Only 18 Russian banks (out of a total of 1,143) have stock traded. Sberbank shares are 'blue chips'; shares of Vozrozhdenie, Rosbank and Bank Moskvy display some liquidity; other shares remain illiquid. All have low shares of free float, usually below 5%. The interest of foreign lenders and small investors in promoting CG grows in parallel with the amount of lending to and portfolio investment in Russian banks. Between 01.01.2001 and 01.01.2006 the amount of outstanding foreign loans to Russian banks increased six-fold, from USD 8.0bn to USD 48.1bn. The magnitude of portfolio investment in Russian banks grows faster than foreign direct investment, so its cumulative volume now exceeds the volume of direct investment in the proportion of 58% to 42%. Determining whether a bank owner shows genuine interest towards CG concept, or merely imitates it, requires a case-by-case study. It remains an open question whether bank owners will ultimately withdraw from management.

**Controlling owners of Russian banks** are the category of stakeholders whose ultimate interests regarding CG matter most. The task of protecting the rights of bank blockholders which lies in the heart of CG is successfully accomplished through traditional local practices. Starting from early 2000s, however, owners of leading banks start showing interest towards codes of corporate conduct, information disclosure, dividend payments, etc. They no longer resist the institutional push coming from the government, but embrace it. Yakovlev (2003, 2004) and Avdasheva *et al*. (2006) argue that positive developments in the area of CG are usually simulations aimed at a demonstrational effect only, especially at early stages of opening up towards capital markets. The importance of external borrowings as a source of financing for Russian banks grows: the share of foreign liabilities in total liabilities rose from 10.7% in 2003 to 16.9% in 2007. Russian banks need to raise additional resources through debt as well as equity in order to keep up with high growth rate of assets. This need drives CG improvements — as well as imitations of CG improvements. In theory, better governed banks must be able to find cheaper funding. In practice investors' concerns with regard to CG have little effect on prices. Abundance of global liquidity allows Russian banks willing to attract additional resources to do so easily. Demand for bank shares from outside investors outstrips supply. Banks tend to sell their shares directly to strategic investors rather than to broad public, because the hurdles of maintaining a listed company status exceed the benefits. Bank IPOs remain a media subject not economic reality.

Measuring the impact of CG quality on bank performance is difficult in emerging markets and transition economies (Choi, Hasan, 2005). The period of observations is too short, the number of observations insufficient, and the quality of bank reporting questionable.

The state has a conflicting agenda regarding governance in banks. As a **regulator,** Central Bank of Russia recommends a bank-specific set of CG norms based upon best international practice (CBR, 2005). At the same time, the state is **owner** of 45% of the Russian banking system, and a transparent framework of governance would complicate privatization of minority stakes by bank insiders and impede bureaucrats' interference into bank management. The balance of real interests might support the 'blockholder model' in the public sector.

## 4. Implications for investors: *Caveat emptor*

Recent acquisitions of Russian banks produce mixed evidence of causality between the quality of CG and the price of a bank as multiple of book value. Investors who buy into Russian banks wonder about solidity and sustainability of new institutions and the extent of genuine commitment of bank owners to good governance. The scope of strategic investors differs from that of portfolio investors. A strategic investor may disregard the present quality of CG in the target bank because he relies on strong corporate culture of the parent organization. An advanced system of CG in the target bank might not appeal to the acquiring bank because it complicates and impedes assimilation and integration into a global network.

So far strategic foreign investors do not show much confidence in the quality of governance in Russian banks and proper functioning of institutions defending property rights in case of conflict or opportunistic behavior. Foreign banks usually eschew minority shareholder role in Russian banks. We use the share of capital invested in 100%-owned banking subsidiaries in all direct foreign investment in the capital of Russian banks (almost three-quarters) as a proxy for the degree of confidence in local institutions. Foreign banks tend to aim for *total* control of their Russian subsidiaries and avoid buying minority stakes unless granted a solid call option for qualified control.

Investors in shares of **public-sector banks (**Sberbank, VTB, Gazprombank, etc.) must have realistic expectations about quality of governance in those organizations. Public offerings of shares do not transfer control from the state to private investors, so governance remains roughly the same, despite all the decorum. To entrench itself, the state develops holding structures of a pyramidal shape with broad foundation and narrow summit. Each of these structures can sell minority stakes without jeopardizing overall control.

## 5. Implications for policy makers: *Primum non nocere*

Introduction of institutions of CG remains supply-driven by bank regulators who promote the Anglo-American concept of CG, assuming that progress in CG will foster growth of 'national champions' and improve competitiveness of Russian banks against foreign entrants.

Demand for institutions of CG must come naturally from a diversified structure of ownership. Exogenous (market) discipline works better than regulatory pressure on bank owners. To ensure sustainability of CG institutions and overcome the blockholder model, Russian bank regulators may need to recur to unorthodox (and unpopular) steps. In the end of

2005 the Central Bank of Russia put forward innovative proposals aimed at increasing depth and liquidity of the market for bank shares, e.g. obligatory flotation of all banks whose assets exceed a certain threshold. The proposal split the bank expert community (see: www.rusrating.ru/ru/news/story/events/Debates). In our opinion, making flotation obligatory for all sizeable banks must be combined with a legislative cap on the size of stake that can belong to one beneficiary. Implementation of this initiative would face familiar obstacles: corruption; 'state capture' by interested bank owners willing to retain full control; untransparency of ownership; weakness of enforcement; and conflict of interest between the state as bank regulator and the state as bank owner.

Emergence of genuine corporations in the banking industry would contribute to the regulators' goal of maintaining a national segment in banking. Dispersed capital base would complicate bank takeovers by global investors. A broad capital base means that the acquired bank is not converted into a mere branch but continues to operate as a stand-alone company. The state might demand foreign subsidiary banks to preserve a minimum share of local shareholders, in order to ensure proper functioning of all bodies of management and governance (Rozinskiy, 2006). Such a measure would serve as an 'intelligent' protectionist tool compliant with WTO rules, contrary to blunt tools of protection.

The state must accompany or precede regulatory pressure on private bank owners to improve CG by efforts to ensure rule of law and protection of private property. Dismantling of the blockholder model requires caution. In the short run it may expose banks to external threats. 'Blockholder model' of control stems from exogenous conditions and factors, e.g. weakness of ownership protection instruments (Dolgopyatova, 2004), and so far the environment has not changed enough to allow disregarding defensive functions of governance in favor of a 'civilized' model. Raiders can utilize CG to take control away from bank owners and managers. Bank owners instinctively feel the potential threat coming from an open model of governance – hence the resistance to apparently uncontroversial initiatives such as disclosure of bank beneficiary owners or delegation of managerial functions to hired professional managers. If new CG rules erode control by owners and significantly increase costs, 'best international practices' would be discredited and bank owners pushed back to reliable modes of control.

Initiatives in CG might trigger unintended consequences by opening banks up to due diligence by potential foreign lenders and buyers, thus increasing the chances of acquisition. If empirical evidence does not prove the existence of positive relationship between CG and bank performance, question will arise whether introducing CG was worth the trouble and the cost.

Progress in CG in public sector banks is related with privatization. Placement of minority stakes on the stock market does not produce a new model of governance. A broadening of the capital base contributes to the entrenchment of the top management and gives rise to agency problem. Market discipline does not affect such an organization to the full extent because it continues to rely on the state. A genuine privatization of core state-owned banks is required, and policy makers ought to make up their mind as to which variant of capitalism they promote – 'bank capitalism', 'shareholder capitalism' or 'state capitalism'. The choice might be path-dependent, but it has to be consistently implemented. A combination of heterogeneous institutions will permanently generate institutional conflicts.

## 6. Conclusions

The models of governance are similar in Russian companies and banks, although in banking the transparency of ownership is higher, the role of business groups less pronounced, and hostile takeovers rare.

The introduction of CG institutions in Russian banks is driven by supply from the state, while the interest of blockholders centers solid control and defense against rivals or the state itself. Formal institutions of CG exist in the Russian banking sector but often bear little relation to the actual framework of control, get by-passed or adapted to existing practice. Minority investors in state-controlled banks should not rely on a radical and irreversible change in corporate behavior and governance.

The universality of CG concept should not be overestimated: CG might be more relevant and important in a certain context and at a certain stage of economic development than at other stages (Berglof, von Thadden, 1999; Shiobara, 2006). 'Anglo-American' concept of governance that implies outsiders' control over the company appears irrelevant for Russian banks where 'blockholder model' of control prevails, unaffiliated minority shareholders do not exist, and stock market plays limited role in the allocation of capital. External financing now becomes essential to the leading group of Russian banks, so their owners and top managers increase demand for CG institutions. It is hard to tell whether improvements in CG are merely a simulation ('window dressing') aimed at foreign investors and lenders. If policy-makers are serious about CG, they have to push for measures to convert Russian banks into genuine corporations, including privatization, obligatory flotation of large banks and a cap on the size of individual stakes.

We envisage 2 directions for future research: (a) impact of CG on Russian banks' performance (stock performance and changes in efficiency); and (b) internalization of CG principles and their interplay with informal norms and patterns of behavior.

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