Corporate governance and control in Russian banks

Andrei Vernikov

Higher School of Economics

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A. Vernikov

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The Working Paper employs the paradigm of new institutional economics to examine peculiarities of the Russian model of corporate governance and control in the banking sector. The study relies upon theoretical as well as applied research of corporate governance in Russian commercial banks featuring different forms of ownership. We focus on real interests of all stakeholders, namely bank and stock market regulators, bank owners, investors, top managers and other insiders. The 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. We suggest some ways of overcoming the gap between formal institutions of governance and the real life.

Key words: Corporate governance; control; banks; Russia; institutions; ownership; management; blockholder; state.

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В работе рассматриваются особенности российской модели корпоративного управления (*corporate governance*) и контроля в банковском секторе. Используется парадигма неоинституциональной экономической теории. Исследование опирается на обзор теоретических работ и на прикладной анализ состояния *corporate governance* в российских коммерческих банках, представляющих различные формы собственности. Особое внимание уделено анализу реальных интересов всех участников *corporate governance* – банковских и фондовых регуляторов, собственников банков, инвесторов, высших менеджеров и иных инсайдеров. Делается вывод о невысокой релевантности англо-американской концепции *corporate governance*, основанной на теории агентских издержек и предполагающей контроль внешних акционеров над банками через механизм фондового рынка. Предлагаются способы преодоления разрыва между формальными институтами и реальной жизнью.

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1. Introduction

In this paper[1] we look at the evolving model of corporate governance (hereinafter "CG") in Russian commercial banks. It is an attempt of empirical analysis applied to a specific sector of the economy, with the help of methodology and instruments of institutional economics. Having to choose from many concepts and definitions of CG[2], for the purposes of this study we stick to the 'narrow' definition of CG as a set of instruments and institutional mechanisms for protecting the rights of shareholders and company owners.

Issues of CG in Russian banks have come to the fore of researchers' and practitioners' agenda in the middle of this decade in connection with the practical steps of both major banks – Sberbank and VTB – towards equity markets, as well as many other banks' plans to place shares on the market. CG is no longer the domain of interest of large international players and leading private banks with global ambitions, but it involves a growing number of market participants including state-controlled banks.

Russia's banking sector shares main features and tendencies in the domain of CG with the rest of the national economy. Since early 1990s, state withdrawal, partial privatization and liberalization accompanied the introduction of a set of institutions[3]

[1] The author acknowledges with thanks helpful feedback received from Tatyana Dolgopyatova, Daniel McCarthy, Iikka Korhonen, Patrick Luternauer, Michel Perhirin, Sheila Puffer, Ivan Rodionov, Ivan Rozinskiy, Pekka Sutela, Natalia Volchkova, and Andrei Yakovlev. A short version of this paper was delivered at the 8th International academic conference 'Economic Modernization and Social Development' (Moscow, April 3–5, 2007) (Vernikov, 2007b). The full version was discussed at a seminar held by the State University – Higher School of Economics in April 2007. This study draws upon 15 years of personal experience in the financial sector, i.a. at the Central Bank of Russia, 2 international financial institutions, a foreign bank subsidiary in Moscow and 2 major private Russian banks. **All views expressed are only the author's own** and should not be attributed to any entity. Facts and figures stem from publicly accessible sources only. I solely respond for all errors.

[2] According to a narrow definition, CG is a set of instruments to protect the rights of company shareholder(-s). In a 'broader' sense CG refers to a system of relations, formalized and informal ones, between investors and the CEO, management board and other interested parties (stakeholders) (CBR, 2005). It is a set of institutional mechanisms that protect the property of a large number of investors and harmonize interests of different categories of investors and other stakeholders. CG might extend to all stakeholders (interested parties), including shareholders, managers, suppliers, creditors, clients, employees and even citizens living in the neighbourhood (Berglof, von Thadden, 1999; Shiobara, 2006). A more practical view on CG distinguishes such aspects as ownership structure and external influences; shareholders' rights and relations with related parties; transparency, information disclosure and audit; structure and effectiveness of the board of directors; internal control and risk management (Standard & Poor's, 1998; IFC, 2007).

[3] By *institutions* we mean steady norms and rules of human interaction. We distinguish between institutions and organizations: if institutions are the rules of the game, then organizations are the players (North, 1990).

through which new owners control and protect their belongings. A consensus view of experts has awarded the title of 'insider model' to the emerging model of CG. In the banking sector the 'insider model' acquires peculiar shape and has specific manifestations. There has been no formal privatization of commercial banks, and banks were eschewed from voucher privatizations, for shares-for-loans schemes, and other centrally-driven efforts. Nevertheless many banks or their valuable assets have effectively changed hands over the last 2 decades. There is no such thing in the banking sector as a truly public corporation with widely dispersed stock. Every lending institution in the country has a blockholder, usually an individual one, less commonly a consolidated group of blockholder partners. Despite opaque modes of transformation, property in the banking sector is reallocated seamlessly and peacefully if judged by the standards of Russian industries. It indicates that the emerging model of corporate governance has been efficient so far in meeting its objectives. Finally, an active direct involvement of the Russian state in the banking sector has led to specific modalities of governance among public sector entities, and concepts of 'state capture' and 'business capture' need to be redefined here to regain explanatory and predictive power.

The purpose of the paper is to try answering the following questions:

(a) How consistent is the CG system in Russian banks with the 'national model' of CG and what distinguishes it?
(b) Does the present model of CG work well for Russian banks?
(c) What are the practical implications for investors and for banking sector regulators?

The concept of CG is broader than just matters of ownership protection and control, but due to space limitation we had to restrict the scope of this study. Subsequent research will pursue relevant and challenging topics such as a comparative analysis of evolution of CG among banks in emerging market countries in Southeast Asia and Latin America whose initial institutional setup might have been closer to Russia's than that in advanced economies in Europe and North America.

The rest of the paper is laid out as follows: *Section 2* offers a short overview of relevant literature. *Section 3* describes main features of the model of governance in Russian banks and its consistency with the system of governance in industrial companies. *Section 4* attempts to identify the real interests of main groups of stakeholders with respect to further evolution of CG in banks. We then discuss some practical implications of our analysis for investors in Russian banks (*Section5)*. *Section 6* suggests a few directions for government policies aimed at strengthening the foundation of CG. *Section 7* summarizes the main findings.

2. Literature

La Porta et al. (1999) survey the main contemporary concepts of corporate governance. Black et al. (2000) inquire what went wrong with Russian privatization and CG. Hellman et al. (2000) introduce the notion of state capture by private interests, measure governance and corruption, and discuss how firms and bureaucrats shape the business environment in transition countries. Radygin and Entov (2001) undertake an empirical analysis of CG in the context of property rights protection. Guriev et al. (2003) identify general trends in CG among Russian industrial companies. Yakovlev (2003) evaluates demand for formal institutions (law) in the area of CG and tracks the evolution of economic agents' behavior strategies. Radygin et al. (2004) review economic and legal factors and constraints to the emergence of corporate governance models. Dolgopyatova (2004) studies property and corporate control in Russian companies. The book edited by McCarthy, Puffer and Shekshnia (2004) collects contributions from scholars and practitioners with a diversity of backgrounds to trace the shaping of a national model of CG in Russia, including its main sources and 'inputs'. Yakovlev (2004) compares government policy with real incentives of economic agents to better understand the main drivers of evolution of CG in Russia. Kapelyushnikov (2005) shows why the 'blockholder model' has greater explanatory power as compared to the usual 'insider model' when dealing with economies with high concentration of ownership. 'Blockholder' stands for a controlling shareholder. Andreff (2005a; 2005b) reviews CG structures in post-socialist economies to find out whether Central and Eastern Europe has developed its own specific model of corporate control and whether it is relevant for Russia as well. IET (2005) evaluates the current level of corporate governance in Russian industrial firms, demand for corporate governance standards and relations between ownership structure, investment needs and quality of corporate governance. Avdasheva et al. (2006) analyze CG and management in Russian companies. Shiobara (2006) elaborates the key notions of CG in the Russian context by drawing attention to such categories as 'final proprietors' and 'true proprietors' when discussing the structure of the property. McCarthy and Puffer (2006) offer a theoretical framework for evaluation of the ethicality of corporate decisions in Russia, with the help of integrative social contracts theory rather than the mainstream of agency theory. Yakovlev (2006) suggests that business – state interaction in Russia has evolved into a combination of state capture and business capture. Puffer and McCarthy (2007) look at the main features and varieties of the Russian model of governance they call 'network capitalism', and compare supply and demand of institutions governing the behavior of Russian corporations.

We are not aware of *scholarly* papers devoted specifically to the subject of CG in Russian banks[4], so this paper aims to start filling the gap.

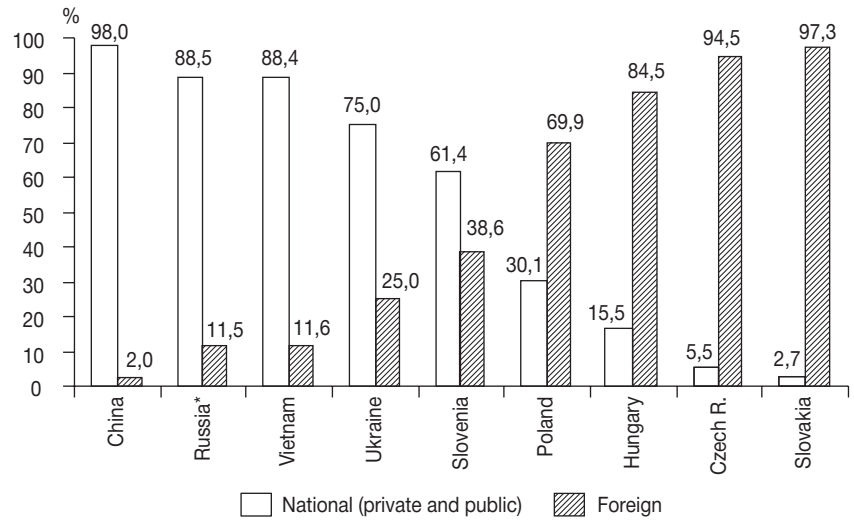
[4] Penetration of Western concepts of CG into Russia has triggered an abundant stream of publications of normative nature, written by staff of international institutions, international audit

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

Several initiatives aimed at assessing CG in Russian banks exist. Standard & Poor's (a rating agency) pioneers in the assignment of CG ratings to Russian corporate and banks, on the basis of elaborate methodology (Standard & Poor's, 1998)[5]. IFC (2004) offers a comprehensive study of all aspects of CG in a sample group of 50 banks to understand the extent to which 'internationally recognized best practices' of CG are implemented in the day-to-day activities of the Russian banks. In 2004–2007 the IFC project is continued, resulting in a detailed report on progress in various areas of CG, this time based on a stronger sample group (IFC, 2007). The report looms into such elements of broadly-defined CG as adherence to the principles of good governance, the role and practices of the board of directors and the board of management, information disclosure and transparency, internal control, audit and risk management, and protection of shareholders' rights. IFC concludes that the level of CG in Russian banks stands at an acceptable level but remains far from perfect. The report does not reveal a systematic and serious abuse of shareholders' rights, mostly due to the chosen method of data collection, i.e. self-appraisal by bank officials. IFC indicates that requirements protecting shareholders are generally complied with, which comes as no surprise given that a small group of people controls overwhelming blocks of shares and at the same time sits in the management bodies of the bank. Validity of conclusions depends on the width of the gap between self-appraisal and formalistic compliance, on one hand, and the real functioning of control mechanisms, on the other; the latter falls beyond the scope of the IFC report.

firms, rating agencies, strategic consultancies, executive search firms, and Russian collaborators and disciples of all the above. Some of this literature tackles CG matters with specific regard to financial institutions. Most of the sources referred to above represent Russian-language versions and interpretations of English-language literature. Their thrust is to promote Anglo-American concepts and experience of CG, to highlight potential advantages of 'good CG' and to describe how things *should be* in Russia. For the purposes of this study we disregard normative literature (except for Russian laws and official documents) and propaganda materials on CG.

[5] Standard & Poor's focuses on the following groups of issues to comprehensively evaluate CG: ownership structure and external influences; shareholders' rights and relations with related parties; transparency, disclosure and audit; and structure and effectiveness of the board of directors. While recognizing inexistence of a single world standard of CG to serve as benchmark for countries with diverse traditions and cultures, Standard & Poor's apply in their evaluations and grading the principles of integrity, transparency, accountability and responsibility. Interpretation of such principles can differ in each society under the influence of national cultural norms. If so, then CG ratings, especially those on the 'international scale', represent but a numerical expression of approximation to a notional benchmark rooted in CG 'best practice' of U.S.A. and U.K.



Source: CBR data; Raiffeisen, 2006; own calculation.

Figure 1: Structure of the national banking sector, as percentage of total banking assets, 01.01.2006 (* 01.10.2006)

What makes CG a topical issue for Russia is the existence of banking entities not integrated into multinational firm structures. Russia differs from most other transition economies in the sense that it has preserved a vast national sector in the banking industry. There are very few large national banks left in the countries of Central and Eastern European (CEE)[6] and South-Eastern Europe where banking sectors consist predominantly of foreign subsidiary banks, branches of foreign banks and local banks controlled by foreign entities (Figure 1). Practically all leading providers of banking services now belong to regional or global network banks (UniCredit of Italy, Erste Bank and Raiffeisen Bank of Austria, KBC of Belgium, Société Générale of France, etc.)[7].

Banks are bound by a set of formal and informal institutions identical to those binding companies in other sectors of the Russian economy; they all are placed in the same economic and institutional environment. In general, Russian corporate

[6] 'CEE' refers to 8 post-socialist economies (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia) that joined the European Union by the time of writing of the paper.

[7] For instance, an assessment of CG in the leading Slovak banks, would imply an assessment of CG quality at the head offices of Erste Bank, Banca Intesa and Raiffeisen Bank that own, respectively, Slovenská Spořitelna, VUB and Tatra Banka.

legislation is quite a developed one — it provides for such institutions and mechanisms as codes of corporate conducts, mechanisms of protection to minority shareholders and small investors, financial and other information disclosure, elected boards of directors, independent non-executive directors, and control over conflict of interest in corporate decisions. Since early 1990s Russia adopts a broad set of formal institutions of CG borrowed from various developed market economies (Puffer, McCarthy, 2004; Radygin et al., 2004). Formal institutions of CG do exist now in the Russian banking sector, but the degree to which they regulate the actual relations between stakeholders varies greatly from one area to another. Their penetration is deepest where they lead to creation of new corporate bodies (e.g. a board of directors), do not come into conflict with existing groups of interest, and do not increase transaction costs to unbearable level. When, however, new norms have the potential of undermining the efficient control of blockholders over their property, or become too costly and burdensome to comply with, compliance become a pure formality, i.e. observance of the form with disregard to the substance.

Unlike CEE countries that consistently borrowed a full set of European formal institutions embodied in the *acquis communautaire*, the Russian government did not limit the range of possible institutional sources to just Europe. Russia chose to borrow separate institutions from a variety of donor societies, resulting in a set of inconsistent and mutually contradictory norms and institutions. For instance, institutions governing stock markets resemble those existing in the U.K. and U.S.A., while banking law leans towards continental European patterns. Governance structure within a bank then becomes misaligned with exogenous institutions and disciplining mechanisms of the stock market. While the system of '2 boards' (a board of directors *and* a management board) stems from European influence, Anglo-American system of law supplies mechanisms applicable to minority shareholders, disclosure, non-executive directors, fiduciary responsibility, directors' liability insurance, etc. The main body of law on shareholding companies and stock markets is supplemented by the Code of Corporate Conduct (FCSM, 2002) recommended by the Russian stock market regulator but not enforced. The adoption of the Code might be interpreted as the regulator's attempt to implement in Russia the American style of governance (Shiobara, 2006, p. 111).

Regardless of formal norms, Russian industrial business groups and banks alike have developed an explicitly 'insider model' of corporate control and governance. It reflects the predominant role played by company insiders in the privatization in 1990s. Banks were not subject to voucher privatization or 'loans-for-shares' schemes. On the contrary, new Russian capitalists used their banks as vehicles to accumulate assets in the course of privatization and to grab valuable industrial companies through 'loans-for-shares' schemes. A substantial proportion of assets of state-owned banks was reallocated to insiders, top managers in the first place, who either took

over their respective institutions in the course of state withdrawal and reorganization, or transferred assets to newly-born private banks, or both.

Russia features high concentration of ownership and control tending to exceed 75% of equity at each company (Yakovlev, 2003). The situation in Russian banking from the viewpoint of ownership concentration fits the description by Morck and Steier (2005): a handful of immensely wealthy families (in the Russian case, individuals) control the largest companies. Not a single Russian bank qualifies to be a 'corporation' in the Anglo-American sense, i.e. a listed company with a broad capital base and liquid stock. Empirical evidence points to the prevalence of 'blockholder model'. In the banking system that role is performed by an individual person, a consolidated group or the state (Kapelyushnikov, 2005). Institutional investors start gaining a role of importance. Blockholders make a decisive impact on the management and strategy of the company; they shape and lead boards of directors and appoint top managers. Officially reported data might suggest that ownership structure is changing in the direction of broader participation of outsider investors: in the sample of banks surveyed by IFC (2007), 39% of banks responded that they have between 1 and 10 shareholders, 23% – between 11 and 50, 23% – between 51 and 1,000, and 14% – over 1,000 shareholders. This statistical phenomenon misrepresents the reality, and recognition of a wide gap between formally registered data and the true structure of ownership is a commonplace. Nominal shareholding, which can consist of multiple intermediate layers, does not reflect real control. Decision-making is highly personified and usually embodied in one person who may or may not appear as a registered shareholder. Focus on such categories as 'final owners' and 'true owners' is needed to get a fair idea of ownership and control structure (Avdasheva et al., 2006; Shiobara, 2006). Russian law contains vague definitions of beneficiary ownership, and its public disclosure is essentially voluntary, but for banks disclosure to the regulator became stringent after 2005 in the context of deposit insurance introduction.

Each of the top 30 Russian banks has a blockholder in the shape of either the State, or a foreign controlling entity, or a private individual, less frequently a tight group of private individuals who happen to be relatives or close business partners. Table 1 contains a list of Russia's largest banks, consolidating 64.7% of total banking assets and 59% of capital, and their respective blockholder(s). In cases where bank ownership structure is not officially disclosed, informal sources also indicate the existence of a blockholder. The identity of blockholders may not necessarily be known to the broad public or even the bank's managers: in only 69% of cases the members of the top executive team confirm awareness of who the bank's ultimate owners are. The assumption that members of the board of directors are the individuals in control of the bank does not find an immediate support. 39% of bank representatives report that members of their board of directors own less than 10% of bank shares, 18% of banks report a stake between 20% and 40%, 13% report a

Table 1: Blockholders of top 30 Russian banks

Rank*	Bank	Blockholder, % of capital / voting power
1	Sberbank	CBR, 60.4% / 63.8%
2	Vneshtorgbank	Federal Government – 99.9%
3	Gazprombank	Gazprom JSC
4	Alfa-Bank	Mr. Fridman – 36.5%, Mr. Khan – 23.3%, Mr. Kuzmichev – 18.1%
5	Bank Moskvy	Moscow City authorities
6	UralSib	Mr. Alekperov, Mr. Tsvetkov, Bashkortostan Government
7	Rosbank	Mr. Potanin – 50%, Mr. Prokhorov – 50%
8	Raiffeisenbank	Raiffeisen International (Austria)
9	Russian Standard	Mr. Tariko
10	Rosselkhozbank	Federal Government
11	International Moscow B.	UniCredit Group (Italy)
12	MDM Bank	Mr. Popov – 90%**
13	Promstroybank	VTB Group, Federal Government
14	Promsvyazbank	Mr. A.Ananyev, Mr. D.Ananyev – 100%
15	VTB 24	VTB Group, Federal Government
16	Citibank	Citigroup (USA)
17	Petrokommerz	Mr. Fedun, Mr. Alekperov
18	Nomos-Bank	Mr. Finogenov, Mr. Nesis
19	Mezhprombank	Mr. Pugachev – 72%
20	Ak Bars	Tatarstan Government***
21	Zenit	Tatarstan Government***
22	Transkreditbank	Russian Railways JSC – 75%
23	Vozrozhdenie	Mr. Orlov
24	Globex	Mr. Motylev
25	MBRR	Mr. Yevtushenkov, Moscow City authorities
26	Impexbank	Raiffeisen International (Austria)
27	Sibakadembank	Mr. Kim, Mr. Taranov, Mr. Bekarev
28	BINbank	Mr. Shishkhanov, Mr. Kerimov
29	Khanty-Mansiysky bank	Khanty-Mansiysk regional government – 93%
30	ING Bank (Eurasija)	ING Group (Netherlands)

* By assets, 01.10.06; ** The bank's official disclosure by 01.01.2007 does not indicate the final beneficiary of the holding company that owns 98.7% of shares. *** Indirectly via state-controlled industrial companies.

Source: bank data; media reports.

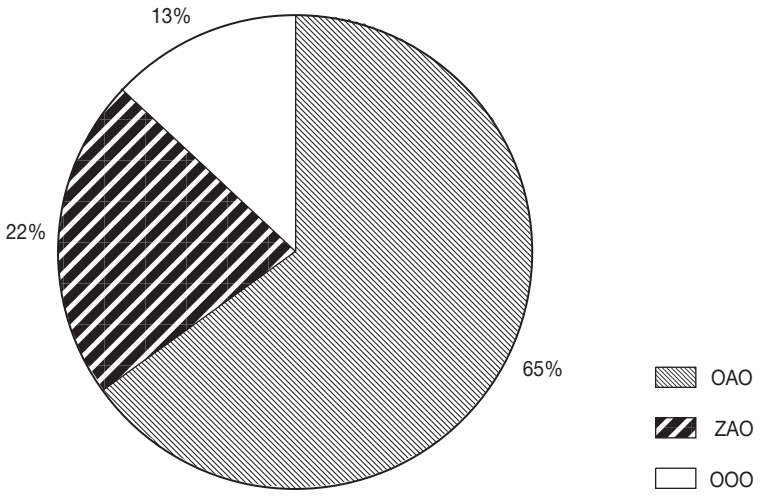
stake between 40% and 70%, and in 30% of banks members of the board are said to control over 70% of equity (IFC, 2007). Such data reflect formal (nominal) holding rather than ultimate ownership which we expect to reveal a much higher concentration of stock in the hands of board of directors.

Alien concepts of CG make it into formal norms (law) and are subsequently complied with or imitated by market participants, but have limited impact on the structure of control and therefore the mode of governance. Each bank registered as a joint-stock company maintains its own set of documents including codes of corporate conduct, codes of ethics, regulations of the board of directors, information disclosure regulation, and so on. The gap between legal form of a bank (joint-stock company) and the true control structure (private company or partnership) is a formidable example of a superficial formalistic adoption of Western institutions of CG. Provided that IFC reviews a representative sample of banks, two-thirds of the Russian banking industry consists of OAOs, or public joint stock companies (Figure 2); OAOs command a greater yet market share in terms of assets. Prevalence of the OAO legal form partly results from the state withdrawal because legally the state could only maintain a residual stake in a public company, so all such companies nation-wide acquired a corresponding legal status. Enforced transformation of state-owned enterprises into OAO created tens of thousands of fictitious public companies that do not need external investors and permanently generate corporate conflicts (Yakovlev, 2003).

Legal status of a bank bears no relation with the structure of control. Some of the 'open joint-stock companies' actually have very few shareholders[8]. Many of the banks registered as OAO possess formal decorations of a public company, including a full set of top-notch documentation regulating CG (codes of corporate conducts, elaborate regulations of the board of directors and its committees) and even non-executive directors. In many cases individuals who stand ballot as 'independent' directors are as a matter of fact affiliated with the bank owners, management or other important insiders.

The system of governance at the 22% of Russian banks organized as 'ZAO' or 'closed joint-stock companies' (an originally Russian bizarre legal form in between a public corporation and a limited liability company) is that of a private company or partnership, not a joint-stock company. On a general note, we observe similar features in CG at banks belonging to diverse legal forms (OAO, ZAO, OOO); the national model of CG works across traditional partitions by type of ownership, legal form, geographical location, and size of the bank.

[8] According to official disclosure, on January 1, 2007, OAO MDM-Bank had two shareholders, one of them, OOO MDM Banking Holding, owning 98.7% of shares (www.mdmbank.ru/f/1/about/emitent/mdm_2006q3.pdf). The bank's stock is not traded in any exchange. 2 natural persons have been disclosed as final beneficiaries through a chain of intermediate holding companies in Cyprus and Austria.



Source: IFC, 2007.

Figure 2: Russian banks by legal form of establishment

The functions of corporate ownership and management are intertwined in Russian companies, in general, and banks, in particular. Blockholders usually sit on the board of directors and/or the management board and exercise direct control over the bank's activities. Data on presence of bank owners in executive management bodies as CEOs or executive directors reflect just the formal set up; the true degree of owners' involvement in bank management could only be measured through informal polls among insiders (unfeasible). Our personal observations suggest a substantial degree of owners' participation in the exercise of executive functions in at least 3 out of 4 private Russian banks.

Instead of individual companies, business groups emerge as an essential unit for analysis of corporate relations in the Russian industry (Avdasheva et al., 2006). It is related to the phenomenon of 'recombinant property' which implies means that corporate centers in charge of decision-making and major transaction structuring are located beyond the legal boundaries of an individual enterprise; legally-registered property rights differ from effective ones, and control mechanisms are blurred (Stark, 1997). The tendency to create business groups equally applies to the banking sector. Not all of the 1,143 nominally independent lending organizations in existence in Russia are in reality stand-alone businesses. Banks make part of industrial groupings (conglomerates) or become the center-pieces of multi-sectoral holdings (Klepach, Yakovlev, 2004). There are as well between 20 and 30 specialized banking business groups that include entities belonging to the same beneficiary(-ies).

In our opinion, in the banking sector a business is associated with a legal entity to a greater degree than in other industrial sectors. Through obligatory disclosure requirements the corporate ownership relations among affiliated banks become sufficiently transparent to the regulator and, partially, to general public. More demanding nature of bank licensing and supervision, as compared to industrial enterprises, neuters some of the advantages of running several banks as a single business group and increases the disadvantages thereof. Being part of a banking group just offers additional flexibility in inter-company placement of liquidity and potentially some benefits from a marketing viewpoint. Still, for most practical purposes each bank of the group is regulated as a stand-alone entity with respect to taxation, minimum statutory capital requirement, capital adequacy, observance of prudential ratios, composition of management bodies, etc. Banking groups of pyramidal shape face additional capital requirement because one bank's investment into another bank's shares exceeding 1% of capital reduces the amount of equity calculated for prudential regulation purposes. Delegation of managerial functions from one bank to another is rare. Unlike in the productive sectors where business groups represent a sustainable form of management, in banking groups the existence of separate independent entities bears a transitory nature because such entities either get consolidated and integrated on a single platform or resold to another owner.

Another feature of the Russian model of corporate control is that majority owners of Russian industrial companies tend to extract income from their holdings via control over cash flows rather than through dividend payments (Rozinskiy, 2002; Yakovlev, 2003). Banks do not constitute an exception with this regard: the schedules and amounts of dividend payments, if any, by banks to shareholders remain erratic.

The main features of 'insider model' of corporate control and governance in Russia banks, namely untransparency of ownership structure, high ownership concentration and the exercise of management functions by owners, derive from objective conditions and factors to which owners are exposed, primarily the weakness of ownership protection instruments, exogenous and internal alike (Dolgopyatova, 2004). The main interest of blockholders has until recently centered on ensuring solid control and defending their property against hostile takeover attempts by rival groupings, managers, or the state. Blockholders now possess the mechanisms of corporate control that are consistent with their goal of achieving an unchallengeable control over their banks and defending it against aggression from other parties. This model enabled a peaceful transfer of property in comparison with other industrial sectors – practically all mergers and acquisitions of banks are amicable. Private owners of Russian banks remain actively involved in the management and immediate oversight of their business, leaving little room for managerial opportunism and lowering agency costs. In sum, the situation with governance reflects a 'bad equilibrium' that may be suboptimal, but economic and political agents in-

terested in changing the system do not demand high quality institutions (Yakovlev, 2003; 2004a).

Continental European and Japanese model of capital accumulation relies on banks, and Anglo-American model assigns the top role to capital markets. Morck and Steier (2005) call it 'bank capitalism' vs. 'shareholder capitalism'. None of these international models of CG clearly prevails in the Russian industry (Radygin et al., 2004) and banking. The selection of formal institutions of CG to be borrowed was influenced by advisors adhering to the Anglo-American model based on agency theory and aimed at protecting small investors and preventing opportunistic behavior by top managers. Those priorities rapidly turned out to be irrelevant in the Russian circumstances. Social institutions responsible for enforcing discipline do not function, agency theory does not work as top managers are often the same persons as shareholders, and minority shareholders do not exist. Facing this reality, the newly-emerging Russian model of CG started to lean towards a German/Japanese model of governance that relies more upon social networks and embraces the interests of all stakeholders, not only private shareholders (Puffer, McCarthy, 2004). That is more consistent with the thrust of Russia's traditional norms of behavior but less aligned with the already existing (on paper) formal norms of CG. While the 2 main international 'models' of CG differ indeed, a process of convergence takes place internationally and mitigates such differences, especially for companies exposed to capital markets discipline. The continental European model and the Anglo-American model of governance have essential common features such as reliance upon rule of law, transparency, trust, contract enforcement and property rights protection. These features have not existed in Russia whose business culture and governance are traditionally associated with disregard to legal norms, opportunism[9], lack of trust, strong reliance on personal relations and close networks, untransparency, secrecy, and equalitarianism (Avtonomov, 1997; Kuzminov et al., 2005; Prokhorov, 2006). McCarthy and Puffer (2007) argue that the norms underlying agency theory can be inappropriate for interpreting the ethicality of CG decisions and behaviors of Russians; integrative social contracts theory is suggested to have more explanatory power with regard to the ethical conflict between traditional Russian values and market-oriented values.

The system of CG that has emerged in Russia represents a compromise between the endogenous priority of defending business against external challenges and the push for innovations in the area of CG coming from exogenous sources, namely the government and the central bank as top bank regulator. CG norms and institutions were formally implemented, but they are not properly employed nor adhered to in substance. Cultural and institutional aspects are overlooked by authors who believe that CG institutions imported from the U.S.A. represent an obvious direction of 'progress' for Russian companies and regulators and that there is no much room for a specific national model of CG. In reality, new CG institutions mix with existing informal norms of behaviour and adapt to actual relations between stakeholders. We attribute the intensity of institutional competition between 'old' and 'new' norms to the fact that Russian banking industry is more or less evenly split between public and private sectors, so neither form of property dominates, and as a result, neither type of economic actors – state-owned banks or private banks – lead in the shaping of rules of the game ('institutions').

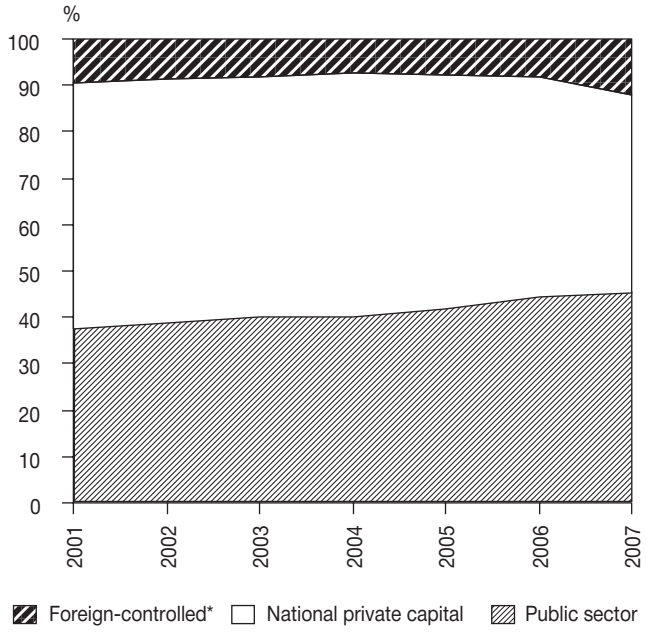
We distinguish a few modifications of the 'blockholder model' of governance among Russian banks, rather than one solid clear-cut model. Each group of banks has specific features along with common ones. *Large banks of the public sector* display blurred control lines and mechanisms and serious agency problems. *Large private banks* are featured by high concentration of property, prevalence of informal mechanisms of control, and untransparency; agency problem is less relevant here. In *lower tiers of private banks* a conflict of interest constantly arises from execution of ownership and management functions by the same people; phenomena of state capture and business capture can oddly co-exist here; minority interests do not exist or are not represented. *Foreign subsidiary banks* and Russian banks under strategic foreign control simulate CG while being actually governed as branches, not corporations (Vernikov, 2005).

An overview of CG in banks needs to give due regard to the **public sector**, in view of its particular and growing role in the Russian banking. IFC surveys (IFC, 2004; 2007) do not cover public sector banks due to mandate restrictions[10]. Public sector, however, is a crucial component of the Russian banking system. Withdrawal of the Russian state from commercial banks has been inconsistent and limited in scope; core banks remain in public property. Since the 1998 crisis we estimate the share of public sector banks[11] in total assets to have grown up to 44%, exceeding the share of the domestic private sector (Figure 3). Poland and Slovenia also keep

[9] Opportunism that endangers private property rights is typical for individual banks as market participants, as well as for executive and legal authorities. In 1998–1999, opportunistic behavior of Russian banks that had entered into currency forward contracts was endorsed by courts (Vernikov, 2006; 2007).

[10] IFC works exclusively with private sector companies in the countries of operations. Still, eschewing public sector banks, as well as banks with a share of foreign legal persons exceeding 25% of capital, from the scope of analysis leaves its conclusions applicable to a category of market players representing less than one-half of Russia's total.

[11] We use certain criteria to allocate a bank in the public sector (Vernikov, 2007). The state, its federal and regional authorities, municipal authorities, Central Bank of Russia, companies effectively controlled by one of the above entities and/or individual government official must exercise decisive influence on a bank's activities, whether they appear as listed shareholders of a bank or not. Lax public disclosure standards do not permit correct allocation based on official data only. Judgmental element is inevitable, but we estimate the possible margin of error resulting from misallocation at no more than 1% of total banking assets.



* Foreign ownership exceeding 50% of charter capital.

Source: Own calculations and estimates based on CBR data.

Figure 3: Breakdown of the Russian banking sector by ownership, as percentage of total banking assets by January 1

large banks in state property, but Russia is the only European economy in transition with a consistently growing share of public sector in banking.

Organisation for Economic Co-operation and Development (OECD) that on behalf of the world's leading economies sets standards in CG, recognizes that CG in state-owned enterprises constitutes a special case compared to universal principles (OECD, 2004; 2005). Interests and motivation of stakeholders of public sector banks differs from those in private companies in that profit and value maximization may be supplemented by non-economic motivations. Agency problem acquires specific shape in state-owned banks because the principal is diluted: the state can only control management performance through civil servants, i.e. individuals who may also act opportunistically in pursuit of their private interests. The state's inability to efficiently run or oversee all public sector banks due to lack and low quality of its managerial resource broadens the autonomy of the banks' top management who are likely to come to terms with individual officials and select-

ed wings of the government 'in charge' of that bank. State-owned banks get effectively 'captured' by insiders, particularly their own top managers, who might own private businesses on the side.

4. Upgrading corporate governance in Russian banks: *Cui bono?*[12]

The universality of CG concept should not be overestimated. In a certain context and at a certain stage of economic development CG might be more relevant and important than at other stages (Berglof, von Thadden, 1999). When, why and to what extent CG does matter – can be determined only empirically (Shiobara, 2006). In this section we try to identify the combination of interests driving the evolution of CG in Russian banks.

Standard & Poor's[13] identify a broad range of stakeholders potentially interested in the application of the mainstream concept of CG and its practical implementation by Russian banks. Relying on practical evidence and personal estimate, we narrow that range to the following 4 main groups, in the decreasing order of importance, whose interests shape the public discussion of CG in Russian banks:

- financial intermediaries and consultants, including international institutions;
- foreign lenders and minority investors;
- controlling owners of Russian banks;
- bank regulators.

Financial intermediaries and consultants, including international institutions

As a financial sector insider the author has witnessed the magnitude of supply of consultancy, advisory, technical assistance, teaching, coaching, and the like, in the field of governance. CG is a consultant's dream product because it is 100% politically correct, carries insignificant costs and no measurable risks, does not allow for accurate cost-benefit analysis by the recipient, and triggers no responsibility in case it goes wrong or yields no result. Consultant's interest goes well beyond theory

[12] Who benefits? (*lat.*)

[13] Standard & Poor's indicate that their CG ratings meet demand from the following categories of stakeholders: shareholders (minority as well as majority ones); lenders; the management; members of the board of directors; regulators and stock exchanges; insurance companies offering directors and officers liability insurance; politicians; financial intermediaries and consultants; analysts; company staff; and other interested parties (Standard & Poor's, 1998).

and best-practice sharing. CG advisory serves as a door-opener to establish links with the client in anticipation of future (profitable) mandates for investment banking. CG-related consultancy accompanies the preparation of hundreds of Russian companies for capital market issues[14]. Consultants, investment bankers, portfolio managers and traders all push for greater transparency and CG practices in order to involve Russian banks into the global market and set a frame for higher profits from investment banking or trading at the next stage.

International institutions pursue their own respective agendas containing a threefold objective. *Firstly*, these institutions have indeed the mandate of promoting 'best international practice' in developing and transition economies. *Secondly*, institutions such as IMF and the World Bank (including IFC that spearheads the CG effort in the Russian banking sector) act under strong influence of their major shareholders, primarily the U.S.A., to promote a heavily-politicized agenda that recently focuses sharply on prevention of terrorism financing and 'money laundering' worldwide. Hence the push for greater bank transparency and information disclosure, stronger compliance and internal audit. *Thirdly*, international bodies promote private interests of important market players and act on their behalf in immature markets, breaking ice and preceding large-scale investment of private capital.

Foreign lenders and minority investors

In the private sector the concentration of property reaches such a degree that many banks do not possess unaffiliated minority shareholders who would demand protection against the opportunism of blockholders. IFC (2007) data say that only 3% of banks have shares circulating in stock markets. According to information from stock exchanges, stocks of 18 Russian banks (out of a total of 1,143) currently float. MICEX stock exchange lists shares of Sberbank, Bank Moskvy, Vozrozhdenie, Avangard, Finprombank, International Bank St. Petersburg, Rosbank, Tarkhany, Industrial and Construction Bank, Primorye, Metkombank, and Bank Dalnevostochny. RTS stock exchange lists six bank shares, namely Sberbank, Rosbank, Sibakadembank, Sobinbank, Stella-Bank, and Vozrozhdenie. Only Sberbank shares are 'blue chips'; in addition, shares of Vozrozhdenie, Rosbank and Bank Moskvy display some liquidity; other shares remain illiquid. Vozrozhdenie's free float is in the order of 10%, and that of other banks below 5%.

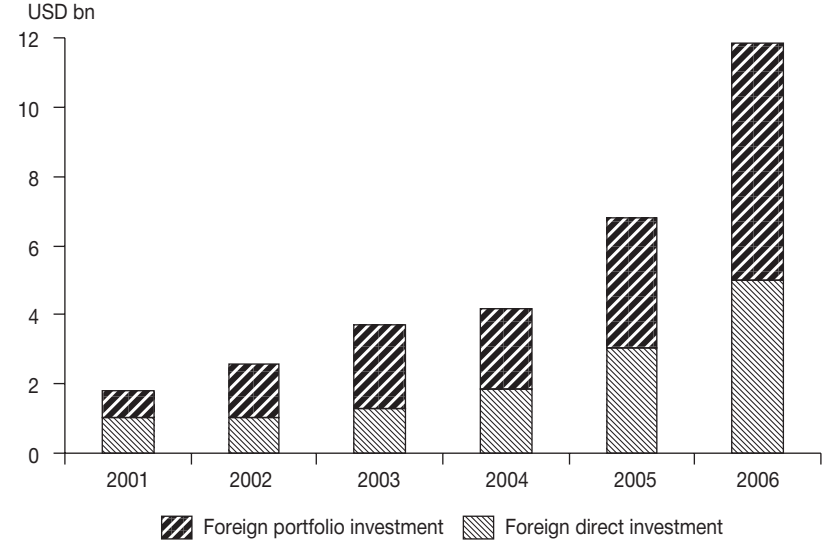
IFC recognizes that the number of bank shareholders remains limited, and controlling stakes usually belong to one or several persons or state entities. These

[14] For instance, Russian companies and banks are persuaded that without 'independent directors' they will be unable to borrow from capital markets at reasonable cost nor to offer shares successfully to investors outside Russia. International executive search firms have all started 'board services' practice in Russia to meet the booming demand for foreign 'independent directors' for pre-IPO companies.

circumstances may turn protection of shareholders' rights into an irrelevant issue. Still, IFC focuses on the status of minority shareholders (those controlling less than 20% of equity) on the ground that for the bank's reputation in capital markets it is essential that such shareholders' rights be equally protected, even if they (minority shareholders) are not in a position to shape the bank's strategy.

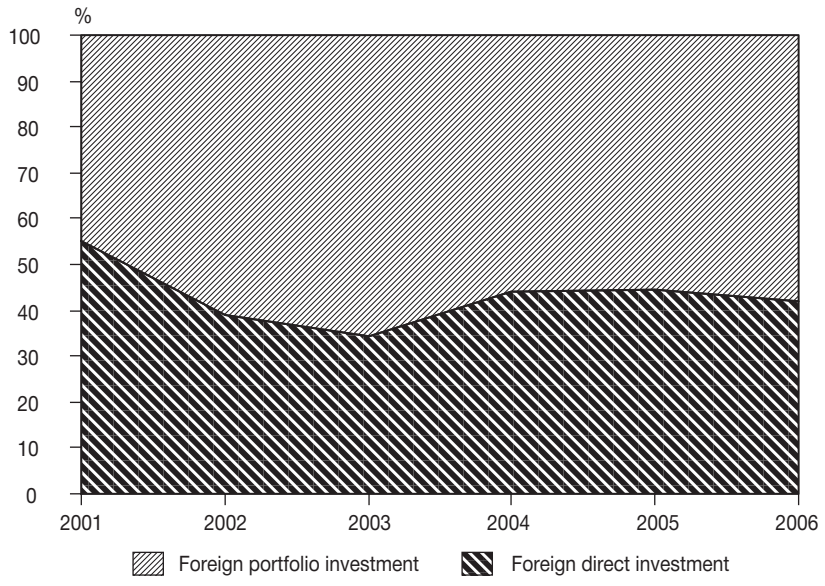
The interest of foreign lenders and small investors in promoting CG grows in parallel with the amount of lending to and portfolio investment in Russian banks. Between 01.01.2001 and 01.01.2006 the amount of outstanding foreign loans to Russian banks increased six-fold, from USD 8.0bn to USD 48.1bn (www.cbr.ru/statistics/). The magnitude of portfolio investment in Russian banks grows slightly faster than foreign direct investment in this sector, so that its cumulative volume now exceeds the volume of direct investment (Figures 4 and 5). In the middle of this decade, portfolio investors for the first time started to diversify from Sberbank in favor of other Russian banks.

Would-be foreign investors and lenders are attracted by high profitability of Russian banks, impressive rates of growth of financial assets, and the potential of the national market for financial services. The current system of CG has worked well for blockholders of Russian banks but not for actual minority holders of shares or potential buyers who are deterred by high concentration, opacity, low transparency,



Source: Central Bank of Russia, balance of payments statistics.

Figure 4: Foreign investment in Russian banks (cumulative volume by January 1)



Source: Central Bank of Russia, balance of payments statistics.

Figure 5: Breakdown of foreign investment in Russian banks, as percentage of total

neglect of legal institutions, insufficient protection of property rights, etc. Lenders and investors favor every initiative aimed at overcoming those constraints - for instance, disclosure of a bank's beneficiary owner(-s). It serves the interest of accessing Russia's market and profitably operating here.

Controlling owners of Russian banks

Controlling owners of Russian banks are the category of stakeholders whose ultimate interests regarding CG matter most and therefore must be understood best. As we argued in Section 3, the task of protecting the rights of bank blockholders which lies in the heart of CG in the 'narrow' interpretation (a set of mechanisms to protect owners against opportunistic behavior) is successfully accomplished through traditional local practices. The blockholder model of corporate control and governance in Russia banks does perform the intended functions: it demonstrates high effectiveness in taking over public sector assets, redefining ownership rights, and safeguarding control over the acquired property against external and internal challenges.

Although ownership and control structures of Russian banks objectively limit demand for modern 'internationally-recognized' institutions of 'good governance',

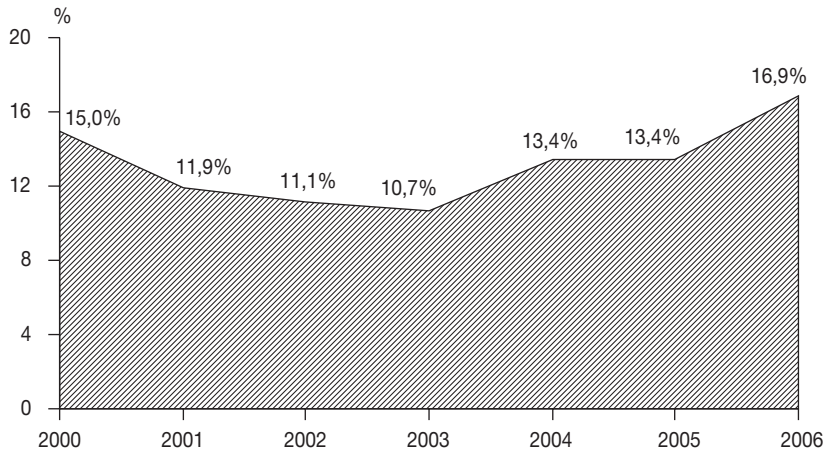
starting from early 2000s a growing share of bank owners show interest in codes of corporate conduct, information disclosure, dividend payments, etc. It also applies to the state in its capacity of a substantial bank owner. Institutional push from the government continues to exist, but this time owners of Russia's leading banks do not resist the efforts of the state. CG initiatives promise more of an upside that outweighs consultancy and implementation costs and potential risks of disruption of control and management. What drives such a change?

Russian banks feel a mounting pressure to keep up with high assets growth rates that gradually erode capital adequacy and demand capital growth. Endogenous sources of capital need to be complemented by external financing. 14% of banks polled by IFC (2007) intend to access capital markets with their equity issues in the next 3 years. The need to raise additional resources from capital markets drives CG improvements — as well as imitations of CG improvements. Positive developments in the area of CG are usually simulations aimed at a demonstrational effect only (Yakovlev, 2003; Avdasheva et al., 2006), especially at early stages of opening up towards capital markets.

The first threshold takes place in the early 2000s when Russian banks start tapping external markets for debt via syndicated borrowing and subsequently Eurobond issues. International Monetary Fund data show that the importance of external borrowings as a source of financing for Russian banks has remained steady throughout this decade within the range of 11 and 15%, although showing an upward trend more recently (Figure 6). In theory, better governed banks must be able to find cheaper funding; in practice this regularity does not consistently reveal itself.

Shiobara (2006) believes that the potential of raising financial resources from capital markets through the use of CG concept may be overestimated. We see evidence that currently this segment is actually the buyer's, not the seller's, market, as global liquidity abundance remove limitations from the supply of capital (both debt and equity). Russian banks willing to attract additional resources can do so, and demand for bank shares greatly outstrips supply of these instruments to outside investors. In view of this imbalance, would-be investors' concerns with regard to CG have no effect on prices.

Quality of CG bears more relevance for equity participation than for debt financing. The majority of banks interested in CG wish to integrate into global financial markets and/or sell their business entirely or partially. Different types of motivation can guide bank owners willing to sell, and CG appears as a universal tool of optimizing capitalization of the business and pushing upwards the price of their bank as multiple of its book-value. Owners may want to cash out because they: grow older, get tired and would like to withdraw from operational management (Yakovlev, 2003); or want to legitimize property for which they have incomplete rights; or need resources to invest in more profitable sectors; or feel increasing competitive pressures from state-owned and foreign banks; or see no prospect for an independ-



Source: International Financial Statistics, International Monetary Fund.

Figure 6: Foreign liabilities as a proportion of total liabilities of Russian banks

ent private sector in Russian banking. After running their respective businesses for almost two decades, owners are exploring mechanisms that would allow them to play a different role in the company and protect their interests through the board of directors. In the absence of family or dynasty banking businesses in Russia, current bank owners need to bring in professional hired managers and give them more power. Some owners, on the contrary, disperse the banks' capital because they would like to entrench themselves, avoid being taken over by a rival, and keep running it unchallenged. Finally, one can identify banks whose official corporate strategies envisage neither a sale to strategic investors nor an IPO, so CG improvement seems to reflect authentic interest of bank owners. Sustainability of CG institutions in the absence of exogenous mechanisms of discipline (stock markets) remains to be tested. It remains an open question whether these owners will ultimately be capable of stepping back from management. We cannot rule out that after initial experimenting with CG, owners will discover the growing agency problem and its related costs and then fall back to the old style of governance.

Consultants' argument about existence of positive causality between progress in CG and capitalization of banks has become commonplace. Thus far Russia has produced insufficient empirical evidence to support this assumption. Identification of causality between quality of CG, on the one hand, and Russian banks' performance, on the other, faces serious methodological obstacles[15]. Measurement

[15] Measuring the impact of CG quality on bank performance and performance of bank stock is a non-trivial task for all emerging markets and transition economies. Choi and Hasan (2005) look at Korean banks to trace dependencies between ownership and governance, on the one hand, and performance, on the other. They conclude that the level of foreign ownership has a significant positive association with the bank return and significant negative association with the bank risk. The number of non-executive directors does not seriously affect performance; however the presence of a foreign director on the board is significantly associated with bank return and risk. We believe that reducing quality of CG to composition of the board of directors is an oversimplification.

of CG quality through selected proxies, such as number of members of the board of directors, number of meetings held, number of board committees, number of independent directors, etc., reflects formality that may be far enough from essence. Exact data on structure of ownership and control remains inaccessible for individual researchers. Going beyond formally reported, and often meaningless, data and employing unofficial sources poses a challenge to integrity of data. Ratings of CG from reputed agencies, e.g. Standard&Poor's, might be regarded as an acceptable proxy for CG quality, however coverage is restricted. By early 2007, Standard&Poor's have assigned and published CG ratings of 16 companies, including only one bank (see Table 2).

Table 2: Corporate governance scores (CGS) from Standard & Poor's (by February 18, 2006)

Global scale CGS	Russia national scale CGS	
Wimm-Bill-Dann Foods OJSC	7+	7.7
Mobile TeleSystems (MTS)	6+	6.9
MDM-Bank	6+	6.7
Pipe Metallurgical Co.	6+	6.7
Vimpelcom	6	6.4
EuroChem	5+	5.9
North-West Telecom	5+	5.6
MGTS	5+	5.5
Dalsvyaz	5	5.3
Sibirtelecom	5	5.3
TGC-1	5	5.3
VolgaTelecom	5	5.1
CenterTelecom	5	5.0
TGC-8	4+	4.8
Southern Telecom Company (UTK)	4+	4.8
TGC-9	4+	4.8
Transtelecom	4	4.1

Source: Standard & Poor's, www.standardandpoors.ru/page.php?path=enggovlist.

It is no less difficult finding solid data reflecting bank performance needed to build regressions on CG quality. Consistent series of data are available on profitability according to Russian accounting standards that are volatile and unreliable. Performance of Russian bank stock resists econometric processing due to short period of observations; small number of bank stocks in free float on the stock market; low share of free float; and high volatility of prices[16]. Banks that have available ratings of CG may have no stock listed and traded (e.g., MDM Bank). Conversely, the most actively traded bank stock is that of a bank without published CG scores (e.g. Sberbank). Other banks' stock display greater yet volatility and lower liquidity. The above-mentioned factors impede regression-building between CG quality and stock performance.

Table 3: Acquisition of Russian banks by foreign investors*

Target	Buyer	Price to book value ratio
Petroenergobank	Skandinaviska Enskilda	1.2
Michinoku Bank (Moscow)	Mizuho	1.3
Metrobank	...	1.9
Monchebank (Murmansk)	DnB NOR	2.2
Stolichnoye kreditnoye tovarischestvo	Société Générale	2.5
IMPEXBANK	Raiffeisen Intl.	2.89
Median	–	2.95
Delta Credit	Société Générale	3.19
Promsvyazbank	Commerzbank	3.3
Ekstrobank	Banco Santander	3.6
Investsberbank	OTP	3.8
ORGRESbank	Nordea	3.85
KMB Bank	Banca Intesa	3.9
Rosbank	Société Générale	4.0
Delta Bank	GE Consumer Finance	4.5
Gorodskoy ipotechniy bank	Morgan Stanley	4.9

* Includes only transactions that transfer control over the bank to the foreign party.

Source: Bankovskoye obozreniye http://bo.bdc.ru/2007/2/bank_price.htm; Boston Consulting Group; bank data.

[16] Sberbank whose stock is the most actively traded Russian bank stock, counts with the presence of an influential blockholder, the Central Bank of Russia with over 60% of equity; less than 20% float freely. The market for other bank stocks is less liquid, more shallow and volatile. For example, in January 2007 the turnover of trade in Vozrozhdenie Bank shares amounted to USD 10 million; one speculative transaction can swing prices.

Bank valuations resulting from acquisition of Russian banks by strategic foreign investors reveal no consistent trend with regard to impact of CG quality (Table 3). Causality between CG quality and the multiple of book value at which a strategic foreign investor agrees to acquire the bank is far from obvious. One of the highest multiples has been applied to the valuation of a former bridge bank that in 1998–1999 received the assets and business of a collapsed bank belonging to the same beneficiaries in order to evade creditor claims. Strategic investors appear to attach higher value to factors other than CG quality, namely to bank size, market share, number of branches and offices, quality of assets, presence in fastest-growing market segments like mortgage lending, car loans and credit cards. Strategic investors may also disregard the present quality of CG in target banks because they rely on strong corporate culture of parent organizations.

High expectations with regard to initial public offerings of shares by Russian banks do not come true. Private 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, and because a sale to strategic investor can produce a high enough valuation. By contrast, public sector banks (Sberbank and VTB) have embarked on the IPO path towards greater inclusion of outside investors because it offers the state and the management a golden opportunity to entrench against new shareholders and to retain full control over operational activities and policies.

Bank regulators

In 1990s a large-scale importation of CG institutions to Russia does not overcome the demand for 'insider model' of privatization coming from managers of former SOEs (Yakovlev, 2003). Puffer and McCarthy (2007) look at the types of networks coexisting within Russia's state-managed network capitalism and show that supply of institutions of a market economy by the federal government (institutional push) has not been accompanied by adequate demand for such institutions among economic agents (institutional push). The Russian model of CG acquires its shape in 1990s regardless of government policies; its functioning is based on a systemic and systematic violation of formal rules of CG (Yakovlev, 2003). Government would like to narrow the gap between spirit of new institutions and current practice based on motivation of economic agents.

As **regulators**, the Federal Commission on Securities Market and the Central Bank of Russia implement CG concepts out of correct interpretation of mission and mandate. Additional motivation to promote good CG economy-wide is generated by peer pressure coming from foreign colleagues and international institutions, as well as lobbying by groups of interest, financial intermediaries and potential strategic investors. Central Bank of Russia specifies the general Code of Corporate

Conduct (FCSM, 2002) in a bank-specific set of recommendations based upon best international practice under the title 'Modern approaches to corporate governance in lending organizations' (CBR, 2005). The document is of informal and unenforceable nature and does not possess legal power.

The state as **owner** of 45% of the Russian banking system may have its own agenda in respect of governance in public sector banks. The Russian state is a notoriously inefficient and loose owner of financial assets. As a rule, state officials and public sector bank managers behave opportunistically, and agency costs are high. At the same time the real balance of interests of all parties concerned might support the 'blockholder model' in the public sector. It allows the state to interfere into bank management and to use banks for the purposes of various policies. It also offers vast opportunities to insiders at public sector banks to pursue their own private objectives, including control over eventual privatizations. Yakovlev (2004b) analyzes evolution of corporate governance in Russia through real incentives of economic agents that may or may not go in the same direction as government policy. The state and its bodies avoid drastic changes in bank governance because a transparent formal system would complicate privatization of numerous minority stakes of the state by respective bank insiders. Once the remnants of state holdings disappear, the task of capitalization of private banks will come to the fore, and attitude towards CG will become more constructive. One can see interest toward formal CG institutions among core banks firmly locked in the public sector that now try to access capital markets.

To sum up Section 4, the balance of interests of stakeholders has shifted in the direction of CG concept based on international (mainly Anglo-American) best practice. This time the institutional push from the government meets growing demand from Russian banks that intend to broaden their capital base. Neither of important interest groups resists promotion of formal institutions of CG at the present stage. Progress in CG goes in parallel with successful transaction involving shares of Russian banks. However, insufficient data and the presence of exogenous factors do not allow identifying causality between CG quality and bank capitalization.

5. Implications for investors: *Caveat emptor*[17]

This section applies to different categories of investors buying into Russian banks. Investors must wonder about solidity and sustainability of new institutions and the extent of genuine commitment of bank owners to good governance.

An advanced system of CG should appear as an advantage from the viewpoint of the acquiring bank. In practice a strong system of CG in the target bank might

[17] Let the buyer beware (*lat.*)

actually complicate and impede its assimilation and integration into a global network. Key managers of the acquired bank are likely to leave out of frustration with the integration process that takes away most of their rights and autonomy.

Investment strategy may consist in the acquisition of a minority stake and gradual increase of the stake. The location of the watershed beyond which minority shareholders obtain a chance to impact strategic decision-making and defending their rights, depends on the mode of functioning and effectiveness of national institutions, including CG. The more mature the institutions, the lower stake ensures due representation of shareholder interests. Identity and profile of foreign investor(-s) matters as much as the size of stake. Predominantly foreign-owned banks include those with a single strategic investor, i.e. controlled by a single party, and those without such a controlling foreign owner. A minority stake held by a strategic investor (most likely, a large international bank) offers better chances of influencing the decisions of bank managers and changing corporate culture than a large stake held by portfolio investors, especially if that stake is dispersed among several parties. In the latter case, control over the bank can remain in the hands of top managers or even the state (Bonin et al., 2005, p. 35).

So far strategic foreign investors in Russian banks do not show confidence in the quality of local governance and proper functioning of institutions that would defend property rights in case of conflict or opportunistic behavior. Practical experiences of minority shareholders offers little encouragement[18]. Foreign banks usually eschew minority shareholder role in Russian banks, or actually regard it as just a transitory stage towards full control (Rosbank gradual acquisition by Société Générale illustrates this approach). As a proxy for the degree of confidence in local institutions we use the share of capital invested in 100%-owned banking subsidiaries in all direct foreign investment in the capital of Russian banks[19]. We assume that high share of contributions into capital of 100%-owned subsidiaries indicates absence of trust in the functioning of legal institutions and governance model because for strategic investors it would make more financial sense to control subsidiary banks through a stake not exceeding 50% plus 1 share. Almost three-quarters of the total cumulative amount of foreign investment go to fully-controlled foreign subsidiary banks (Table 4).

[18] In 1997–1999, foreign holders of minority stakes in Russian banks found themselves fully insulated from reliable information regarding banks' financial condition, magnitude of risks taken, direction of cash flows, etc. Membership of foreign investors' nominees in the respective boards of directors did little to prevent asset-stripping, looting, transfer of assets to bridge banks and other opportunistic conduct.

[19] These data might appear contradictory to the balance of payments data according to which portfolio investments now exceeds foreign direct investment (Fig. 4 and Fig. 5), but Table 1 only contains CBR data on registered foreign direct investment, while the bulk of foreign portfolio investment is concentrated in Sberbank and does not require clearance or registration with CBR.

Table 4: Breakdown of foreign contributions into charter capital of Russian banks (RUB mln)

	01.04.2002	01.01.2003	01.01.2004	01.01.2005	01.01.2006	01.10.2006
Cumulative total, *of which*	13 679	15 887	18 903	23 553	49 555	70 798
100%-owned subsidiaries	8 652	10 114	13 036	15 776	40 953	52 164
share, %	*63.3%*	*63.7%*	*69.0%*	*67.0%*	*82.6%*	*73.7%*

Source: Central Bank of Russia data.

The direction of change matters as well: the indicator did not fall since 2001 and has actually increased[20]. Given that strategic foreign investors have at their disposal the corporate culture and institutions of the parent company to effectively address any CG issues, these investors should *theoretically* need 50% + 1 share to enjoy control over the subsidiary bank. In practice, they tend to aim for *total* control of their Russian subsidiaries and avoid buying minority stakes unless granted a solid call option for the controlling stake of up to 100% of shares. Assuming rational behavior of foreign investors (and no reason exists to assume otherwise), their preference for 100% ownership of Russian banks tells that the threshold of control is located way above 50%+ 1 share, probably close to 100%, due to the country-specific features of CG mechanisms and the quality of legal institutions.

It takes an in-depth case study to determine whether a particular bank owner shows sincere and genuine interest towards good CG or merely imitates it under pressure from capital markets. Investors in shares of **public-sector banks**, in particular, must have realistic expectations about quality of governance in those organizations. Russia plans to place shares of Sberbank and VTB through the stock market; partial divestment of state-owned company from the capital of Gazprombank is likely. We find more similarities between Russia's strategy with regard to state-owned banks and that carried out in China, not in transition economies of CEE (Vernikov, 2007a). Public offerings of shares aim to broaden capital base, produce fiscal result and absorb liquidity, but under no circumstances the state intends to yield control over core banks to private investors. Regardless of precise techniques of shares placement, the state remains the single largest shareholder (i.e. 'blockholder') of the top lending organizations in Russia. We see a sign of 'entrenchment' strategy implementation by the state in the choice of stock dilution and broad market placements over sale to a strategic investor. Among institutional and political

[20] The fall 82.6% to 73.7% over January – October 2006 may be attributed to one large acquisition of a minority share (Rosbank) with an option to buy controlling stake at a later stage.

factors that predetermine such public choice we see the willingness of the state to preserve its own instruments of industrial, social, regional and other policies. The government has doubts whether after privatization banks will keep making resources available to those companies and projects that for whatever reason are deemed essential (or 'strategic') by bureaucrats. Doubts grow stronger with regard to foreign banks as possible new owners. A more cynical explanation consists in the hunger for permanent sources of rent among the top brass of the government officials, including law enforcement agencies ('*siloviki*'); a genuine privatization would erode these opportunities. To entrench itself and retain control, the state develops holding structures of a pyramidal shape with broad foundation and narrow summit (Kapelyushnikov, 2005). Public sector banks may be grouped into pyramid-like vertical holding structures where the state controls one bank which in its turn controls several [nominally independent and "private"] others, and so forth. VTB and Gazprombank are good examples of such practice.

For public sector banks steady progress in CG is closely related with privatization. We intentionally avoid calling the dilution of the government's stake 'a privatization' because privatization implies a shift of control from the state to private owner(-s). Partial state withdrawal from core public sector banks via placement of minority stakes on the stock market somewhat decreases property concentration, but does not convert the bank into an organization run by outside investors. It is unlikely to result in a new model of governance or a definite departure from current management practices. The quality of governance might remain roughly the same as before, despite the corporate decorum. A broadening of the capital base contributes to the entrenchment of the top management and gives rise to agency problem. Market discipline, on the other hand, does not affect such an organization to the full extent because it continues to rely on the state as its controlling shareholder who will shelter it from external threats and bail it out if need be.

At the same time, over time form can exert impact on the substance. The new institutions of CG that start as artificial and fight for survival begin gradually to shape corporate life and behavior to an ever increasing extent. The need to observe formalities imposed by stock market rules has a chance of becoming an effective constraint on an omnipotent blockholder.

6. Implications for policy makers: *Primum non nocere*[21]

Although the blockholder model of governance now approaches its own limitations in terms of financial efficiency and potential for future growth, introduction of

[21] First, to not harm (*lat.*)

norms and institutions of CG remains supply-driven. The difficulty of implanting CG in Russian banks rests in the high concentration of property, both private and public. In the absence of a broad investor base the allocational mechanism of the stock market has no chance to take off. Experiments with CG run the risk of marginalization and unsustainability. Policy makers would rather make up their mind soon as to which variant of capitalism they want to promote in Russia – 'bank capitalism', 'shareholder capitalism' or 'state capitalism' (state-guided accumulation and allocation of capital). The choice might be path-dependent to a greater extent than policy-makers would like. Whichever the choice, it has to be consistently implemented, because a combination of heterogeneous institutions will permanently generate institutional conflicts.

By setting new formal institutions that affect governance the state can exert different kind of impact on national market participants – positive, neutral or negative. In the short run the change in the governance model may go in a direction that will render Russian banks less resistant to external threats. Relying on the drive to raise financial resources for growth, bank regulators continue to promote the Anglo-American concept of CG. The official doctrine has it that progress along the path of CG determines the level of competitiveness of Russian banks against foreign entrants. Propaganda spread by international consultancies and international financial institutions unambiguously presents CG as a potential competitive advantage of Russian banks, on the ground that evidence from mature market economies points to the existence of positive relationship between CG and performance. Hopefully such evidence will emerge over time for Russian corporations and banks as well. In case it does not, the question will arise whether introducing CG was worth the trouble and the cost.

By broadening the capital base of public sector banks and modernizing their governance systems the Russian state intends to foster growth of 'national champions'. Good CG allows to access cheaper resources and thus enhances banks' competitiveness vis-à-vis foreign players in anticipation of WTO membership and further globalization of the banking sector. At the same time, initiatives in the filed of CG open up the banks to due diligence by potential foreign lenders and buyers, so successful introduction of CG increases chances of acquisition of Russian banking businesses by foreign investors. Despite positive impact from foreign capital injection on stability and efficiency of the banking sector, takeovers of Russian banks by foreign investors reduce the scope of domestic banking business and inevitably restrict the base for CG institutions. This might become an unintended consequence of government policies.

Foreign subsidiary banks appear nominally as independent Russian stand-alone corporations in the legal form of ZAO or OOO (limited liability companies), but *de facto* function as elements of foreign business groups. Parent companies located abroad govern these entities as branches (Vernikov, 2005). Foreign parent banks as

controlling owners of an increasing number of Russian banks play limited role in CG initiatives in the banking sector *en large*. Apart from twinning programs with Russian banks (some of which programs actually serve the purpose of pre-feasibility study) foreign parent banks do not objectively need CG to effectively run their Russian subsidiaries. CG institutions are as nominal in foreign subsidiaries in Russia as they are in most of domestic market participants. We argue in Section 3 that existence of national businesses *not* integrated into global structures makes CG a topical issue for Russia, unlike for most transition economies in Central and Eastern Europe. Dispersed capital base of banks would complicate takeovers by global foreign investors. In case of an acquisition, a broad capital base ensures that the target bank is not converted into a mere branch of a global bank but continues to operate as a corporation. Diversified structure of control objectively generates demand for institutions of CG that now exist only formally.

Restriction of the power of blockholders over Russian banks would deepen financial markets and reduce systemic risks in banking. Market discipline works better than regulatory pressure on bank owners alone. Emergence of genuine corporations in the banking industry would contribute to the regulators' and the government's goal of keeping a significant proportion of Russian banks under 'national control', whatever this ideological construction might signify. In the end of 2005 the Central Bank of Russia put forward innovative proposals on CG that triggered a public discussion. In particular, CBR considers regulatory measures aimed at increasing depth and liquidity of the market for bank shares, e.g. obligatory public flotation of all banks whose size exceeds a certain threshold in terms of assets, regardless of their current form of ownership. Expert community is split between the need to create a liquid stock market and the possible outcomes of such regulatory action for bank owners (see: www.rusrating.ru/ru/news/story/events/Debates). Those who disapprove the idea of obligatory flotation argue that the regulator has no right to intrude in decAsions concerning private property, and that enforced flotation can incur losses of bank owners.

If the Russian society and the bank regulators really are concerned with a gradual replacement of private domestic banks by foreign players, then they may need to recur to unorthodox steps in order to overcome the blockholder model of governance. The state might demand foreign subsidiary banks to have a certain 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 as compared to the now dominant blunt tools of protection. In our opinion, could come from a legislative cap on the size of stake that can belong to one beneficiary would work very efficiently. Such limitation exists in a few countries and yields positive results. Another far-reaching measure would be to consistently follow the Anglo-Saxon model by forbidding bank ownership by industrial companies and other non-

financial entities. Only natural persons and their collective investment vehicles (e.g. mutual and pension funds) must be allowed to own bank shares. Eventual implementation of this kind of proposals would face the same obstacles as other institutional innovations: corruption; 'state capture' by interested bank owners who do not wish to share control voluntarily; untransparency of ownership; weakness of enforcement; and conflict of interest between the state as bank regulator and the state as bank owner. Nevertheless, we would not overestimate potential disruptions, costs and difficulties, provided that there is sufficient political will to maintain 'national control' over banks.

However, dismantling the blockholder model of governance requires caution. This model originates from low quality of institutions and the credibility of external threats, not from bank owners' ill will or lack of Western training. So far the environment – primarily the degree of property rights protection – has not changed sufficiently to support 'civilized' governance and completely disregard defensive functions of the governance model; open transparent models of governance seen in the Anglo-American world might not yet fit such an environment. Raiders and institutional investors would love to rely on CG in order to take control away from company owners and managers. In mature economies corporate raider activity faces solid constraints that do not exist in Russia. Russian 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 full delegation of managerial functions to hired professional managers. If new CG rules increase the risk of undermining the control by owners and significantly increasing their costs, such a risk will materialize early or later. Even an isolated case of loss of control as a result of CG introduction would discredit 'best international practices', push bank owners away from them back to reliable modes of control, and trigger opportunistic behavior in other banks. Improper and hasty implementation of institutional reforms has produced negative outcome in other areas. Fine-tuning of the national model of CG needs to take into account the transitional nature of the economy and the local peculiarities, so it happens as evolution, not a revolution (Radygin et al., 2004). Importantly, pressure on private bank owners to improve CG must be accompanied, or even preceded, by the state's efforts to ensure rule of law and protection of private property.

7. Conclusions

Formal institutions of corporate governance transplanted into Russia bear little relation to the actual model existing in Russian banks. New institutional forms are either by-passed or utilized to legitimize existing practices. 'Blockholder model'

of control clearly prevails; unaffiliated minority shareholders do not exist or are not represented; and stock market plays limited role in the allocation of capital. 'Anglo-American' model of governance based on agency theory appears to be broadly irrelevant for Russian banks because it implies outsiders' control over the company which does not exist in Russia. The model of governance in the banking sector displays some peculiarities with that typical for Russian industrial companies and well researched in the literature. The role of business groups might be less pronounced in banking than in mining and manufacturing; transparency of ownership and control is higher due to the more demanding disclosure rules imposed by the bank regulator; corporate wars and hostile takeovers remain rare.

The main interested parties within the blockholder model objectively do not demand high quality institutions, including CG; the introduction of those institutions is driven by supply from the state. Since the beginning of this decade the balance shifts in favor of CG concept as it receives support from 4 groups of interest, namely financial intermediaries and consultants, including international institutions; foreign lenders and minority investors; controlling owners of Russian banks; and bank regulators. Each of these groups pursues own agenda. Foreign parties wish to involve more Russian banks into the global market, with the view of profitable trading, lending, advisory, and acquisition. Russian bank owners become interested in borrowing from the money market at reasonable cost and/or selling their business wholly or partly. Bank regulators implement their respective mandates. On the basis of this common vector of interests CG now make progress in the leading group of Russian banks.

Foreign financing becomes essential to Russian banks, privately-held and state-controlled alike. Thus far evidence rather supports the assumption that improvements in CG (adoption of codes of corporate conduct, information disclosure, dividend payments, etc.) constitute a simulation ('window dressing') aimed at foreign investors and creditors, while bank owners give low intrinsic value to CG. As long as the quality of institutions does not improve, investors in Russian banks have to rely mainly upon the goodwill of bank owners that progress in governance will not be reversed. This particularly applies to minority investors in public sector banks. Reduction of the state's share in core banks should not be described as 'privatization' because privatization implies a shift of control from the state to private capital. That is not envisaged in Russia whose strategy regarding banks bears common features with China's. Core banks will firmly remain in the public sector, and the state, its bodies and officials will keep exerting decisive influence. Minority investors in these banks cannot confidently expect a radical and irreversible change in corporate behavior and governance practice.

The current ownership structure is likely to lead to crowding out of domestic private banks and their replacement by foreign and state-controlled ones. If the authorities prefer to see a substantial portion of financial assets in domestic prop-

erty, they have to implement far-reaching measures to convert Russian banks into genuine corporation, including introduction of a cap on the size of stake held by one beneficiary. Government measures to broaden the capital base of banks will set foundation for new institutions of CG and prevent their stagnation and marginalization in case CG remains undemanded.

We envisage 3 directions for future research:

(a) the impact that new standards of CG produce on the performance of Russian banks, measured both through performance of their shares in the stock markets and as a change in efficiency;

(b) the process of internalization of CG principles and norms and their interplay with informal norms and patterns of behavior;

(c) evolution of CG institutions across national banking systems of emerging market countries in Europe, Southeast Asia and Latin America, and its interplay with bank privatizations.

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