15 Main Corporate Governance Mechanisms and Their Specific Features in Russia

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15.1. Corporate Governance in a Transition Economy: Preliminary Methodological Notes

The crystallizing structure of ownership rights and corporate governance is important both for the postprivatization development of enterprises and for the economy in general, for a number of reasons:

- The optimal organization of ownership rights in a corporation (as well as the delegation of authority over those rights) provides an incentive for restructuring and increasing microeconomic efficiency.
- The historically (or traditionally) formed structure of ownership distribution in a corporation defines specific national models of corporate governance and accordingly shapes concrete legislative concepts and models of government regulation.
- A transparent (clearly defined) model of corporate governance in which the rights of all types of investors (shareholders, creditors) are protected is requisite to attracting investment.
- The corporate governance model and the structure of the capital market together determine differences in how corporations are organized and financed, as well as the industrial structure of the corporation and the relationship between employers and employees.
- At the microlevel, the corporate governance model is one of the major institutional components of economic growth.

If we interpret a firm as an institution, an organization, or a network of contracts (Alchian and Demsetz 1972; North and Thomas 1973; Williamson 1985) and assume a similar approach to corporate governance, we can draw some practical conclusions for an economy in transition. In particular, the absence of a developed system, of a

long-standing culture, and of standardized mechanisms for contract implementation as means for transferring property rights opens opportunities for large-scale violations of shareholders' rights, biased enforcement of property laws for political purposes, the development of nonmarket relationships between economic players, increased rent-seeking, and corruption (for details, see Radygin and Entov 1999).

Consequently, conflicts between managers and outside shareholders, both large and small, within the framework of the "principal-agent" relationship become acute. Problems related to the monitoring of managers by shareholders (see Hart 1995) are aggravated by the fact that managers, either directly or through proxy, are acting both as the insiders and the outsiders of the corporation.[1] In such a scenario, the problem of an issuer's transparency becomes crucial not only for potential investors but also for de facto outside shareholders of the corporation.

The corporate governance problem is no less important from the standpoint of the financial system, which is understood as certain institutional arrangements that provide for the transformation of savings into investments and for allocating resources among alternative users in the industrial sector (Tobin 1984). In a transition economy, the development of an efficient system of financial institutions, especially banks, within the overall framework of the financial system becomes especially important for shaping a national model of corporate governance and the financing of industrial development.

As the overall weakness of financial institutions in Russia became absolutely clear during the financial crisis of 1998, theoretical discussions about the applicability of any particular country's model of corporate governance (such as the American model versus the German one) became useless. Similarly, discussions of the potential role

1. Numerous constructions of "insiders" and "outsiders" exist in the literature: (a) internal (employees, managers) and external (banks, funds, other corporations) investors of a corporation; (b) from the standpoint of their involvement in the system of intercorporate ownership (in holdings or in cross-ownership schemes); (c) from the standpoint of the diffusion of the ownership (insiders as large controlling shareholders and outsiders as small portfolio shareholders); and (d) as "internal executives" and "independent" directors in the unitary or two-chamber governing body. Some scholars of Russian legislation include in the insider category board members, members of the collegiate executive body of the company, the person performing the function of single-person executive body, and majority shareholders who can shape the decisions made by the company.

of banks as an alternative mechanism of corporate control when other mechanisms that might have forced managers to act not solely in their own interests have failed (see Stiglitz 1994, 77–78, 189–90) and also turned out to be of little relevance.

From the standpoint of corporate control issues, the situation in the transitional economy is unclear. On the one hand, the "manager's revolution" concept, known since the 1930s (Berle and Means 1932), suggests there are reasons to place formal owners outside the framework of the real authority relationships involving control and management in Russian joint-stock companies. This model was typical of the first postprivatization years, before the law *On Joint-Stock Companies* was enacted. On the other hand, there is also evidence to claim that the process of ownership—corporate control—corporate governance does exist. The latter makes sense when it is possible to identify different types of the "hard-core" shareholders exercising control either directly or through affiliated entities ("coalitions," in the language of organizations theory). In this respect the key problem becomes one of identifying the hubs of real control (Aghion and Tirole 1996) in a corporation with a formally dispersed ownership structure.

It should also be pointed out that when a market is illiquid, the choice between the mechanism of "vote" and the mechanism of "exit" loses all meaning (Hirschman 1970, 15–54), since there is essentially no alternative: if it is impossible to sell one's shares, then the voting mechanism must be upgraded. One way to implement this mechanism in a transition economy is suggested by the self-enforcing model of corporate governance (Black, Kraakman, and Hay 1996; Black, Kraakman, and Tarasova 1997).

Corporate governance theory describes a number of mechanisms to ensure the realization of shareholder rights and to form a system of relations among shareholders, managers, employees, creditors, and other participants in firm operations with respect to the order in which assets are disposed of and income is distributed.[2] Economic theory, jurisprudence, sociology, psychology, and other avenues approach the operation of these mechanisms. In general, there is a tendency to use an interdisciplinary approach in develop-

2. See, for example, Andreeff (1995); Charkham (1994); Clark (1986); Monks and Minow (1995); OECD (1999); Prentice and Holland (1993); Radygin and Entov (1999); and Wouters (1973).

ing theories about corporate governance (see Prentice and Holland 1993).

The mechanisms of corporate governance are traditionally differentiated into internal and external mechanisms. Internal mechanisms include procedural mechanisms of governance within the corporation; external mechanisms refer to influential factors in the external environment. External mechanisms of corporate governance usually include the following:

- Corporate legislation (codes, special company laws, conjugate laws, departmental acts, rules, instructions) and its executive infrastructure (enforcement)
- Financial markets (for example, if the securities of ineffective corporations are dumped on liquid financial markets, managers face the insurmountable problem of finding new resources in a climate of declining investor interest in the corporation's securities)
- The threat of bankruptcy owing to managers' poor policies (in the most extreme case, bankruptcy results in the transfer of control to creditors)
- The market of corporate control (the threat of a hostile takeover and the replacement of managers)

This chapter reviews the key mechanisms necessary for the development of a national model of corporate governance in Russia and other CIS members, and obstacles to their implementation. The discussion is mostly concerned with open joint-stock companies set up in the industrial sector, generally medium-sized and large public enterprises, and with the course of their development and privatization. The data used in analyzing trends in Russia are current through 1 January 2000; for other countries the data may vary, depending on what sources were available.

15.2. Internal Mechanisms

Following the work of Tirole (1999), at least three internal mechanisms regulate the coordination of decisions made within the corporation with the interests of shareholders:

1. Retaining a managerial post for the manager (and upholding management's business reputation when a corporation proves successful)

2. Maintaining an incentive for effective management (from the shareholders' point of view) by means of special systems of payment
3. Direct monitoring, mainly by large shareholders and their representatives

In different countries the role played by each of these mechanisms can differ fundamentally. Nevertheless, despite all the differences in existing structures of corporate governance, in each developed country a system of checks and balances safeguards the interests of investors while allowing managers some independence and initiative.

In countries with a transitional economy, the weak development of external mechanisms of corporate governance makes internal mechanisms especially important (Table 15.1).

In all developed countries, a two-tiered system of governance is in place. One tier consists of the executive board or managing board and the other tier consists of the board of directors or the supervisory council. The existence of a board of directors may be tied to a company's size (Russia, Latvia, Poland). In some countries the board can be dissolved at the discretion of shareholders (Bulgaria, Romania). On the other hand, in other countries the two-tiered system is mandatory (the Czech Republic, Hungary). The board of directors (supervisory council) is usually considered the main internal or direct mechanism of control.

With respect to the executive management of a joint-stock company, a primary problem in a transitional economy is getting rid of the concept of "principal owner." Retaining the concept of principal owner generally results in a fierce struggle for control (in "amorphous" or "insider" models), or resistance to new owners.

One more principal trend should be noted. The second half of the 1990s was characterized by a very specific process of merging the functions of managers and outsiders in Russian corporations. The managers gradually became stockholders in corporations, while the outsiders, consolidating their control, started function as managers. This is a conflict-ridden process, and so far it has not played a decisive role. However, in perspective this process is very important for its potential to smooth over bitter corporate conflicts and further stabilize ownership control in a corporation.

Data on the replacement of managers in the hundred largest Russian corporations provide some indirect confirmation of ownership

Table 15.1
Standard Elements of Corporate Law and Their Presence in Some Transition Economy Countries at End of 1996*

	Russia	Czech Republic	Hungary	Bulgaria	Poland	Romania
Main legal acts	Civil Code (1994), Law on JSC (1995)	Commercial Code (1991)	Law VI on commercial societies (1988)	Commercial law of 1991 and 1994	Commercial Code (1934 with amend.)	Commercial Societies Act (1990)
1. Clear distribution of decision-making authority	Weak	Exists	Exists	Weak	Exists	Weak
2. Governance structure (two-tier, i.e. management and board of directors)	Two-tiered if more than 50 shareholders	Always two-tiered	Always two-tiered	According to shareholders decision	Two-tiered if capital is more than 50 mln zloty	According to shareholders decision
3. Nomination of directors (necessary number of votes)	More than 50%	More than 50%	More than 50%	More than 50%	n.m.—some directors can be appointed by large shareholders	Competence of the board
4. Removal of directors	More than 50%	More than 50%	More than 50%	More than 50%	More than 50%	More than 50%
5. Control over votes (proxies)†	Exists	Exists	Exists	Exists	Exists	Exists
6. Rules for disclosure of information and audit	Standards rapidly developing	Low level	High standards	Low level	High standards, close to EC	Low level
7. Rights of minority shareholders						
a. Preemptive right	Exists	Exists	Exists	Exists	Exists	No data
b. Qualified (or higher) majority during important decisions	75%	66%	75%	$^2/_3$ of chartered capital	May be 50%, $^2/_3$, $^3/_4$, $^4/_5$	$^2/_3$ of quorum 75%

c. Takeover rules	Exists	No	Exists	No	No data	No data
d. Cumulative voting	Exists	No data	No data	No data	Exists	No data
e. Limitations on number of votes per 1 shareholder	NM	May be	May be	NM	May be	May be
f. "Independent" directors	Exists	No data	No data	No data	No data	No data
g. Rules for important transactions	Exists	No data	No data	No data	No data	No data
8. Participation of employees in supervisory board	NM	1/3–1/2, if more than 50 employees	1/3, if more than 200 employees	NM	NM	NM
9. Minimum quorum for meeting	More than 50%	30%	More than 50%	According to the charter	NM	50%
10. No. of votes per 1 share	As a rule, 1	1	Not limited	1	1–5	1
11. Insider dealing prohibited	Yes	Yes	Yes	Yes	Yes	Yes
12. Enforcement	Weak	Weak	Weak	Weak	Weak	Weak

*Data may be obsolete. According to the EBRD (1997), in 1997 a number of countries enacted modern company laws (the Czech Republic, Estonia, Hungary, Lithuania, Poland, Slovak Republic, Slovenia, and Uzbekistan). NM, not mentioned in the legislation.

†In reality, depends on: (a) rules of excess to shareholder registers and (b) prospects of the formation of a depository system resembling that in Germany (where depository banks vote for shareholders who do not express their opinion on the subjects of agenda). This directly contradicts the rules in the United States, where such votes are cancelled.

Sources: RF laws; Böhm (1997); Gray and Hanson (1994); *Aktsionernoye obschestvo* (1995); EBRD (1998).

stabilization (Khoroshev 1998). Fifty percent of the general managers of these companies assumed their position after 1992, while 25% of those assumed their position in 1997. Before assuming office, a minority (36.4%) had no prior experience at the company at all, but the majority had, either as deputy general managers (45.5%) or in some other position (18.2%). The study also found that the average age of general managers was between 50 and 65 years; 19% of them were younger than 40.

On the whole, the problem of a board's (managers', executive directors') loyalty to joint-stock companies and their shareholders is acute in all countries undergoing transition. The most draconian measures to ensure such loyalty are stipulated in Latvia's law on joint-stock companies. This law states that members of the executive board are elected at general meetings, and in the first month following the election each member of the board must acquire a certain percentage of shares in the company (usually 0.1%–5%, but since 1996 up to 25%) without the right to sell them. Should a joint-stock company suffer losses because of the activities of a board member, that individual's shares will be sold to cover the loss. If this is not adequate to cover the loss, the individual is forced to sell personal property.

In this connection, problems of representation of external shareholders in different bodies of joint-stock companies become more important. In particular, in Russian joint-stock companies there is a significant stratum of shareholders who, while participating in the capital investment, are neither represented in any corporate governance body nor participate in current management. Most affected are shareholder—employees and individual external shareholders, while commercial banks and industrial enterprises (suppliers and buyers) are least affected. That commercial banks and industrial enterprises are not much affected is not surprising, because both kinds of entities have more possibilities of ensuring their shareholder rights by using other financial and trade mechanisms.

15.3. General Legislative Situation

After the achievements of the first half of the 1990s, Russia made little progress in the development of new legislation and legal institutions. In 1996, the World Bank noted that "there was some progress

in legislation and insufficient in institutions." This reality placed Russia in the third group of countries in the World Bank's classification, a group that included Kyrgyzstan, Moldova, Armenia, Georgia, and Kazahkstan. Russia lagged seriously behind the leaders—the countries of the first group (Poland, Slovenia, Hungary, Croatia, Macedonia, the Czech Republic, and Slovakia)—where there was "significant progress both in legislation and in institutions" (World Bank 1996).

By the end of the 1990s the situation had changed markedly (EBRD 1998). In regard to addressing commercial laws, Russia joined the group of leaders, being granted the "expert" grade of 4– (Bulgaria, the Czech Republic, Hungary, Poland, Romania, Lithuania, and Croatia have been given a grade of 4, and industrially developed countries are graded as 4+). The lag is greater in regard to the "efficiency" of commercial laws (Russia received the "expert" grade of 2, while the leaders are graded 3 or 4). As a result, according to this classification, Russia holds an intermediate position among the countries in transition.

Of course, not a single country in transition has legislation on corporate governance (in the broad sense—encompassing all the necessary regulatory documents) that could be considered highly developed. This legislation "does not so much reflect what already is but what should be or, in the best possible case, what is emerging" (Aktsionernoye obschestvo ... 1995, VIII–IX).

The federal law *On Joint-Stock Companies*, adopted in 1995 and in force since 1 January 1996, became the landmark piece of legislation in the field of commercial law in Russia. In principle, it could be considered quite progressive, at least at the moment of its adoption, because it included a generally accepted set of traditional provisions for corporate governance.

The major objectives of corporate governance regulations cover several areas relevant to the protection of shareholder rights:

- To fill in the legal gaps characteristic of Russian corporate legislation (such as regulations on insiders' transactions, affiliated persons and relationships, corporate reorganizations, and so on)
- More rigid regulation of relations between legally independent but economically connected companies (an example is the definition of a "group" in French law)

- To clarify procedural issues bearing on corporate relationships (authority and procedure of shareholders' meetings, boards of directors, new securities issues, and so forth)
- To establish requirements for an issuer's transparency (at present the quantitative approach to disclosure of information prevails; however, qualitative aspects—the reliability of the information—are no less important)
- To strengthen the sanctions against violating the provisions of corporate law
- To enhance the authority of the governmental regulatory bodies
- To widen the scope of judicial control over a company's "activity"

Moreover, a new, systemic approach to the development and updating of legislation is needed, as well as conciliation between the provisions of the different branches of law (administrative, civil, civil procedural, criminal, and criminal procedural) regulating the activity of corporations. Another crucial factor now is the general legal environment in which companies function. Another important element is the systematization of the related regulatory documents: on the securities market, bankruptcy, mergers and takeovers, protection of investors, investment institutions, banks, and so on.

In countries in transition, the process of developing regulations for this broad range of problems is usually stepped up when reforms have reached a certain qualitative stage. All of the above-mentioned considerations allow us to conclude that at present, there is no real need for any radical changes in the corporate law. Under normal conditions, a policy of gradual improvement and filling in the legal vacuum is probably the optimal solution.

The key problem today is that the efficient regulation of corporate relationships demands not only active (or even leading) legal regulation of the developments in this sphere, but also the creation of a system of state control and enforcement that would bring companies into compliance with existing legislation. The "self-enforcing" model of internal protective mechanisms cannot be strengthened indefinitely, nor does it work under conditions of continuing struggle for control within corporations. Such external mechanisms of protection and control as a liquid securities market and a well-functioning bankruptcy mechanism are weak in Russia. In such a situation, internal methods of control and enforcement of existing laws become much more important.

No single law on companies can cover the whole spectrum of corporate problems. Thus, a governmental regulatory body that could efficiently and legally intervene in corporate governance disputes would become the most important element of the law enforcement system. The role of such factors as political will in establishing such an efficient regulatory body is self-evident.

15.4. The Corporate Securities Market

The importance of the securities market to shaping the model of corporate governance needs no comment. When a developing market is illiquid and the major objects of trade are securities issued by ten to fifteen entities, the mechanism of "exit" (sale of stock) as an element of corporate governance in the absolute majority of cases simply does not work. The market for the shares of a specific issuer may be liquid for only a short period of time, and it is only one-way: small shareholders may only exit, and only during periods of consolidation of a controlling interest or times of corporate conflict between large shareholders and managers. In many cases small shareholders are unable to sell, either because absolute control of the company has been established or because the enterprise is of no interest to investors.

Thus, there is almost no alternative to the currently forming corporate governance model: if the exit mechanisms do not work—if you simply cannot sell your shares—then there should be a natural tendency to strengthen the voting mechanism. If problems arise in this connection as well (resulting from the ideology of a "principal owner" still supported by the managers), the only way left is the intervention of state executive and judiciary authorities. Some intercountry comparisons of this process are presented in Table 15.2.

However, the opposite type of relationship also exists. According to many estimates, violations of corporate governance rules in Russian corporations were a major factor leading to the withdrawal of investors and the collapse of the securities market in 1998.[3] An excellent example in this respect is the adoption of federal law No. 74-FZ of 7 May 1998, *On Specific Aspects of Disposal of the Shares of the*

3. According to various estimates, this factor accounted for between 30% (FCSM of Russia) and 100% (Brunswick Warburg) of the decrease in market capitalization in 1998, although estimates are obviously very artificial.

Table 15.2
Comparative Corporate Securities Market Development Data, End of 1996 to End of 1997

	Czech Republic	Hungary	Poland	Russia	Romania	Slovenia	Slovakia
Capitalization: US $ (bill.) / % of GDP	18.1 / 39	5.3 / 12	8.4 / 7	68 / 11	0.9 / 2	2.5 / 15.9	2.2 / 12
Trading volume: US $ (bill.) / % of capitalization	8.4 / 47	1.6 / 31	5.4 / 64	3.0 / 8	0.5 / 55	0.7 / 33	2.3 / 106
No. of listed shares	1,000 tot., 50 liquid	50 (types A and B)	129 (incl. NIFs)	30,000 tot., 150 liquid	60 (two tiers)	73	19
No. of securities dealers	460 licensed	98 licensed	50 (incl. 16 banks)	1,561	100	42	ND
% of shares trading on stock exchange market	3	86	OTC since 1997	2	BSE and RASDAQ	100	ND
Universal banking	Yes	Since 1997	Yes	Yes, with restrict.	No	Yes	Yes, with restrict.
Central depository (or central clearing and settlement entity)	Yes	KELER (all clearing and settl for BSE)	Yes	No	Central Company for clearing and settlement	Central clearing corp.	Yes

Independent securities commission	Since 1998	Integrated office for banking and securities under government	Since 1991	Since 1993, under President	Yes, under Parliament	Yes	No, control office within MF
Securities law	Act on Securities; Act on Stock Exchange; new law (1997)	Law on Securities Issues and Stock Exchange (1990)	Law on Securities Trading and Investment Trusts (1991)	1996 Law on Securities Market	1994 Securities Law	1994 Law on Securities Market (new law will be close to EC)	New (1998)
Insider laws, investor protection, disclosure and compliance regulation	Yes, with weak enforcement	Well-developed standards (close to IOSCO)	Well-developed standards (close to IOSCO)	Yes, with weak enforcement	Yes, with weak enforcement	Standards developed, with weak enforcement	Yes, with weak enforce-ment

Sources: OECD, 1998a; Thiel (1998); RF FCSM; various countries' legislation.

Russian Joint-Stock Company in the Field of Energy and Electrification "Unified Energy System of Russia" and the Shares of Other Joint-Stock Companies in the Power Sector Under Federal Ownership. Article 3 of this law permitted foreign states, international organizations, foreign legal persons and their affiliated Russian legal persons, and foreign individuals to own up to 25% of all types of an RAOs' shares (RAO is the abbreviation for *rossiskoye aktsionernoye obschestvo* or Russian government-controlled corporation). At the time the law was adopted, 30% of shares in RAOs were already owned by foreigners.[4] The adoption of this quota, which hypothetically meant a demand for nationalization of a certain percent of shares, became one of the key factors in the Russian stock market crash of 1998.

The Russian corporate securities market was developing robustly during 1996–1997. The global financial crisis that began in 1997 dealt an especially severe blow to emerging markets, including Russia (the overall decrease in capitalization was 90% between October 1997 and September 1998). Nevertheless, even if we take into account the sharp drop in the stock market indices in 1997, Russia at the time was still the global leader in the growth of its stock index (which by the end of 1997 had increased by 88% compared with 1996). To a considerable degree the growth in the index was explained by significant legislative progress, development of the securities market infrastructure, and the increasing attractiveness of Russian corporate securities in the setting of decreasing yields on other financial instruments during 1995–1997.

Nevertheless, the Asian crisis and lower world prices for raw commodities were just external factors contributing to the financial crisis in Russia, which had its own specific features. The catastrophic crash of the Russian stock market in 1998 cannot be explained solely by the unfavorable global financial situation. The latter only aggravated the accumulated internal negative trends in the Russian economy, and it

4. Limiting foreigners' share to 25% was essentially a psychological factor, because it was not realistic to expect that the foreigners' share could be legally brought down to the required level. There is only one legal way to decrease this share—by issuing additional shares, which becomes possible only after a decision made at a general shareholders' meeting (foreigners have a blocking interest, the government has a controlling interest), after which the issue must be registered with the FCSM, which has the right to refuse to do so in accordance with the RF Civil Code. According to some data, by February 1999 the share of foreign investors increased to 33%, which was explained by the expectations (apparently mistaken) that the prohibitive quota would be canceled and the companies' stock prices would significantly increase.

was these internal trends that proved fatal in 1998. The significant drop in stock prices and liquidity between the autumn of 1997 and the autumn of 1998 was linked to a whole range of different macroeconomic and institutional factors.[5]

The financial crisis uncovered several shortcomings of the domestic securities market:

- The market players were speculators and not interested in long-term investment.
- Individual domestic investors had an insignificant presence on the securities market, which is inexcusable.
- Issuers had little interest in opening the market (because of ongoing struggle within corporations, among other reasons).
- Issuers had insufficient knowledge of market opportunities to mobilize capital.
- There was loose coordination between governmental agencies that regulate the securities market, and a permanent conflict of interest between governmental agencies.
- Gaps and contradictions in the normative and legislative base of the securities market persist.

The persisting postcrisis economic growth in 1998 and 1999 (the GDP increased by 3.2% and industrial output rose 8.1%), the relative stability of the macroeconomic situation (contrary to some predictions, hyperinflation did not occur), and political changes at the end of 1999 and the beginning of 2000 positively affected the situation on the Russian securities market. According to most rating agencies, the Russian stock market in 1999 was among the three fastest growing markets in the world. The value of Russian debts increased by 60%–70% of the nominal value. The annual yield of Russian bonds was 130% (Brazilian bonds yielded 39%). The capitalization of blue chip companies increased by 182% during the year. The RTS-Interfax index was the second fastest growing national stock market index in the world, after Turkey's. In January 2000, investors again began showing interest in "second-echelon" companies, a sign that investors were starting to turn to a more long-term strategy from purely speculative short-term investment.

5. For more details see FKTsB (1997, 1998, 1999); IEPPP/IET (1998); and Radygin (1998, 1999).

The profitability of mutual investment funds increased substantially. Most profitable were the mutual funds that invested in state securities and utilized the results of the novation and growing OVVZ quotations (Ilya Muromets showed a profit of 1,877%, and Templeton Funds a profit of 854%). Although several funds were liquidated in the wake of the crisis, their total number reminded almost the same, since new corporate equity funds were created. Moreover, the number of depositors in many mutual funds increased by a factor of four or five. However, the flood of private funds into the securities market (including money invested through mutual funds and the Moscow Stock Center) was linked not to the advantages of one or another investment method but to the absence of alternative high-profit instruments on the financial market in 1999.

Foreign funds that invested in Russian equities in 1999 ended the year up 150%. These results led experts to anticipate that investors would continue to be interested in Russia after the presidential elections in March 2000. Although political stability is an important factor in this case, for many funds the market's growth rate is no less important, as it is the fund manager's mandate to invest in the fastest growing markets.

In 1999, for the first time since the financial crisis, some large Russian corporations (Sibneft, Unified Energy System of Russia) announced their intention of issuing depository receipts. It is also significant that a majority of Russian corporate borrowers strove to meet their current liabilities on the eurobond market on time. The year 1999 also saw renewed interest in the Russian corporate securities market. Some of the largest companies issued securities in 1999 (including those linked to the novation of governmental securities), while others planned their issues for 2000.

In the short term, the Russian securities market could probably be characterized by the following main tendencies:

- Fewer (as a result of mergers) and larger companies, and greater competition among professional securities market players
- The postcrisis redistribution of ownership in financial groups and corporations, which, together with low prices on the weak stock market, could result in widescale abuses and violations of shareholder rights
- The appearance of instruments not typical for the Russian market, owing to the attempts of real sector enterprises to find alter-

native sources of financing (corporate bonds, warehouse receipts, mortgages)

- The development of new forms of collective investment (real estate investment trusts, for example)
- A more active role for self-regulatory organizations of professional participants in the securities market and investors (shareholders)

The Russian securities market has a significant potential for further development. This potential is based on such factors as the large number of open joint-stock companies that were created in the course of privatization, the substantial number of enterprises with good prospects, the interest many enterprises have in additional issues, and the desire of many regional and municipal authorities to place their loans (bonds). To a considerable degree, the prospects for growth in the Russian market depend on reasonable policies for financing the deficit of the federal budget through the issuance of various types of government securities.

Favorable conditions for the medium-term development of the securities market are determined by a number of qualitative characteristics unrelated to the current business situation:

- A considerable understatement of assets (although this factor may remain hypothetical in the absence of effective management or the greater transparency of issuers)
- The inflow of funds from large Russian investors into the corporate segment of the Russian securities market
- The appearance of conservative foreign investors on the Russian market
- An increasing share of long-term investment by global mutual funds in Russian corporate securities
- Favorable shifts in the development of the securities market infrastructure
- Increasing transparency of the Russian market
- Removal of political risks
- Removal of the ruble devaluation risk
- Decreasing tax-related risks
- Decreasing risks related to protection of stockholders' rights and "anti-outsider" policies of companies' managers

- The reduction of risks by creating a central depository linking regional depositories
- The development of a system of collective investors

In general, the securities market in a transitional economy can perform four major functions: attract investment, fill the portfolios of speculative investors, achieve the postprivatization redistribution of ownership rights within corporations, and serve as a mechanism of outside corporate governance (to put pressure on managers).

Throughout the 1990s, attracting investment in enterprises remained the weak link in the market that was taking shape during this time. The possibility of an efficient start-up of the market mechanisms of corporate governance is definitely limited in such a market. Probably in the next few years the major function of the market will remain, as it has been all along, the redistribution of ownership in Russian corporations. However, this redistribution will take into account the specifics of the postcrisis situation. Correspondingly, the problem of shareholder rights protection and strengthening governmental regulation in this field become especially urgent.

15.5. Bankruptcy Procedures

The role of potential bankruptcy as a mechanism for putting pressure on corporate managers in a market economy is well-known. The threat of bankruptcy managers face when they adopt an incorrect market policy (and, in the most severe cases, the transfer of control to creditors) is usually regarded as a major external instrument of corporate governance control. Regardless of the specific country model and regardless of whether bankruptcy favors creditors or debtors, bankruptcy should alleviate the financial situation of the corporation, and the corporate operations should thus become efficient.

At the same time, in a transitional economy there are objective limitations to the broad implementation of bankruptcy as a means of external control:

- The traditionally soft budget restrictions
- The existence of a large number of corporations with state shareholding
- The lack of an adequate executive and judicial infrastructure

- Social and political obstacles to conducting real bankruptcy procedures in the case of loss-making corporations, especially if they are very large corporations or located in one-employer towns
- Numerous technical difficulties in evaluating the financial situation of candidates for bankruptcy
- Corruption and other criminal aspects, including problems connected with the redistribution of ownership

Under these conditions, since the time of its appearance and during the 1990s the institution of bankruptcy in Russia has performed two major functions: the redistribution (obtaining, retaining, privatization) of property, and as a way for the state to apply permanent political and economic pressure, which has been extremely rarely and very selectively applied.

The number of bankruptcy petitions during the period of 1993–1997 when the law *On Insolvency (Bankruptcy) of Enterprises* (adopted by the RSFSR Supreme Soviet on 19 November 1992 and in force since 1 March 1993) was valid is very insignificant.[6] From 1993 to 1 March 1998, arbitration courts saw altogether 4,500 cases. As of 1 March 1998, the courts were engaged in proceedings involving 2,900 cases, an increase in the annual docket. (Table 15.3).

A new law, *On Insolvency (Bankruptcy)*, No. 6-FZ, was adopted on 8 January 1998 and became effective on 1 March 1998. We will not try to evaluate its innovations and content here (but see, for example, *Kommentari* ... 1998), but will only point out that this law is more detailed and progressive than the earlier one. The problem can be condensed to the following points. First, all political, social, and economic obtacles to the widescale application of this law still remain (and have become even more relevant after the crisis of 1998). According to Goskomstat, 55.2% of small and medium-sized Russian enterprises were in the red in 1998.

Second, in an environment of high levels of corruption and the continuing redistribution of ownership, alternative solutions envisioned by the law and the procedures for their adoption become a convenient tool for manipulation and applying pressure in the inter-

6. According to the Single State Register of the enterprises and organizations of all forms of ownership, the number of registered businesses in Russia as of 1 January 1999 (including affiliates and remote subdivisions) was about 2.7 million units, including more than 1.6 million joint-stock companies and partnerships (RF Goskomstat 1999).

Table 15.3
Bankruptcies in Some Transition Economy Countries

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998
Russia									
No. of bankruptcies filed	—	—	—	100	240	1,108	2,618	5,810*	12,781*
No. of companies recognized as bankrupt	—	—	—	50	ND	ND	1,035	2,600†	4,747†
Czech Republic									
No. of bankruptcies filed	—	—	350	1,098	1,816	2,393	2,990	ND	ND
No. of bankruptcies completed (‡)	—	—	5	61	290	482	725	ND	ND
			(0)	(1)	(2)	(2)	(6)		
Hungary									
No. of bankruptcies filed	—	—	14,060	8,229	5,900	6,461	7,477	ND	ND
No. of bankruptcies completed (‡)	—	—	1,302	1,650	1,241	2,276	3,007	ND	ND
			(740)	(510)	(90)	(21)	(9)		
Poland									
No. of bankruptcies filed	151	1,327	4,349	5,936	4,825	3,531	3,118	ND	ND
No. of bankruptcies completed (‡)	29	305	910	1,048	1,030	1,030	984	ND	ND
	(1)	(8)	(98)	(179)	(235)	(287)	(173)		

*Applications filed with arbitration courts.

†In 1997, external management was instituted in 850 cases. During the first months of the new law enforcement (in March–June 1998), 800 applications were submitted (80 were rejected). By the beginning of November 1998 the number of applications had grown 10 times, to 8,000, and arbitration courts had appointed 3,000 arbitration managers. In general, according to the figures of the Federal Insolvency Agency (FIA), in 1998, 12,781 applications were filed demanding the pronouncement of debtors as bankrupts, including 4,573 cases involving the bankruptcies of industrial enterprises (out of which monitoring was instituted over 1,462 enterprises, external managers were appointed in 472 cases, bankruptcy proceedings were begun in 2,006 cases, and in 80 cases an amicable settlement between creditors and managers was achieved).

‡Including reorganizations.

Sources: RF FIA; EBRD (1997); *Kommentari* (1998).

ests of different participants of this process. Of importance here is the type of arbitration manager appointed, as well as the choice between liquidation and rehabilitation (reorganization).

In this connection, any significant simplification in the procedure for initiating bankruptcy (at the level of arrears equal to 500 minimum wages for legal persons) would make it much easier to put this procedure into operation for the liquidation of property. From the Russian experience it is well-known that the appointment of a "friendly" arbitration manager (whether temporary, specifically for the liquidation process, or an external one) almost automatically means that the problems of "the manager's friend" will be settled in his or her favor, whether it is protection against aggression or aggression.[7]

Third, if the number of bankruptcy petitions is compared with the total number of Russian enterprises and the number of debtor companies, this figure, instead of impressing, will rather alarm. Apparently the overwhelming majority of private creditors are not in a hurry to use the legal schemes offered by the new law. Instead, they prefer the traditional "private enforcement." Bankruptcy as an institution has not yet gained wide recognition and become a universal and uniform system but remains largely a tool to apply selective pressure on debtors, and its application is quite often motivated by the political interests at the federal and regional level.

Fourth, the problem of legal and practical support for the protection of rights and interests of all types of shareholders within the framework of the bankruptcy procedure remains unresolved. In particular, the threat of forced bankruptcy of many large corporations in arrears to the federal budget became a factor in the rapid withdrawal of portfolio investors from the corporate securities market in 1998.

Consequently, it is hardly possible today to regard the institution of bankruptcy in Russia as a stable and efficient external mechanism that improves the management and finances of a company. The increase in the number of bankruptcy petitions apparently does not indicate an enthusiastic response by creditors to the new legal avenues open to them. Rather, it seems simply to provide a trial run of new methods of privatization, protection of managers against hostile takeovers, or, conversely, a way to hostilely take over assets of in-

7. For detailed descriptions of different schemes for taking property away by appointing arbitration managers, see Volkov, Gurova, and Titov (1999).

terest. It is not accidental that this process co-occurred with the general rise in ownership redistribution around the time of the 1998 crisis.

15.6. The Market of Corporate Control (Takeovers)

Along with bankruptcy, the market of corporate control, which bears the threat of a hostile takeover and the replacement of managers, is considered to be a key external mechanism for effective of corporate governance. Many researchers believe that an active takeover market is the only way to protect shareholders from the arbitrary actions of managers. Coffee (1988) has pointed out that this method of corporate control is most efficient when it is necessary to break the opposition of a conservative board of directors not interested in listening to reason, which might call for splitting up a company, or when a company is already highly diversified. The numerous theoretical writings on the subject have also noted the relationship between takeovers that have provided a "private" (special) benefit to large shareholders and an improvement in the economic efficiency of the corporation after the new owner took control.

At the same time, the effectiveness of a takeover threat from the standpoint of subsequent improvement in corporate governance has been increasingly questioned. In particular, many commentators stress that the threat of a takeover pushes managers toward nearsightedness because they are afraid of stock prices going down in the near term. Other critics believe that takeovers serve only the interests of shareholders and do not take into account the interests of all "accomplices." Finally, there is always the possibility that the takeover will destabilize both the buyer company and the company that is taken over (see Gray and Hanson 1994).

Estimates of the amount of takeover activity depend on the methodological approach chosen. If a broad definition is used, many large privatization transactions may be characterized as friendly or hostile. If narrower definitions are applied, only the following may be singled out as not possibilities for takeovers in the Russian situation: (1) companies in the postprivatization period, (2) individual secondary transactions, and (3) large companies. Both mergers and takeovers are limited in all three cases by the need for large amounts of money, typically acquired through loans, which are available only to

largest companies (banks), or by mobilizing sizable blocks of shares in order to exchange them.

Corporate mergers in the strict sense of the term—that is, friendly transactions between equal (large) firms that are not accompanied by the buying up of small stockholders' shares but do involve an exchange of shares or establishment of a new company—are not yet common in Russia. This process is traditionally common at the stage of economic growth in which share prices increase. However, in Russia corporate mergers are more often regarded as a potential anticrisis mechanism, or as political maneuvering, or as the institutional formalization of technological integration.

Thus, the oil company Lukoil's transition to a single-share company is deemed to be the final stage of integration in the full merger of the company into a single financial and economic entity (the subsidiary companies have merged with the holding company).[8] Among the better-known examples from 1998–1999 are the noncompleted merger of oil companies YUKOS and Sibneft, the announced merger of joint-stock company Izhorskie zavody (St. Petersburg) and Uralmash zavody (Yekateriburg), and the announced merger of Neftekamsky automotive plant (Bashkiria) and Kamsky automotive plant (Tatarstan).

In essence, mergers and friendly takeovers can be regarded as synonyms. The capital market is unnecessary for friendly takeovers (which are initiated on agreement between the parties), and there is no visible connection with the problems of corporate governance. Mergers have been the most typical form of takeover for post-privatization Russia. They have occurred in a large number of newly established corporations and were motivated primarily by technological reasons: to reestablish old business ties, to control market share, and to integrate vertically.

The oil company Surgutneftegaz, for example, as opposed to Lukoil, completed the process of technological integration through a series of takeovers (of joint-stock company KINEF and a number of refined-product supply companies). Typically, such a process followed the establishment of financial and industrial groups repre-

8. At the same time, the shares of Lukoil remained relatively attractive and liquid (for more details, see Lyapina 1998), as happened similarly in a number of cases involving full takeover with the withdrawal of the company's shares that was taken over (Surgutneftegaz), but as is not typical of takeovers in which only the controlling interest is purchased, such as the takeover of Chernogorneft by the oil company SIDANKO.

senting a cross-ownership system around large corporations (especially in the chemicals and construction industries). It should also be pointed out that this process is highly politicized, and federal and regional authorities play an active role in it (especially in Bashkiria and Tatarstan).

In fact, only hostile takeovers hypothetically compensate for faulty corporate governance through the enforced replacement of managers. This market—the market of corporate control as such—has not yet developed to any considerable degree in Russia, and the transactions that actually take place are usually not advertised. Among the major factors limiting wider development of this market, the following can be singled out:

- The need to consolidate large shareholdings. In Russia the share capital (notwithstanding the trend toward concentration) still remains rather dispersed; even at the peak of market activity, in 1996–1997, no more than 5%–7% of shares in blue chip companies were bought and sold on the market.
- The structure of ownership within a corporation should be relatively clear and should remain fixed. In Russia in 1998–1999 the process of ownership rights redistribution once again intensified (simultaneously providing an incentive for takeovers).
- Insufficient liquid capital in case of financial crisis.

Nevertheless, the first hostile takeovers in Russia date back to the mid-1990s (see Radygin 1996). There was a well-known attempt (that ultimately failed) by Menatep Bank to take over confectionary factory Krasny Oktiabr through a public tender offer in the summer of 1995. In another well-known case, the holding company of Inkombank purchased a controlling interest in the confectionary company Babayevskoye. Many of the largest banks (financial groups) and portfolio investment funds engaged in takeovers of companies in completely different branches of industry for their subsequent resale to nonresidents and strategic investors. In 1997–1998 the food industry once again saw takeovers of regional beer brewing companies by the Baltika group; takeovers also occurred in the pharmaceutical and tobacco industries and in consumer goods production companies.

An interesting example of a takeover attempt was the conflict between Gazprom and ONEXIMbank, the international financial cor-

poration of the Renaissance group, in 1997. The latter was intensely buying up stock and hunting for voting proxies in order to participate in the general meeting of Gazprom's board. The objective of the group was to get one out of the eleven seats on the board of directors of Gazprom, since at that time one seat practically equalled a blocking vote (the rest were divided equally between Gazprom and the state). Nevertheless, this attempted takeover failed, and the group had to retreat.

According to some estimates, the postcrisis financial situation of 1999–2000 may accelerate the tempo of mergers and takeovers in those sectors of the economy that were susceptible to takeover even before the crisis. These are chiefly the food and pharmaceutical industries, ferrous and nonferrous metals, cellular telephone communications, and the banking sector (Kamstra 1998).

The following features of this potential process can be singled out:

- A significant stepping up of these developments in the branches, where takeovers do not require a serious concentration of financial resources, can be expected.
- In the takeover policy, major emphasis should be placed on companies that are relatively cheap today and that may strengthen the buyers' independence from the environment.
- A high degree of rationalization of these processes is to be encouraged (as opposed to the general precrisis policy of taking over any potentially profitable entities).
- There is the possibility of an increasing number of international mergers and takeovers due to the low share prices and financial problems of Russian companies in the situation of financial crisis.
- Opposition from regional authorities can be expected when the "aggressors" are not connected to the local-regional elites.
- Favorable incentives (the threat of hostile takeovers) may appear for whole branches to streamline the structure of their share capital.

15.7. Existing Instruments of Corporate Governance in State-Owned Enterprises and Their Effectiveness

As of November 1999, there were 13,786 unitary state-owned enterprises (SOEs) and 23,099 agencies in Russia. The Russian Federation is a participant (shareholder), having over 25% interest in the charter

capital of 2,500 joint-stock companies representing basic sectors of the national economy (including 382 joint-stock companies in which the state has 100% interest, 470 joint-stock companies in which the state has over 50% interest, and 1,601 joint-stock companies in which the state has 25%–50% interest). In addition, the state has a "golden share" in 580 joint-stock companies.

Blocks of shares in 697 joint-stock companies producing goods and services of strategic importance for national security (the list of such joint-stock companies was approved by RF government decision No. 784 of 17 July 1998, "On the List of Joint-Stock Companies Producing Products (Goods, Services) of Strategic Importance for Ensuring National Security, Shares in Which Fixed in the State Ownership Are Not Subject to Anticipatory Sale") were fixed in federal ownership. According to other acts, shares in 847 joint-stock companies are fixed in the RF's ownership.

Dividends on federally owned blocks of shares amounted to Rb 574.6 million in 1998, Rb 270.7 million in 1997, Rb 118 million in 1996, and Rb 115 million in 1995 (in 1998 prices).

It is impossible to analyze in detail here all the aspects of managing the state's property. The section that follows is limited to a short survey of existing instruments and an appraisal of their effectiveness.[9]

As the major element of the state policy in this area, the *institution of state representatives* may be singled out. Presidential decree No. 1200 of 10 June 1994, "On Some Measures for Ensuring State Management of the Economy," envisioned (1) framework requirements applicable to contracts between the government (a federal agency) and the chief executive officer of a federal SOE, and (2) framework requirements applicable to private individuals representing state interests in joint-stock companies. These representatives were divided into two categories: government officials, and other RF citizens (working on contract to represent the state's interests in joint-stock companies).

At present there are about 2,000 state representatives, of whom 92% are officials of federal executive bodies and 8% are officials of different agencies. In only a few cases were professional managers invited to manage state-owned blocks of shares. The major reasons

9. See also "Papers of the All-Russian Conference 'On the System of Managing State Property in the Russian Federation'" (photocopy, November 1999).

behind this fact include that the state pays irregularly for services and has a complicated mechanism for transferring blocks of shares held in trust.

Available appraisals indicate that the institution of state representatives is ineffective, for the following reasons: simultaneous common representation in several joint-stock companies, lack of expertise, lack of material (legal) incentives, lack of clear (contractual) aims of representation, lack of mechanisms of property accountability aimed at lowering risks for the state, lack of reports on the situations of joint-stock companies, lack of approved decisions, and so on. However, the same requirements are applied to joint-stock companies with a different proportion of state shares, although the degree of the state's influence is unequal.[10]

The experience of federal shareholdings management in 1993–1996 proved that officials are incapable of effectively managing shareholdings in five to ten joint-stock companies located in different regions and often operating in different sectors of the economy. It is not only technical and time considerations but also the lack of necessary qualifications (primarily knowledge of the specific enterprises) and lack of material incentives that prevent such management from being effective. To illustrate the dimensions of the problem, two of the most common types of behavior found among state representatives in joint-stock companies are the following:

1. "Indifferent behavior": State representatives to joint-stock companies show no interest in the companies, despite the state having controlling stakes and the companies sometimes being major budget debtors. In fact, such a position allots joint-stock company management an absolutely free hand.

2. "Self-interested behavior": Officials intentionally ignore joint-stock companies' debts to the government during their tenure as

10. The dilution of state-owned blocks of shares approved by state representatives inflicted considerable losses on the state budget. According to various estimates, the dilution of federal shareholdings led to losses for the state to the tune of hundreds of billions of rubles. It happened at a number of strategically important enterprises for ensuring national security: at joint-stock companies NII Delta (from 25.5% to 17%) and Irkutskoye Aviatsionnoye PO (from 25.5% to 14.5%) in 1996, and at joint-stock company Permskiye Motory (from 14.25% to 6.7%) in 1997. Of course, in a few instances state representatives actively influenced the behavior of respective enterprises. For instance, they initiated the resignations of CEOs who were responsible for wage and budgetary payment arrears at twenty-two joint-stock companies across different sectors.

state representatives and as a payback receive highly paid jobs at these joint-stock companies later on; and officials vote on behalf of the state at shareholder meetings of joint-stock companies for secondary share issues, as a result of which the state's proportional holdings are significantly reduced.

The shareholdings that are still held in state property funds and that for some reason have not been sold tend to become the object of bargaining between the fund, the management, and other interested parties. The fund itself or state representatives to joint-stock companies typically do not have a position concerning the management of specific enterprises.

Among the instruments the state used selectively or on a limited basis in 1992–1999 were the following:

- Individual arrangements with strategically important entities (for instance, a personal trust agreement concerning 35% of state-owned shares in Gazprom)
- Installing boards of state representatives at the largest holdings
- "Strengthening" enterprises (holdings) with state participation by contributing to their charter capitals state-owned blocks of shares in other enterprises (coal joint-stock companies, Svyazinvest)
- The transfer of state-owned blocks of shares in trust (oil, coal, electric power engineering in 1992; general "Rules of Transferring Blocks of Shares Fixed in the Federal Ownership in the Process of Privatization in Trust, and on Concluding Trust Contracts for These Shares," promulgated in 1997–1998)
- The transfer of blocks of shares in trust of managing (central) financial-industrial group companies, or in the management of holding companies (FIG Ruskhim, Russian joint-stock company Biopreparat, Nosta-Gaz-Truby, joint-stock company Rosmyasmoltorg, special construction)
- Personal appointments to boards of directors by a decision of the RF government or on instruction from the President (Gazprom, Norilsk Nikel, oil companies)
- Allowing the order of voting at shareholders' meetings to be determined by state-controlled blocks of shares (for oil companies, by RF governmental decisions; for Russian joint-stock companies EES Rossii and Rosgazifikatsia, by the decision of state representatives' boards)

- "Re-attestation" of state representatives and investigation of instances when federal blocks of shares were diluted

Currently, the main complaints of the state as a shareholder about the operations of these joint-stock companies coincide with the complaints of other categories of shareholders. The major complaints include the following:

- Lack of transparency, both for ordinary shareholders and for the state.
- Without their consent, outside shareholders in joint-stock companies see their share reduced by additional issuances of shares in favor of inside investors.
- Tangible and financial assets are transferred from parent to daughter companies (the daughter companies as a rule are controlled by managers) or to companies connected to them.

At *unitary SOEs* (including "quasiholdings" controlling daughter unitary enterprises), there are specific problems of management:

- There is no complete register of unitary enterprises with information on their assets and the major results of their financial and economic operations.
- The number of unitary enterprises exceeds the state's ability to manage them and to control their operations.
- Clear criteria concerning the functioning of unitary enterprises are lacking.
- The major lines of business of unitary enterprises do not always coincide with or complement the state's interests (many of them retain their status because their property is insufficiently liquid for privatization).
- Functions concerning the management and regulation of unitary enterprises are not clearly divided between different federal executive bodies.
- A number of unitary enterprises created before the Civil Code became effective are not in line with current legislation in organizational and legal terms.
- No contracts were concluded with a majority of the chief executive officers of unitary enterprises. The contracts in force do not include the terms of the CEO's accountability. Whereas labor legislation ef-

fectively protects the rights of CEOs, it creates considerable difficulty in applying measures making CEOs responsible for the results of enterprises' operations.

- The legal construction of full economic jurisdiction grants to its subjects (in reality, the CEOs of enterprises) broad authority in regard to ownership rights, including the independent management of financial flows and utilization of profits,[11] while the authority of the owner is exhaustively detailed.
- No mandatory regular audits are envisioned, which makes it more difficult to control their financial and economic operations.

In practice, the broad authority of CEOs of unitary state-owned enterprises (particularly in the situation in which the state lacks effective means of managing and controlling the enterprises and incentives for the CEOs are generally of their own devising) results in the redirection of some financial flows to satellite firms, as well as in insider deals in the CEO's interests, and in loss of budget revenue. In this connection, it is not surprising that the law *On State- and Municipally-Owned Enterprises in the RF*, which was intended to amend the respective provisions of the Civil Code, has not yet been approved.

When the new privatization law (Article 20) was adopted in 1997, it was expected that unitary SOEs would be reorganized as joint-stock companies, with 100% of shares transferred to state (municipal) ownership. Via this instrument, the state would enjoy an additional opportunity to sell certain property, although that situation would remain hypothetical should unitary enterprises preserve their right of "full economic jurisdiction."

The situation we have outlined with respect to SOEs clearly shows the desirability of achieving positive changes in the system of managing the property owned by the state, within the framework of a comprehensive reform of the system of managing state property at large.[12] The political and economic constraints on such a reform program are also well-known.

11. Government officials' lack of interest in settling this question officially (in the framework of the charter) should be included among the reasons for uncontrolled utilization of profits. This right was granted to them by Articles 294 and 295 of the RF Civil Code, which stipulate that the owner has the right to receive a share of the profits.

12. Certain measures are envisioned in "Concept of Managing State Property and Privatization in the Russian Federation" (approved by RF government decision No. 1024 on 9 September 1999). See also Chapter 12.

15.8. State-Owned Holdings and Financial-Industrial Groups

Integrative processes in Russia are driven by the desire for stability in business relations and by the desire to increase the business's economic importance, thus ensuring survival both through the mutual support of business associates and through the inevitable state subsidization. This is particularly important, given the uncertainty of the market in its formative phase. The process of financial-industrial integration, despite its contradictions and negative aspects, should be viewed as an important element in the postcommunist transformation of the Russian economy. At the same time, however, many holdings and financial-industrial groups (FIGs) are artificial, political creations and are not effective from an economic perspective.

The establishment, functioning, and legal regulatory procedures of holding structures in the Russian economy are among the least developed economic matters. The first holding structures in modern Russia were established in the 1980s and 1990s.[13] They can be divided into four large groups, according to origin:

- Pseudoholdings, which were created on the basis of the former USSR's and Russia's ministries and government agencies, follow the interests of high-ranking authorities. These holdings initially emerged as various concerns, unions, and associations (with such distinctive features as a vague system of ownership relations, a high level of management centralization, and low efficiency of management—the latter something they inherited from the former bureaucratic structures).[14]
- Industrial holdings, which were created voluntarily either (1) in the process of developing horizontal links between SOEs (with an initially low level of management centralization, which grew in the course of capital concentration, and scarce capital as their distinctive features), or (2) on the basis of state-owned (industrial and/or re-

13. See, for example, Radygin (1992, 1995).

14. The first well-known example of a pseudoholding in the form of joint-stock company (a closed type of joint-stock company) on the basis of a ministry is Avtoselkhozmash Holding, established in October 1991. The company was headed by the former minister. That structure was characterized by all of the typical legal collisions of that time: the holding comprised state-owned enterprises of the whole former USSR, the enterprises had a right to acquire the holding's stocks, the holding was prohibited from possessing the enterprises' assets, and so forth. On the whole, by early 1992 there were approximately 3,100 associations, 227 concerns, 189 unions, and 123 consortiums in Russia.

search) associations, or (3) in the course of separating structural subdivisions.

- Combined (production-finance-trading) holdings, which were established in particular under large SOEs (and where a strict "mother company-daughter company" relationship is characteristic).
- Banking, financial, and exchange holdings (characterized by attempts to optimize control over accumulated capital).

The emergence of classic "combined" holdings (that is, holdings characterized by the combination of production activity plus control over the daughter companies) distinctly coincided with the incorporation and privatization of enterprises after 1992. Financial holdings ("pure" in the classic sense: they participate only in joint-stock capital) began to emerge in Russia after mass privatization. Until the 1998 crisis, they were characteristic of the organization of banks' expansion to the real sector.

The emergence of holdings, like the emergence of other forms of corporate ties, can be traced to the disintegration of the Soviet economic system after the collapse of the USSR, the liquidation of sectoral management in the national industry, and the cessation of subsidization of the real sector from the state budget. Those factors resulted in broken links in production, an imbalance in the activities that take place over a product's life cycle (research and development, production, marketing, sales), and a crisis in enterprises' finances.

As was mentioned earlier, the former ministries (or their departments) are also maintained in a form of holding, which is why holding is often perceived as a modified element of the administrative system of state governance. At the same time, the main reason for the emergence of holdings in Russia was the protective reaction of enterprises to the dissolution of their accustomed environment and previously established links.

The general advantages of a holding structure are well-known. They include: (1) the possibility of exercising control over capital that substantially exceeds the mother company's capital; (2) securing the necessary conditions for the vertical (and horizontal) integration of enterprises; (3) economizing on trade operations; (4) price control; (5) consolidating the financial reporting of enterprises for taxation purposes; (6) optimizing production capacities; (7) centralizing participation in other companies' capital; (8) penetrating commodity markets; (9) optimizing large companies' strategy, finance, and gov-

ernance; (10) manipulating the prices of the mother and daughter companies' stocks; (11) eliminating destructive competition; (12) the possibility of establishing a relationship between the holding's subsidiaries as legal entities; (13) maintaining the daughter companies' formal independence to buttress their managers' prestige; and (14) increasing the immunity to external factors.

Nevertheless, not all enterprises favor being incorporated into holding structures, private or mixed. The data available on Russian corporations' ownership structure for the period 1994 through 1999 show an extremely low share of holdings in the authorized capital of "standard" Russian corporations (Radygin 1996, 1999). According to a 1996 survey of 160 enterprises, only 11% reported the attractiveness of holding structures (Vinslav 1996). For some, that is related to the lack of capital to acquire stakes, while others either are reluctant to become a daughter company or encounter difficulties in the course of registering with several government agencies. The majority of enterprises are focused on a "softer" form of cooperation. Holding as a form of relationship between enterprises is most characteristic of those enterprises that (1) find themselves in the "stabilization" or "growth" phase and (2) are industries with relatively high profits or clear vertical integration patterns.

It should also be noted that the formation of holding structures may be motivated by a number of considerations: control over financial flows, control and redistribution of state property, capital resources, political and budgetary interests of federal and regional authorities, and so on. These considerations also apply to the formation of state-owned holdings (SOHs).

Here we consider the main types of SOH that emerged in the country during the 1990s.[15]

1. The first type of SOHs were created simply by the transformation of SOEs into joint-stock companies without any preliminary reorganization or compulsory integration into larger structures. Their control (large) stake was fixed as government property (see Section 3 of this chapter for the statistics). In this group we can also include companies whose authorized capital included a "golden share" (which provided the government with possibilities to influence the joint-stock company's activities) and joint-stock companies in which the government owned the remaining stake. The holdings were

15. See also IET (1998).

formed spontaneously, by separating subdivisions of the mother company and acquiring daughter companies.

2. The second type of holding structure is represented by the largest companies, mostly monopolies, which were established by special decisions. The first of these became Russian joint-stock companies UES Russia and Gazprom, which were created as early as autumn of 1992. Their authorized capital was established with the total amount of capital (assets) of their industries in total (in this case, the largest producers of electric power and gas), plus controlling stakes in their daughter joint-stock companies. For all of those companies, Gazprom and UES Russia have become powerful holding companies.

Among the key corporate governance problems of the electric power holding UES Russia are the holding's control over regional companies and its relationship with local authorities. During the 1990s, many daughter companies of the holding became notorious for abrogating shareholders' rights. For example, some daughter companies required that an increase in a shareholder's stake by over 1% of voting shares first had to pass the preliminary consent of the board of directors—an illegal and discriminatory provision. Another example was the attempt made in 1998 to restrict foreign shareholders' share of a holding to 25%, through the introduction of new legislation. However, in October 1998 UES Russia attempted to remedy matters by proposing changes to the charters of forty-five (out of more than eighty) daughter regional companies that would bring them into line with the law *On Joint-Stock Companies*.

In 1998–1999, because of anticipated difficulties with domestic gas supplies, power plants' transition to coal fuel became an urgent matter. Projects were developed to create energy power–coal companies by integrating enterprises in the electric power sector and coal-mining companies (to date, only in those regions where coal is produced by open mining). The first company of this type was LuTEK (in Primorsky krai, currently in operation); BurTEK (Byryatia) and UralTEK (Chelyabinsk oblast) are in the planning stages. Projects to establish power-metallurgical companies (such as the merger of the Sayano-Shushenskaya hydroelectric power plant with Sibirsky Aluminum) are also being considered.

As for Gazprom, entrenched management successfully lobbied for a number of measures that would benefit management at the cost of the state and minority shareholders:

• On 20 January 1999, the State Duma passed in a second reading the law, *On Gas Supplies in the RF*. In particular, the law fixes the blocking share of the holding (25% plus one share) in the state's ownership, provided that the share of nonresidents is 25% minus one share (versus the 9% stipulated by presidential decree No. 529 of 28 May 1997). That provision of the 20 January 1999 law unquestionably maximizes the interests of Gazprom's managers: the smaller the state's share in an SOH, the less effective is the government's pressure on the board of directors, given that other shareholders are affiliated, controlled, dispersed, or are strategic partners of the parent company. Furthermore, statute 15 of the law prohibits division of the "single system of gas supplies," which implies that any reform of Gazprom as a natural monopoly is legally impossible.[16]

• Some sources note that by way of applying additional political pressure (against attempts to change top management and impose reorganization), Gazprom considered selling part of the stake controlled by the RJSC and using the funds for the pre-election campaign (according to some estimates, Gazprom's management controls ca. 7% of the company's stake, yet 15% is controlled by the parent company itself).

• Management successfully blocked in the State Duma passage of amendments to the law *On Joint-Stock Companies* that would have changed corporate governance procedures in favor of minority shareholders.

The process of institutional transformation in the oil sector started with the establishment of single oil-extracting corporations and their privatization in 1992–1993. Then the state-owned blocks of shares were accumulated in the respective holdings, and between 1995 and 1997 the newly established structures were privatized. Since then their authorized capital has consisted of several controlling blocks of enterprises. These enterprises were incorporated into those amalgamations. A similar process occurred with stakes in oil-refining and other related companies. The largest oil companies (Lukoil, YUKOS, Surgutneftegas), oil transportation companies (Transneft), and companies that transport petroleum derivatives (Transnefteproduct)

16. Nonetheless, in 1999, Gazprom's seventeen daughter companies were transformed into joint-stock companies with their own financial reporting and all nonprofile structures eliminated. It is envisioned that this reorganization will meet the World Bank's requirement of transparency.

occupied a special position vis-à-vis other structures. Their distinctive feature was that their authorized capital consisted of controlling stakes in joint-stock companies that had been created in the course of amalgamation.

Buyers during the "second wave" of privatization, who obtained a majority control over holdings, inevitably entered into conflict with the minority shareholders, who were buyers of the "first wave." According to some estimates, such conflicts delayed the appearance of "efficient owners" in the oil sector for at least three years. (Lukoil, which adopted the single share in 1995, was an exception.) The conflict between the "two privatizations" became one of the symbols of the corporate wars of 1997–1999 and a permanent source of economic destabilization.

By 1999, the majority of the SOHs had been privatized. Some oil companies have undergone numerous structural changes as a result of organizational and legal reorganizations and the realignment of "influences" as a consequence of multilateral lobbying. Typically, stakes in single enterprises that were fixed in the government's ownership were transferred from one company to another. In addition, there were some well-known instances of attempts to change some companies' management that were dictated by financial and political interests (Gazprom and Transneft in 1999).

3. The third type of state-owned holding structure consists of state-owned enterprises (companies) that were established for the specific purpose of governing the stakes (fixed in the state's ownership) of some industries' amalgamations and enterprises. Such state-owned companies, although not formally capital owners (as Gazprom's), were designated to exercise, on behalf of the government, the functions of holding companies in respect to those joint-stock companies in which the government had a stake. At the same time, the companies were required to carry out the provisions of state support for enterprises and to implement industrial policy. Examples of such companies are Rosneft (in addition to the said tasks, the company also sells the state's share of hydrocarbons received according to the production-sharing agreements and is the general commissioner of research and development); Rosugol (which also distributes budget funds to support the subsidized coal-mining industry, mine construction, and the production of equipment); and Roslesprom.

In 1995, Rosneft became a vertically integrated oil company in the form of an OJSC. The company's authorized capital was established

on the basis of thirty-two companies' stakes fixed in federal ownership, and Rosneft was entrusted with the government's stake in ninety-eight additional companies. At the same time, Rosneft became a symbol of the failure of the "cash privatization" policy of 1998–1999. Rosugol also attained OJSC status, but the company was liquidated shortly thereafter.

4. Holdings with unitary SOEs' participation became a special kind of SOH structure. These holdings are established by special acts. An example is the OJSC Industrial Company Antei (a 51% stake is owned by the state). In the course of establishing the company, the participating SOEs and joint-stock companies were granted daughter company status.

Holdings in which unitary enterprises participate are not corporations per se. Created as a rule to maintain the research, industrial, and export potential in the metallurgical-industrial complex, they are used to achieve a certain level of competitive strength. In organizational terms, such structures are created as follows: the parent enterprise of the "corporation" is granted the ownership of the SOEs, which become daughter unitary enterprises. Simultaneously, blocks of shares in joint-stock companies that are part of a production chain and are temporarily owned by the state are transferred to the parent enterprise.

The idea of the sectoral organization as a few state-owned concerns dominates the metallurgical-industrial complex at present. In 1999 a first step in this direction may become the merger (and issuance of common shares) of two existing holdings producing military aircraft, VPK MAPO (part of which is ANPK MIG) and AVPK Sukhoi. At the end of June of 1999, the RF government approved the merger of the ANTK (named after A. N. Tupolev) and Aviastar (Ulianovsk); the state's share in the new holding was 50% plus one share. Another holding, interstate aircraft-construction company Ilyushin, was organized only in December 1998. At present, the Tashkent Aircraft Industrial Association is expected to join this organization. The creation and reorganization of holdings in this industry will likely go on for a long period of time.

5. An example of a "financial" SOH (and of an ineffective management strategy) was the formation of Rossiyskaya Metallurgia in 1995. The charter capital of this holding was formed of 10% blocks of shares in several Russian metallurgical joint-stock companies, including the largest integrated iron-and-steel works in Cherepovets,

Lipetsk, and Magnitogorsk, as well as in some other property (including a number of research institutes and centers).

These blocks of shares should have been transferred in the trust of the new joint-stock company, or purchased by selling 49% of the company itself, with 51% remaining in the ownership of the state. According to available appraisals, the real purpose for creating this holding was to prevent outside shareholders from buying blocks of shares. The liquidation of the holding in 1997 was yet another example of an ineffective privatization strategy (an attempt to sell 49% of the shares in the holding) in a situation in which a relatively formed ownership (control) structure already existed at the majority of the metallurgical enterprises.

Another example of a financial SOH is Svyazinvest, created for the mixed aims of preserving sectoral control and increasing budgetary revenues via privatization. First, regional communications companies were created and privatized (including Rostelekom), then controlling interests (38% of shares) were transferred to Svyazinvest. As a result, the principal problem Svyazinvest now faces is improving corporate governance in order to overcome trends toward disintegration and the possible sale of a block of shares in 2000. For instance, in order to strengthen control over the property transfer of daughter joint-stock companies to third parties, it has been suggested that representatives of the largest shareholders (beginning with the Mustcom Ltd. consortium) be included on the boards of directors of daughter regional electric communications companies. It is also possible that the most profitable lines of business will be amalgamated into special daughter companies.

In 1998–1999, the holding's shareholders also discussed the possibility of a merger of Svyazinvest with its daughter company Rostelekom, 50.67% of whose shares are owned by the holding. In 1999 the holding's charter was amended in favor of minority shareholders. (One amendment stipulated that appointment of the general director was to be approved by a three-quarters vote.) Other amendments implied that the issue of new shares in the daughter joint-stock companies was to be approved by the holding's board of directors. The creation of ten to fifteen large daughter companies based on existing regional companies was likewise discussed in 1999.

6. Another kind of SOH structure is represented by newly created companies with mixed capital and a certain amount of state investment. Such a structure can be created in several ways, but chiefly

(1) by implementing investment projects, real estate and equipment operations, and some commercial activities; and (2) privatizing an enterprise by contributing its property to the charter capital of other economic entities (there were two such cases in 1998).

7. Finally, an SOH can be formed by the contribution of state-owned property in financial-industrial groups. The law on FIGs does not set a quantitative limit on the share of state property in FIGs. Moreover, presidential decree No. 141 of 1 April 1996 allows FIG participants to contribute state-owned property to charter capitals of FIGs' central companies, to lease this property, and to mortgage it. Central FIG companies may be entrusted with state-owned blocks of shares.[17]

The common flaws of SOHs are well-known: a trend toward monopoly (oligopoly) behavior, additional costs for procedural questions and the audit of integrated companies, difficulty controlling the redistribution of resources (assets) and revenues, a trend toward politicization, bureaucratization, and so on. However, three points require special attention for a deeper understanding of the flaws of Russian holding structures:

- At the stage of initial and essentially noneconomic reorganization of the largest SOEs, there was no possibility of creating optimal market-oriented management structures aimed at economic efficiency.
- The chronic inability of public authorities to manage effectively is coupled with the general problems of corporate governance of, and control over, Russian corporations.
- There was general economic, financial, and political instability in the 1990s.

The combination of these factors resulted in two processes characteristic of the 1990s. The first was the permanent reorganization of holding structures (state-owned, private, mixed) accompanied by violations of property rights, a struggle for control, transfers of blocks of shares, and so on. In this process, economic effectiveness and rational management did not always hold sway. Here we should distinguish between the motives for reorganizing state and

17. The RF Goskomimuschestvo letter of 17 October 1994 states that FIG status is incompatible with holding company status. A holding company cannot be a FIG participant in case (1) tangible assets make less than 50% in the structure of its total assets and (2) the share of state-owned property in its charter capital exceeds 25%.

private holdings. Motives in the first case were dominated by political considerations, lobbying, different types of ownership transfers, budgetary considerations, IMF pressure, and corruption. Motives for reorganizing private holdings were dominated by an interest in optimizing management, an interest in mergers, the disposal of companies operating at a loss, banishing outside shareholders, expansion, tax avoidance, and export of capital. In reality, however, the two sets of motives are often interwoven.

The second result of the three factors listed above was the use of a holding scheme (including holdings with state participation) to serve the narrow interests of government officials and private interests and to place financial resources out of reach (through offshore holdings, the use of transfer prices, creating profit centers outside the formal SOH, infringing the rights of shareholders in holdings and daughter companies, and so on). The 1998 financial crisis further intensified these processes (see Radygin 1999).

By 2000, about 100 officially created holdings existed in Russia. In evaluating the entire process of creating holding structures, the compulsory integration dictated by the state can be considered justified in regard to the fuel and energy complex, some other industries (atomic power engineering, communications, the metallurgical-industrial complex, and other special enterprises (such as the Russian space company NPO Energia and aircraft holdings formed around major design offices).

This allowed the state to maintain formal control over the largest natural monopolies and some strategic industries. This fact prevented the disintegration of traditional economic relations and full degradation of unique R&D projects, and sustained the manageability of link "enterprise associations" in the framework of integrated industrial-technological complexes.

At the same time, there is some doubt over the degree to which the creation of state-owned holding companies in other sectors of the economy (construction, civil engineering, textile and light industries, wholesale trade) is justified during the transition to a market economy. As practical experience has shown, "voluntary" affiliation in holdings and the economic rationale for affiliation in terms of corporate management have not always been high on the list of considerations.

It should also be noted that the formation of new structures of this type may act to the detriment of the existing corporations,

- Transparency in privatization policies (in this case as an element of corporate governance)
- A transition from the system of "hierarchical bargaining" between the state and the largest SOHs to strict budgetary discipline
- Rejection of extra-economic motives in reorganizing, redistributing ownership, financing, and changing top management at SOHs

Many of these recommendations may seem trivial or naive in light of Russian realities. The overarching goal, however, is to place the development of the Russian economy securely on a global trajectory.

The first regulatory act covering FIGs was presidential decree No. 2096 of 5 December 1993, "On the Creation of Financial-Industrial Groups in the Russian Federation." Although formally catering to the interests of the *nomenklatura* and major branch and bank lobbyists, this decree was essentially an attempt to obstruct the process of FIG formation, which began during the mass privatization phase and amounted to spontaneous distribution of state property. The decree was also a reaction to the scheme proposed in August 1993 to create hundreds of giant FIGs in Russia by administrative means, encompassing the majority of enterprises in the industrial processing and extractive sectors, the chief aim of which was to reproduce the previous centralized system of economic management.

FIG operations are currently regulated by the law *On Financial-Industrial Groups* (signed by the president on 30 November 1995). According to Article 2, a FIG is defined as a collection of legal entities, functioning as parent with subsidiary companies, either wholly or partly integrated in terms of their material and intangible assets. Companies are permitted to participate in only one FIG officially registered in the state register. Subsidiary companies can only join a FIG together with the parent company. A key concept in the law is the "central company of the FIG," which is usually an investment institution but may also be a production company, association, or union. There are two main methods of creating a FIG:

1. According to the holding company model, which includes a "central company" with subsidiaries. This method is most commonly used for FIGs created by commercial banks and their subsidiary investment companies.

2. According to the FIG model, in which the "central company" is established by all members of the group, by signing an appropriate agreement.

The number of official FIGs has been growing: in 1993 there was only one FIG in Russia; in 1994 there were six; in 1995 there were twenty-one. At the beginning of 1998, seventy-two FIGs were registered in the state register (about 1,500 enterprises and organizations, and about 100 credit organizations).

The mechanisms for managing and monitoring enterprises in FIGs have not proved particularly effective. The hopes that they would facilitate the flow of investments from FIG financial institutions (primarily commercial banks, which many experts considered to be the "structure-forming" element of the FIG itself) have not been justified. Banks have shown themselves unwilling to submit to "intergroup discipline" and to invest in unprofitable projects. The most common motive for forming a FIG is to strengthen lobbying leverage, and consequently to benefit from preferential treatment. It is rather obvious, moreover, that despite attempts to observe antimonopoly law, many of the FIGs created have made the Russian economy more monopolistic.[18]

The technological benefits and economy of transaction costs achieved by the integration of enterprises work predominantly in the case of vertical integration. However, there are very few examples of vertically integrated FIGs, except for companies such as Lukoil, which are not officially registered as FIGs. Horizontal (sectoral) integration has primarily been a product of the monopolistic aspirations of those involved. The majority of FIGs have attempted, and evidently will continue to attempt, to create highly diversified holdings, uniting a number of enterprises that are individually powerful but that have weak synergies.

There are also examples of FIGs being used as a cover for attempts to prevent outside shareholders from gaining control over company operations. This has particularly been done by creating a more strictly hierarchical structure within already existing associations and concerns. Constituent enterprises tend to have their own "branch" banks and have no intention of cooperating with "alien" banks. These measures have not only obstructed the development of a competitive market and the free flow of capital in pursuit of investment opportunities; they have also, in some respects, preserved the old structural production patterns and hindered structural reform of the economy overall.

18. For details, see, for example, TACIS (November 1998).

According to available estimates, it is expected that in the near future, ten to twenty particularly powerful universal FIGs will emerge in Russia, along with 100 to 150 major groups, comparable in size to their foreign counterparts and together accounting for more than 50% of industrial production. However, state policy with regard to financial-industrial integration requires some correction, primarily to remove inefficient restrictions, to switch from permissive to required registration of FIGs, to renounce declarations concerning unrealistic privileges, and to strengthen monitoring of antimonopoly law observance in FIG formation.

Broadly speaking, the issue here has to do with developing organizational and managerial structures for the Russian economy. Although the most probable outcome is somewhere in between, here we highlight two polar scenarios:

- either there will be genuinely efficient associations of diverse economic units that (1) are created voluntarily or on the basis of mergers and takeovers, or (2) are based on genuinely effective management of shareholdings, or (3) are oriented to reducing their costs and increasing revenues through operations in a civilized marketplace; or
- in the next few years several dozen giant conglomerates and branch monopolies will emerge that enjoy "cozy" relations with the state and will succeed by virtue of these relations. This scenario could result in the revival of a form of centralized management of the economy but under rather different conditions.

15.9. Conclusion: New Institutional Reform for Long-Term Economic Growth

The most general conclusion that can be drawn from this study is that Russia is not an exception to the rules of transitional economics. There is no unique path in this transitional process. All more or less typical trends accompanying the emergence of the corporate control and governance model, including the struggle for ownership, apply in one way or another to Russia as well. We believe that Russia, all its problems notwithstanding, is among the pioneers and, compared to some other transitional countries, has made significant progress in this field.

With regard to further objectives in the formation and regulation of the national model of corporate governance, we suggest very simply that there are neither special obstacles to nor special recipes for the formation and emergence of such a national model. All of the transition economies have encountered most of the problems Russia has faced. Both the problems and the means of their resolution are well-known. The formation of a national model of corporate governance presumes that it is necessary (first of all for the state) "only" to recognize the *need* for the following preconditions to be satisfied:

- Understanding the special role of the state (as a "creative destroyer") in a transition economy
- Understanding the long duration of this process, roughly comparable to the duration of the transition period itself
- The exercise of political will in developing and enforcing efficient legislation to screen the interests of special groups (political, populist, criminal)
- The need not for radical interventions, but for the daily regulatory operation of a single body capable of pursuing a rigid centralized policy

In many countries undergoing economic transition, privatization did not result in any sizable enterprise investment. This places greater pressure on corporate governance practices. However, in the legislation of many countries the necessary mechanisms have not been sufficiently developed yet. The problems that need to be addressed by such mechanisms are those we have discussed: how additional shares are to be issued, the problem of transparency, ensuring that different categories of shareholders are protected, and so on.

In the short term, speculative portfolio investments, which drove the market in 1996 and 1997, are unlikely to retain their previous allure. However, it would be a mistake to ignore the potential for market development through portfolio investments. The problem is not the lack of prospects for this type of investment but whether these financial resources can be directed for the benefit of developing the national economy, while at the same time being secure. It is precisely portfolio investments that are paving the way for the emergence of direct investment funds and the participation of long-term conservative investors. Considerable household resources, which at

the moment are outside of the economic turnover, are another substantial source of portfolio investment.

In a study of efficiency in ten sectors of the Russian economy conducted in 1998 and 1999 by the McKinsey Company (with the participation of Nobel prize laureate R. Solow), the key conclusion was that the working efficiency of the Russian economy is unrelated to profitability. Medium-sized enterprises are not interested in restructuring and increasing productivity; more productive enterprises lose out to less productive ones and have no incentives to invest (even with opportunities to do so).[19] This phenomenon is based on the unequal conditions under which they must function (compete): different rates and schedules of taxation; different tariffs on energy resources; different debt requirements; unequal administrative requirements and access to export; inequality in legal terms; local authorities' resistance to restructuring (the problem of social tension); unequal access to land and state procurement orders; unequal access to economic information; corruption, and so forth.

However, the situation is not desperate; at least no purely economic obstacles that could prevent economic growth (up to 8% annually, with a consequent twofold increase in per-capita GDP) were uncovered by the McKinsey study. Moreover, it was noted that 75% of Soviet enterprises created before 1992 would be viable if they were restructured and modern management systems were introduced. Renewing those companies could bring about a growth in production of 40% on average if spot investments were made at less than 5% of GDP over five years (about $7.5 billion at the exchange rate of early 2000—considerably less than the investment requirements of Russia as claimed, for instance, by the Ministry of the Economy). In other words, the principal conclusion was that economic growth, at least in its initial stage, should be based not on very large investment (understood by many as a hard-to-reach panacea, and often as a self-sufficing goal) but on tough and to a considerable degree political efforts to create a generally favorable environment for the operation of enterprises.

These conclusions are important to determining the future path for reform of the Russian economy. The institutional climate necessary

19. In 1997 labor productivity in Russian industry was 17% of the US figure, whereas in 1991 it was 30%. Although productivity fell by 50%, employment decreased by a mere 10%.

to attract investment mandates renewed emphasis on appropriate and comprehensive legislation, protection of ownership rights, equal access to financial markets, equal terms of competition, and enforcement of legislation. The paltry achievements of Russia in this field in the 1990s were the most serious breakthrough for long-term economic growth.

At the same time, in modern Russia the external mechanisms of corporate governance, such as the control exercised through the financial markets and the institutions of takeover, merger, and bankruptcy, do not work. Such a situation is typical both for countries with a concentrated ownership structure and for those with an amorphous (nontransparent) structure of corporate control. This means that active control by shareholders (by voting) should become the predominant form of corporate control (as opposed to passive control through the sale of shares). This also creates a special burden for external (legislative) and internal (boards of directors) mechanisms of corporate control. The problems of enforcement become especially relevant.

It should be noted that the increasing instability in the arena of property rights following the August 1998 crisis led to the conservation of an unstable and intermediate corporate governance model in Russia, and this model will probably remain in place at least for the medium term. In this context, there is currently no alternative to the development of legal mechanisms of corporate governance and their enforcement in the medium run.

The fact that during the 1990s Russia moved toward market economy institutions and democratic values is undeniable. At the same time, besides periodic financial crises, "investment hunger," and regular scandals about the property-immanent features of this movement, we cannot ignore the chronic incompleteness of institutional reforms; the system of soft budget constraints and hierarchic bargaining between the state and large corporations; the stages of property redistribution following one another; the absolute insecurity of ownership rights; noncompliance with contracted terms; inefficiency and corruption of the system of state authority; state enforcement as a measure of selective influence; and private enforcement as a variant of the criminal fight to sort things out.

The progress achieved in certain important areas—and here we note the progressive corporate legislation after 1996, a potentially effective bankruptcy mechanism in place since 1998, a system for

regulating the corporate securities market, and antimonopoly legislation in place since 1998—was limited by all sorts of constraints, and therefore these mechanisms could not function as intended and needed. This situation became patently obvious by early 2000. Most of the institutional reforms adopted in the second half of the 1990s exist on paper only. Russia must either accept this legacy of the 1990s or prepare for a new stage of tough institutional reforms.

Progress in surmounting these problems depends to a considerable degree on the volumes, efficiency, and intensity of the institutional regulation. In the wake of the financial crisis, and with the country in a new stage of the redistribution of ownership rights, activities to protect investors' rights must be sharply stepped up to restore the investment attractiveness of the country. It scarcely needs mentioning that a real change can be achieved only in conjunction with other macroeconomic and institutional changes.

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16 Russian Banks in the Transition Period

Igor Doronin and
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16.1. The Emergence of the Contemporary Banking System in Russia

Reform of the banking system in Russia began with the adoption by the Russian Supreme Soviet of the resolution *On the State Bank of the RSFSR and Banks on the Territory of the Republic,* on 13 July 1990. On 2 December 1990 the Russian Supreme Soviet adopted the laws *On the Central Bank of Russia* and *On Banks and Banking Activity on the Territory of Russia.* These two laws provided the legal foundation for the formation of a two-tier banking system.

Among the main tasks of the Russian Central Bank was to assist in the formation of a network of independent commercial banks. The central bank's policy toward commercial banks at this time consisted in "simplifying the procedure for setting up commercial banks." The liberal and in large measure encouraging approach of the Russian Central Bank at the outset of economic reforms led to the formation of a network of commercial banks.

The majority of commercial banks were created by transforming the branches and departments of former state specialized banks (Promstroybank, Zhilsotsbank, Agroprombank, and Vneshtorgbank) into independent commercial banks. The exception to this was Sberbank, which largely preserved its branch network.

A not insignificant number of new banks were formed under the aegis of ministries and departments (for example, Promradtechbank, Morbank, Aviabank, and Khimbank). The creation of such banks made it possible to monitor the movement of intrabranch financial flows and ensured ministries' and departments' control over enterprises in their branch via control of their accounts and lending them money.

Table 16.1
Credit Organizations and Their Branches in Russia, January 1996 through January 2000

	1 Jan. '96	1 Jan. '97	1 Jan. '98	1 Jan. '99	1 Jan. 2000
Credit organizations	2,295	2,029	1,697	1,476	1,349
Branches of credit organizations*	5,581	5,123	6,353	4,453	3,923
Total no. of credit organizations and their branches	7,876	7,152	8,050	5,929	5,272

*Excluding Sberbank.

Source: Internet: www.cbr.ru

Some banks were created by enterprises and organizations. This gave the founder-enterprises the opportunity to attract funds for their own needs and to get credits on preferential terms from "their own" bank. A major portion of the charter capital of most of these banks came from enterprises' own funds.

The number of credit institutions and their branches continued to grow until 1996, and the increasingly stricter central bank requirements placed on the banks did not impede the emergence of new banks. The number of credit organizations and branches decreased during the financial crisis, from 1,573 on 1 August 1998 to 1,389 on 1 September 1999 (Table 16.1).

Compared with the situation in leading Western countries, there are relatively few bank branch networks in Russia. Banks with a developed branch network (by Russian standards) are the exception. The reasons for this situation include not only the weakness of the overwhelming majority of banks, which have proved incapable of maintaining an extensive branch network, but also such factors as the uneven distribution of financial resources across Russia.

The liquidity deficit of the regions limits banks' potential development, and often they are forced to depend on a limited number of local clients (frequently these clients are also shareholders in the bank).

The period of extensive growth in commercial banks, which ran from the beginning of the market reforms until 1996, had its pluses and minuses. The fact that over a comparatively short period of time a fairly extensive network of commercial banks emerged (more than 2,000), a development crucial to the very development of the market,

was clearly a plus. However, the quality of the banking system, and of the banks themselves, was poor. Rapid growth in the number of banks led to dispersed banking capital, while the emergence of a large number of small and medium-sized banks created difficulties in managing and ensuring the stability of the banking system and in raising the quality of banking services.

Russian commercial banks can be divided into four groups. Sberbank and Vneshtorgbank, both large, state-controlled banks, are in a group by themselves. At the start of 1997 Sberbank held approximately 24% of the total assets of the Russian banking system, and Vneshtorgbank held 3.3%. Furthermore, Sberbank's branch network is much larger than that of any other Russian commercial bank. Sberbank's special status is also due to the fact that it holds around 70% of all household deposits.

The second group comprises the largest private commercial banks. The third and most numerous group of banks is made up of small and medium-sized banks. Roughly one-quarter of these banks have capital of less than $500,000. Finally, the fourth group of commercial banks consists of foreign banks and banks established with the participation of foreign capital. At the end of 1996, there were fifteen representative offices of foreign banks and 133 commercial banks that were partly foreign-owned. The role of foreign commercial banks has been relatively insignificant: whereas the law limits foreign ownership of capital in the banking sector to 12%, the actual figure is closer to 3%.

In order to regulate the influx of foreign banks into Russia, two transitional periods were established during which Russia had the right to set restrictions on the operations of foreign banks. The conditions were set down in an agreement on partnership and cooperation with the European Union that was signed by the Russian President in June 1994.

During the first period, which ended on 1 January 1996, all banks from European Union member states, with the exception of those banks that had acquired their license from the Russian Central Bank and started servicing Russian residents before 15 November 1993, were prevented from working with Russian residents. A separate agreement was reached for banks that had received their licenses prior to 15 November 1993, and this agreement was strengthened by the presidential decree of 10 June 1994.

In the second transitional period, from 1 January 1996 to the end of June 1999, restrictions on foreign banks involved in particular operations with shares of Russian companies, and the establishment of a minimum balance of 55,000 ECUs for Russian residents' private accounts. Furthermore, during this period the Russian authorities were entitled to restrict the number of branches foreign banks could open in Russia. Finally, the Russian Federation reserved the right, without limits or conditions, to maintain a ceiling on the maximum share of foreign equity ownership in the Russian banking system.[1]

As of 1 January 2000, the share of nonresidents in the banking charter capital amounted to 10.7%, compared to 6.4% in January 1999. There were 177 Russian banks registered that were partly foreign-owned and twenty banks that were 100% foreign-owned.

According to estimates provided by the Expert Institute, at the end of 1993 there were about 480 "banking centers" in Russia—that is, populated areas in which there was at least one independent commercial bank. Of these, 114 banking centers had more than one bank, while more than half the country's banks were concentrated in thirty populated areas.

Between 1993 and 1995, the number of banking centers declined both in the country as a whole and in the majority of Russian regions. In a number of regions, such as Kareliya, Ryazan, and Tula, the number of banking centers fell to a minimum: the whole regional banking system was controlled either by banks of the regional (or republican) centers or by banks of other regions (mainly Moscow). Figures on bank branches in the regions for 1997–1999 are given in Table 16.2.

There were more appreciable changes in the regional banking system in 1996, when the process of bank consolidation and expansion got under way. During this process, small and medium-sized banks in the regions were closed and liquidated or became branches of banks based in other regions. In 1996, the number of independent banking institutions in the regions fell by 21%. The closing of regional banks' branches in their own regions occurred at a slower rate. This suggests that banks that had branches were more stable and capable of maintaining their branch networks, and possibly also indicates that independent banks were becoming branches of regional banks.

1. *Vestnik Banka Rossii*, 27 September 1994, p. 2.

Table 16.2
Distribution of Commercial Banks and Their Branches Across the Regions of Russia

	As of 1 January 1997			As of 2 January 2000		
	1	*2*	*3*	*1*	*2*	*3*
City of Moscow	823	198	159	604	106	60
City of St. Petersburg	43	53	60	41	34	68
Northern zone	48	109	118	26	37	138
North-western zone (excluding St. Petersburg)	18	31	85	12	9	92
Central zone (excluding Moscow)	133	145	541	99	81	460
Volgo-Vyatsky zone	65	98	166	37	61	178
Central black earth zone	24	85	182	16	27	154
Povolzhsky (Volga) zone	144	318	231	91	134	297
North Caucasian zone	244	401	258	135	197	305
Urals zone	141	396	228	96	209	335
Western Siberian zone	150	247	261	93	161	253
Eastern Siberian zone	64	148	191	34	38	186
Far Eastern zone	110	240	144	46	79	179
Baltic zone	23	21	17	14	6	24
Total in Russia	2,029	2,482	2,641	1,344	1,179	2,719

Key: *1*—number of banks in the region; *2*—number of branches of these banks in the region; *3*—number of branches of other banks in the region.

Sources: *Byulleten' bankovskoy statistiki* no. 2 (1997); Internet: www.cbr.ru

The reduction in the number of small and medium-sized banks continued in 1997 and clearly will continue further. According to representatives of a number of major Russian banks, the number of merger proposals is on the rise. However, most such proposals are not particularly attractive, as they come from banks that have already accumulated debts and have a significant portion of unprofitable assets. Frequently it is simpler for a major bank to open its own branch than to take on the debts of a bankrupt bank.

16.2. Concentration of Capital in the Banking Sector

Increasing banks' capital is one of the fundamental problems in developing and stabilizing the Russian banking system. Although the total capitalization of the banking system has grown throughout the years of economic reform, it has not kept up with the needs of the economy. The percentage of banks with declared charter capital exceeding $4 million grew from 1.4% on 1 January 1994 to 9.3% on 1 January 1997. At the same time, the percentage of banks with

Table 16.3
Capitalization of Russian banks

	1 Aug. '98	1 Mar. '99	1 Sept. '99
Total declared charter capital			
In billions of rubles	102	41.2	83.5
In billions of dollars*	16.35	1.80	3.36
Number of registered credit organizations	1,573	1,456	1,389
Average declared charter capital per registered credit organization			
In millions of rubles	65.0	28.3	60.1
In millions of dollars*	10.0	1.2	2.4

*Calculated at the dollar exchange rate on the given date.

Source: Internet: www.cbr.ru

declared charter capital of less than $1 million on 1 January 1997 was 61%, down from 93% in 1994. (Figures on the capitalization of banks in 1998–1999 are given in Table 16.3.) Growth in the capital base was most common among major banks.

The main consequence of the financial crisis of 1998 was loss of banking capital. The declared charter capital was halved. Several months later it had somehow regained its previous level.

The general level of bank capital concentration in Russia remains low compared with Western countries (Table 16.4). In countries with a developed market economy, the overwhelming majority of banking assets are concentrated in several large commercial banks. A high level of concentration is necessary for the formation of a stable national payments and settlements system, for the development of national capital markets, and to ensure links with the international payments and settlements system.

In Russia, there are no major credit institutions comparable to those in Western countries.

The move toward the concentration of banking capital in Russia came about not so much as a result of competition between commercial banks to improve the quality of their services but because of stringent central bank requirements concerning bank stability. These requirements have largely determined the way in which the concentration of banking capital has occurred. In particular, this has been done through mergers, takeovers, and liquidations, as opportunities for increasing banking capital in conditions of low average incomes and decreasing profitability of financial market operations are distinctly limited.

Table 16.4
Comparative Analysis of Commercial Banking Indicators in Russia and Countries with a Developed Market Economy

	Russia*	USA	Japan	England	Germany	France	Italy
Total assets (bill. of $)	73.8	3,707.2	6,130.2	2,189.4	963.2	1,379.4	964.1
Bank assets per unit of GDP	0.21	0.59	1.46	2.33	0.50	0.91	0.97
Total deposits (bill. of $)	42.2	2,754.1	3,914.8	1,558.6	411.9	279.7	526.5
Ratio of deposits to assets (%)	57.2	74.3	63.9	71.2	42.8	20.3	54.6
Loans made (bill. of $)	55.8	2,151.0	4,275.3	1,502.8	631.9	477.4	402.3
Ratio of credits to assets (%)	75.6	58.0	69.7	68.6	65.6	34.6	41.7

*Data on Russia are calculated as of the end of 1995 using IMF, *International Financial Statistics* (February 1997). Conversion to dollars was done using the exchange rate at the end of 1995 (Rb 4,640/$1 US). The authors' calculations correspond to estimates of Western experts. Thus, according to the April 1997 issue of *Banker*, the sum total of Russian banking assets was US $60 billion, or 15% of GDP.

Source: J. Barth, D. Nolle, T. Rice (1997): Commercial banking structure, regulation, and performance: An international comparison. Economics Working Paper 97-6, Offce of the Comptroller of the Currency (Washington).

Banks can be roughly divided into three groups, based on banking capital concentration.

The first group comprises banks with a relatively high level of liquidity that seek to diversify the range of services they provide and to restructure their balances and meet the norms established by the central bank. The business of these banks is concentrated mainly in major financial centers, principally Moscow, while the business of their branches is predominantly in the regional financial centers, where they operate on the regional foreign exchange, interbank credit, and securities markets.

The second group comprises banks that are experiencing a liquidity deficit and thus are forced to limit their activities. The majority of these banks have difficulty meeting central bank requirements. Their business tends to be concentrated in regions where small firms and agriculture dominate, and their strongest competition comes from branches of major banks based elsewhere.

The concentration of funds in the branches of banks based in other regions increases the stability of the regional banking system overall, but it also has a negative side: the strengthening of the position of branches of banks based in other regions is frequently attended by an outflow of financial resources from the regions to major financial centers.

Finally, the third group comprises "problem" banks that are struggling to keep afloat. Banks in this group may be experiencing considerable growth or very little growth, and their fortunes are largely tied to the economic situation prevalent in a specific region.

The creation of informal banking unions and associations has had some impact on the process and character of bank ownership concentration. The majority of associations were created to lobby on behalf of banks or for the realization of specific programs and projects. Later on, associations were set up for the purpose of uniting banks' efforts in the development of specific markets.

A number of banking groups and bank holding companies have also been created. The interest of commercial banks in forming these groups and holding companies is founded on the belief that it will facilitate access to investment, including foreign investment.

Another factor spurring banks to create holding companies has apparently been their unsuccessful involvement in financial-

industrial groups, in which banks have often been demoted to the position of the settlements department and a source for cheap credit.

16.3. The Functions of Russian Commercial Banks

According to the federal law *On Banks and Banking Activity* (in the version of 3 February 1996), "a bank is a credit organization which has exclusive right to carry out all of the following banking operations: attracting deposits from individuals and legal entities; investing these deposits in its own name and on its own account on conditions of repayment within the terms specified; opening and handling the accounts of individuals and legal entities." The law specifies banking operations that can be carried out by banks not only in rubles but also in foreign currency (given the appropriate license), and also operations with precious metals (with the appropriate license). Banks can also carry out trust, guarantee, and leasing operations and can provide consultative and informational services. Production, trade, and insurance are among the activities that banks are barred from undertaking. If we compare Russian bank legislation with that of other countries, it becomes clear that commercial banks in Russia enjoy virtually the same rights to conduct business as commercial banks in any other country with a market economy.

According to the law *On Banks and Banking Activity*, banks can obtain a central bank license giving them the right to work with securities, either to make payments (on checks and promissory notes, for example) or to confirm deposits (savings and deposit certificates). Professional activities on the securities market are regulated by other federal laws. Particularly important is the law *On the Securities Market*, which delegates regulatory functions in this sphere to the Federal Securities Commission (FKTsB).

Although at first glance the data on Russian banks' operations appear generally comparable with analogous data on the operations of banks in developed market economies, it is important to bear in mind that in the latter, a significant portion of financial resources is accumulated by various investment funds, pension funds, insurance companies, and other institutions. These funds consequently bypass banks altogether. Investments, including financial market investments, can be made through these institutions. Thus, the relatively modest role of commercial banks in the economy of more progres-

sive countries is a result of the development of a parallel financial sector, whereas in Russia the majority of household deposits are in banks. In this respect Russia is similar to other states with a developing market economy, in which the share of banking assets in the sum total of financial institutions' assets is 75%–95%.[2]

Russian banks differ from banks in developed countries in the structure of their balance sheets. The balance sheets of Russian banks have a small portion of interest-bearing obligations on the liabilities side, around 17.1% of total liabilities, while the share of non-interest-bearing or virtually non-interest-bearing obligations is around 70%.[3] Among the latter obligations are funds on current accounts, budget and fund money, funds on Loro correspondent accounts, and so on. In developed countries the ratio of interest-bearing obligations to non-interest-bearing obligations is the reverse.

The relatively small volume of deposits has a significant influence on the structure of Russian banks' obligations. Moreover, the overwhelming majority of household deposits in Russian banks are short-term, while in Western banks most deposits are either demand or savings deposits. In the United States, the volume of savings deposits is on average double that of current account deposits.

In the structure of Russian banks' obligations, correspondent accounts make up 18% of liabilities, compared to 0.9% in American banks. This relatively high proportion of liabilities in the form of correspondent accounts can be explained by the hypertrophied development of the interbank credit market in a situation of sustained currency and financial instability.

A significant portion of Russian banks' assets do not generate income. Some examples are cash, ruble payments in transit, correspondent accounts with the central bank, mandatory reserves in the central bank, nonperforming loans, equity capital, inventory, intangible assets, and other ruble receivables. Their share is estimated at about 50% of total banking assets, which exceeds analogous assets in US banks by a factor of 3.5.

Also specific to Russian banks is the structure of performing assets. Among the performing assets are freely convertible hard currency, correspondent accounts in hard currency, sundry hard-currency receivables, short-term credits, long-term credits, interbank credits,

2. *Economist*, 12 April 1997.
3. *Finansovye izvestiya*, 26 November 1996.

investments in securities, and the like. Whereas for Western banks the main business activity is lending money to industrial and trade companies, for Russian banks the share of such business is considerably lower. The share of Russian banks' loans to the nonfinancial sector constitutes about 30% of active operations, as opposed to 50%–60% in American banks. The share of government securities among Russian commercial banks' assets varies substantially.

After the financial crisis the structure of commercial banks' balance sheets started changing, but not radically.

16.4. Commercial Banks and the Real Sector of the Economy

The role of commercial banks in the development of the economy largely depends on how effective the banks are at performing their role as intermediaries, mobilizing funds and lending them to enterprises and to the public.

In Russia the problem of banks' interaction with the real economy is particularly severe. A number of factors can be offered to explain why banks have so far not effectively performed their role as intermediaries. Aside from the fact that neither the public nor enterprises have exhibited an interest in keeping their money in banks, as inflation has been higher than interest rates on deposits for much of the transition period, one of the major obstacles was the policy followed in 1992–1994 of financing the budget deficit through central bank credits. As long as the state provided substantial credits and subsidies on privileged terms to enterprises and banks, the latter did not have to concern themselves with attracting enterprise and household deposits.

Banks did not have to concern themselves with profitable and careful investments, which require constant evaluation of the creditworthiness of the borrower, minimizing credit risk, securing the loans as far as is possible, developing and maintaining effective, long-term credit relations with borrowers, and the like. A significant portion of central bank credits were targeted, and the credits were granted at below-market interest rates.

Although the central bank's lending policy was set in order to support production, nonetheless, throughout the years of central bank lending, the economic recession continued. Moreover, the policy of central bank lending did not facilitate resolution of the long-term structural problems in industry, without which banks could not

start developing credit relations with enterprises on a commercial footing.

The end to centralized credits in 1995, the introduction of financial stabilization policies, stabilization of the exchange rate, and the decreasing profitability of money market operations all forced commercial banks to review their policies with regard to attracting deposits and lending to the public, enterprises, and other organizations. However, banks were still not able to develop effective credit relations with the real sector.

The hypertrophied development of the financial sector was another side effect of the policy of central bank lending during high inflation. Here we will just mention that the development of the Russian financial sector went through a number of stages. The first was a period of intense operations on foreign exchange markets by banks and their clients, both of which speculated on a weakening of the ruble. According to banks' accounts, at this time 70%–80% of banks' profits were generated by speculative foreign exchange operations.

The interbank credit market developed in parallel, and operations on this market provided a significant portion of the funds for speculating on the foreign exchange market. Cheap central bank credits to a large extent subsidized operations on the interbank credit market and stimulated demand for foreign currency.

In May 1993, the government bond market started operations. Although the volume of operations grew, the profitability of the bonds largely depended on the profitability of foreign exchange operations in general.

Bank operations on the financial markets continued to dominate in 1997, despite the fact that the financial market structure underwent serious changes. Beginning in 1995, the state abandoned its policy of covering the budget deficit through central bank credits. Consequently, the situation on the foreign exchange market gradually stabilized. After the introduction of a foreign exchange rate corridor in July 1995 and a managed exchange rate in May 1996, profits from foreign exchange operations fell considerably. Bank operations were gradually displaced by the market for government bonds. The large budget deficit forced the government to borrow money, and bank lending to the state was more profitable and less problematic than lending to enterprises.

The dynamics of enterprise deposits in commercial banks and the volume of bank loans to enterprises serve as an indicator of the interaction between banks and the real economy. As shown in Table 16.5, the volume of funds on enterprises' and organizations' accounts decreased somewhat in 1994. This resulted from a considerable fall in production, on the one hand, and from substantial speculation on the foreign exchange market on the other ("Black Tuesday"—11 October 1994—is an example).

In 1995, following the curtailment of central bank credits, the volume of enterprise and organization deposits increased; at the same time, bank lending also increased. These positive shifts can be explained by the decline in speculative activity on the foreign exchange market, the strengthening of the ruble exchange rate, and the slowing of inflation. All of these processes made it easier for banks to attract deposits. The volume of funds on enterprises' clearing and current accounts grew by 65%. Stabilization of the economy in 1995 led to a 37% increase in the volume of credits extended to enterprises and banks.

The situation in 1996 was more ambiguous. It is difficult to assess the change over the year, because in the second half of 1996 the central bank changed its methodology for calculating individual items on the balance sheets of commercial banks. Thus, comparable data are available only for the first five months of 1996. These data show that in the first half of 1996 the volume of enterprise deposits fell, as did the volume of bank lending. Moreover, bank lending dropped even further than the volume of bank deposits during this period.

Substantial growth in profits on operations in the government bond market in this period may provide an explanation for this trend. In the second half of the year government bond yields fell. However, it was difficult to turn around these negative trends in the second half of the year because of the ongoing economic recession and the general worsening of enterprises' financial positions.

One indicator of banks' involvement in the real economy is the ratio of enterprises' and organizations' bank balances to lending by commercial banks to the real economy (Table 16.6). This coefficient of business activity serves as a rough indicator. It changes depending on the dynamics of the component parts—the volume of enterprise funds in bank accounts and the volume of loans to enterprises and organizations.

Table 16.5
Volume of Funds on Current Accounts of Enterprises and Organizations and Volume of Bank Loans to Enterprises and Organizations (mill. of $)

	As of Jan. 1994	As of Jan. 1995	As of Jan. 1996	As of Jan. 1996 (New Method)*	As of Jan. 1997 (New Method)*	As of Jan. 1999 (New Method)*
1. Balances of enterprises' and organizations' current accounts	6,600	6,412	10,603	42,116†	49,380†	2,746†
2. Bank credits to enterprises and organizations	24,302	23,382	32,130	46,932‡	46,762‡	13,647‡

*Data calculated by the Central Bank according to a new method for calculating specific balance sheet items; also with the inclusion of Sberbank data in the combined data on commercial banks, but without Vneshekonombank data.

†Funds attracted from enterprises, organizations, and households in rubles and foreign currency; in 1997, excluding budget funds for financing capital investments.

‡Loans made to the economy, banks, and the public in rubles and foreign currency (including overdue debt, without interest). In 1997, excluding long-term credits for financing capital investments.

Sources: Calculated using central bank data published in *Byulleten' bankovskoy statistiki* no. 6, 1994; no. 6, 1995; no. 6, 1996; no. 3, 1997, and no. 6, 1999. Conversion to dollars was calculated using the exchange rate on the relevant date.

Table 16.6
Coefficients of the Relative Business Activity of Commercial Banks in the Regions (%)*

	As of 1 Jan. 1994	As of 1 Jan. 1995	As of 1 Jan. 1996	As of 1 May 1996	As of 1 Jan. 1999
City of Moscow	61	49	64	55	36
City of St. Petersburg	94	96	98	75	44
Northern zone	19	22	29	20	17
Northwestern zone (excluding St. Petersburg)	45	62	68	56	32
Central zone (excluding Moscow)	45	43	49	41	30
Volgo-Vyatsky zone	37	29	37	28	21
Central black earth zone	34	54	55	34	30
Povolzhsky (Volga) zone	27	36	41	35	31
North Caucasian zone	24	28	56	41	35
Urals zone	21	33	46	30	25
Western Siberian zone	13	39	53	35	33
Eastern Siberian zone	22	31	49	27	21
Far Eastern zone	13	15	48	31	18
Baltic zone	55	29	60	54	25
Average across the regions	32	36	55	43	30

*The coefficient of business activity is calculated as the ratio of balances on current and deposit accounts of enterprises to loans made by banks. In the second half of 1996, the Central Bank changed its methodology for calculating balances of enterprises' accounts. As a result, the data starting from the second half of 1996 were excluded from the table.

Sources: Calculated using Central Bank data published in *Byulleten' bankovskoy statistiki* no. 6, 1994; no. 6, 1995; no. 6, 1996; and no. 6, 1999.

The situation with bank lending to enterprises and organizations remained complicated. Here a trend toward reduced bank lending is clearly visible.

Although the general trend toward a decreasing volume of bank lending continued throughout the period under review, nonetheless, the rate of decline slowed down. At the beginning of 1996, in individual regions, after a substantial decline in the volume of bank lending, some growth was registered. One can conjecture that as favorable economic conditions emerged in 1997—falling inflation, falling interest rates, and declining government bond yields—certain positive shifts occurred in lending to the real economy.

In banks' credit portfolios, the overwhelming majority of loans have short maturities, up to three months. Long-term lending, which in Russian practice includes any loan with a maturity of more than a year, makes up an insignificant share of credit portfolios. On the positive side, this share of long-term credits is growing, although

1996, and 27 February 1997), provides the legal basis for the central bank's role as supervisor and regulator of commercial banks' activities. In Chapter 10 of the law *On the Central Bank of the Russian Federation* it is stated that the main aim of banking regulation and supervision consists in "supporting the stability of the banking system and defending depositors' interests."

Currently the central bank issues two kinds of licenses. The general license permits banks to conduct all kinds of banking operations, with the exception of those operations requiring a special license, such as operations with precious metals or foreign currency. Apart from the general license there is also the restricted license, which permits banks to conduct deposit operations—that is, to accept household deposits in rubles and foreign currency. Furthermore, restrictions on the operations that a given bank may conduct can be included in the bank's license.

According to central bank data, on 1 January 2000 the total number of registered credit organizations was 2,376, of which 2,342 were banks and thirty-four were nonbank credit organizations. Two hundred forty-two Russian credit organizations held general licenses, 1,264 held licenses to work with household deposits, and 669 held licenses to conduct foreign currency operations. One hundred thirty-four credit organizations had licenses to conduct operations with precious metals, and another eighteen credit organizations had been granted permission.[5]

The central bank monitors whether a bank is meeting capital and reserve requirements; the observance of mandatory norms; whether internal reserves are correct; liquidity; the quality of a bank's credit portfolio, and other indicators. Observance of established requirements is checked against accounts that the banks regularly provide, and also by inspections and targeted audits. Sanctions are applied to banks that violate these requirements, including the refusal to register increases in charter capital, restrictions on operations that a bank can conduct, and revocation of licenses.

The banking norms provide an instrument for regulating the activities of commercial banks, making it possible to check their stability and liquidity. The procedure for calculating norms and their parameters is established in the central bank's directive No. 1, adopted on 30 January 1996 and amended on 23 May 1997.

5. *Byulleten' bankovskoy statistiki*, no. 1, 2000. *Vestnik Banka Rossii*, no. 39, 18 June 1997.

First Group of Norms

The first group of norms comprises two absolute indicators: minimum charter capital for newly established commercial banks and minimum shareholder equity for commercial banks. One relative indicator also falls in this group: the ratio of a bank's equity capital to its total risk-weighted assets. This norm is intended to maintain some minimum permissible percentage of a bank's own resources that it can use for investments.

The minimum charter capital required for newly established credit organizations has gradually increased. In particular, it increased from 2 million ECUs on 1 April 1996 to 5 million ECUs on 1 July 1998. For existing credit organizations, minimum shareholder equity, defined as the sum of the charter fund of the organization and retained profits, is set at a sum equivalent to 5 million ECUs (starting from 1 January 1999).

The capital adequacy norm is defined as the ratio of a credit organization's capital to its total assets, weighted to take into account counter-party risk. The procedures for weighing assets according to risk and capital adequacy norms are consistent with international standards.

At the beginning of March 1997, the central bank's board of directors toughened its capital adequacy requirements. For banks with capital in excess of 5 million ECUs, the capital adequacy norm from 1 February 1998 was set at 7%; from 1 February 1999 at 8%, and from 1 February 2000 at 11%.

For banks with capital of 1 to 5 million ECUs, the capital adequacy norm was set at 7% in 1998, 9% in 1999, and 11% in 2000. Banks with capital between 1 and 5 million ECUs will be restricted in their activities; in particular, they are not allowed to conduct operations abroad, apart from opening correspondent accounts; restrictions are also imposed on opening branches and on participating in the charter capital of other organizations.

For banks with capital of less than 1 million ECUs, the capital adequacy reserve requirement was set at 7% for 1998. After this year it was assumed that these banks will either grow their capital or they will cease to be banks.

The policy of toughening central bank capital adequacy requirements is in line with world practice concerning the regulation of commercial banks. The Basel Agreement of 1988 set the minimum

capital adequacy norm at 8%. This became a mandatory requirement for banks in countries that signed the agreement and a guideline for those that did not. Although this initiative was taken by states with a developed market economy, it was also approved by many states undergoing economic transition (Table 16.8).

Norms are viewed as one of the effective instruments for ensuring the stability of a banking system. In 1996, central bank representatives from a number of developing countries and countries undergoing economic transition noted that the standard set by the Basel Agreement, while probably corresponding to the needs of banking systems in developed countries that are quite stable, was inappropriate for countries in which the macroeconomic and financial situation was undergoing significant fluctuation. A number of countries consider the Basel requirements to be a necessary minimum for maintaining bank stability, and some countries introduced even higher requirements; in particular, in Argentina the capital adequacy norm was set at 11.5%, and in Colombia it was set at 9%.

Second Group of Norms

The second group of norms comprises *liquidity norms*, which are required to force banks to balance outgoing and incoming financial flows by volume and term:

- The *current liquidity norm* is the minimum necessary ratio of liquid assets to demand deposits up to a period of thirty days.
- The *instant liquidity norm* is the minimum necessary ratio of high liquidity assets to demand deposits.
- The *long-term liquidity norm* is the maximum permitted ratio of long-term financial investments of a bank to the sum total of shareholder equity and long-term obligations.
- The minimum necessary share of liquid assets in the sum total of a bank's assets is another liquidity norm.

Third Group of Norms

The third group of norms comprises risk norms. The aim of these norms is to encourage banks to ensure maximum diversification of their assets and liabilities. Risk norms establish the following:

- The maximum permissible risk linked to one borrower or group of connected borrowers

Table 16.8
Comparison of the Procedure for Weighing Assets for Risk in the Basel Agreement and in the Normative Requirements of the Russian Central Bank for Russian Commercial Banks

Basel Agreement	Central Bank Directive No. 1
CAPITAL	
Tier 1: Common shares; retained profits; capital revaluation; preferred shares not providing for the accumulation of dividends; noncontrolling stakes in consolidated daughter companies less intangible capital. Tier 2: Reserves to meet unforeseen loan or leasing losses, and also subordinated debt instruments.	(There is no division of capital into tiers): Officially registered charter capital; retained profits; retained earnings reserves; less debts with a maturity of more than 30 days; less incomplete capital investments; and less bank's own shares, purchased from shareholders.
ASSETS	
The following weights are attached to the various elements: 0%—Cash; and claims on the central government and central bank. 20%—Deposits in other banks; claims on domestic public-sector entities, excluding central government. 50%—Loans fully secured by a mortgage; claims on local governments and loans with a maturity of over 1 year. 100%—Claims on the private sector; real estate and other investments.	Assets, weighted for risk. 0%—Funds on central bank accounts, claims on the government. 2%—Cash. 10%—Credits guaranteed by the government, with government securities, or precious metal bullion as collateral. 20%—Local government securities, and loans collateralized with these securities; funds on the accounts of foreign banks which are OECD members in foreign currency, and loans made to these banks. 70%—Funds on the accounts of foreign banks which are not members of the OECD (except banks in the near abroad), traded securities, real estate (apart from that used as collateral). 100%—Commercial credits and all other assets.
INDICATORS OF CAPITAL ADEQUACY	
The ratio of first-tier capital to risk-weighted assets should not be lower than 4%. The ratio of total capital (i.e., tiers one and two) to total risk-weighted assets should not be lower than 8%.	The ratio of capital to risk-weighted assets should not be below: 5% as of 1 July 1996 6% as of 1 Feb. 1997 7% as of 1 Feb. 1998 8% as of 1 Feb. 1999

Source: Analytical report *Rossiyskaya bankovskaya sistema* (Agency Praym, 1996): 31.

- The maximum permissible risk linked to one of the bank's creditors (depositors)
- The maximum permissible risk linked to one borrower who is also a shareholder in the bank
- The maximum permissible risk linked to one borrower who is also an "insider" of a given bank
- The maximum permissible risk linked to investment in the charter capital of one organization
- The maximum permissible volume of household deposits
- The maximum permissible size of major credit risks.

In August 1996, the central bank decided to add to directive No. 1 another (the thirteenth) mandatory norm, to regulate the issuance by banks of their own promissory notes. This was called the "Risk norm for own promissory note obligations" (No. 13), which is calculated as the ratio of total promissory notes issued by a credit organization to bank acceptances in rubles and foreign currency plus 50% of the total balanced obligations of a credit organization from the endorsement of promissory notes, banker's guarantees, and promissory intermediation to a credit organization's own capital. The maximum permissible No. 13 norm was set at 200% of the balance sheet as of October 1996 and lowered to 100% of the balance sheet as of 1 March 1997.

The central bank also established a series of norms from 1 July 1996 to 1 February 1999, with each successive norm more stringent than its predecessor.

Verification of Norm Observance

The effectiveness of introduced norms largely depends on observance of established reporting requirements, which excludes the possibility of manipulating various items on the balance sheet. The central bank intends to devote considerable attention to issues of reporting. At the Sixth International Bank Congress, held in St. Petersburg on 3–7 June 1997, it was noted that out of the 643 credit organizations audited, shortcomings in account reporting were found in 565. The central bank has started to develop a method for supervising multibranch banks and banking groups working in and outside of Russia.

Verification of norm observance is also carried out by the central bank in the issuance of credit support. Banks can hope to qualify for central bank support only if they observe the norms set in the documents regulating the procedure for lending to commercial banks.

16.6. Monetary and Credit Instruments for Regulating Banks' Liquidity

In 1995, following the establishment of control over the growth of the money supply and reduced financing of the budget deficit by central bank credits, instruments of monetary and credit market intervention started to become increasingly important. These instruments had an impact on the liquidity of the banking sector, on money market interest rates, and on the yields of various financial instruments. From 1995 there was a continuous process of renewal and strengthening of the role of previously functioning instruments (for example, obligatory reserves, and the granting of refinancing credits). New regulatory instruments were developed and introduced (for example, lombard credits, deposit operations, open market operations, repo operations, and one-day settlement credits).

The use of instruments of monetary and credit regulation was made possible by the development of the financial market and its developing liquidity.

Operations on the open market include central bank operations for the sale and purchase of government bonds on the secondary market, including repo operations.

The central bank's role on the secondary market for government bonds started to increase from 1995 with the start of financial stabilization. Operating on the open market, the central bank can resolve a number of problems. First, it can smooth out fluctuations in the liquidity of the banking sector. Second, it can regulate the money supply by removing money from circulation through the purchase or sale of government bonds on the secondary market. Third, it can exert influence on other segments of the market by influencing operations on the foreign exchange market, and also on the interbank credit market by regulating banking sector liquidity.

Refinancing credits in Russia have been granted on an auction basis since 1994. The interest rate on auctioned credits depends on existing refinancing rates and commercial banks' demand for these credits.

When granting refinancing credits, the central bank takes into account growth in net domestic assets and the movement of funds on commercial banks' correspondent accounts. The central bank issues refinancing credits as an instrument for supporting banks, and also for encouraging commercial banks to observe established norms and strengthen financial discipline.

Lombard credits are a form of short-term lending by the central bank to commercial banks that was first used in Russia in April 1996, in which government bonds were used as collateral. According to central bank data, at the end of April 1997, around 900 banks held government and other securities that could be used as collateral. From the end of August 1996, the central bank started to extend Lombard credits at fixed interest rates at banks' request. The purpose of these operations is to maintain commercial bank liquidity. Banks that have met central bank obligatory reserve requirements in a timely fashion and in full and that have no overdue debts to the central bank are eligible for lombard credits.

Deposit operations are central bank operations to attract commercial banks' surplus liquidity. In Russia they were first carried out in the middle of 1995, and at the beginning of 1996, the provision for conducting these operations was institutionalized. They are conducted on an auction basis or directly in the form of a deposit at a fixed interest rate. In the first seven months of 1996, the central bank attracted a total of Rb 1,860 billion of commercial banks' surplus funds. The deposit rate, as a rule, is lower than the current market interest rate, which should spur commercial banks to invest their resources on the market.

Mandatory reserve requirements in world practice are considered one of the strongest means of regulating banking sector liquidity, and thus of influencing the money and credit markets. In contrast to operations on the open market and altering refinancing rates, changing mandatory reserve requirements directly affects the liquidity of credit organizations. In countries with a developed financial market infrastructure, this instrument is utilized in exceptional circumstances. In less developed countries, however, it is considered to be one of the more effective ways of regulating liquidity.

In Russia, the importance of this monetary and credit policy instrument grew considerably in 1995–1996. Commercial banks' deposits are also included in reserve requirements. The reserve proce-

dure is defined in the provision on commercial banks' mandatory reserves, which came into force on 1 May 1996. This provides for the exaction of funds from any credit organization that fails to transfer funds in full to the mandatory reserve fund, together with the enforcement of a fine, which should spur banks to observe the requirements.

Since the middle of 1996, the central bank has been conducting a policy of gradually reducing mandatory reserve norms for commercial banks' ruble deposits, which has assisted in increasing commercial banks' liquidity and their relative stability.

One of the aims of the mandatory reserve fund is to create liquid reserves for the support of commercial banks, as the central bank can use these funds to lend to banks. If a bank goes bankrupt, funds from the mandatory reserve fund are transferred to the account of the liquidation commission and to the fund for meeting competing creditors' demands.

Despite the importance of the profound changes in the central bank's monetary and credit policy, involving a broader range of instruments for monetary and credit regulation, it should be recognized that the effectiveness of these instruments remains limited. This situation is not a reflection of central bank capabilities or the degree to which these instruments can affect the liquidity of the banking system. Rather, to a considerable extent, their effectiveness is limited by a host of unresolved problems, primarily structural ones. It can hardly be described as normal that around 70% of household deposits are concentrated in one bank, Sberbank, and that the trend toward the concentration of deposits in this bank is continuing. Whereas in 1994 Sberbank's share of total household deposits was around 50%, by the middle of 1997 it had grown to 74%. Another manifestation of structural problems is the sustained high level of dollarization of the economy. This reality is explained by the fact that the public prefers not to keep the bulk of savings in banks but to exchange it for foreign currency.

Aside from the structural problems, there are also general economic problems.

First, the problem of improving the level of coordination in conducting budgetary, monetary, and credit policies is a serious one. Monetary and credit policies can be effective only if the government's finances are balanced. Under these conditions, tightening

or loosening these policies should have an even impact on the behavior of market participants. If budgetary imbalances, tax privileges, changes in the tax regime, and the like exist, then tightening monetary and credit policies can create an excessive burden for some, while barely affecting others.

Long-term strengthening of the stability of the banking system can be achieved only by consistently keeping the budget deficit low, increasing tax collection, and spreading the tax burden evenly across all market participants.

Second, further efforts must be undertaken to develop financial market infrastructure, in part by increasing guarantees that operations are settled. Another important task is to ensure the balanced development of major segments of the financial markets, to lower and level out the yields of market instruments and to redirect market participants to long-term instruments.

Third, the system of interbank settlements and payments needs improving and developing. Economic agents' lack of confidence in the payments system, due to the long time it takes to process payments and the high risk level, as well as the severe financial positions of economic agents has been one of the factors encouraging the proliferation of various forms of barter and the widespread use of foreign currency to settle accounts. The creation of an effective payments and settlements system would make it possible to carry out mutual interbank and other settlements, and to calculate the net financial position of banks and other economic agents much more rapidly.

On 1 April 1996, the Central Bank's Board of Directors approved a strategy for developing the payments system of Russia. It was directed at "creating a modern, automated settlements system, working chiefly in real time, by the beginning of the next century."[6]

According to the adopted strategy, initially the system of real-time settlements between credit organizations would be based on carrying out settlements exclusively through commercial banks' balances' on central bank correspondent accounts. At the same time, the central bank planned to develop its capabilities in granting short-term credits to banks for the purpose of completing payments in timely fashion.

6. *Vestnik Banka Rossii*, no. 17, 23 April 1996.

As monetary and credit policy instruments are improved and the Russian banking system is strengthened, it will become possible to switch to the automated extension of such credits while remaining within the limits set for the banks' mandatory reserves held in the central bank.

16.7. The Creation of a System for Regulating and Monitoring Bank Activities

The central bank document, "On the Fundamental Aims of the Central Bank's Monetary and Credit Policy and Principles of Banking Sector Regulation," was promulgated in May 1995.[7] This document stated, first, that the regulatory system should be built on a coherent combination of direct central bank regulation and the self-organization and self-restraint of members of the banking community. Second, the creation of interbank institutions to manage banks in crisis was identified as a promising area of bank cooperation. This process would enable the adoption of joint measures to stave off chains of nonpayments and thus to support the stability of the whole financial system. The document also stated that it was important to create a national system for checking the solvency of borrowers, as banks lack full and objective information on potential bank and nonbank borrowers. And finally, the document pointed to the need to develop principles for establishing mutual correspondent relations, insofar as the lack of relevant universal rules increased systemic risks to the banking system. According to the document, the central bank was to increase the level of commercial bank supervision significantly in the near future.

In 1997, the central bank prepared a draft document on organizing internal, commercial-bank risk management. The system included three elements: first, clarifying the distribution of powers and duties within the bank; second, defining a bank's policy in various segments of the market; and third, ensuring that there are checks on the implementation of the first two elements.

In the final analysis, the investment preferences of the public are the best criterion for evaluating confidence in the stability of the banking system. The dynamics of household deposits compared to other investments can provide an indication of general confidence.

7. *Vestnik Banka Rossii*, no. 22, 30 May 1995.

In financially stable conditions, in which interest rates on deposits are positive in real terms, the major factor constraining the growth of deposits is generally lack of confidence in the stability and reliability of banks. In many countries with developed market economies, this problem has been resolved through the establishment of household deposit insurance.

In the presidential decree of 10 June 1994, "On Improving the Work of the Banking System," the central bank was instructed to "accelerate the setting-up of a federal fund for insuring the assets of Russian banking institutions that handle the deposits of citizens of the Russian Federation." The decree specifically stated,

> to ensure the protection of Russian citizens' savings the central bank must accelerate the setting-up of a federal fund for insuring the assets of Russian banking institutions that handle Russian citizens' deposits. To establish that in cases provided for in Russian legislation, the safety of deposits can be guaranteed by the state using funds from the federal fund for insuring the assets of Russian banking institutions, handling the deposits of Russian citizens.[8]

The central bank expounded its position on this issue in April 1995 in a document entitled "Information on Measures Undertaken by the Central Bank Toward Commercial Banks Not Fulfilling Their Obligations to Creditors and Depositors." In this document it was noted that "creating a federal fund without the participation of the Russian government, and in particular, the Ministry of Finance, the State Property Committee, the Federal Bankruptcy Committee, Rosstrakhnadzor [the state insurance supervisory body], is impossible." However, the Ministry of Finance, citing budgetary constraints, refused to participate in the creation of this fund—even though, as world practice has shown, the costs of undermining confidence in the banking system could be considerably greater than the possible expenditure on the state's participation in this fund at the current time.[9]

Nonetheless, a Russian banking publication has identified a solution to this problem:

> Before the adoption of the law on mandatory insurance of household deposits, commercial banks and bank associations can set about creating

8. *Vestnik Banka Rossii*, no. 14, 21 June 1994.

9. As indeed was demonstrated in the 1998 financial crisis in Russia.—*Translation editor.*

funds for insuring household deposits on the basis of voluntary participation of banks through the creation of tax-deductible reserves.[10]

The problem of bank insolvency is another major obstacle to improving supervision and monitoring of credit institutions' activities. Some 1,035 credit organizations have gone bankrupt, while external management has been introduced to 430 credit organizations. However, a special law on insolvent credit institutions does not exist. In the current law, *On Enterprise Bankruptcy*, adopted in 1992, only one article is devoted to the peculiarities of bank bankruptcy. This article provides that a bank can be declared bankrupt only after its banking license has been revoked by the central bank. Otherwise all the norms of enterprise bankruptcy are applied in full to bank bankruptcy. This approach does not take into account the specific position of banks, and the fact that bankruptcy of a bank can lead to the insolvency and bankruptcy of many other organizations. For this reason, in practice, bank bankruptcy in many countries, independent of whether or not there exist any special laws, is viewed as an extreme and exceptional measure.

In Russia, revocation of a bank's license forces the bank into bankruptcy. However, as follows from Article 6 of the *Law on Banks and Banking Activity*, a banking license can be revoked not only because of bankruptcy but also on other grounds that are not directly linked to insolvency. Furthermore, a bank that has had its license revoked is not capable of conducting its professional activities, and consequently goes bankrupt. Simply having its license revoked can turn a solvent bank that has committed some minor violations into an insolvent bank. A situation is created in which a bank is deprived of its license but does not cease to exist as a legal entity. As a result, the claims of bank depositors and creditors are not satisfied, and the bank's capital is plundered. As of 11 April 1997, the central bank had revoked the licenses of 714 credit organizations; against 335 of these organizations, no one (out of those who were entitled to) had initiated bankruptcy proceedings. The central bank itself does not have this right.

At the beginning of 1997, a draft law was prepared, *On the Bankruptcy of Credit Organizations*, which granted broader powers to the central bank. This bill allots the central bank the right (and even the obligation) to undertake any actions aimed at "preventing the bank-

10. *Vestnik Banka Rossii*, no. 13, 4 April 1995.

ruptcy of credit organizations with the purpose of preserving depositor and creditor confidence." In this case, if the central bank has doubts about the solvency of a bank, it is entitled to:

- Require the founders of the bank to provide financial assistance.
- Propose to the bank that it decrease its dividend payments to founders and not to make loans to them.
- Demand that the bank change its organizational structure, including closing branches and representatives' offices.
- Introduce temporary administration if central bank requirements concerning maintenance of solvency are not adhered to.

Bank bankruptcy and liquidation are enforced as a last resort. In the draft law, the procedure is preserved in which the central bank strips the bank of its license in order to initiate bankruptcy. However, a new addition is the central bank's right to initiate bankruptcy procedures if a bank displays signs of insolvency—if creditors' claims on the bank are more than 1,000 minimal wages and these claims are not met within a period of three months.

According to the bill, founders are responsible if their bank is put into bankruptcy. There is a provision that arbitration courts may hold the founders of a bank that has been declared bankrupt responsible for its debts. Thus, if the bill is adopted, the role of the central bank in maintaining the stability of the banking system will increase significantly.

One aspect of the problem of increasing the stability and reliability of the banking system that is relevant not only to Russia is bad debts. Suffice it to say that the share of bad debts in the sum total of commercial bank loans in countries undergoing economic transition is 14%.[11] Moreover, as has been noted in studies by the International Monetary Fund, from year to year there has been an alarming growth in such debts.

In Russia, the figure is estimated to be around 9%. This level of bad debts has been a harbinger of serious banking crises in a number of countries. On the eve of the banking crisis in Argentina at the end of 1980, the figure was 9%; in Finland at the end of 1992, it was 9%; in Mexico in September 1994, it was 11%; in Norway at the end of 1991, it was 6%; in Sweden at the end of 1992, it was 7%; and in

11. *World Economic Outlook* (Washington, D.C.: International Monetary Fund, October 1996), 98.

Venezuela at the end of 1993, it was 9%.[12] It is worth adding that the real situation in the banking sector of countries undergoing economic transition, including Russia, is considerably more serious than the data on bad debts as a share of loans suggest, insofar as these countries are just beginning to switch to international standards for classifying assets, and to international accounting standards.

A serious deficiency in policies to increase the reliability and stability of the banking system is that they are carried out through a regime of special measures in the absence of a clearly formulated long-term systemic approach. In Russia in particular, the main method is "market-based": if banks cannot meet established norms and requirements for increasing capital and reserves, their licenses are revoked, and the banks cease operating. This approach is justified if banks are capable of fulfilling established requirements; however, it is also risky, for if banks are unable to fulfill the established requirements, this policy could precipitate a systemic banking crisis.

Developing and implementing a long-term program is a preferable method for tackling the task of bank restructuring. Such a program would require the allotment of necessary funds for bank sanitation, possibly the creation of special institutions and the development of appropriate regulatory documents; in parallel, it would also require the implementation of measures for the structural reform of industry as a necessary addition to the program of bank sanitation. This presupposes close coordination between the government and the central bank.

The chief task of the program would be to reduce the share of bad debts in bank loan portfolios and prevent their increase in future. There are two approaches to this—decentralized and centralized. In the first approach, the bulk of responsibility for regulating the problem of bad debts is placed on the banks themselves, which would have to set up special departments for this purpose; in the second instance, this task falls to a special agency that would take on banks' bad debts and regulate them. Such an agency should have the appropriate status and sufficient capital for the purchase of bad debts from banks. As the international experience of bank restructuring has shown, in most countries at some stage in the sanitation process, government funds of one kind or another are necessary.

12. Ibid.

The bank restructuring program should include provisions to encourage effective work by banks, such as the creation of a self-regulating mechanism, to prevent subsequent weakening of the banking system. For this reason it is necessary that commercial banks be able to act exclusively on a commercial basis, minimizing the possibility of pressure or interference from federal or regional regulators. It is also necessary to strengthen risk management, in addition to strengthening external supervision and creating a system of deposit insurance.