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CORPORATE GOVERNANCE THROUGH THE BANKS: THE EXPERIENCE IN RUSSIA

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1. Introduction

Between late 1995 - 1997 the new phase of post-privatisation property redistribution in Russia began to develop; in this phase, the following major features are characteristic:

- use of non-trivial technical schemes, such as loans-for-shares auctions, legalised dilution of state-owned shares, conversion of debts into securities, sales of debit liability, trust schemes, purchase of promissory notes, manipulations with preferred shares, etc.;

- emergence of large banks (financial groups - see Table 1) as major players (initiators) in this new phase of property redistribution;

- restructuring of control, which to a degree has already taken place in the largest or most “interesting” Russian companies (including certainty as regards to state-owned shares), which are the major objects of the afore-mentioned process;

- government’s active assistance: while fulfilling the interests of the largest financial and industrial alliances, the government also achieves its various objectives of its own (political, budgetary, etc.).

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The core conflict of the above-mentioned stage may be characterised as a clash of interests between the old (although currently in a new corporate "shell") natural monopolies - large industrial and mining structures - on the one hand, and the new financial and industrial groups on the other: the expansionist interests of both groups have intersected in the course of the new property redistribution. Undoubtedly, in order to understand the afore-mentioned conflict, one should also take into account the political factors and vested interests within the different branches of the Russian "power", primarily within the government.

In other words, beyond the "facade" of the largest transactions (including those not yet completed) which took place between 1995 - 1997, the new stage is under way, the essence of which is the property redistribution in a number of key Russian companies. In some of these companies, the major centres of influence have already mobilised consensus and property redistribution - with other conditions being equal - is most unlikely. In the other group of companies the final stage of establishment of control over the enterprise is delayed, due to the ongoing struggle and intensive lobbying; this process is multidimensional: the major participants in the process are both federal and regional authorities, natural monopolies, large banks and industrial enterprises.

It is obvious that commercial banks are currently the most powerful financial institution and also intensively participate in the processes of property redistribution. Nevertheless, as it was mentioned above, only the largest banks, in which the major part of the Russian banking capital is concentrated, participate in such a struggle.

At the same time, the activity of the banking sector as a whole in this sphere is also determined by the development of the general macroeconomic situation in Russia. Even between 1992 - 1994 (during mass privatisation) the majority of commercial banks were far from investing in industrial enterprises' shares as a financial instrument. If purchases of portfolios ever took place, it was done only for the purpose of control, or, more rarely, in order to resell the shares as a long-term perspective. It should be noted that the process was rather chaotic and spontaneous.

In essence it was the first stage of the banks' infiltration into the industrial corporate sector of the economy.[1]

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[1] One should also take into account the fact that initially, many credit banks were founded by industrial enterprises themselves. Later, some of these banks

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The banks preferred to receive their revenues in the monetary market "at the expense" of the expensive short-term credits and by playing on the dynamics of the RUR/hard currency parity. Since 1993, the state securities market began to develop intensively: it attracted bank resources for a long time.

It is obvious that the fall in the inflation rate and stabilisation of the RUR/USD parity between 1995 - 1997 (see figures 1-4) became one of the key factors which caused the crisis of many small-and-medium-sized banks. Such banks would grow accustomed to certain "rules of the game" and instruments in the financial markets, and failed to adjust themselves to the new macroeconomic situation in time. Those banks which managed to re-focus themselves in 1995 - 1996 focused on the state securities, investing up to 60 per cent of their assets in these securities.

Only since 1996 has the decrease in yields of state securities determined some transfer of financial resources to the corporate sector of the securities market. At the same time, between 1996 - 1997 the secondary corporate securities market showed significant reserves of growth (capitalisation). Various enterprise shares became of a great interest to banks as a short-term financial instrument and not merely as an instrument for establishing control.

In other words, since 1996, in search for new financial instruments, the second stage of bank infiltration in the industrial corporate sector began. Simultaneously, as mentioned above, the largest banks (financial groups) began a cut-throat struggle for the new property redistribution.

2. The general state of the banking sector in 1997: terms of reference

As of early 1997, there were more than 5.000 licensed (in compliance with the requirements of the RF Ministry of Finance) investment institutions. As of the same date, there were about 350 specialised investment privatisation funds operating. The intensity of development of both non-government pension funds (appr. 800) and the insurance market (appr. 2.700 companies) is rather high;

managed to "get rid" of their initial founders. In the course of the stage of privatisation, the relationship between banks and the real sector changed radically: Banks themselves began to purchase the enterprises' portfolios and then started to strengthen their control by buying additional issues of enterprises' shares and in other ways.

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appr. 130 credit unions appeared (see Table 2). Nevertheless, it is the banking sector which is the most powerful segment of the Russian financial market.[2]

According to the data of Goskomstat of the Russian Federation (RF), as of May 1997, the number of registered credit entities (of which commercial banks make up 99 per cent) amounted to 2.582 units (Table 3). At the same time, the 7 per cent reduction in the number of operating credit organisations was noted since the beginning of 1997 (for reference: the respective rate was 7.6 per cent for the whole of 1996). The existing number of commercial banks actually functioning as of May 1997 was 1.887 (with 39.254 of their affiliates, including Sberbank of the RF, operating). The total amount of authorised capital of the operating credit entities in September 1996 made up RUR 15.9 trln.

According to the data compiled in early May 1997, the commercial banks' credits issued to the economy, population and banks made up RUR 270 trln., of which the credits to the economy and the population amounted to RUR 220 trln. and to banks 48 trln. Short-term credits traditionally prevail in the banks' credit policy. The share of such credits in the total volume of credits issued to the economy and the population grew somewhat and made up over 95 per cent (against 92 per cent observed in September 1996).

Among the reasons why the share of long-term credits to the real sector remains very small, experts traditionally single out the following problems:

- lack of capital for long-term credit (i.e. the bank has to have a significant amount of capital in order to keep probable losses from becoming critical);
- if, on the contrary, free capital is at hand, a lack of experience in working with the real sector's projects;
- high risks of non-return of credits and the probable situation of non-recoupment of the project on time;

2 In terms of the leading positions by amount of assets and volume of investment, the commercial banks are followed by insurance companies (the amount of insurance reserves was RUR 7-8 trln. at the beginning of 1996). The summary amount of all the voucher investment funds' assets as of 1 January, 1996, made up RUR 2.2 trln. (RUR 1.77 trln. as of 1 July, 1995) by balance sheet value, while the summary assets of the non- government pension funds at the beginning of 1996 were estimated at the level of RUR 1.5- 1.7 trln.

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- unfavourable tax climate;
- lack of strict guarantees of control over the enterprise, even if the bank has control or the blocking majority of shares;
- few stable, long-term personal perspectives of the bank's top management necessary for them to be interested in long-term projects.

In general terms, the banks' infiltration into the real sector happens through the following major channels:

- short-term credits to enterprises;
- financing investment projects both in the direct (issuance of long-term credits) and in the portfolio (purchase of a new series of shares emitted specifically for investment projects) forms;
- purchase of portfolios of shares (in certain branches, regions, by certain characteristics of enterprises of different branches and regions, etc., depending on the concrete bank's strategy);
- trust agreements on governing enterprise portfolios;
- purchase of debts of the real sector's enterprises.

By the end of 1995, according to the data of the Central Bank of Russia, the average proportional weight of the banks' investment in shares of joint-stock companies made up 7-8 per cent, by September 1995, 5-6 per cent in enterprise shares,[3] and over 80 per cent of the total amount of banks' investment in state securities. At the same time the volume of bank transactions with industrial enterprise shares was extremely unstable, correlating to the general dynamics in the corporate securities market. On the whole, bank investment in non-government securities between 1994 - 1995 fluctuated between 0.5-8 per cent of the banks' assets. The last data as of 1997 (Table 3) have not yet given any grounds to conclude that the banks' investment in the corporations' shares grew notably.

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3 With regard to shares of joint-stock companies and other enterprises, the separate "balance accounts" No. 191 and 192 were originally used, leading to problems when only account No. 191 remained, which takes into account investment to joint- stock companies.

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“Menatep”, ONEXIMbank, Rossiysky Credit, Nationalny Rezervny Bank”, ‘Imperial”, “Alfa- Bank”, “Incombank”, can be considered the most active participants in the corporate securities market. In practice, the banks showing real interest in privatised enterprises purchase their securities through daughter structures, which is why the real amount of capital invested by the banks in corporate securities cannot be properly calculated. In some cases, such an investment activity is performed within the framework of a financial and industrial group (FIG) of which the bank is an informal nucleus.

Moreover, in general terms, the current state of the Russian banking system is far from ideal. After the systems crisis in the summer of 1995, it has continued to periodically experience mini-crisises. In spite of strict control over the banks on the part of the Central Bank, by the end of 1996, more than two-thirds of the Russian commercial banks were attributed to the category of “problematic”, i.e. experiencing various difficulties. Between 1995 - 1997 the Central Bank of Russia cancelled over 700 banking licenses because of violations against both the banking legislation and the Central Bank’s instructions. By May 1997, according to their shareholders’ decision, 360 banks were either completely liquidated or re-organised into affiliate structures. According to some estimations, in 5 years there will be no more than 200 - 400 banks in this country.

3. The legal framework of banks’ investment to corporate securities (including privatisation transactions)

In the majority of countries with an advanced securities market (US, Japan, etc.), banks are formally prohibited or restricted to perform a number of services for professional participants in the securities market. Such restrictions were introduced for the purpose of separating different types of risks (the separation of a number of risks related to transactions with securities from the risks directly related to banking operations themselves), in order to increase the stability of the banking sector and protect investor rights.

As for the situation in Russia, the introduction of some restrictions in credit institutions’ activity in the securities market had been considered in the early 1990s, in the course of the elaboration of the government’s Resolution No.78. Nevertheless, in the end, these restrictions were not introduced as banks practically did not participate in transactions with securities at that time, with the exception of the placement of their own securities.

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Thus, in terms of normative and legislative acts, the system of so-called "universal banks" is taking shape in Russia, of which Germany has been an example until recently.[4]

According to Article 6 of the Federal Law No.395-1 "On Banks and Banking Activity" of 2 December 1990 (the amendments were introduced in the new variant adopted 3 February 1996, No.17-FZ), in compliance with the license granted by the Central Bank of Russia for performing banking operations, a bank has the right to perform issues, purchases, sales, depository, custodian and other operations with those securities that perform the function of the payment document, with securities which confirm the attraction of monetary capital to deposits and bank accounts, and with other securities, the performance of operations with which does not require a specific license to be obtained in compliance with the Federal Law. In addition to the above, the bank has a right to enter into trust agreements with both physical and legal entities to govern the latter groups' securities. The credit institution has a right to perform its professional activity in the securities market in compliance with the federal laws.

In practical terms, only a number of the normative acts concerning privatisation provide restrictions with regards to banks' purchases of Russian enterprise shares in the course of privatisation. Thus, in compliance with para. 9.5. of the State Program of Privatisation of 1993 (which currently is partially still in force), banks cannot:

- perform as buyers of shares (stocks) of the privatised enterprises and voucher investment funds;

- possess more than 10 per cent of stocks of any joint-stock company and cannot have more than 5 per cent of shares of joint-stock companies within the structure of their assets.

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4 Any cross- country comparison is fairly arbitrary. It is known that currently within the framework of the unification of the legislation concerning capital market of the EC countries, the changes are being introduced to the legal framework of the German securities market. The purpose of this is to provide non- banking institutions with the access to the securities market. One of the most clearly opposite examples of the '90s - the discussion in the US concerning cancellation the Glas- Steagall law, which had divided commercial and investment banks after the Great Depression.

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Due to the above, the banks had to establish their daughter companies for the purpose of performing investment and trading in the corporate securities market.

The afore-mentioned qualitative restriction imposed on investing financial and credit institutions' resources practically correlated with the restriction concerning the banks' activity within the framework of FIGs: no more than 10 per cent of the banks' resources may be invested in no more than 10 per cent of the shares of enterprises-participants in the FIGs.

It is provided in a number of the normative documents of the Central Bank of Russia that:

- reserves should be established in case the securities purchased by the bank are devaluated;
- there are restrictions with regard to the bank's use of its own capital to purchase shares of other legal entities;
- there is a minimum amount of reserves to be accumulated under high- risk assets, as well as other measures with regards to the banks' investment to securities.

4. The major types and incentives of banks' operations with corporate securities.

The incentives for banks investments in corporate securities vary greatly:[5]

- establishment of control over the concrete "attractive" privatised enterprise;
- creation of a base for the bank's expansion into certain business branches;
- purchase of shares of privatised enterprises for large-scale foreign and domestic investors can result in commission fees or shared profits resulting from re-selling the portfolio);

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5 In this work, the author does not attempt to specifically focus on bank performance as issuers, trust managers, registrars, investment consultants and depositories. Nor are bank operations with corporate promissory notes considered in this paper.

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- redistribution of government revenues resulting from the sales of shares to investors (the system of the authorised banks);

- possession of a specific "insurance fund" (taking into account that the government has strong incentives to disallow industrial giants to face bankruptcy, it is likely that it grant subsidies or privileges to the enterprises concerned, which the shareholder/outsider might profit from as well);

- possession of the largest industrial joint-stock companies' shares to create the image of a "serious investor" (see also FCSM, 1995- 1997).

As investors in the securities market, commercial banks focused mostly on government securities. The high profitability of transactions with government securities between 1993 - 1996, the liquidity and reliability of GKOs, along with the fact that many banks have found themselves incapable of forming a qualitative credit portfolio, resulted in an extremely high proportional weight of T-bills in the structure of many commercial banks' assets (see para.2 and Table 3).

For a number of banks, investing in enterprise shares is a way to establish direct control over the enterprise. Purchasing privatised enterprises' securities from both large-scale strategic investors and from portfolio investors in the open market is for many large banks a part of their strategy of forming FIGs. Such a targeted purchase of shares is the component in the process of property redistribution and market "correction" of the ownership structure, which resulted from the privatisation of the former state-owned enterprises.

A number of large Moscow banks implement this policy of establishing control over the perspective enterprises. This process is accompanied by the transfer of the respective enterprise's bank accounts to the investor banks, and subsequently allows the bank to gain access to cheap money and binds the enterprise to the bank. In a number of cases, particularly in St. Petersburg, upon the purchase of large portfolios of shares, a bank could block previously made decisions concerning new emission of shares, in order to make the latter claim for a credit at its own institution.

At the same time, one of the major problems related to the banks' conscious decision to limit the volume of credits issued to enterprises and organisations, is their incapability to analyse a borrowers financial state, estimate risk and diversify the respective interest rate depending on such risks. As a result, many banks (with the exception of those banks being controlled by a small number of large-scale trade and/or industrial companies, which are capable of making the

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banks finance their projects regardless of their efficiency) experience difficulties with placing accumulated capital. That is why, when there is a lack of effective control over an enterprise, banks choose other means of placement. Investing in securities allows banks to focus on resolving investment related matters at their head-quarters, neglecting an expensive and thorough training and education of their personnel in local affiliates, who could duly implement the programme of issuing credits to enterprises.

On the whole, one cannot presently refer to banks as real strategic owners responsible for an enterprise's long-term development (in the context of the continental European model, according to which, apart from the control functions, the bank in some form also finances the enterprise). This is related both to corporate policy as defined by its management, and the banks' problematic relationship as: "strategic holder of shares (of a pledge, trust,) - source of financing".

The purchase of a privatised enterprise's shares for large-scale foreign and domestic investors, i.e. brokerage, is a very common incentive. In this sense, the banks have become a serious competitor to non-banking institutions, independent broker companies, investment companies and funds.

With their operations in the corporate securities market, the banks also often play a role of both brokers and depositories. Having direct access to the payment system of the Central Bank of Russia and the possibility to use both their own and attracted capital for their operations, the banks thus find themselves in a more advantageous position when compared with the non-banking financial institutions; nonetheless, banks still fail to play a leading role in the corporate securities market. The reasons are twofold: first, for objective reasons, i.e. due to the fact that the banks' respective departments dealing with securities often have subordinated position; in addition, the operations with securities are not a priority to banks as credit institutions. Second, banks as large-scale multifunctional structures are too large to properly cope with these operations.

Thus, in particular, the broker services market with regard to corporate securities is mostly under the control of Russian, non-banking, broker companies, while the market for depository and custodian services is occupied by daughter companies and banks, established by foreign financial institutions in the RF. Consequently, according to expert projections, the strategy of broadly developing "universal banks" (i.e. banks which perform the complete set of classic banking operations along with operations in the securities market)

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has not proved to be very efficient in the RF mainly due to a number of defects, both in terms of overall market development and from the viewpoint of the Russian banks' competitiveness in single segments of the securities market.

The purchase of shares in order to resell these at a higher price is performed by the banks both in the course of privatisation and in the secondary market. In conditions of rising market prices for privatised enterprise shares, such operations, as a rule, turn out to be profitable. However, taking into account significant fluctuations in prices for corporate securities, if financial difficulties do occur, the investment in corporate securities bears an additional danger and often results in extended financial troubles the banks may face.

For example, if difficulties with a bank's liquidity coincide with the period of a decrease in quotation of the securities previously bought by the bank at a higher price, the bank then, on the one hand, is confronted with the necessity to sell its securities even at a lower price in order to renew the liquidity; on the other hand, the loss resulted from such transactions would immediately lead to a decrease in the banks' own capital, thus deteriorating the economic requirements set by the Central Bank of Russia. Because of this, in spite of high potential profits, the banks' portfolio investment is of high risk to the commercial banks. At the same time, the mass redistribution of bank assets in favour of corporate securities may be attributed to the threat of a general systems crisis in the banking sphere.

5. Other methods of banks' establishing control over corporations.

During the stage of mass privatisation between 1992 - 1994, the purchase of privatised enterprise shares was performed by banks via various daughter companies and mostly within the framework of the standard privatisation legislature. However, between 1995 - 1997 the use of various "non-standard" methods initiated by the largest banks became characteristic for that period of time. This may be attributed to a whole range of reasons:

- actual failure of the "monetary" privatisation of 1995- 1996 (lack of demand for the majority of shares set for sale);

- coinciding interests between government (accumulation of revenue for the budget) and a number of banks (gaining control over industrial and mining corporations with minimal expenses);

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- existing large enterprise debts towards the state budget and towards each other;
- the beginning of the new "war for property" between Russia's biggest FIGs.

5.1. Consequences of the loans-for-shares auctions (1995 - 1997)

The practice of the loans-for-shares auctions of late 1995 is well known.[6] The 12 auctions of a number of the largest Russian enterprises have brought around RUR 5.1 trln. to the federal budget, and paid off RUR 1.5 trln. of enterprise debt to the government. There are the two large Russian banks - "Menatep" and "ONEXIM" - which dominated among the actual winners. Regardless of the auctions legal "shell", in the authors opinion, they were either "camouflaged" enterprise buyouts, or - in the majority of cases - direct non-competitive sales of blocks of shares to the concerned banks.[7]

Upon the expiration of the pre-set term (1 September 1996), the pledge holder had the right to sell the respective block of shares in the market. Originally, variants of a simple prolongation of the pledge agreement and various schemes of government buyout of some blocks of shares were considered (in the cases with RAO "Norilsky Nickel", YUKOS, Surgutneftegas and Sibneft). In particular, a "pledge pyramid" was considered, that is to arrange for a buyout of the pledged blocks of shares at the expense of new credits; in addition to this, there were talks concerning the payment for a range of blocks of shares with the use of GKO, "free hard currency resources of the Ministry of Finance in the commercial banks", etc.

Finally, in late September 1996, the government and the Security Council made a joint decision and confirmed the banks' right to sell the pledged blocks of shares after 1 September 1996. At the same time it was noted that such sales would be performed under government control and on the basis of competitive open auctions. The blocks of shares of "Norilsky Nickel" and North-West River Steamship could not be sold to foreign investors. As for the oil

6 For details, see Radygin, 1996a

7 By the results of the auctions a few trials were held. The majority of them ended in favour of the winners in the auctions and Goskomimushestvo. An intermediate decision declaring the invalidity of the auction's results was made with regard to Sibneft.

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companies, the overall quota of foreign investor participation could not exceed 15 per cent. It was also decided that those holders of pledges who would not sell the blocks of shares within 3-6 months, would have to secure “efficient governance” for the blocks; the government reserved the right to legally protect the owner’s interests, should “inefficient governance” occur.

Thus, the right of choice was granted to the banks/winners. In this regard, their strategy was determined by three conditions as follows: (i) the concrete objective of the transaction (control or revenues), (ii) expiration of the term of the commission agreement (3 years) and (iii) existing restrictions imposed on governing a block of shares (while the ownership right of these shares would have eliminated these conditions). It was obvious that practically all the pledge holders were interested in owning the above-mentioned portfolios and simultaneously in minimising the respective financial costs.[8] In practice the following variants of behaviour were possible:

(i) the least probable variant (if the simplest one): the open competitive sale of the block of shares in favourable market conditions. The rise of capitalisation in the majority of companies (objects of the considered scheme) would assist in a return of credit and enable to receive a sales profit.

(ii) the variant most typical incurred for the period between 1996 - 1997 was to retain the right to run the enterprise, provided for with the pledge agreement, since the willingness to maintain control is a dominating incentive for the majority of winners. Upon the expiration of the three-year term of the commission agreement, the prolongation of the latter is possible (with the automatic prolongation of the trust), or, alternatively, the bank’s ownership rights for the shares could be fixed via its daughter structure’s.

Some winners in the loans-for-shares auctions currently implement (apparently, as an intermediate measure) the policy of consolidation of shares (in their ownership) at the expense of relatively small blocks, which were put up for various tenders, and at the expense of the secondary market.

(iii) transfer the shares to a third party with the government’s consent. This is related to the fact that within the framework of the current legislation, some

[8] See also: Perspectives of the loan- for- shares auctions.- Rynki Capitalov, 1996, No.33, pp. (2)-1- (2)-4; No. 34 (2)-1-(2)-3.

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holders of a pledge do not have a right to become owners of the respective enterprises' blocks of shares. Thus, the pension fund "Surgutneftegas", which became the pledger of 40 per cent of shares in "its" oil holding "Surgutnftegas", does not have a right to become an owner of a large block of shares, in compliance with the norms regulating the structure of the pension funds' assets.

(iv) sale of a part of the block in the "heated" market (by the commissioner himself), in order to return the credit. The rest of the block is held in trust.

(v) sale of shares (with a slight excess over the government's obligations under the credit) and a repurchase of these via affiliated entities. This variant has been already used with regards to the blocks of shares of some oil holdings ("YUKOS", "SIDANCO", RAO "Norilsky Nickel").

According to the results of the loan-for-shares auction in 1995, 45 per cent of YUKOS shares were assigned to Menatep and its affiliated structures as a pledge and yet 33 per cent of shares were owned by this group according to the investment tender's results. Upon the dilution of the YUKOS' authorised capital (see below as per the additional issue) in 1996, the government share (i.e. the pledged block) was reduced to 33.3 per cent, the overall share of the three Menatep's daughter companies made up 38.57 per cent, the share of the joint-stock company "Russian Investors" (a new shareholder, with "close" to Menatep) was 12.79 per cent, "YUKOS- Invest Ltd." owned 7.05 per cent and individual investors' shares amounted to 8.29 per cent. Therefore, Menatep, thanks to the dilution of the government share, has kept control over YUKOS, in one way or another, retaining over 50 per cent of the holding's shares.

For the sale of the state-owned portfolio of shares to proceed, however, it was required to obtain the qualified majority. That is why on 20 December 1996, the commissioner, Menatep and the Russian Fund of Federal Property put up the pledged state-owned block of the YUKOS oil company for commercial auction with investment terms and conditions. Evidently, the joint-stock company named "Monblan" - an affiliated structure of Menatep - succeeded in "buying" the block. Monblan "paid" USD 160.1 mln. for the portfolio with the initial asking price being USD 160 mln. (plus USD 200 mln. to be invested until 1998). The "competitor" of Monblan, Moscovsky Pischevoy Kombinat, was under Menatep's control through the financial and industrial group "Rosprom". As a result, the Menatep's control grew from appr. 51 to appr. 85 per cent.

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The state of affairs in the transaction of the shares of "SIDANCO" oil holding is less clear. A block of 51 per cent of the holding's shares was put in pledge to the group "ONEXIMbank"/"MFK". The winner of the tender, which was held on 10 January 1997, became "Interross-Oil" affiliated company, which currently possesses 85 per cent of the holding's shares (with the account of 34 per cent of shares "additionally bought" in September 1996 and including "Chernogorneft"). The winner paid USD 129.8 mln, with the initial bid price of USD 129. The problem is that the ownership rights for the daughter company "Purneftegas"(with an annual oil output of 9-12 mln. tons) is not clear. Thus, the other oil holding, "Rosneft", also claims for its right on the latter.[9]

The pledged block of shares (40.12 per cent) of "Surgutneftegas" oil company, which remained under the holding's control, was also set out for sale at the commercial tender. The block was formally purchased by the company "Surgutfondinvest".

The perfect example of a conflict situation after the loan-for-shares auction was the struggle between "ONEXIMbank" and the former administration of RAO "Norilsky Nickel" crowned with the resignation of the latter in mid-1996. Even today it is hard to estimate to what extent the new management is efficient, since (with a lack of transparent financial accounting and international audit) any estimations may become "politicised" and reflect the competing parties' interests.

One of the facts "disclosed" was that the credits issued by the ONEXIMbank's group made up appr. RUR 370 bln. (which in itself was the instrument of pressure), and the new administration elaborated on a strategy of "crisis-control". According to a number of estimations on the part of ONEXIMbank's competitors, the bank constrained itself with the control over RAO's financial

9 "Sibirsko-Dalnevostochnaya Kompaniya" (SIDANCO) was established by the Resolution of the RF government No. 452 of 5 May, 1994. The Act reads that the shares of "Purneftegas" joint-stock company would be transferred to a new company (previously they were under the corporate governance/"control" of the state-owned oil company "Rosneft"). The series of trials between 1995 - 1997 have not brought about any certainty in this case. The conflict intensified with the ONEXIMbank's gaining control over SIDANCO. In summer 1997 the problem became particularly acute to the government, since it was intended to sell "Rosneft's" shares in the course of privatisation (naturally, without one of its biggest oil-extracting companies, Rosneft would be incapable of bringing about significant revenues to the budget).

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flows and has not invested in production. ONEXIMbank's representatives state, in addition to other achievements of the bank, that the bank has managed to stop the activity of many intermediaries, which would not return money to RAO for delivered metal. At the same time, ONEXIMbank itself concentrated 99 per cent of RAO's sales with the bank's affiliated company "Interrossimpex". All of RAO's tax burden was transferred to the Norilsky Gorno-Metallurgichesky (Mining and Metallurgical) industrial complex, while the financial resources remained concentrated in the RAO itself (see: Latynina, 1997).

On 5 August 1997, the commercial tender with investment conditions took place (the object: the pledged block of 38 per cent of shares put up at the tender by the holder of the pledge). The tender was awarded to a company named "Swift", which represented the interests of ONEXIM. The conditions of the tender were as follows: the initial bid price for the block of USD 147 mln., in addition to USD 170.1 mln. in unpaid collateral credit, USD 300 mln. in investment to develop "Pelyatkinsky" gas deposit, and RUR 400 bln. in equal shares to finance the social sphere and to pay the RAO's daughter companies' debts to the Pension Fund.

The terms and conditions of the tender raised serious criticism by the Audit Chamber of the State Duma of the RF, General Prosecutor of the RF, various ministers, etc. In particular, the rationale behind the criticism was as follows:

- the organiser of the tender, MFK-Moscow Partners, coincided with the "concerned" party, a member of the ONEXIMbank's group;
- the procedures of the advance depositing the sum of USD 511 mln. were complicated;
- the short time frame allotted to submit applications (between 22 July- 1 August 1997);
- the international audit had not been performed.[10]

Under pressure, the Prime-Minister ordered that the tender's terms and conditions would be reviewed and that the terms of the tender would be

[10] It should be noted that analogous (organisational) conditions took place in the course of the sale of Sibneft's portfolio of shares which had already been completed.

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suspended. This decision, however, stood in contradiction to the Civil Code and was the reason why the decision was made to examine the tender's validity post-factum.

5.2. Financial and industrial groups (FIGs)

In the meantime, there are various - and often contradictory - views on the efficiency of such a structure's activities. By mid-1997, around 50 FIGs were officially registered in this country. Among the largest groups of "banking origin", one can single out the following groups: "Interrossprom" (ONEXIMbank), "Rosprom-YUKOS" (Menatep), "Alfa" (Alfa-bank) and the "Rossyisky Credit" banking group. These groups are made up of either holdings or complex structures with a big number of daughter and affiliated companies with cross-holdings of shares. The bank's consolidating role (as a subject of the corporate control) in the afore-mentioned examples is obvious, however, there are no convincing data on the banks' investment activity within the framework of a group.

At present the following difficulties in the FIGs' functioning are noted:

- consolidation of property under the *aegis* of the central company has not yet been resolved (the FIG's participants' contribution to the authorised capital of the central company, paired together with an insignificant share of assets leads the participants to form "lobbying associations" and not to a concentration of financial and industrial capital);

- the banks' minimum interest in the implementation of investment projects within FIG's; and

- the contradiction between the overstated (at the moment of establishment) estimation of the FIG's potential and actual difficulties of its functioning.[11]

5.3. Trusts

With regards to securities, trusts are attributed to those transactions which banks have a right to perform along with their major operations (Articles 5-6 of the Law "On Banks and Banking Activity"). One of the trust's functions is the

[11] See also: Radygin A., 1996b

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governance of blocks of shares, which banks obtained from the loans-for-shares auctions.

With the Presidential Decree No. 1660 of 9 December 1996, "On the Trusting of Shares Fixed in Federal Ownership of Joint-Stock Companies Established in the Process of Privatisation", the banks received new opportunities. When the Decree came into force, the general provisions for the transfer of state-owned blocks of shares were determined: according to the results of a tender on the right of concluding the trust agreement on the blocks. The trust manager (in contrast to the loan-for-shares scheme) does not have a right to manage shares entrusted to him. Moreover, in the agreement both parties can stipulate restrictions in terms of the trust manager's activities on crucial matters of the joint-stock company's operations.

As a priority, five joint-stock companies in the coal industry were selected (according, apart from other reasons, to the IMF's requirement). This is why the more detailed government Resolution No.1485 of 11 December 1995 "On Holding Tenders on the Right to Conclude Trust Agreements on Managing Shares Fixed in Federal Property of Joint-Stock Companies in Coal Industry (coal companies)", from a formal viewpoint, is related solely to the coal industry. However, ideally these rules should have covered the other economic sectors as well. Nevertheless, one should not hope for an application of new standards soon. According to expert opinions, the "Provision on Tenders" has so many defects that they should become a significant obstacle to any application of the Provision. The other negative consequence is the problem of real guarantees of protection, of both enterprise and public interests from such a temporary provision (regardless of the provided requirements that obligations undertaken by the winner are secured with his own holdings).

Some changes to the provision were introduced merely in the Spring of 1997 (the Resolution of the RF government No. 517 of 30 April 1997, "On Introduction Changes to the Resolution of the Government of the Russian Federation of 11 December 1996 No. 1485". In particular, the Ministry for Fuel and Energy was authorised to act as a founder for trust governance and conclude trust agreements on governing shares held in federal ownership with the winners of the tenders. Changes have been also introduced to the rules of holding the tenders.

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5.4. The privatisation "wars" of 1997

As between 1995 - 1996, in 1997 the government regarded privatisation as an instrument to resolve its budgetary problems. The previous years' experience showed an extremely low efficiency (for the budget) of mass sales in the course of "monetary" privatisation. That is why the decision was made to provide budgetary revenues at the expense of several large transactions.

The placement of 8.5 per cent of RAO "EES Rossii" shares for auction in late 1996 serves as another example of conflict. The estimated preliminary cost of the transaction was appr. RUR 1.87 trln. It was intended that the formal buyer, Incombank's daughter company Swiss "Incomfinance Group AG", would represent the interests of the consortium of banks and non-banking companies headed by Nationalny Reservny Bank ("Gasprom's group"). According to the author's data, "CS First Boston" failed to close the transaction (although, according to some estimations, it had already gained 10.36 per cent of the RAO's shares, while Credit Suisse controls about 20 per cent on the whole) and at the same time played a role as the official consultant to Goskomimuschestvo on the transaction. On the other hand, according to other sources, Nationalny Reservny Bank received a credit from the Central Bank of Russia to "pay" for this transaction, while a part of the formal "revenues" from the transaction were to be substituted by settlement of the RAO's debts to Gasprom. As a result, it would not make any sense to show the transaction in the list of budgetary revenues, even if some money was formally transferred.

The largest transaction of 1997 became the sale of the blocking majority of shares (25 per cent plus 1 share) of the financial and investment holding "Svyazinvest" at the auction held on 25 July 1997. The holding was established in August 1995, and 51 per cent of its shares were fixed in federal property, while 49 per cent were set for sale (25 per cent for foreign and Russian investors, yet 24 per cent for Russian investors only). The auction was held by the "MFK" bank (from the ONEXIMbank group). The formal winner became MUSTCOM Ltd. from Cyprus, founded by the companies of the ONEXIM's group ("dominating control"), Deutsche Morgan Grenfell (Deutsche Bank), Morgan Stanley broker company and Quantrum investment fund controlled by George Soros.

The winner offered USD 1.875 bln., while the competing TeleFUM company (Alfa-bank, Most-bank and Telefonica de Espana) offered USD 1.710 bln. It should be noted that what the government received only differed slightly from what was offered in November 1995 by the Italian holdings "Stet" (USD 1.44

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bln.). However, following the failure with the initial deal, the controlling block of shares of *inter alia* the "Rostelekom" and "Central Telegraph" joint-stock companies were transferred to the holding.

On the whole, since 1995, the capitalisation of the Russian stock market grew notably.[12] Obviously, it would not be possible to receive a real price, however, it would have been possible to compensate for the government's loss from the current undervaluation of the holding by selling the blocking stake of shares to a real strategic, not financial, investor. Then, with the sale of 24 per cent of shares to portfolio investors, it would have become possible to proceed on from a real price.

Although branches require significant amounts of investment, 85 per cent of the money received from the transaction will be forwarded to the federal budget. It is most likely that the winner of the tender should not be regarded as a strategic investor capable of providing "Svyazinvest" with access to modern telecommunication technologies. Of substantial importance is the fact that the holding is not a communications operator, though it may establish telephone companies. At the same time the winner in the auction does not have a company-communications operator among its founders.

Moreover, none of the largest international telecommunication companies (or their consortium) participated in the auction. Upon the sale of the blocking stake of shares, the government does not have an instrument (apart from a complete privatisation of the holding) to attract a strategic investor. Some experts also note the growing danger of the holding's break-up: in the current situation its regional companies will have to search for strategic investors on their own (Starostenkova, 1997).

Serious confrontations between the largest financial groups occurred in 1997 and concerned oil companies. The beginning of the "Second Oil War" was caused by the Presidential Decree No.505 of 19 May 1997 "On Sale of Previously Fixed in the Federal Ownership Shares of Single Joint-Stock

[12] According to the data of "Svyazinvest" joint- stock company, the total market capitalisation of the holding's 88 companies is USD 15 bln. The total market capitalisation of the holding's 23 companies which passed the listing of the Russian Trade System makes up USD 11 bln. Between 1995- 1997 the capitalisation of "Svyazinvest" grew by 118 per cent, while between 1998-1999, according to some forecasts, it should grow 2 times over.

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Companies of the Fuel and Energy Complex of Russia" and the Resolution of the RF government, bearing the same name, No. 616 of 21 May 1997.

In compliance with these documents, the blocks of shares of 6 oil companies - Vostsibneftegas (38 per cent), Vostochnaya Neftyanaya Kompaniya (51 per cent), "Sibirsko-Uralskaya Neftegasochimicheskaya Kompaniya "Siberia" (36.28 per cent), Tymen Oil Company "TNK " (48.68 per cent), Komi TEK (21.7 per cent) and NORCI-OIL (45.45 per cent) - were withdrawn from the prohibition list and are to be set for sale at specialised monetary auctions. Although these specialised auctions were designed for small private investors (the analogue to the cheque auctions), undoubtedly competing Russian banks will be their major participants.

For 3 companies (Vostochnaya Neftynaya Kompaniya, TNK and NORCI-OIL) it was stipulated to hold investment tenders as the preliminary condition for the special auctions. The first conflict, accordingly, erupted around TNK. Thus, the major daughter company of TNK, the "Nizhnevartovskneftegas" joint-stock company, has struggled against the winner of the investment tender (40 per cent of shares), i.e. the "New Holding" company, which is a member of the "Alfa-bank's" group.

The destiny of the state-owned oil company "Rosneft" has also been defined: around 7 per cent of its shares will be distributed among the company's administration and employees, 51 per cent of shares will be put up at an auction, while the rest will be sold as a single block at the commercial tender with investment conditions. According to some estimations, in the struggle for control, there will be a clash of interests of such groups as "ONEXIMbank-MFK", "Menatep", "Inkombank", Lukoil, Gasprom, "Sibneft-LogoVaz-Obyedinenny Bank" grouping and foreign partners of Rosneft.

5.5. Restructuring enterprises' debts

It is most likely that the new phase of property redistribution (both between the state and other "concerned" subjects, and between the largest financial and industrial alliances) will also be connected with debt relations and their transformation into property rights. This, in particular, serves as additional evidence to the fact that the key participants in the process of the redistribution are the largest creditors: the government, financial groups and natural monopolies, which have both common and opposite interests.

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In this connection, it is necessary to note three interesting documents related to the emission of shares and obligations by privatised enterprises:

(i) the Presidential Decree No. 1504 of 20 July 1996 “On Measures on Liquidation of Backwages and Arrears of Joint-Stock Companies”. The Decree allows to those enterprises with state-owned blocks of shares exceeding 25 per cent to hold new issues in order to pay off their debts to the budget. In other words, there is an alternative: either the government share would grow at the expense of new issues (i.e. the shares are recognised as the offset against the debt) or the dilution of the government stocks in favour of other shareholders occurs (“strategic”, according to the first scheme, and/or small-size “financial shareholders in case of a public placement).

The first such sample became the placement of the issue of YUKOS oil company. The issue amounts to RUR 499 bln. and was placed among the shareholders by open subscription (however, among “friendly” structures). At the time of the issue, Menatep’s affiliates owned 33 per cent of the company’s shares (resulting from the investment tender), and were the holder of a pledge of yet 45 per cent of shares. YUKOS’s authorised capital grew by more than 30 per cent (by RUR. 2.3 bln.) and made up RUR 8.9 bln. The state-owned block in the company decreased from 45 to 33.3 per cent.

(ii) The Presidential Decree No. 1203 of 17 August 1996 “On Issue of Bonds by Organisations for the Purpose of Restructuring their Arrears with Regard to Compulsory Payments to the Federal Budget”. It is envisioned that this would help many enterprises avoid selling their holdings against debts (liquidation). In other words, in a number of cases the bankruptcy is merely postponed and the government receives the enterprise’s obligations. The enterprise holdings or third party guarantees are pledged as a security for obligations. The government has a right to either sell these bonds before the maturity date or to receive from the enterprise the respective sum in addition to a certain percentage at the maturity date.

(iii) Resolution of the RF government No. 254 of 5 March 1997 “On the Conditions and Order of Restructuring Organisations’ Debts on Payments to the Federal Budget”. The last document (which appeared nearly on the eve of the well-known cabinet reshuffle) is of crucial importance. Those companies which have arrears to the federal budget as of 1 January 1997 (major debt), as well as penalties and fines on this debt, perform debt

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restructuring through the issuance of securities (shares or bonds) as collateral for major debt. Should shares be issued, the controlling block will be submitted to the Russian Fund of Federal Property as collateral. The issuer should pay off its major debt (by equal monthly payments over the period of five years) and penalties and fines (over the ten year period, on a lumpsum basis), otherwise the shares are subject to sales. The analogous scheme-sales of assets pledged on the security of the given bonds is also provided for, should the bonds be issued (keeping in mind the specifics of such securities). As in many other known documents (concerning the loans-for-shares auctions and trust), this document has several defects from the viewpoint of the current legislature.

The present Resolution - it can be assumed that the largest banks are most interested in its implementation - may be regarded as an alternative to the intensifying activity on the part of, for example, Gasprom on the sale of debit liability (or, on the contrary, to maintain such a liability, in order to convert them into ownership rights afterwards).[13]

In the majority of the afore-mentioned cases, the problem undoubtedly is not the applied technique. It is known that in the growth period of the 1880s in Russia, such forms of resource acquirement from the capital market were practised among industrial enterprises, as emissions of obligations and collateral of shares in commercial banks. The key problem of the current phase of property redistribution remains the same - a discrepancy between the institutional and legal base, as well as mechanisms of “cut-off” and control over the interest of both narrow, private and/or public groups, or populist groups, and securing their “filtration”.

Property redistribution may be implemented in practice only through special federal laws which should exclude any legislative preferences and “special relationships” with the government. It should also secure rigid public competition and give details on access, control and liability. Political will should also be an obvious condition in order to both maintain the given mechanism and protect it from a criminal component.

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13 The order of RAO “Gasprom” of 22 January 1997 “On Organisation of the Work on Sales of Debit Liability of the Consumers for the Natural Gas Supplied by the Enterprises of RAO Gasprom”. With the volume of the debts amounting to over RUR 50 trln., the RAO’s potential in the field of an organization for the whole “market of corporate control” in this country is obvious.

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6. Conclusion: banks and forming models of corporate governance

Despite the fact that according to the formal legal signs, the model of universal banks is taking shape in the RF, it is not yet possible to talk of banks as real strategic owners responsible for an enterprise's long-term development (in the context of the European model, in which, apart from control, the bank also provides for the financing of the enterprise in one form or another).

On the one hand, there are a whole number of characteristic features of the Russian economy, due to which there is a clear inclination towards the banking-focused (continental) type of financial system. First of all, the economy's industrial sector, which has found itself in a situation of severe crises, is incapable of providing the necessary level of investment to modernise and restructure production at the expense of self-financing. In addition to the lack of capital, it is inflation expectations and inefficient management which are factors in suppressing investment activity. As to inefficient management, it is determined by both a lack of market control (competition) and defects in the "intra-reform" management related to the non-completion of the property transformation, and therefore to the uncertainty in manager's incentives.

The market for liquid securities, which takes shape rather slowly in terms of turnover of the industrial corporations' shares, also determines the problem of a lack of outside mechanisms of the capital market's control over the Russian corporations' activity. It is also obvious that there is a trend of banks establishing control over enterprises through the creation of holdings and FIGs.

On the other hand, the afore-mentioned reasons in favour of forming a banking-focused model in Russia - with all their indisputability - cannot be an absolute statement, due to many current opposite trends. These opposite trends either neutralise the banks' role in forming the Russian financial system or testify in favour of the market-oriented (Anglo-Saxon) model.

Firstly, within the framework of mass privatisation, the dispersion of Russian enterprise joint-stock capital was made (the current non-liquidity of the majority of shares and the trend towards concentration in this case are secondary to this general process).

Secondly, the concentration of ownership rights which started in the course of privatisation, does not merely mean that there would be a dominating transfer of those rights to the banks, since, at present, the types of institutional investors in the structure of Russian enterprise joint-stock capital may vary greatly.

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Thirdly, the typical structure of joint-stock capital, which has taken shape in the process and immediately after the completion of mass privatisation, has rather an amorphous structure. The process of erosion of shares received by employees continues too. In other words, the struggle for the controlling block, which is characteristic of the present time, is continuing between managers, banks and investment institutions; and the banks play a serious, albeit exclusive role in this struggle.

Fourth, a certain exaggerated impression on Russia’s leaning towards the banking-focused model of finance may be caused by the largest Moscow banks’ activities, and is not necessarily reflective of the situation in Russia on the whole.

Fifth, the enterprises, regardless of certain share-reductions in the banks’ joint-stock capital, often keep their status of founders of banks. According to the data of some surveys, enterprises own on average up to 50 per cent of shares in the former special banks’ capital and up to 20 per cent in the new commercial banks’ capital. The above-mentioned condition (to the extent in which the founders may place pressure on the banks) constrains the pro-market modification of a bank’s credit policy. At the same time, many banks essentially are mere corporate treasury departments for large-scale enterprises.

Sixth, the control on the part of some of the largest banks is weakened by their specific role as intermediaries between government and enterprises. In hope of state support, to some enterprises the banks practically do not control the latter’s activity.

Seventh, it is also necessary to take into account the hard financial constraints the banks face themselves. Due to these, many banks cannot bear additional costs related to enterprise control. Provincial small-and-medium-sized banks thus find themselves in very difficult positions (such banks were established on the basis of former special bank affiliates and departments). In these banks the assets are typically “tied up” to the issuance of credits to enterprises. At the same time, as per many of the larger banks with more stable financial positions and qualified personnel, credits to production often make up an insignificant part of the assets. At present, only a small group of Russian banks deal with the issuance of commercial credits to Russian industrial enterprises. The refusal to issue credit is, of course, also a specific form of control over the enterprise, as it may become an outsider’s appraisal of management quality. However, it is obvious that it is insufficient as a prevailing form.

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Finally, when compared with the industrial sector, the Russian banking sector is neither large in size, nor can it fall back on a large amount of experience.

Thus, according to a number of expert predictions, it is rather improbable that the banking sector will, in organisational terms, be able to meet the growing needs of enterprise finance within the forthcoming few years. This therefore should allow for a cautiously led discussion on the forming of a banking-focused model of corporate finance in the RF, as the matter is still open.

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Table 1. Russian banks included into the list of the 1000 largest banks of the world

	1	2	3	4	5	6	7	8
Vneshtorgbank of RF	908	52,2	315	4234	3,5	750	154	79,5
Sberbank of RF	823	42,2	344	17993	107,8	300	933	301,8
Oneximbank	524	86,4	504	3659	43,7	807	48	42,2
Incombank	355	41,0	662	2900	9,2	883	135	1,2
Menatep	238	107,9	831	2143	70,9	946	14	- 34,9
MFK	235	í.ä.	837	1808	í.ä.	966	87	í.ä.
Tokobank	233	33,5	842	1005	77,3	994	8	46,2
Imperial	210	31,3	888	1110	- 14,2	992	65	48,8
SBS- Agro	193	32,9	937	937	70,1	995	34	490,7
Mosbusinesbank	183	303,9	963	1509	33,8	985	82	835,0

1- Tier 1 capital, USD mln.; 2- change in capital, %; 3 - rating by capital; 4 - assets, USD mln.; 5 - change in assets,%; 6 - rating by assets; 7 - before- tax profit, USD mln.; 8 - change in profit,%
Source: The Banker, 1997, July.

Table 2. The structure of financial institutions in Russia

Investment institutions	**end of 1993**	**first half of 1997**
Banks (registered)	2019	2600**
Investment institutions (total)*	2159	5065
- including investment companies	307	485
-including financial brokers	943	3000
- including investment consultants	898	2700 ***
- including investment funds of closed and open type (voucher funds exclusive)	11	40
Voucher investment funds	636	350
Mutual investment funds	0	15
Pension funds, approximately	100	800****
Insurance companies, approximately	1000	2700
Credit unions	-	130*****

*The data according licenses. Obviously the number of investment institutions-registered legal entities is somewhat less, due to their combining functions.
** As of the beginning of 1997 the factual number of operating banks did not exceed 2000.
*** Mostly combine with the functions of financial broker and investment company. The separate licenses of investment consultant were acquired by not more than 40 subjects.
**** Including those operating without licenses

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***** According to experts' estimations
Source: the data of the Central Bank, Goskomimuschestvo, Federal Commission for Securities, Rosstrakhnadzor

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Table 3. Some characteristics of credit organisations in Russia in 1997

	January 1997.	May 1997
Number of registered credit organisations (including organisations with withdrawn licenses, but not yet liquidated as legal entities)	2589	2582
Credit organisations which have a right to perform banking operations (having licenses)	2029	1887
Credit organisations with withdrawn licenses	570	706
Liquidated credit organisations	351	361
Credits, issued to economy and population, RUR trln..	261,1	269,3
Long- term credits, issued to economy and population, RUR trln..	5,8	6,7
Short- term credits, issued to economy and population, RUR trln..	195,9	213,9
Securities and shares purchased by banks, RUR trln.*	190,3	211,8
including government securities	127,8	142.7
promissory notes in the bank’s portfolio	29,6	33,8

*the data as of April 1997
Sources: Goskomstat RF, 1997; Bulletin Bankovskoy Statistiki, 1997, ¹ 5 (48).

Figure 1.: Weekly Consumer Price Index for 1995 - 1997

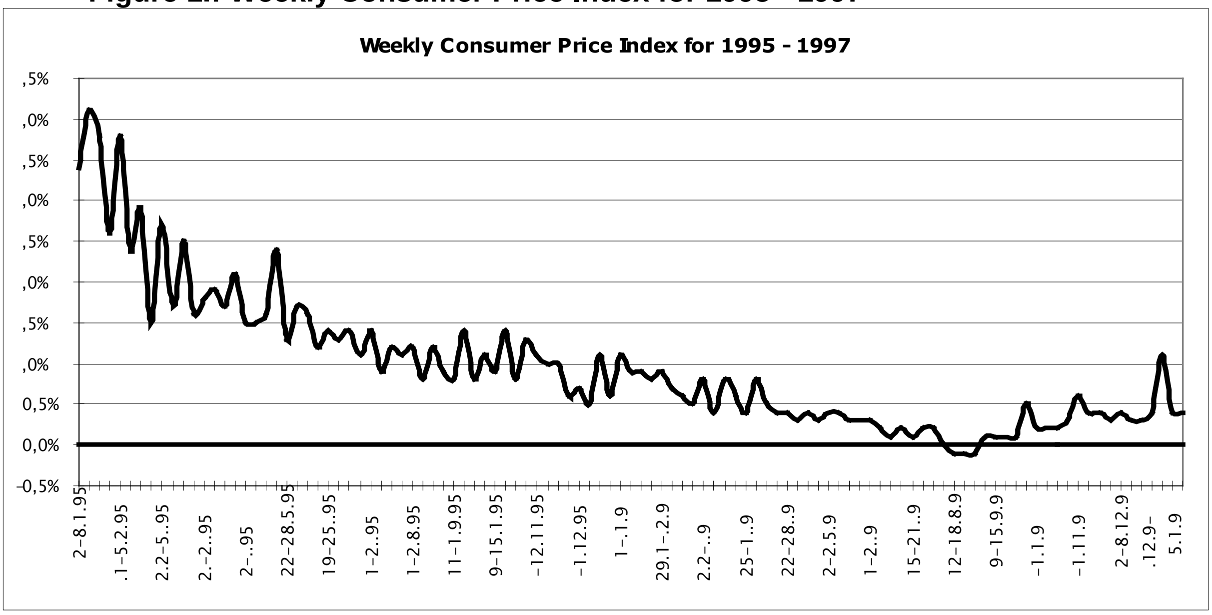

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Figure 2.: RF Central Bank refinancing rate

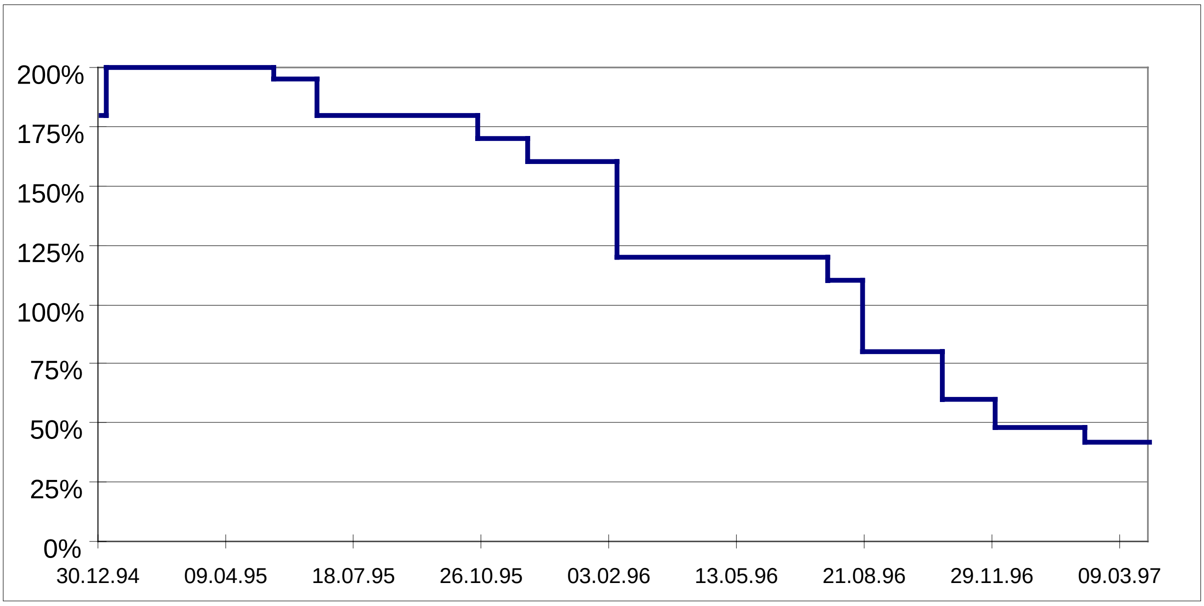

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Figure 3. Dynamic of GKOs-OFZs market in 1996-1997

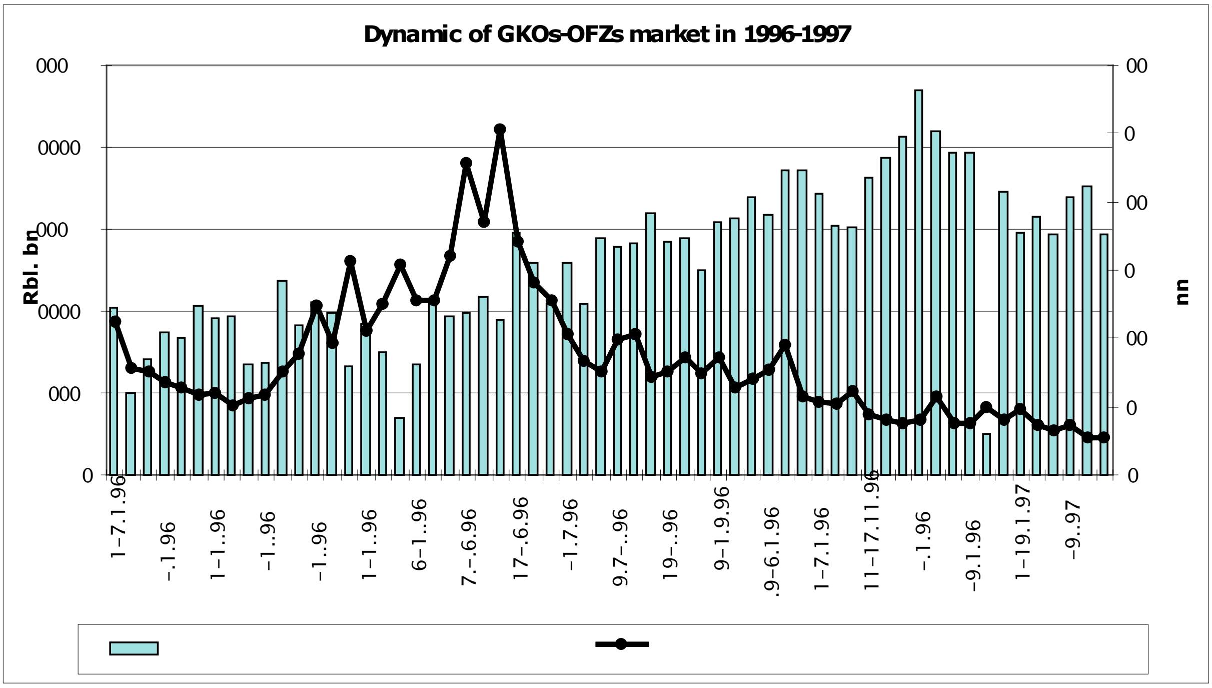

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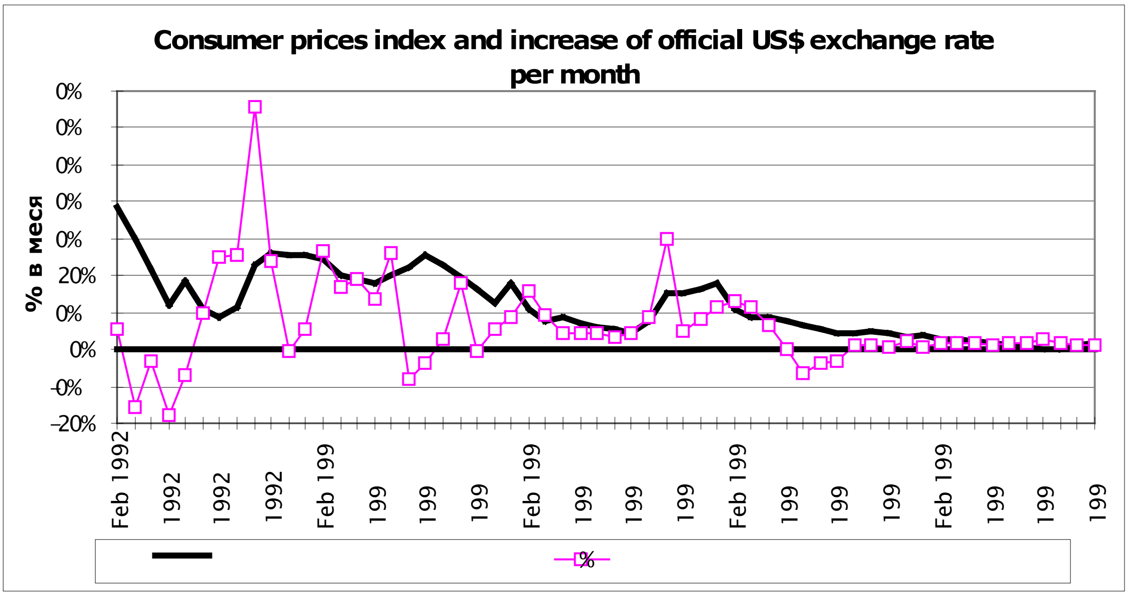
Figure 4.: Consumer prices index and increase of official US$ exchange rate



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