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FINANCIAL SECTOR ASSESSMENT PROGRAM

# RUSSIAN FEDERATION

ROLE OF STATE IN FINANCIAL SERVICES

## TECHNICAL NOTE

JULY 2016

This is a Technical Note (TN) produced by the World Bank team on the Role of the State in the Financial Sector. The TN on the Role of the State was produced by Ilias Skamnelos and Jean Michel Lobet, with background research from Alena Kantarovich. The note was prepared in the context of a joint World Bank/International Monetary Fund Financial Sector Assessment Program mission in the Russian Federation during February-March 2016 led by Aurora Ferrari, World Bank and Karl Habermeier, IMF. The note contains technical analysis and detailed information underpinning the FSAP assessment's findings and recommendations. Further information on the FSAP program can be found at [www.worldbank.org/fsap](http://www.worldbank.org/fsap).

The TN is based solely on publicly available data and state-owned bank replies on a Corporate Governance focused survey. The TN was informed by the interviews undertaken during the FSAP mission, which did not include VEB and Gazprombank.



The World Bank Group

Finance & Markets Global Practice

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# EXECUTIVE SUMMARY

## The Role of the State in the Financial Sector

### Structure and Policy

1. **State-owned financial institutions fall into three main groups: commercial banks, hybrid banks, and development institutions.** The larger state-owned commercial banks/ groups include Sberbank, the VTB Bank group, and Gazprombank. Like private commercial banks, these institutions do not have a policy mandate and are profit maximizing, and target similar market segments. The main state hybrid bank is the Russian Agricultural Bank (RAB), which has a policy mandate to focus on agribusiness, while also engaging in broader commercial banking activities. The principal state development institution is the VEB group, which has a broad policy mandate, subject to a legal obligation not to compete with commercial credit institutions. It on-lends or directly lends to firms, but does not collect retail deposits.<sup>1</sup> There are also several smaller state-owned banks that primarily engage in commercial activities and are owned by sub-national entities. The ownership structure of the state-owned financial sector is dispersed and complex (see below).

2. **The authorities should continue pursuing the gradual privatization of state-owned commercial banks, as economic conditions permit.** There has been a gradual divestment of state ownership in recent years. The sale of a 7.6 percent stake in Sberbank in 2012 brought CBR's ownership to 50 percent plus one voting share in terms of statutory capital. The sale of VTB Bank shares in 2013 brought state ownership down from over 75 percent to just above 60 percent in terms of voting shares, with a further sale being explored by the Federal Agency for State Property Management (FASPM). Further divestment is dependent on securing anchor investors. Moreover, a drop below a controlling interest (particularly in Sberbank) is being weighed against the safe-harbor benefits of state ownership during periods of turbulence.

3. **There may be benefits to revisiting the role and structure of the state hybrid and development institutions, with corporate governance reforms being a priority.** RAB has a narrow focus, but its policy mandate is high risk and has required annual capital injections, with the bank gradually diversifying away from agribusiness. The VEB group has two key functions. First, Rosximbank of Russia provides traditional export financing, EXIAR provides export insurance coverage. Second, the VEB acts as a quasi-fiscal agent in support of a wide range of strategic projects, including infrastructure and post-2008 anti-crisis measures. Both RAB and the VEB group would benefit from corporate governance reforms to increase their autonomy and effectiveness. In addition, their financial soundness would be enhanced by obliging the government to cover the cost of any subsidized activities in its annual budget, and by ensuring that lending rates are no lower than the cost of funding.

4. **State-owned financial institutions should not be used to bail out struggling commercial banks.** This practice can undermine the financial soundness of state-owned financial institutions, and is also not

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<sup>1</sup> Globexbank and Sviazbank are noticeable exceptions among VEB subsidiaries. The two banks were bailed out by the VEB group during the crisis of 2008, and are expected to be sold in the near future.

consistent with transparent and efficient public finances. It would be preferable to apply sound resolution practices, as described elsewhere in this report.

5. **In other respects, the administration of financial subsidies appears to follow a number of good principles, although coordination could be improved.** Both state-owned and private banks can act as a government agent in administering state financial subsidies and other programs, and the subsidy component of such programs is often covered by the budget. The multiplicity and lack of coordination of financial subsidy programs, however, can lead to poor targeting, duplication, and even “double-dipping” by beneficiaries. It would be beneficial to establish a subsidies’ bureau to coordinate and to assess the impact of the programs.

### **Corporate Governance**

6. **There have been many positive changes in the corporate governance of state-owned banks in recent years.** Key developments include: (i) listing of shares in capital markets; (ii) improved disclosure (implementation of IFRS standards, disclosure of ownership structure, conflicts of interest and remuneration of supervisory and management board members, and public and comprehensive annual reports); (iii) greater board effectiveness (independent directors, board subcommittees); and (iv) risk, audit and internal controls (separation between permanent and periodic control functions, ensuring that the head of internal audit reports directly to the board, creation of risk management departments, and recruitment of chief risk officers). The largest SOBs have embraced these changes as they are required to operate under the same legal and regulatory environment as private banks. Sberbank and VTB Bank are listed on the Moscow Stock Exchange, as well as in Frankfurt, London, and New York. The more stringent listing requirements, market discipline, shareholder activism, and stronger rule of law in foreign capital markets have obliged these banks to adopt more professional management practices, transparent governance, and improve their financial performance.

7. **The ownership of SOBs remains dispersed and complex.** In many other jurisdictions, the ownership of State Owned Enterprises (SOEs) and SOBs has been consolidated under a single entity. By contrast, in Russia, public ownership interests are dispersed: the CBR for Sberbank; the FASPM for VTB Bank, SME Bank and RAB; and various administrative regions in several smaller SOBs. Ownership relations are also complex. SOBs and SOEs have subsidiaries in the banking sector, including VEB owning Globex Bank and Sviaz Bank; VTB Bank owning VTB 24, BM-Bank PJSC and Pochta Bank; Gazprom owning Gazprombank; and, Rosneft owning the Russian Regional Development Bank. Finally, the DIA owns Bank Rossiysky Capital, which it resolved and recapitalized in 2011.

8. **An unusual feature of SOB governance in Russia is the dual role of the CBR as the major shareholder and regulator of Sberbank.** Although this arrangement appears to have worked reasonably well in practice, in particular thanks to a strong and professional management team at Sberbank, it may impede the longer-run transition to a more market-oriented and competitive banking system, and may raise doubts among potential private investors in the banking sector about the authorities’ commitment to providing a level playing field.

9. **A reform of the current ownership structure could support the spread of good corporate governance practices.** At present, some SOBs such as Sberbank and VTB Bank have solid corporate governance practices. Others, however, lack good practices such as board committees, independent directors, a strong control environment, and adequate disclosure. In varying degrees, these shortcomings inevitably reflect the incentives created by the current ownership structure. Thought could therefore be given to institutional reforms that oblige the current owners to implement better practices, or even to the reassignment of ownership to other government entities that might be better placed to make the desirable improvements. A reform of the current dispersed and complex ownership structure of SOBs could have significant benefits. One option is the transfer of the ownership of additional SOBs to FASPM.

10. **The composition and functioning of many SOB boards is an area that requires attention.** Many SOB boards are composed of an important number of civil servants and high level government officials, and not enough board members have experience in commercial banking. Moreover, the boards of SOBs lack autonomy as board members (except independent directors) vote by “instruction” of the major shareholder. A new legal and regulatory framework to increase board effectiveness by reducing the share of government officials in SOB boards and expanding the share of professional and independent board members would help to mitigate these issues, notably by helping to align decision-making more closely with commercial objectives.

11. **Finally, SOB lending to SOEs should be conducted on an arm’s length basis and on commercial terms.** Internal procedures do not treat these transactions as related-party transactions. CBR regulations on major exposures and related-party exposures do not appear to capture lending to SOEs. As a result, these are treated as normal transactions and are not separately disclosed to the public. Moreover, when state commercial and hybrid banks support the implementation of state programs, these are kept on balance sheet, thus potentially undermining the soundness of these banks. Efforts should be made to ensure that SOB lending to SOEs is also properly disclosed in financial statements and annual reports.

<b>Table. Summary of FSAP Main Recommendations<sup>2</sup></b>	
<b>Recommendations and Authority Responsible for Implementation</b>	<b>Timeframe</b>
Legal reforms to increase SOB board effectiveness (MOF, CBR)	Short term
Continue gradual privatization of state-owned commercial banks (MOF, CBR)	Medium term
Reconsider current dispersed and complex ownership structure of SOBs; possible transfer of SOBs to FASPM (MOF, CBR)	Medium term

<sup>2</sup> Annex 1 offers the Full Recommendations.

## MAIN FINDINGS

### A. STRUCTURE AND POLICY

#### I. Macro-financial Background

12. **The Russian economy is experiencing a protracted recession.** The sharp decline in oil prices has negatively affected growth, along with sanctions that have impaired access to international markets. These developments have exacerbated the pre-existing structural slowdown in growth and taken a toll on the banking system.

13. **The authorities' policies have helped to keep the banking system stable, but risks remain.** The policy response has relied on a combination of liquidity provision, capital support, and temporary regulatory forbearance. Decisive efforts are underway to weed out weaker banks. The authorities' crisis management framework is well-developed and has repeatedly been tested in practice. The key risks include a weaker medium-term path for oil prices, the intensification of geopolitical tensions and sanctions, and a further slowdown in growth.

14. **The Russian financial sector is relatively small and banks dominated, with bank assets amounting to 103 percent of GDP at end-2015.** Pension funds, insurance, and mutual funds have assets of 2.8, 2.2, and 1.7 percent of GDP, respectively. The payments infrastructure is well developed. The ratio of bank credit to GDP is the lowest among a group of comparator countries composed of Brazil, Turkey, India, China, and South Africa (BTICS). Russia's overall financial development index (0.58) is higher than the Emerging Market (EM) average (0.37), but slightly lower than the BTICS average (0.64).<sup>3</sup> Russia scores much higher than the BTICS in financial market development, reflecting higher access and efficiency. Financial market depth is slightly lower than in the BTICS, but much higher than the EM average. Financial institutions, however, are less efficient and deep than in the comparator groups, while access to financial institutions is about the same.

15. **The largest 10 banks by assets extend about 70 percent of total lending.** The three largest (and state-owned) banks held 54 percent of the system assets and 59 percent of the system deposits. Government-related banks accounted for 60 percent of system assets at end-2015. The top 10 private universal banks hold 15 percent of system assets, foreign banks 7 percent, and the remaining 18 percent are in specialized and small banks. Many of the small banks operate in monoindustrial cities and are often important in their respective regions, complicating efforts to further consolidate the banking sector.

16. **Russian banks use a relatively simple but costly business model of credit intermediation.** The majority of assets are loans (70 percent of banking assets), followed by securities (mostly in domestic government and corporate bonds), and interbank lending. Banks are mainly funded by deposits of non-financial corporations and individuals. Capital market funding is very limited. Banks are mostly profitable thanks to fees and other non-lending revenues. Bank operations are high cost, with overhead about 5 times greater than in the BTICS group.

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<sup>3</sup> For a description of the index, see Sahay, et al (2015). "Rethinking Financial Deepening: Stability and Growth in Emerging Markets." Staff Discussion Note No. 15/8 (Washington: IMF). The comprehensive index captures multiple indicators (measuring depth, access and efficiency) under two distinct areas: (i) financial institutions that include banks, insurance companies, mutual funds, pension funds, and other types of nonbank financial institutions; (ii) financial markets include mainly stock and bond markets.

## II. State Presence in the Banking Sector

17. **Elements from the Soviet times still resonate in the Russian Federation’s current banking system.** The Soviet period’s financial system was a reflection of state control of the economy, with Gosbank being the central bank and only commercial bank at the time, Sberbank being a savings bank making saving available to the government, Stroybank providing investment credits to enterprises, and Vneshtorgbank (VTB) handling trade financial transactions. Under Gorbachev, Gosbank transformed into the Central Bank of Russia (CBR) and gained autonomy over time, Agroprombank focused on agriculture, Promstroybank focused on industry and construction, and Zhilsotsbank focused on social development. Despite the privatization efforts of the 1990s, many of these ‘brand names’ continued under partial state ownership but diversified into broader commercial activities, while others remained or emerged specializing in, for example, agriculture or trade.

18. **State ownership in the banking sector has increased in recent years, with the 2008 global financial crisis further exasperating the trend.** The 1990’s saw a decrease in state ownership, but the failure of systemically important private commercial banks in 1998 triggered a reversal. The 2008 global financial crisis further strengthened the dominance of majority state-owned banks (SOBs), which provided a safe harbor and served as bail-out vehicles during a turbulent period.

19. **SOBs dominate the Russian Federation’s banking sector, with the two largest groups capturing almost half of the system’s assets.** State owned banking groups account for 4 of the 5 largest banking groups in Russia (see Table 1). Sberbank alone accounts for over 45 and 24 percent of total retail and corporate deposits, respectively, with VTB Bank group capturing another 12 and 14 percent, respectively. With over 16,000 branches, Sberbank is the only bank present throughout the country.<sup>4</sup> Overall, there are 36 banks with regional and state authorities’ control (see Table 2 for a subset), bringing state ownership at about 60 percent of total system assets in Russia. See Annex 3 for a brief description of selected state-owned banks.

**Table 1. Top Banking Groups in the Russian Banking Sector**

	<b>Bank</b>	<b>Ownership (majority/controlling)</b>	<b>Total Assets (RUB bln)</b>	<b>Share in System Assets (%)</b>	<b>Share in System Deposits (%)</b>
1	Sberbank	State	23,040	29.6	34.4
2	VTB Bank Group	State	13,754	17.7	16.4
3	Gazprombank	State	5,127	6.6	7.7
4	Otkritie Group	Private	3,807	4.9	3.3
5	Russian Agricultural Bank	State	2,642	3.4	3.6
6	Alfa-Bank	Private	2,223	2.9	2.9
7	B&N Bank Group	Private	1,526	2.0	1.5
8	PromSvyazBank	Private	1,439	1.9	2.1
9	Unicredit Bank	Foreign	1,422	1.8	1.9
10	Soc. Gen. Group	Foreign	1,106	1.4	1.0
11	Raiffeisenbank	Foreign	842	1.1	1.1
12	SMP Bank Group	Private	771	1.0	0.8
13	VEB Group	State	769	1.0	0.8

*Source: Annual Reports, IFRS statements*

<sup>4</sup> The Russian Agricultural Bank also has a broad network of branches in the majority of Russian regions.

**Table 2. State Presence in the Russian Banking Sector<sup>5</sup>**

	<b>Bank</b>	<b>Bank Group</b>	<b>Share in System Assets (%)</b>	<b>Notes</b>
1	Sberbank	-	29.6	
2	VTB Bank	VTB Bank Group	12.0	
3	VTB24	VTB Bank Group	3.7	
4	BM-Bank PJSC	VTB Bank Group	1.9	Previously Bank of Moscow
5	Pochta Bank*	VTB Bank Group	0.1	Previously Leto
6	Gazprombank		6.6	
7	Russian Agricultural Bank		3.4	
8	Sviaz-Bank	VEB Group	0.5	Bailed-out
9	Globexbank	VEB Group	0.3	Bailed-out
10	SME Bank	SME State Corporation	0.2	Second-tier
11	Eximbank of Russia	VEB Group	0.0	Exim
12	Bank Rossiysky Capital		0.4	
13	Novikombank		0.3	
14	Russian Regional Dev. Bank		0.2	
15	Russian National Comm. Bank		0.1	
16	Cetelem Bank	Sberbank Group	0.1	
17	Evrofinance Mosnarbank		0.0	
18	GPB Mortgage		0.0	
19	Credit Ural Bank		0.0	
20	Fondservicebank		0.0	
21	Sotsinvestbank		0.0	
22	Russia Finance Corp. Bank		0.0	
23	Denizbank Moscow		0.0	
<i>Regional Governments or Territorial Administrations</i>				
24	AK BARS Bank		0.0	
25	JSC Krayinvestbank		0.6	
26	Almazergienbank		0.1	
27	Bank Orenburg		0.0	
28	Elita Bank		0.0	
29	Yoshkar-Ola Bank		0.0	
30	Narodny Bank Respubliki Tyva		0.0	
	<b>Total</b>		<b>60</b>	

Source: Annual Reports, IFRS statements

Note: YandexMoney, MobiMoney, and Universal Electronic Bank (NBFIs) were not included in this table;

\* Pochta Bank is a new postal bank created together with the Russian Post. This is expected to allow the VTB Bank group to compete forcefully with Sberbank's wide retail network on the collection of retail deposits. The Technical Note on Financial Inclusion provides more details, identifying it as a welcome step towards more competition.

<sup>5</sup> This table captures the main state owned banks based on available data, although further state presence cannot be excluded.



### **III. The Role of the State**

20. **The 2008 global financial crisis prompted a global rethink by policy makers on the role of the state in the financial sector, including state ownership of banks.** SOBs account for less than 10 and about 20 percent of banking system assets in developed economies and emerging markets respectively.<sup>6</sup> In the 70s, that share was about 70 percent in emerging economies - the drastic decline led by the ECA region as a result of massive privatization programs. The 2008 global financial crisis resulted, however, in an increased use of SOBs to ramp up financing to the private sector.<sup>7</sup> The World Bank's Global Financial Development Report for 2013 provides many insights on the early post-crisis thinking on the role of the state, ranging from regulatory and supervisory practices, competition policy, direct state interventions, and financial infrastructure.<sup>8</sup> In this technical note, the emphasis is on state interventions through State Commercial and Development Financial Institutions (SCDFIs) – a 'catch-all' category for institutions operating in the financial sector and being publicly owned.

#### **Rationale and Typology of State Intervention**

21. **The rationale for state intervention as it relates to SCDFIs is diverse, with recognition of the countercyclical role they can play being front and center in recent years.** There is a wide academic literature on the rationale for state intervention (see Table 1). Three of the most frequently quoted reasons by policy makers in underwriting the SCDFI's mandates evolve around market failures, externalities, and more recently the countercyclical/ safe haven role that SCDFIs can perform. With quantitative easing appearing to have small impact on economic growth (either failing to expand banks' lending portfolio, or bank lending failing to target those with high propensity to consume)<sup>9</sup>, and many countries facing tightening fiscal constraints, policy makers have increasingly explored SCDFIs as potential countercyclical instruments (see Box 1). Characteristically, following the global financial crisis, a heated debate erupted in the US over introducing public banks modelling the Bank of North Dakota, in the UK the publicly owned British Business Bank was instituted to assist smaller businesses, and in Europe the "Juncker Plan" included a prominent role for "National Promotional Banks" as financial intermediaries of European Fund for Strategic Investments resources. Less frequently quoted arguments involve around promoting competition, trust, or providing a financial return to the State.

22. **The rationale for public intervention is not without criticism, although the counter-arguments take different approaches depending on the nature of the SCDFI.** Each of these rationales has been used to back specific focuses for state intervention (as well as different types of institutions, as explored further below). Counter-arguments to each rationale also abide, although the most typically quoted arguments focus on state commercial banking activities and evolve around political capture, unfair competition, or the 'Sisyphus syndrome', which is based on inherent contradictions between a banking and social policy mandate. In the case of counter-arguments to state development banking activities, the emphasis is on the need to address the fundamental underlying failure more directly. For example, credit or collateral information weaknesses should be addressed by policy work targeting the country's financial infrastructure. Lack of long-term finance should be addressed by capital market and institutional investors

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<sup>6</sup> "Global Survey of Development Banks", 2012, Jose de Luna-Martinez, and Carlos Leonardo Vicente, Policy Research Working Paper 5969, World Bank.

<sup>7</sup> "State Owned Banks: Do They Promote or Depress Financial Development and Economic Growth?", 2005, Eduardo Levy Yeyati, Alejandro Micco, and Ugo Panizza, IADB conference background paper.

<sup>8</sup> "Global Financial Development Report in 2013: Rethinking the Role of the State in Finance", 2013, World Bank.

<sup>9</sup> "Do Banks Pass Through Credit Expansions to Consumers Who Want To Borrow?", 2016, Sumit Agarwal, Souphala Chomsisengphet, Neale Mahoney, and Stroebel, Johannes.

related reforms. However, policy makers argue that such reforms tend to be a long-term process, with direct state intervention providing a bridge until the constraints are lifted.

**Table 3. State Intervention Rationale as it relates to SCDFIs (i.e. not prudential regulation)**

State Intervention Rationale	Intervention Focus Example	Counter-Arguments
(i) <b>Market failures.</b> Financing financially profitable projects that do not get financed due to market failures (e.g. asymmetric information).	SMEs, Agriculture, R&D and capital intensive sectors. International trade. Long term finance (incl. infrastructure).	Develop financial infrastructure and capital markets (however this takes time).
(ii) <b>Externalities (social value).</b> Financing financially unprofitable projects that are socially valuable.	Rural and isolated areas.	Address through subsidies.
(iii) <b>Countercyclical/ safe haven.</b> Financing financially profitable projects that do not get financed when private bank risk appetite overreacts to recessions. Reduce employment volatility. Provide safe haven for depositor flight and contagion circuit breaker during crisis. Note: guarantees and subsidies may take time to materialize vs direct lending.	Labor intensive sectors. Wide geographic branch presence.	Use monetary policy (however lenders may underreact to policy). Foreign banks as safe haven (but can also be source of uncertainty). If lending growth continues after economic recovery, misallocations are possible.
(iv) <b>Competition.</b> Guaranteeing competitive behavior in a collusive banking sector.	Broader commercial banking.	Fix regulation and monitoring (however this may be non-binding).
(v) <b>Trust.</b> Promoting intermediation in a context of a general mistrust of private banks.	Broader commercial banking.	Develop institutions and regulation (however this takes time).
(vi) <b>Return.</b> Provide returns to the state as shareholder.	Broader commercial banking	Not appropriate public funds use.

Source: Author's analysis

**Box 1. Examples of countercyclical interventions during the Global Financial Crisis**

The combined loan portfolio of development banks increased by 36 percent y/y in nominal terms at the end of 2008, compared to a 10 percent growth in private bank credit. Some examples of the countercyclical role played by state owned banks during the global financial crisis can be found in Brazil, Mexico and Poland. In Brazil, the government used its public bank infrastructure to play a countercyclical role in credit markets, extending special credit facilities through a government capital injection to the country's development bank (BNDES), and subsidizing long-term lending rates. In Mexico, state owned banks expanded their loan portfolios and supported key markets through special guarantee programs, with modest fiscal costs as banks were adequately capitalized before the crisis and did not need additional funds to increase their lending portfolios. Finally, in Poland, its state-owned bank, PKO BP, played a role in credit stabilization by expanding credit at a faster pace than private banks, partially offsetting the decline in overall credit. This was possible due to the bank's conservative funding structure that made it less dependent on wholesale funding than foreign-owned subsidiaries, which controlled almost 75 percent of the banking system.

Source: GFDR, 2103

23. **The underlying rationale ultimately determines the type of SCDFIs, with activities broadly ranging from the purely commercial to the purely developmental.** Although trying to ‘box’ the state ownership of banks into strict types is almost impossible, in broad terms one can differentiate among five key types of SCDFIs (see Table 4, and Table 5 on the diversity of institutions in ECA). At one extreme of the spectrum, the state commercial banks are practically full-fledged profit-maximizing, deposit-taking, direct-lending commercial banks. At the other end, state development institutions do not collect deposits and rely increasingly on indirect lending instrument (i.e. on-lending through private commercial banks, providing guarantees etc.) and technical assistance, or, in the case where the mobilization of savings is the ultimate goal, collect deposits but do not intermediate. The underlying rationale is important in defining performance expectations. For example, a focus on externalities implies that a state development oriented institution (i.e. all SCDFIs, except for SCBs) would not be expected to be profitable. A focus on addressing market failures could also imply an emphasis on capital preservation versus profit maximization (which would be more suited to the rationale underlying a state commercially oriented bank). A consequence under both cases, and discussed in more detail below, is that transparency in government transfers becomes fundamental in state development oriented institutions.

**Table 4. Typology of SCDFIs**

<b>Typology</b>	<b>State Intervention Rationale</b>
(i) <b>State commercial banks (SCB).</b> These institutions do not have a policy mandate, and are profit maximizers with operations virtually indistinguishable from those of private commercial banks. They collect deposits from the public and use them to directly lend to firms and individuals. In some cases, they are universal banks - directly or through affiliates.	(i) Return; (ii) Countercyclical/safe haven; (iii) Competition; (iv) Trust
(ii) <b>State hybrid banks (SHB).</b> These institutions have a policy mandate, but perform commercial banking activities. They collect deposits from the public and use them to directly lend to firms and individuals. They act as a government agent in administering state subsidies and other programs.	(i) Return; (ii) Countercyclical/safe haven; (iii) Competition; (iv) Trust; (v) Market failures; (vi) Externalities
(iii) <b>State development banks (SDB).</b> These institutions have a policy mandate. They do not take deposits and are funded by IFIs, bonds or government transfers. They on-lend or direct lend to firms in specific sectors (SMEs, exports, agriculture, etc.).	(i) Countercyclical; (ii) Market failures; (iii) Externalities
(iv) <b>State development agency (SDA).</b> These institutions have a policy mandate. They make no loans and do not collect deposits. They provide technical assistance, issue partial guarantees, matching grants, and subsidies.	(i) Countercyclical; (ii) Market failures; (iii) Externalities
(v) <b>State narrow financial institutions (SNFI).</b> Their mandate, ultimately, is to mobilize savings. They collect deposits, but make no loans and invest only in government paper. Typically postal offices.	(i) Market failures; (ii) Externalities

*Source: Author's analysis*

24. **SOBs in Russia can be broadly categorized in three key groups – state commercial, hybrid, and development banks.** The first group comprises of larger state commercial banks/ groups, and includes Sberbank, the VTB Bank group, and Gazprombank. They do not have a policy mandate, are profit maximizers with operations virtually indistinguishable from those of private commercial banks, and target similar market segments among them.<sup>10</sup> The second group comprises of large state hybrid banks, and entails

<sup>10</sup> Notably, VTB 24, of the VTB Bank group, recently created the Postal Bank together with the Russian Post (see Technical Note on Financial Inclusion). This will allow the VTB Bank group to compete forcefully with Sberbank's wide retail network on the collection of retail deposits.

the Russian Agricultural Bank (RAB). RAB has a policy mandate (focused on agribusiness<sup>11</sup>), and performs commercial banking activities, collecting retail deposits and lending directly to firms and individuals. The third group comprises of large state development banks, and entails the Russian Development Bank (VEB group). The VEB group has a policy mandate (broad, and subject to the legal clause to not compete with commercial credit institutions)<sup>12 13</sup>, on-lends or directly lends to firms, but does not collect retail deposits. Globexbank and Sviazbank are noticeable exceptions among VEB subsidiaries. The two banks were bailed out by the VEB during the crisis of 2008, and are expected to be sold to the DIA in the near future. Finally, a fourth group consists of smaller SOBs that primarily pursue commercial activities and are mostly owned by Regional Governments or Territorial Administrations. For a more detailed discussion on the ownership of state banks please see Section B.III.

**Table 5. Diversity of SCDFIs in Europe and Central Asia**

Country	Institution	SCDFI type	State Own. (%)	Market Share (%)	Instruments	Deposits (Y/N)	Law (Y/N)	Superv.
BG	Bulg. Dev. Bank	SDB	99.99	2	DL, OL, G	Y	Y	CB
DE	KfW	SDB	100	6	OL	N	Y	SA*
DE	Bayerische Landesbank	SCB	75	3	DL, OL	Y	Y	SA
HU	Hung. Exim Bank	SDB (Exim)	100	1.7	DL, OL, G	N	Y	M
ES	Instituto de Crédito Oficial	SDB	100	3	DL, G	N	N	CB
FR	Caisse des Dépôts et Consignations	SHB	100	2	DL, I	Y	Y	CB
IT	Cassa Depositi e Prestiti	SDB	80	10	DL, G	N	N	CB
PT	Caixa Geral de Depositos	SCB	100	21	DL	Y	N	CB
SE	Svensk Exportkredit	SDB (Exim)	100	3	DL, G, I	N	N	SA
TR	Turkiye Vakiflar Bankasi	SCB	58.45	8	DL, G, I	Y	Y	CB

Notes: DL=Direct Lending, OL=On-Lending G=Guarantees, I=Insurance; CB= Central Bank, SA= Supervisory Authority, SB= Supervisory Board, M=Ministry; \*No banking license.

<sup>11</sup> The mission of RAB is to meet the needs of commodity producers of agribusiness, fishery and forestry sectors, population and businesses of rural areas, small and medium-sized towns for qualitative and affordable banking and related financial services. This mission accommodates a hybrid role with a focus in the agricultural sector, while operating with broader commercial considerations. Characteristically, the RAB 2020 Strategy outlines a 70-75 percent concentration in the narrow agriculture/rural space, with diversification to other market segments to support risk, funding and income diversification.

<sup>12</sup> See Federal Law ‘Bank for Development and Foreign Economic Affairs (Vnesheconombank)’, published in «Rossiyskaya gazeta» on May 24, 2007; Memorandum on financial policies of state corporation ‘Bank for Development and Foreign Economic Affairs (Vnesheconombank)’, approved by Directive of the Government of the Russian Federation#1007-r dd. On July 27, 2007.

<sup>13</sup> VEB group’s bank subsidiaries with a developmental focus have more focused mandates. RoseximBank’s mission is to provide Russian exporters access to convenient credit instruments and to create an infrastructure that will enhance the competitiveness of Russian national business abroad. SME Bank’s mission is the development of small and medium-sized businesses in Russia through SME financing in line with state priorities and VEB’s targets.

25. **An important feature in Russia is the diffusion of state ownership and control (see Table 6).** Ultimate state bank ownership is spread among the CBR, the Federal Agency for Property Management (FASPM), the DIA, regional authorities, and Ministries. It is frequently indirect, through holding companies or SOEs, and intertwined, with a state entity owing shares of another. As a consequence, not only is control diffused, but supervision is also hampered (see Section B.III “Ownership Function”).

**Table 6. Complexity of State Ownership (Part I)<sup>14</sup>**

	<b>Bank / Bank Group</b>	<b>State Ownership</b>	<b>Notes</b>
1	Sberbank	CBR (50 percent and 1 voting share)	
2	VTB Bank Group		Holding Company
	VTB Bank	Voting rights: FASPM (60.93 percent); RAB (2.48 percent); Otkritie Cap. Int. Lim (1.77 percent) o/w VTB Bank owns 9.99 percent of shares	Corporate banking
	VTB24	VTB Bank (99 percent)	Retail banking
	BM-Bank PJSC	VTB Bank (100 percent)	
	Pochta Bank	VTB24 (50+1); MoF via Russian Postal Office (50-1)	Previously Leto Bank
3	Gazprombank	Voting rights: Gazfond (49.65%), Gazprom (35.54%), VEB (10.19%)	
4	Russian Agricultural Bank	FASPM (71.302); MoF (7.649)	
5	VEB Group		
	Sviaz-Bank	VEB (99.65%)	Bailed-out
	Globexbank	VEB (99.99%)	Bailed-out
	SME Bank	SME State Corporation (100%)	Second-tier
	Eximbank of Russia	VEB (99.9999%) via RosExportCenter	Exim profile, aka RoseximBank
6	Bank Rossiysky Capital	DIA (100%)	Under recovery
	Sotsinvestbank	Bank Rossiysky Capital (100%)	
7	Novikombank	Rostech (30.65%), Rosoboronexport (21.273%), Astrofizika (10%)	
8	Russian Reg. Dev. Bank	Rosneft oil company (84.67%), Rosagroneftproduct oil company (9.52%), RegionFinansResurs (5.81%)	
7	Russian National Comm. Bank	FASPM (100%)	
8	Cetelem Bank	Sberbank (79.2%)	
9	Evrofinance Mosnarbank	Gazprombank (20%), VTB bank (7.987%), VTB France (7.965%); Gazprombank via Novfintech (5%)	
10	GPB Mortgage	Gazprombank (80.8 percent)	
11	Credit Ural Bank	Gazprombank (57.3 percent), Gazprombank via Novfintech (42.7%)	
12	Fondservicebank	Novikombank (99.9 percent)	
13	Russia Finance Corp. Bank	ROSOBORONEXPORT (100 percent)	
14	Denizbank Moscow	Sberbank (99.85%) through Denizbank Turkey (49%) & Austria (51%)	

Source: Annual Reports, IFRS statements

<sup>14</sup> This table captures information based on publicly available data only, and it points accordingly to different data i.e. shares in statutory capital or voting rights.

**Table 5. Complexity of State Ownership (Part II)**

	<b>Bank / Bank Group</b>	<b>State Ownership</b>	<b>Notes</b>
<i>Regional Governments or Territorial Administrations</i>			
15	AK BARS Bank	Regional authorities of Tatarstan (40.3%); Svyazinvestneftehim (14.7%)	
16	JSC Krayinvestbank	Regional authorities of Krasnodar Region (98%)	
17	Almazergienbank	Ministry of Property and Land Relations of the Republic of Sakha (85.82%); FASPM via NizheLenskoe (10.9%)	
18	Bank Orenburg	Regional authorities of Orenburg Region (99.4%)	
19	Elita Bank	Regional authorities of Kaluga Region (100%)	
20	Kubansky Universalny Bank	Admin. of the Municipal City of Krosnodar (98.944%)	
21	Yoshkar-Ola Bank	Regional authorities of Republic of Mari El (77.9%)	
22	Narodny Bank Respubliki Tyva	Regional authorities of the Republic of Tuva (90.597 %)	

*Source: Annual Reports, IFRS statements*

## **Broader Strategic Considerations**

26. **Policy maker’s decisions with regard to SCDFIs often evolve around idiosyncratic country characteristics, and their strategies for the structure and evolution of the financial sector.** Policy makers, including the Ministry of Finance and Central Banks (or Bank Supervisors), are typically faced with a wide range of choices on how they would like to shape their countries’ financial sectors. For example, a number of western Europe and Central Asia (ECA) countries made the choice of encouraging a high degree of foreign entry in their banking sectors prior to the global financial crisis, indirectly limiting the role of domestic players, including SOBs. The rationale was that foreign banks add to competition, increase access to finance, and bring greater financial stability. Key factors behind these arguments included the introduction of new products, modern technologies, know-how spillovers, as well as the flow of wholesale funding from parents abroad. The possibility of joining the European Union was catalytic in this trend. Following a very different approach, a number of eastern ECA countries did not attract foreign investors or encouraged a higher degree of domestic and, often, state ownership in their financial systems. The transition from central planning, which begun in the late 80s and heightened in the 90s, was particularly challenging for them with regard to the financial sector (compared to the privatization of State-Owned Enterprises - SOEs-, trade and foreign exchange reforms, and price liberalization), and followed a more gradualist approach.<sup>15</sup> This is partially explained by deep weaknesses in the financial sector such as a high prevalence of NPLs, unsuccessful privatizations leading to the emergence of strong domestic interests, and limited political will for change routed in the belief that a degree of national control over the banking system underwrites national security. It should be noted, that national security concerns over the financial sector are common worldwide given the central role that finance plays in an economy – for example, a large debate is taking place in the US in 2016 over a proposed takeover of the Chicago Stock Exchange by a group of Chinese investors, with lawmakers wishing to submit the deal to a national security review.

<sup>15</sup> “25 years of transition: post-communist Europe and the IMF“, 2014, International Monetary Fund; “Economic Growth in the 1990s: Learning from a Decade of Reform“, 2005, World Bank.

27. **A key debate that has emerged from the global financial crisis is on the role of state bank ownership as it relates to dealing with and overcoming financial crises.** High foreign participation exposed many western ECA countries to foreign shocks, with the global financial crisis triggering deleveraging and banking instability. Banks with high levels of foreign funding and subsidiaries with weak parents experienced large funding reductions, changing dramatically bank business models (with foreign bank branches ring-fenced into subsidiaries) and funding patterns (with domestic deposits substituting cross border flows). As foreign banks were suddenly perceived as a source of risk, as credit growth collapsed, as depositors looked for safe havens, and as failed banks had to be resolved -all events with high political consequences-, many policy makers begun reconsidering the role that SOBs can play in their financial systems. Although the benefits of foreign participation continued to be recognized, many policy makers saw state bank ownership as a possible tool to jump start credit flows, retain formal savings, and provide solutions in bank resolutions. Eastern ECA countries are currently experiencing similar pressures. Oil-exporting countries in eastern ECA face the difficult adjustment to low commodity prices, with adjustments in sharp real depreciations, job losses, falling asset prices, and increased fragility in partly dollarized financial sectors. Very similar adjustments are taking place in neighboring countries with strong links to oil exporters through remittances and trade flows. As financial sectors come under pressure, the role of the state is becoming a central discussion.

28. **The Russian financial system has and is facing similar obstacles and policy dilemmas.** The 1990's saw a decrease in state ownership, but the failure of systemically important private commercial banks in 1998 triggered a reversal. The 2008 global financial crisis raised the importance of state ownership, with SOBs, such as Sberbank, playing a safe harbor and further solidifying their dominance in deposits, and VEB serving as bail-out vehicle in the case of Globexbank and Sviazbank. The authorities also played a critical role in December 2014 with the recapitalization of banks through a one-off capital support program. Funds from the Federal Budget and the National Wealth Fund initially worth about 2 percent of GDP were allocated for the recapitalization of 27 large banks<sup>16</sup>, accounting for 43 percent of system assets, smaller banks affected by the sanctions and selected regional banks. The capital support program was subsequently reduced as estimates of capital needs were decreased. The capital support program came with a number of strict conditions, including raising funds equal to at least 50 percent of the government's support; increased monitoring; a commitment to increase credit to selected sectors by 1 percent monthly for three years; and a three-year ban on increasing management salaries and the overall wage bill of the bank.

## **Refocusing the Role of the State**

29. **While the debate of state intervention is destined to continue, SCDFIs remain a part of financial systems worldwide and policy makers need to address their shortcoming.** Undertaking an analysis of the rationale that may justify state intervention is critical. The authorities will have to, subsequently, prioritize reforms to overcome the underlying fundamental failure that justifies state intervention in the short term. The impact of such reforms may take a long time, and may cover a wide spectrum – for example on macro, financial regulation and supervision, financial infrastructure and capital markets. At the same time, authorities will need to undertake an assessment of whether existing SCDFIs perform the interim functions that the identified state intervention rationale and state strategy dictate. For example, justifying a pure SCB may be difficult, particularly if the financial system enjoys broad competition and trust by depositors. At the same time, state development oriented institutions (all SCDFIs,

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<sup>16</sup> This excluded Sberbank due to CBR's ownership. CBR, however, did authorize to support Sberbank with capital injections as needed.

with the exception of SCBs) may require reforms along three key dimensions – their mandate, the instruments deployed, and their governance structure.<sup>17</sup>

30. **In the case of the Russian Federation, the authorities should continue pursuing the gradual privatization of state-owned commercial banks, as economic conditions permit.** The authorities are pursuing a path of gradual privatization for state commercial banks, facing adverse conditions in the short term. The current thinking, but not explicit policy, evolves around the gradual divestment of state ownership among state commercial banks with more direct control. The sale of a 7.6 percent stake in Sberbank in 2012 brought CBR’s ownership to 50 percent plus one voting share in terms of statutory capital. The sale of VTB Bank group shares in 2013 brought state ownership down from over 75 percent to just above 60 percent in terms of voting shares, with a further sale being explored currently by the Federal Agency of Property Management (FASPM). Further divestment is, however, dependent on securing anchor investors. Furthermore, a drop below a controlling interest (particularly as it relates to Sberbank) may be weighed against the safe-harbor benefits state ownership of commercial banks provides in times of instability. It should be noted that a smaller bank (but with a wide retail network) and/or smaller state controlling interest (i.e. below 50 percent) could still perform this function.

31. **State development oriented institutions should have clear mandates driven by the state intervention rationale.** Mandates should include a target sector that directly emanates from the market failure or externality the state aims to address. As a consequence, a well targeted mandate should ensure that the state intervention has no significant market distortion and, instead, complements private banks. The concept of “gap-filling” is essential in the mandate of such institution. For example, SMEs may be too large for microfinance institutions and too small for corporate banking models because they are considered too risky or too costly to service; trade financing may be hampered by risks associated with the complexity of international trade; banking services in remote areas may be too expensive to service; or agriculture financing may be too complex due to risks associated with crop yields. When more than one state institution is present in a country, strong coordination and clear mandates become essential to avoid overlaps that lead to inefficiencies. With regards to financial sustainability, the mandate should include an objective that state development oriented institutions generate enough resources to be financially sustainable over time, so as not to be a financial burden to the state. However, the SOB objective should not be to maximize profits, since this creates the market failure that the institution is trying to address in the first place.

32. **The countercyclical role of the SCDFIs does not need to be explicitly defined in the mandate, yet governance mechanisms should address its timing and duration.** Such mechanisms may include a protocol to communicate a change in the authorities’ priorities. In order to avoid compromising the financial stability of the institution, the shareholder should be willing to support these additional risks with capital. Importantly, mechanisms should be set up to ensure that the activities and balance sheet of the SCDFI contracts as overall financial sector activity recovers.

33. **The selection of instruments by SCDFIs should depend on the intervention rationale, with a preference for indirect market friendly structures.** Table 7 offers a range of SCDFI instruments. The structure and degree of institutional development of the country’s financial system should be taken into account. Overall, direct lending by state development oriented institutions should be undertaken in market segments not covered by the private sector. Market segments can be defined in different ways, e.g. by client type, maturities offered, security levels available etc. Importantly, direct lending requires highly specialized risk management, strong credit underwriting skills, and an efficient operational functioning. On-lending by state development oriented institutions, on the other hand, limits the scope for political interference and

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<sup>17</sup> “Development Banks: Role and Mechanisms to Increase Their Efficiency.”, 2011, Eva Gutiérrez, Heinz P. Rudolph, Theodore Homa, and Enrique Blanco Beneit, Policy Research Working Paper 5729, World Bank.



distorting competition, and enables the channeling of a higher volume of resources at lower costs since it leverages the infrastructure of other financial intermediaries. Risk sharing facilities are another indirect and market-friendlier way for state intervention, with the additional benefit of allowing the leverage of public resources. Regarding non-financial products, capacity building and training programs for existent and prospective clients (financial intermediaries and ultimate beneficiaries) can increase the sustainability of state intervention through financing.

**Table 7. Typology of SCDFI instruments**

<b>Typology</b>	<b>Use</b>
(i) <b>Direct lending</b> (aka first-tier, retail). SCDFI direct provision of finance to the ultimate beneficiary. Finance can be a regular loan, leasing, or factoring.	Targeted approach, when ultimate beneficiary or location is too expensive for private financial intermediaries to serve.
(ii) <b>On-lending</b> (aka second-tier, wholesale). SCDFI on-lending to financial intermediaries for their direct provision of finance to the ultimate beneficiary. Finance can be a regular loan, leasing, or factoring.	Lower cost and risk management burden for the SCDFI. Limited scope for political interference and market distortion. Higher demonstration effect.
(iii) <b>Risk sharing facilities</b> . SCDFI offering of credit guarantees that partially offset loan losses by private financial intermediaries upon the ultimate beneficiary's default.	Leverage public resources. Alleviate enterprise collateral constraints, and financial intermediary risk aversion.
(iv) <b>Grants</b> . SCDFI direct or indirect (through third parties) provision of grants.	Achieve socially desired objectives, ensure equitable income distribution.
(v) <b>Non-lending products</b> . SCDFIs offering advisory services, capacity building, and training programs to financial intermediaries or ultimate beneficiaries.	Strengthen financial intermediaries or ultimate beneficiaries, typically complemented by financing.

*Source: Author's analysis*

34. **Good governance plays an important role in avoiding government interference in credit decisions** (see Section B). It creates a clear differentiation between the rights and responsibilities of the SCDFIs' different stakeholders - including the shareholders, the board of directors and the management. Many of the problems that commonly affect SCDFIs, can be associated with, if not attributed directly to, weaknesses in corporate governance.

35. **In the case of the Russian Federation, there may be benefits to revisiting the role and structure of the state hybrid and development institutions, with corporate governance reforms being a priority.** The authorities are currently not exploring state divestment from state banks with a developmental mandate, which is not unusual for this type of banks. RAB enjoys a narrow focus, but is characterized by an inherent contradiction between its profit-oriented banking and high-risk-of-loss social policy mandate (with annual capital injections). Notably, as profitability in the agricultural sector suffered in recent years, the bank's portfolio moved away from agribusiness to compensate through diversification. The VEB group, bailed out banks aside, is characterized by two key functions. First, the Roseximbank of Russia performs traditional exporters support, the EXIAR provides export insurance coverage, and the SME bank is a narrow mandate market-friendly instrument institution (focused on on-lending to SMEs through other financial intermediaries). Second, under its wide mandate, VEB group acts as a quasi-fiscal agent in support of a wide range of projects, including strategic priorities, infrastructure and post-2008 anti-crisis measures. Both RAB and the VEB group would benefit from corporate governance reforms to build autonomy and effectiveness. To support long term sustainability, the authorities would benefit by the introduction of law or regulation obliging: (i) the government not to impose the subsidy of any programs

without paying the difference between the bank's regular interest earning and the applied rate; (ii) SOBs not to charge an interest rate that is less than its cost of funding.

36. **State-owned financial institutions should not be used to bail out struggling commercial banks.** This practice can undermine the financial soundness of state-owned financial institutions, and is also not consistent with transparent and efficient public finances. Irrespective of the privatization path, any benefits from the bail-out functions that SOBs performed in the past should be eliminated under an appropriately funded mechanism for the deposit insurance scheme (see technical note on Safety Net and Crisis Management).

37. **The implementation of state programs or public service obligations by SOBs should be transparently accounted and financed by external sources.** When state commercial and hybrid banks support the implementation of state programs, these are not accounted transparently as distinct activities, thus potentially undermining the soundness of these banks. In addition, some SOBs face implicit public service obligations, including maintaining branches and agencies in remote areas despite being unprofitable (with the bill paid by the profits generated by the bank). Many countries have formally tackled this issue by ensuring that public service obligations are funded by external financing sources, including annual allocations in the government budget or specific tax exemptions.

38. **In other respects, the administration of financial subsidies appears to follow a number of good principles, although coordination could be improved.** Both state and private banks can act as a government agent in administering state financial subsidies and other programs. Subsidies are funded directly from the budget, and are administered as a transfer of the difference of the market-based pricing from that extended. The multiplicity and lack of coordination of financial subsidy programs, however, can lead to ill-targeting, duplications, and even “double-dipping” by beneficiaries. The authorities would benefit from the establishment of a subsidies bureau for coordination, as well as to assess the impact of the programs.<sup>18</sup>

#### **Box. Subsidies and Programs**

Subsidies and targeted programs are another form of state intervention in the financial sector, typically advocated under the same rationale as SCDFIs, and frequently administered through SCDFIs. As a general principle, subsidies and targeted program should have a clear mandate, avoid duplications (and “double-dipping” by beneficiaries), be funded directly from the state budget, be open to multiple financial intermediaries (private and state owned), and be continuously evaluated on their impact. A centralized unit focused on subsidies and programs can significantly contribute to achieve these objectives. SCDFIs must, in particular, transparently account for the targeted programs and subsidies – and the latter should be clearly backed by transfers by the state to compensate for the gap between market and subsidized pricing.

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<sup>18</sup> Mexico has made progress in establishing such a subsidies bureau. A Federal Programs Restructuring Committee analyzed multiple programs in order to rationalize them and make them work more efficiently, with a Decree including specific measures such as on a beneficiaries' register, an intermediaries register, and minimum prudential and accountancy rules of the financial intermediaries channeling the subsidies.

## B. CORPORATE GOVERNANCE

### I. Introduction

39. This Section of the TN does not offer a formal assessment against the Basel Committee's Principles for Enhancing Governance; rather, it assesses key issues and provides a set of recommendations to the authorities with the view to strengthen state bank governance and the State's ownership structures in the Russian Federation. The review did not evaluate governance in the other private commercial banking institutions. The mission did not assess the governance of the VEB since it does not operate as bank. Furthermore, the mission was not able to meet with this institution despite multiple requests. Any information on the VEB is based on publicly available information. Annex 2 offers insights into the bank governance review methodology, the importance of corporate Governance, as well as key tenets of effective corporate governance in state-owned banks.

### II. Legal and Regulatory framework

40. **The corporate governance legal framework, in particular, as it relates to banks, has been a priority reform agenda for the Russian government since the transition.** Key initiatives have been implemented across the banking sector to improve disclosure (e.g. implementation of IFRS standards, disclosure of ownership, and publication of comprehensive annual reports); board effectiveness (e.g. election of independent directors and creation of subcommittees of the board); and risk, audit and internal controls (e.g. separation between risk, audit, compliance and internal control functions, ensuring that the heads of internal audit report directly to the board, creation of independent risk management departments, and recruitment of chief risk officers). SOBs have also embraced these positive changes, as they are required to operate in the same legal and regulatory environment as private banks.

41. **Banks in Russia are incorporated as Joint Stock Companies or Limited Liability Companies and, therefore, their corporate governance framework is set forth by the Civil Code<sup>19</sup> (CC), the Joint Stock Company (JSC) Law<sup>20</sup>, the Limited Liability Companies (LLC) Law<sup>21</sup> and the Law on Banks<sup>22</sup> (LoB).** Furthermore, the Central Bank of Russia (CBR) has issued additional regulations on risk management, internal controls and disclosure to complement the existing regulatory framework. The CC establishes the available corporate forms, including the Limited Liability Company, Public Joint Stock Company and Non-Public Joint Stock Company.<sup>23</sup> The JSC Law provides for the different corporate governance structures and duties, including the general shareholders meeting, supervisory board and management board. In addition, it provides regulation on related-party transactions and major transactions; election and removal of directors; dividend policy; preemptive rights; squeeze out rules; director duties and director liability regime; disclosure procedures and external audit requirements. The Law on Banks outlines, inter alia, the requirements to become a shareholder, a supervisory board or management board member of a bank, conflict of interest regulations, and disclosure requirements. Article 11.1-1 of the LoB also charges the banks' supervisory board members with additional good practice duties, such as approving the strategy, ensuring capital adequacy and approving the procedure for managing major risks; approving remuneration policies of high level executives; and evaluating the performance of the management board. Additional

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<sup>19</sup> Federal Law 51 of November 30, 1994 (as amended)

<sup>20</sup> Federal Law 208 Of December 26, 1995 on Joint Stock Companies (as amended).

<sup>21</sup> [Federal Law 14 of February 8, 1998 on Limited Liabilities Companies (as amended).]

<sup>22</sup> Federal Law on Banks and Banking Activities December 2, 1990 (as amended)

<sup>23</sup> Federal Law No. 99-FZ 'On Amendments to Chapter 4 of Part 1 of the Civil Code of the Russian Federation and on Invalidation of Certain Provisions of Legislative Acts of Russian Federation'

corporate governance requirements in the case of listed banks are laid out in the Securities Law<sup>24</sup>, and Listing Rules of the Moscow Stock Exchange, including disclosure procedures, inclusion of independent directors, establishment of sub-committees of the board, corporate secretary duties and internal audit structures and standards.

42. **Banks operating in the Russian market are under the supervision of the Central Bank of Russia.** All commercial banks, including SOBs (with commercial or developmental mandates), are under the supervision of the CBR. The only exception to the rule is the VEB since its incorporation act exempts the institution from the CBR's supervision (for a more detailed discussion on the VEB Bank, please read the Ownership and Structure section).

43. **The CBR plays an important role in the corporate governance of Russian banks.** First, the CBR is in charge of conducting the "fit and proper" tests of individuals and legal entities - founders (shareholders, owners) of more than 10 percent of the shares of a credit institution, the persons, establishing (exercising) control over shareholders (owners), and the CEO of these legal persons, supervisory board members and high level executives, including the CEO (Article 16 LoB). The CBR ensures that fit and proper requirements are met on an-ongoing basis (Article 60 of the CBL). Second, the CBR controls the ownership and transfer of shares of all banks (Article 11 LoB and Article 61 of the CBL). Any person or entity acquiring more than 10 percent of the shares of a bank requires clearance from the CBR. Third, the CBR controls compliance with corporate governance rules (disclosure, supervisory board composition and risk management, internal audit and internal control functions) during its supervisory process. Fourth, the CBR, in addition to being the banking sector regulator, is also the capital markets regulator. Therefore, any bank listing shares in the Russian capital markets is under additional scrutiny by the CBR to ensure compliance with the securities regulations. Currently, the CBR is in a conflict of interest position, since it is the major shareholder of Sberbank (see Ownership Function Section), the largest Russian commercial bank, and is also the banks and securities regulator.

44. **The CBR adopted a new Corporate Governance Code in 2014.** The corporate governance code is a voluntary document for all companies (listed and non-listed). The corporate governance code focuses on the rights of shareholders (including recommendations on electronic voting, information on annual meetings and dividend rights); the role of the board (including definition of the role and the duties of board members, functions and organization of the work of the board through specialized committees); the role of independent directors, including a detailed definition of independence; remuneration policies for management boards and high level executives (e.g. short term versus long term incentives); risk management and internal controls; disclosure of material information; and protection of shareholders in major corporate actions. The Code has been well-received, as it clarifies some loopholes of the existing legislation (particularly, in the case of director duties and definition of independence). However, some stakeholders have found it too prescriptive and imposing complex obligations on issuers. Since the adoption of the code is very recent, it is difficult to assess the level of implementation by issuers at this point. The CBR could implement a structured monitoring framework to measure the level of implementation of the Code.<sup>25</sup>

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<sup>24</sup> Federal Law 39 of April 22, 1996 (as amended); Bank of Russia Regulation No. 534-P On Securities Admittance to Organized Trades.

<sup>25</sup> Please note that Ordinance of the Bank of Russia No. 2005-U of April 30, 2008 "On estimating banks' economic position" sets out procedure and list of questions for quarterly assessment (both by banks and by the CBR) of substantial elements of corporate governance, such as risk management, internal control, strategy, motivation. The CBR issued list of questions for corporate governance self-assessment by the credit institution (Letter of the Bank of

45. **Despite the important improvements on the corporate governance legal framework, some shortcomings remain.** The definition of related-party transactions, as provided by Article 81 of the JSC Law<sup>26</sup>, does not take into consideration the complex ownership structures in the Russian market. In addition, the laws are not very clear regarding the duties of supervisory board members. Furthermore, the judicial system has limited knowledge and capabilities to enforce effectively corporate governance rules. The court system in Russia is considered to lack independence and objectivity, and is not seen as a good source of shareholder redress. Court actions are considered to be expensive and slow.<sup>27</sup> Over the years, courts have not issued case law related to corporate governance, particularly in the case of director duties, making the practical enforcement of corporate governance very unpredictable.

46. **Russia has not developed an ownership policy or a general legal framework to regulate the corporate governance of its SOBs.** As it will be explained in the following sections, the ownership of Russia banks is scattered. The multiplicity of owners have resulted in various levels of application and compliance of corporate governance. To bring greater clarity and consistency to ownership issues, some countries have developed comprehensive ownership policies as a tool for communicating expectations and good practices to shareholders, boards, and management. Ownership policies provide the legal framework necessary to ensure consistent application across the board of key corporate governance functions including board and CEO nomination procedures, board evaluation, performance monitoring, remuneration, internal controls and disclosure and management of public service obligations. If concentration of ownership functions is not possible in the short and medium term, the development of such a general legal framework applicable to all SOBs regardless of the owner can contribute significantly to the improvement of corporate governance in practices in SOBs and more importantly improve the role of the state as the owner of banks. A few countries such as Colombia and Norway have developed such policies to ensure consistent application of good corporate governance practices across the SOE sector.

### **III. Ownership Function**

47. **The ownership of Russian SOBs is complex and scattered compared to other jurisdictions.** Multiple ownership arrangements exist, and different government agencies including the CBR, the FASPM, VEB, the Deposit Insurance Agency (DIA), several administrative regions, SOBs and SOEs exercise controlling rights in close to 36 SOBs, some of them of systemic importance (see Tables 3, 4 and 5). In many other jurisdictions, the ownership of SOEs and SOBs has been consolidated under a single entity (see Box 3) or a specialized SOB ownership entity (see Box 4).

#### **Box 3. Khazanah Nasional: An Investment Company in Malaysia**

As the investment-holding arm of the government of Malaysia, Khazanah Nasional's main objective is to promote economic growth and make strategic investments on the government's behalf. Incorporated in 1993 as a limited-

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Russia No. 11-T of February 7, 2007). In addition, The CBR issued a list of questions for corporate governance self-assessment by the banks to be conducted annually (Letter of the Bank of Russia No. 11-T of February 7, 2007).

<sup>26</sup> A related party is defined by the JSC Law as a supervisory board or management board member, a 20 percent shareholder, a "person who has the right to give a company instructions which are binding", and their affiliates, who either directly or indirectly (beneficiary, through representatives) participate in the transaction, hold board or management positions, or are 20 percent shareholders in the company on the other side of the transaction (this note contains definition of an affiliated person stipulated by the Anti-Monopoly Law. Definition of related parties is stipulated by Section 64.1 of the CBR Law. Furthermore, the definition of related party will be enlarged by Section 64.1 of the CBR Law which comes into force on 1st of January 2017

<sup>27</sup> Corporate Governance ROSC Russian Federation 2013.

liability company and governed by the Companies Act, Khazanah is a wholly owned entity of the government, entrusted with holding and managing the state's commercial assets and undertaking strategic investments in new sectors and markets. One share is owned by the Federal Land Commissioner and all other shares are owned by the Minister of Finance (Inc.), a corporate body established pursuant to the Minister of Finance (Incorporation) Act, 1957. Khazanah holds investments in more than 50 government-linked corporations (GLCs) in which the government has a direct controlling stake, valued at about US\$25 billion, in a range of sectors, including finance, telecommunications, utilities, communication services, property development, information technology, and transportation. Khazanah's nine-member board, made up of public and private sector representatives, is chaired by the prime minister and assisted by executive and audit committees. The management team consists of professionals with financial sector experience. Khazanah does not participate directly in GLC management. Instead, its main roles are to ensure the appointment of qualified boards and senior management, push through high-quality business strategies, develop key systems and controls (such as governance, risk management, and internal audit), and monitor progress and performance. A main focus for Khazanah is the transformation of GLCs (those in which the government has a direct controlling stake). Khazanah is funded by the retention of returns generated through its investments, as well as by the issuance of bonds.

Since 2004, one of Khazanah's most important tasks has been to improve the corporate governance of GLCs to increase shareholder and strategic value. It acts as secretariat to the Putrajaya Committee on GLC High Performance, an inter-ministerial committee formed to oversee the GLC Transformation Program. The program has taken a number of steps, including replacing senior managers with seasoned professionals, developing key performance indicators, adopting the GLC Transformation Manual (with guidance on corporate governance), developing performance contracts and an incentive system for managers, removing government officials with a regulatory role from company boards, and requiring all suppliers to bid for contracts.

A clear mandate, combined with operational autonomy, has enabled Khazanah to work closely with government-linked companies on the restructuring process and to recruit and dismiss enterprise managers on the basis of performance. According to a 2008 study, the aggregate annual earnings of the largest GLCs nearly doubled between the start of the program in 2004 and 2006, thanks to improved corporate governance and other reforms undertaken in the companies as the world economy reached its peak. In addition, the total shareholder return of the companies outperformed the Kuala Lumpur Composite Index by 3.3 percent in November 2007, while market capitalization increased by 83 percent. Reflecting its investment focus, the net worth of Khazanah's investment portfolio has shown substantial volatility. It rose by about 60 percent between 2004 and 2008. The 2007–08 financial crisis wiped out nearly all the gains in share value that the GLCs had earned. By the end of 2012, however, the portfolio had recovered, and the net worth of the portfolio had shown a compound annual growth rate of 11.8 percent since the GLC Transformation Program began in 2004.

*Source: State Owned Enterprise Toolkit, World Bank Group 2014.*

#### **Box 4. State Holding Company in China: Huijin Investment Company Ltd.**

Central Huijin Investment Ltd (Central Huijin) is a state-owned company incorporated in accordance with China's Company Law, and is a wholly-owned subsidiary of China Investment Corporation. Established in 2003, its mandate is to exercise the rights and responsibilities as an investor in major state-owned financial institutions on behalf of the State. In 2007, the Ministry of Finance issued special treasury bonds and acquired all the shares of Central Huijin from the People's Bank of China (the central bank). The acquired shares were injected into China Investment Corporation (CIC) as part of its initial financial contribution. CIC owns the shares of Central Huijin but the investment business of CIC and the share management function conducted by Central Huijin on behalf of the state are separated. The members of Central Huijin's board of directors and the board of supervisors are appointed by and are accountable to the State Council.

Central Huijin, as authorized by the State Council, makes equity investments in major state-owned financial institutions and exercises the state's shareholder and performs the obligations as an investor on behalf of the State in accordance with the applicable laws. The goal is to preserve and enhance the value of state assets. By the end of 2014, it held stakes in 19 state-owned financial institutions (banks, insurance companies, securities companies, asset management companies).

It has established internal procedures and policies for corporate governance of its companies, many of which are incorporated in its Articles of Association. Central Huijin makes equity investments in the financial enterprises and carries out other relevant functions as authorized by the State Council. The company's board of directors has not

less than five members appointed by the State Council with a three year term (renewable). The board of supervisors has not less than 3 members appointed by the State Council.

Central Huijin's structure consists of ten departments, covering banking (two departments), insurance, securities, management, legal and compliance, public relations and international cooperation, financial and accounting, and human resources.

*Source: www.huijin-inv.cn*

## Existing ownership arrangements

### 1. Central Bank of the Russian Federation

48. **The CBR owns 50.0 percent plus 1 share of Sberbank, the largest Russian commercial Bank which controls 27.9 percent of the market share.** The remaining 47.68 percent of the bank shares are traded in Moscow, Frankfurt and New York (under ADR, American Depositary Receipts) stock exchanges. Despite the strong financial performance of the bank, its ownership presents serious conflicts of interests. The CBR is the “mega regulator” of the financial sector, as it is in charge of supervising financial institutions, insurances and listed companies. Interviewed market participants (including major public and private competitors) do not feel that Sberbank has received any preferential treatment despite its unusual ownership structure. The CBR has explained that clear measures have been taken over the years to ensure a separation between the ownership function of Sberbank and the supervisory function of the CBR. Although this ownership arrangement appears to have worked reasonably well in practice, in particular thanks to a strong and professional management team at Sberbank, it may impede the longer-run transition to a more market-oriented and competitive banking system, and raise doubts among potential private investors in the banking sector about the authorities' commitment to providing a level playing field. This issue has been raised by different development partners, including the OECD, particularly, in the context of the accession process.

49. **Despite the separation of the supervisory and ownership function explained by the CBR, an independent “shareholder unit” in charge of exercising the ownership rights of Sberbank does not exist in the organizational chart of the CBR.** A unit in charge of exercising the shareholders rights over Sberbank on behalf of the CBR, including supervisory board nominations, financial performance monitoring and participation on annual shareholders meeting does not exist. According to interviews with staff of the CBR, the above-mentioned issues are handled by the board of directors of the CBR. The CBR has not issued official nomination policies or performance monitoring frameworks. Dividend policies are proposed by the supervisory board of the CBR and approved by the shareholders as per JSC Law requirements.<sup>28</sup> The way the CBR exercises its ownership rights over Sberbank remain opaque. Some informed stakeholders mentioned that the CBR follows a hands off approach regarding its ownership rights and most issues are handled by the supervisory board and the management board. However, other stakeholders explained that major decisions related to Sberbank are made at the highest level of the Russian Government. In case further divestment by CBR or consolidation of ownership under one roof for SOBs in Russia is not possible or desirable, an official shareholder unit with specific and transparent terms of reference placed at an arm's length distance from the supervisory units and high level leadership of the CBR could improve the ownership function of the CBR.

### 2. Federal Agency of Property Management

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<sup>28</sup> As of FY15 Sberbank dividend policy was of 20 percent of net profits for all shareholders.

50. **The FASPM (Rosimuschestvo) exercises ownership rights over major Russian SOEs including two systemic Russian banks.** The FASPM was created in 2004<sup>29</sup> to manage the privatization process of Russian SOEs, organize the sale of confiscated property, represent the state in SOE-related disputes in courts and exercise the ownership rights of major Russian SOEs. The ownership entity operates under the Ministry of Economic Development. This agency manages a portfolio of 30 major SOEs including Gazprom (the largest gas company in the world) and Rosneft (the Russian oil company). The FASPM also owns 60.93 percent of VTB Bank,<sup>30</sup> the second largest banking group in Russia, and 71.302 percent of the RAB.<sup>31</sup> In addition, it exercises ownership rights in 20 smaller SOEs, manages the participations of the state in close to 1500 companies (minority and majority stakes), and manages more than 3000 assets (movable and immovable property) in the Russian Federation. The central office is located in Moscow and has also offices in 80 territorial divisions. The FASPM employs close to 1,200 staff (with 500 working in the Moscow office). FASPM has set up a dividend policy (Government Order № 705-r dated 18.04.2016) of 25 percent of net profits applicable to all the SOEs in its portfolio.<sup>32</sup>

51. **The FASPM exercises the functions of a standard centralized SOE ownership entity; however, it lacks autonomy due to its “dual or multiple management models”.** The FASPM manages the SOE supervisory board nomination process, represents the state in annual shareholders meetings of SOEs, monitors SOE financial performance (KPI program),<sup>33</sup> and issues corporate governance regulations and recommendations.<sup>34</sup> In practice, the ownership rights exercised by the FASPM are of dual nature: “dual management model” or a “multiple management model.” The dual management model sees the responsibility for exercising the ownership function shared between the FASPM and the sectoral ministries. Where an SOE is of primary importance for a given sector, then the ministry, rather than the FASPM, has primary responsibility for setting the ownership agenda –setting the strategic priorities, developing instructions for board members and determining voting positions. Where sectoral priorities are considered to be of secondary importance, the FASPM takes the lead role. For example, in the case of the RAB, the FASPM coordinates the positions of the Ministry of Agriculture, Ministry of Finance and Ministry of Economic Development. In the case of VTB, the FASPM coordinates the positions of both the Ministry of Finance and Ministry of Economic Development. As a result, the FASPM behaves more as a coordinator of governmental positions rather than a professional shareholder unit in search of shareholder value and financial performance (like Khazanah in Malaysia or Temasek in Singapore).

52. **The lack of autonomy of FASPM can hamper its effectiveness to implement its ownership policies consistently.** The risk of this multi-sector approach is that the diffused nature of the control mechanisms limit the capacity of the government to provide a clear mandate and deliver coherent strategic guidance and consistent application of good corporate governance practices. This may also result in opaque ownership structures, where different components of the state’s shareholdings are held by different institutions or entities. For instance, the state’s majority holdings in Gazprom are split between the state’s direct ownership of 38 per cent, held by FASPM, and an indirect holding of approximately 12 per cent held through a JSC Rosneftgaz. The FASPM is the owner of the Government’s holdings in Rosneft, against which it borrowed to purchase the stake in Gazprom. The same situation exists in the case of VTB bank,

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<sup>29</sup> Presidential Decree, №314, March 9, 2004.

<sup>30</sup> VTB Bank is listed in Moscow and London stock exchanges.

<sup>31</sup> The remaining shares 10.08 percent are owned by the Ministry of Finance.

<sup>32</sup> According to a recent Financial Times [Article](#), the following Russian SOEs will have to pay higher dividends: Gazprom, Alrosa, Bashneft, Zarubeshneft, Rushydro, Sovcomflot, Transneft, Rosneftgaz.

<sup>33</sup> KPI Program Policy: Mandatory program for all SOEs under FASPM. The program requires 70 percent of financial KPIs and 30 percent of non-financial KPIs. There are 2 mandatory financial KPIs that together should represent 30 percent of the weight of the financial KPIs: return on equity (ROE) and total shareholder return (TSR).

<sup>34</sup> The FASPM encourages Russian SOEs to adopt the corporate governance regulations issued by the CBR.



which is owned by the FASPM, but the RAB also has a minority stake of 2.01 percent. Moreover, the FASPM cannot exercise any ownership rights over the subsidiaries of the companies in its portfolio. For example, in the case of VTB Bank's subsidiaries, namely VTB 24, Pochta Bank or BM-Bank PJSC, the FASPM has no say in the governance of these banks. A more consistent and structured ownership policy can give the FASPM a more prominent role in the process of being the shareholder representative of the government in SOE and SOB boards.

### **3. Bank for Development and Foreign Economic Affairs (a.k.a. the Russian Development Bank (VEB))<sup>35</sup>**

53. **The VEB Bank is the development arm of the Russian government.** The VEB is a state corporation incorporated under its own act.<sup>36</sup> Article 3 of the VEB Incorporation Act gives this development institution a very broad mandate that includes the promotion of competitiveness, foreign investment, infrastructure development, SMEs, trade and several banking related activities. Despite its name, VEB is not a bank. VEB does not have a banking license and does not collect deposits.<sup>37</sup> Its incorporation documents exempt the institution from compliance with the JSC Law, LoB, insolvency procedures or CBR supervision. The exemptions created by the incorporation framework of VEB can create discriminatory situations vis-à-vis private sector counterparts, since the institution can negotiate unique operating conditions or exemptions. A good example of this situation is the involvement of VEB in banking sector activities through subsidiaries despite not having a banking license and not being supervised by the CBR which is not in line with its original mandate.

54. **The VEB bank is involved in commercial banking activities through four subsidiaries.** The VEB owns 100 percent of Globex Bank and Sviaz Bank.<sup>38 39</sup> It also owns Roseximbank of Russia through the Russian Agency for Insurance of Export Loans and Investments (EXIAR).<sup>40</sup> These four subsidiaries are incorporated as joint stock companies, have banking licenses and are supervised by the CBR. VEB exercises the ownership rights over these four banks. Therefore, it appoints all board members, agrees on specific KPIs with every bank and participates in the annual shareholders meetings. The VEB has no formal policies on how its ownership rights are exercised over these banks.

### **4. Regional Governments or Territorial Administrations**

55. **Regional Governments authorities, administrations and territories are also owners of commercial SOBs.** The regional authorities of Tatarstan, Krasnodar, Orenburg and Kaluga own respectively AK Bars Bank, Krayinvestbank, Bank Orenburg, and Elita Bank respectively. The regional republics of Mari El, Tuva own Tosh-kar Ola Bank Narodny Bank. Finally, the Ministry of Property and Land of the Republic of Sakha own Almazergienbank. The above-mentioned banks are considered small in terms of assets and do not present systemic risks for the Russian banking sector. Due to the small size, non-

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<sup>35</sup> The governance of VEB was not evaluated since this institution is not formally a bank. Therefore, the author of the note will briefly describe the governance of VEB in the context of its ownership function of three commercial banks. The mission tried to meet with representatives of VEB during its visit to Moscow without any success.

<sup>36</sup> Federal Law on Development Bank of May 17, 2007 and published in the Official Gazette on May 24, 2007.

<sup>37</sup> VEB does not collect deposits. However, Article 3 of its incorporating Act allows the VEB to collect deposits from corporates that are benefiting from its financing.

<sup>38</sup> The SME bank was purchased by VEB since it can help achieve its SME finance mandate. Globex and Sviaz Bank were purchased by VEB in the context of bail out operation mandated by the government.

<sup>39</sup> As of the day of the drafting of this report, there are discussions regarding the transfer of ownership of Globex Bank and Sviaz Bank to the DIA.

<sup>40</sup> EXIAR owns 100 percent of Eximbank of Russia. The Russian Export Center owns 100 percent of EXIAR. VEB owns 100 percent of the Russian Export Center.

systemic nature of these banks and geographic dispersion, the team did not assess the governance of these institutions.

## **5. Subsidiaries of state-owned banks, state-owned enterprises and state corporations**

56. **Ownership of SOBs is not limited to government agencies, as SOBs and SOEs also own controlling stakes in large systemic commercial banks.** The VTB Bank owns controlling stakes in 3 major banks, including VTB24 (99 percent), BM-Bank (previously known as the Bank of Moscow) (100 percent) and Pochta Bank<sup>41</sup> (which is a subsidiary of VTB24). The VTB Bank exercises ownership rights on behalf of the state over these 3 Russian banks and over 25 additional financial institutions across eastern and central Europe. Gazprom and Rosneft, the largest Russian SOEs with activities in the extractive sectors, own controlling stakes in Gazprombank and Russian Regional Development Bank respectively. Recently, the SME State Corporation, which is controlled by FASPM, became the new owner of SME Bank which was previously owned by VEB Bank.<sup>42</sup> The ownership rights of these subsidiaries are exercised directly by the parent company. Despite the FASPM being the ultimate beneficial owner of these banks, the agency does not exercise any ownership rights over these banks. The FASPM should exercise the ownership rights over these institutions either through its beneficial owner position or through an official transfer of the shares to the top.

## **6. Deposit Insurance Agency**

57. **The DIA owns 100 percent of the capital of the Russian Capital Bank (Bank Rossiysky Capital), which, in turn, also owns 100 percent of the capital of Sotsinvestbank.** The DIA is a state corporation in charge of managing the deposit insurance scheme of the Russian Federation. In addition, the DIA is in charge of exercising the corporate receivership, liquidation and resolution of systemic banks. The incorporating act of the DIA also allows the agency to become the legal owner of banks that are in the process of resolution which is the case of Russian Capital Bank. Recently the DIA through its investments in Russian Capital Bank purchased Sotsinvestbank.<sup>43</sup> Both institutions have recently merged their operations. Although, transitional ownership arrangements by deposit insurance schemes are not uncommon in other jurisdictions, these arrangements are usually of temporary nature. The DIA has been the owner of Russian Capital Bank since 2009, and has not sold the bank yet due to a lack of serious buyers. A sale of the institution should be pursued whenever possible.

## **Consequences of the scattered ownership arrangements**

58. **The lack on centralization of the ownership of SOBs has resulted in the inconsistent application of good corporate governance across the SOB sector.** At present, some SOBs such as Sberbank and VTB Bank have strong corporate governance practices, mainly thanks to the listing of their shares in domestic and foreign capital markets.<sup>44</sup> Others, however, lack good practices such as board committees, independent directors, strong control environment, and adequate disclosure (see following sections). In varying degrees, these shortcomings inevitably reflect the incentives created by the current ownership structure. Thought could, therefore, be given to institutional reforms that oblige the current owners to implement better practices, or even to the reassignment of ownership to other government entities

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<sup>41</sup> As of the day of the drafting of the report, Leto Bank was in the process of becoming the new Postal Bank (Pochta Bank).

<sup>42</sup> The single ownership of SME Bank is SME State Corporation, which is owned 62,5 percent by FASPM and 37,5 percent by VEB.

<sup>43</sup> Press release CBR: [http://cbr.ru/eng/press/pr.aspx?file=22092015\\_173746eng2015-09-22T17\\_34\\_15.htm](http://cbr.ru/eng/press/pr.aspx?file=22092015_173746eng2015-09-22T17_34_15.htm)

<sup>44</sup> Sberbank is listed in Moscow, London, Frankfurt and New York (in the form of ADR). VTB Bank is listed in Moscow and London

that might be better placed to make the desirable improvements (e.g. FASPM). A reform of the current dispersed and complex ownership structure of SOBs could have significant benefits.

59. **A unified ownership through a general centralized agency (e.g. FASPM) or a specialized SOB ownership entity could offer a more consistent approach towards corporate governance and more coherent ownership strategy for the sector. If centralization is not politically feasible, at least application of good corporate governance practices across all SOBs should be explored.** Many developed and emerging market countries have followed the OECD Guidelines, and established strong ownership units to drive the development and implementation of sound corporate governance frameworks and practices in SOBs. The objective of establishing a strong and specialized ownership entity is to bring greater clarity and professionalism to the state's ownership role, while reducing the scope for political involvement. More specifically, the objectives are to: i) Separate the state's ownership functions from its policy-making and regulatory or supervisory functions so as to avoid or minimize potential conflicts of interest; ii) Minimize the scope for political interference and bring greater professionalism to the state's ownership role by building specialized capabilities and concentrating scarce resources; iii) Promote greater coherence and consistency in applying corporate governance standards and in exercising the state's ownership role across all SOEs and SOBs; iv) Manage state assets in a way that protects and grows shareholder value; v) Achieve greater transparency and accountability in SOE and SOB operations through better oversight and performance monitoring. The final objective is to provide SOBs full operational autonomy and refrain from intervening in the management of the banks. This means that the ownership entity should let SOB boards exercise their responsibilities and should respect their independence. At the same time, the ownership entity should focus on exercising the state's ownership rights in an effective manner in order to protect and maximize value and to enhance transparency and accountability. In case centralization of ownership is not possible in the near future, at least consolidation of practices of key corporate governance functions including board nomination, board composition, performance monitoring and internal control systems should be thought and implemented within a predictable timeline. Consistent application of good corporate governance practices will address, at least temporarily, the shortcomings of the existing scattered ownership structure.

#### **IV. The Board of Directors Function**

60. **The board of directors is the function where key responsibilities of a bank converge.** Given that banks are considered special interest entities that play a key role in all economies, bank boards are charged with the public's trust to act responsibly and with integrity. Boards have special duties to act in the best interest of all stakeholders, not only the owners. The board must set the appropriate "tone at the top" through which it directs the manner in which the bank conducts its business - through strategic planning, risk parameters, and policies. It must set clear risk parameters within which management and staff execute the business plan. It must ensure key control functions are established and independent so that it can monitor the bank's existing and prospective risks, the overall success of its business strategy, and financial performance and soundness. As a result, the board must be composed of a balanced mix of skills and experience, must be objective, and must fulfil its fiduciary duty through prudently guiding the bank. The boards of Russian SOBs have yet to fulfil the full scope of their responsibilities.

#### **Nature, Role and Duties**

61. **The nature of Russian supervisory boards is the result of multiple legal transplants (German, British and American).** The JSC Law requires a German-based 2 tier board system (supervisory

and management boards). However, the nature of the Russian board of directors falls more between the models of the German supervisory board, and the U.S. board, including managers, “*but fails to fulfil either function adequately.*”<sup>45</sup> A more accurate description is that of a single tier board, where management is limited to 25 per cent of the seats, and where the CEO may not hold the chairman position.

62. **According to the law, the board is in charge of directing the key decisions of the banks in compliance with global good practice.** Article 65 of the JSC Law in conjunction with Article 11.1-1 of the LoB state that supervisory boards are tasked with the approval of the strategy, approval of the risk appetite statement, approval of all major risk policies (credit, market, liquidity and operational), dividend policies, and ensuring that the internal control and internal audit functions are operating in compliance with the current laws and regulations. Boards are also involved in the approval process of related-party transactions that represent less than 2 percent of the assets of the bank. Transactions representing more than 2 percent are approved by the shareholders meeting. Finally, the supervisory board reviews the financial statements; however, it does not sign them, since these are signed by the Revision Commission and the external auditor. This could weaken the accountability of the board in this key item which is accountability for the financial health of the institution.

63. **Despite the progress in different corporate governance fronts, the role of the board and, particularly, the concepts of fiduciary duties remain underdeveloped under the Russian law.** The law remains vague in terms of accountability of the board members. The JSL law requires *a director to exercise his discretion and expertise in acting in the utmost faith and best interests of all shareholders*. However, particularly in the case of financial institutions that collect deposits from the citizens, directors should have a higher duty to act in the best interest of the bank and its depositors, and not in the best interest of the shareholders. These conflicting duties dilute the accountability regime of directors, particularly, in the case of SOEs and SOBs composed mostly of directors who represent the shareholders and vote by instruction of the government (see section on the board’s authority).

## Nomination Procedures

64. **Appointment policies vary across SOBs and depend on the internal policies of the entity exercising the ownership rights.** Some ownership entities (such as FASPM) have formalized and structured procedures, while others do not have any policies, and appointments are made at the discretion of the leadership of the entity exercising the ownership rights. As a result, scattered ownership has resulted in inconsistent approaches towards the appointment of board members of SOBs. A consolidated nomination approach based on competencies and transparency could improve significantly the leadership role of boards of SOBs.

65. **The FASPM has put in place a formalized and structured appointment policy<sup>46</sup> of supervisory board members of SOEs (including SOBs); however, the process is not exempt of political interference.** The FASPM has a nomination committee in charge of organizing the election process of supervisory board members of SOBs and SOEs. This committee is composed of representatives of line ministries, FASPM and 10 civil society associations (including the Russian Institute of Directors). In practice, line ministries (mostly Ministry of Finance, Ministry of Economic Development and Ministry of Agriculture) with interests on the SOBs (VTB Bank and RAB) propose their nominees to the nomination committee of FASPM. Then, the nomination committee screens the applications and conducts interviews for the available positions and prepares a shortlist. The final list of preferred candidates is, then, submitted

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<sup>45</sup> OECD High Level Experts Meeting on Corporate Governance Development of State-Owned Enterprises in Russia, 2006, p. 5 (<http://www.oecd.org/dataoecd/28/62/38699164.pdf>).

<sup>46</sup> Decision 738 of the Government of the Russian Federation, December 3, 2004

for approval to the Minister of Economic Development. At this stage, the Minister of Economic Development can also propose additional candidates, even if they were not previously screened by the nomination committee of FASPM. Finally, the list of selected candidates is submitted for final approval to the cabinet. This procedure applies to both representatives from the government and independent directors. In case the SOE or SOB is of “strategic importance” as defined by the Presidential Decree 1009 of August 4, 2004, the prospective director must be cleared and screened by the presidential administration.<sup>47</sup> The presidential administration can also propose additional candidates even if they were not screened by the nominations commission. VTB and RAB are considered of strategic importance; therefore, prospective directors require clearance at the highest level of the Russian government. In the case of independent directors, interested candidates have to register in the roster of FASPM. However, due to the high number of applications, in practice, in order to be considered for a position, independent directors have to be “sponsored” or presented by the civil society or a private organization (Russian Institute of Directors). The nomination procedure is highly exposed to political interventions; therefore, efforts should be made to ensure the selection process is transparent and competitive.

66. **Despite the structures offered by the existing selection process put in place by FASPM, this ownership entity has no control over the nomination procedures of the subsidiaries of the SOEs in its portfolio.** In the case of the banks that are subsidiaries of SOBs or SOEs, or the banks that are under ownership of the DIA and VEB, every owner follows its own internal nomination procedures. In most cases (with only very few exceptions),<sup>48</sup> the supervisory boards of these banks are largely composed of supervisory board and/or management board members of the parent company. The FASPM should have a say on the nomination procedures of the subsidiaries of the SOEs in its portfolio either through taking the lead on the election process or by exercising a veto or clearance right on potential nominees.

67. **In the case of Sberbank, no formal supervisory board nomination policies exist and the nomination process is controlled by the board of directors of the CBR.** The CBR mostly nominates its own staff to sit in the board of Sberbank. A quick review of the profile of board members of Sberbank shows that a large portion of them are high level staff of the CBR (mostly deputy governors). In the case of the independent directors, the nomination committee of the board of Sberbank plays an important role in identifying and screening prospective directors. Independent directors must also be cleared by the board of the CBR. Finally, since Sberbank is considered of “strategic importance” by the Presidential Decree 1009, all board members must also be cleared by the presidential administration. A more transparent and competitive nomination procedure of all board members either through a shareholder unit within the CBR or through the nomination committee of Sberbank should be explored.

68. **Board terms are very short compared to other jurisdictions.** The terms of SOB board members are only of one year. However, directors can be reappointed for an unlimited number of times. In practice, a large majority of board members are renewed. On average, according to the responses to the received surveys, the majority of board members have been in their positions for 6-7 years. As a result, owners have to go through long screening and complex nomination procedures every year. Good practice jurisdictions require terms of 3 years that can be renewed two or three times. In addition, the terms of board members must be staggered to ensure that business continuity and institutional knowledge is preserved and effectively transferred.

69. **CEO appointments remain in the control of the major shareholder across all SOBs.** Article 69 of the JSC Law states that either the supervisory board or the shareholders meeting must elect the CEO

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<sup>47</sup> The presidential Decree provides a list of 1200 SOEs of strategic importance for the Russian Government including: Gazprom, Rosneft, Aeroflot, VTB, Russian Agricultural Bank and Sberbank.

<sup>48</sup> Globex has one independent board member and SME bank has three.

of the bank.<sup>49</sup> However, in practice, CEOs are either appointed directly by the shareholders or by (shareholder) boards that directly represent the controlling owner, confusing the lines of responsibility and accountability. Once the controlling owners appoint the CEO, the lines of responsibility from the CEO to the board essentially are bypassed. As a result, CEOs are more obliged to represent and respond to the interests of the major shareholders who elected them. In all banks interviewed, important decision-making responsibilities were clearly concentrated in the CEO position rather than clearly held and executed by the board. Therefore, supervisory boards should be in charge of the nomination process of the CEO. To ensure a proper accountability framework. If this is politically not possible, CEOs should be recruited through transparent and competitive processes (e.g. through headhunter companies).

## Composition and Structure

70. **Boards of SOBs are mostly composed of high level civil servants (or proxy lawyers)<sup>50</sup> from line ministries and politically exposed persons.** Many SOB boards are composed mostly of civil servants and high level government officials, including ministers (Minister of Finance, Minister of Economic Development, and Minister of Agriculture), and not enough board members have experience in commercial banking. As a result, key skills and competencies are sometimes lacking in SOB boards. Boards composed mainly of government representatives lack the objectivity, skills and industry-specific knowledge (see Box 5) that is required for the effective operations of a bank. Since board members are mostly civil servants, they can find themselves in conflict of interest situations frequently (e.g. board members with regulatory powers sit on SOB boards or may be direct conduits for state directed lending or government programs). Sometimes, it is not clear which interests government directors are representing: interests of the company or interests of the government. Government representatives in SOB boards may excel at ensuring that the bank is attentive to political or policy goals, but may elevate those goals to the detriment of the economic and financial health of the institution.

### Box 5. Relevant technical skills for board members of banks

Although the right mix of skills vary across banks, the following skills can be very useful

- ✓ Financial expertise, including knowledge of finance, accounting and audit.
- ✓ Risk management expertise.
- ✓ Marketing expertise: an understanding of marketing techniques and practices.
- ✓ Information technology (IT): an understanding of the use of systems for storing, retrieving and transferring information.
- ✓ Professional experience: relevant years of professional experience in the banking sector (15-20 years)
- ✓ Legal expertise: knowledge of the regulatory environment of the banking industry and understanding of the regulatory, legal, fiduciary and ethical requirements affecting directors.
- ✓ Business management expertise: familiarity with up-to-date business management techniques and related ethics.
- ✓ Business environment: awareness of major external influences on the general company and commercial environment, including political, economic, social and technological issues.
- ✓ Sector-specific experience: familiarity with industry trends and developments, to be able to guide management in setting strategy.
- ✓ International experience: knowledge of operations in a foreign country can also be of great benefit, for example in case of opening offices or launching products in foreign countries.

<sup>49</sup> CEOs are appointed for terms of 4-5 years.

<sup>50</sup> Proxy lawyers are hired the ownership entity to represent the government on SOB or SOE boards and vote by instruction. In this case director liability is transferred to the ownership as the director is only a messenger of the shareholder position.

✓ Good gender distribution should also be a priority in SOB boards.

*Source: Author's compilation*

71. **With the exception of the SOBs that have listed their shares in domestic and foreign stock exchanges, the majority of SOBs do not have independent directors in their supervisory boards.** Sberbank and VTB Bank have the largest number of independent directors in their boards, 6 (some of them foreigners) and 4 respectively. However, the share of independent directors vis-a-vis the share of directors representing the government remains low. The rest of SOBs, including the subsidiaries of listed SOBs, do not have independent directors. The only exception to the rule is SME Bank, which has three representatives from different SME federations and GLOBEX bank with one independent member. In the case of the RAB, the bank used to have independent directors in the past; however, these were phased out progressively over the years. Independent directors have an important impact in terms of credibility of the bank. A board of directors with independent members can help demonstrate the commitment of leadership to operate the bank with the highest levels of integrity and objectivity. For example, the majority of board members of SOBs in Sweden, Singapore, Korea, Australia or New Zealand are independent (see Annex 4). India and Malaysia require that a third of the members of the board be independent.

72. **Despite the efforts of certain SOBs to elect independent directors in SOB boards, the definition of independence and its application in practice have some shortcomings.** An independent director is a board member who does not have a material or pecuniary relationship with the company or related persons except for the sitting fees (see Box 6). Analysis of the information provided by Russian SOBs, in addition to the biographies of SOB board members publicly available, show some of the shortcomings of the practical application of the definition of independence. For example, a board member of a large SOB is listed as independent; however, he is also a supervisory board member in a subsidiary bank of the group. Another board member listed as independent is also shareholder of the SOB, and another represents the interests of minority shareholders. According to representatives from the Moscow Stock exchange, some of Sberbank's independent directors do not pass the stock exchange's independence test.

#### **Box 6: Definition of independent director**

An independent director:

- Has not been employed by the company or its related parties, including its major shareholders (e.g. the state), in the past five years;
- Is not affiliated with a company that is an advisor or consultant to the company or its related parties;
- Is not affiliated with a significant customer or supplier of the company or its related parties,<sup>51</sup> including enterprise or other financial institutions owned or controlled by any of the major shareholders;
- Has no personal service contracts with the company, its related parties, or its senior management;
- Is not affiliated with a non-profit organization that receives significant funding from the company or its related parties;
- Is not employed as an executive of another company where any of the company's executives serve on that company's board of directors;
- Is not a member of the immediate family of an individual who is, or has been during the past five years, employed by the company or its related parties as an executive officer;
- Is not, nor in the past five years has been, affiliated with or employed by a present or former auditor of the company or of a related party; and

<sup>51</sup> "Related Party" shall mean, with respect to the Company and its Major Shareholders, any person or entity that controls, is controlled by or is under common control with the Company and its major shareholders (e.g. the state).



- Is not a controlling person of the company (or member of a group of individuals and/or entities that collectively exercise effective control over the company) or such person's close relative, widow, in-law, heir, legatee and successor of any of the foregoing or the executor.

*Source: IFC Methodology*

73. **The majority of SOBs have already or are in the process of creating specialized sub-committees of the board, but smaller SOBs, in particular, require more work in this area.** SOBs have established sub-committees of the board to professionalize their operations. The majority of systemic SOBs have an audit, a strategy, and an HR and nominations committees. In the case of Sberbank, there is even a risk management committee. These committees are usually presided and composed of independent directors, when available. The largest banks have established these committees mainly as a result of listing requirements and not CBR requirements. Smaller SOBs have no sub-committees of the board or are in the process of establishing the HR and nominations committee since it is a requirement of the CBR.<sup>52</sup> Specialized committees professionalize the work of the board. Boards have found it beneficial to establish subcommittees that can dedicate focused attention and talent to the key issues of the bank and through which their responsibilities can be further met. The audit committee is probably the most important committee since it oversees the areas of internal controls, operational risk, and financial reporting and integrity. This committee, however, is not mandatory by law for Russian banks. The CBR should review its regulations to make it mandatory for all banks (private and state-owned).

74. **Despite Russia's adoption of a two tier board system, the supervisory boards of SOBs have executive members.** The objective of the two tier board system is to ensure a clear separation between the oversight function and the management function. This separation allows the board to more effectively and independently evaluate the performance of the management, in particular, the performance of the CEO. However, in the case of Russia SOBs, the CEO is a member of the supervisory board. Although, the law requires a separation of the roles of chairman of the board and CEO, the fact that the CEO is a member of the board hampers the independence of the board and at the same time does not allow an effective evaluation of the management. Russian SOBs must explore the possibility of not having the CEO as a member of the board to ensure the independence of this key function.

## **Autonomy**

75. **The supervisory boards of SOBs lack autonomy as board members (except independent directors) vote by "instruction" of the major shareholder.** Large number of decisions affecting the SOBs are not taken in board rooms. Most of the representatives from the government are not allowed to vote based on their professional opinion, but based on a system of instructions controlled by the major shareholder. The instructions are developed by the ownership agency or agencies involved in the oversight of the entity, and cover both strategic and operational matters. At the federal level, the entities involved in the development of the instructions can include the Ministry of Economic Development, FASPM, and line ministries who have policy responsibility for the sector in which the commercial bank or enterprise operates. For enterprises designated as "strategically important," instructions are developed directly by the Russian Government. When the position has been consolidated, an official resolution is prepared which instructs both representatives from the shareholders and proxy attorneys how to vote. Independent directors are exempted from the instructions system. As result, since the majority of board members in SOB boards

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<sup>52</sup> CBR Instruction 154-1 of June 17, 2014



are representatives from the government and the share of independent directors remains low, the board is a simple messenger of the shareholder.

76. **The instruction system can have implications in the operations of the bank or in the rights of minority shareholders.** Based on discussions with staff representing the owners, the instruction system can be quite problematic to coordinate as different entities and line ministries may have different points of view. Sometimes, consensus of different positions may be very difficult to achieve and, therefore, decisions on key issues of the SOBs are delayed due to the lack of unified positions. This can affect the efficient operations of the SOBs, particularly, in situations when a rapid decision-making process is required (e.g. crisis situations). In addition, this system is problematic in case the SOBs have private minority shareholders. Since the instructions are not publicly disclosed, it is difficult, if not impossible, for minority shareholders and other stakeholders to determine the underlying basis of government ownership positions. The autonomy of boards should be enhanced in order to fulfil their mandates effectively.

## **Remuneration, Evaluation and Training**

77. **SOB board members representing the state are not remunerated; however, independent board members receive an annual compensation for their services.** Government representatives are not remunerated, and receive only their salaries as civil servants. Being part of an SOB board is considered an honorific position; therefore, no additional compensation is provided for civil servants and high level government officials. Independent directors are, however, remunerated for their services. The remuneration is calculated based on the size and complexity of the SOB, and participation in sub-committees of the board. Remuneration is proposed by the HR and nominations committee of the board and is approved by the general shareholders meeting. According to board members, the remuneration is competitive, but not as high as a private sector remuneration. Remuneration of independent board members should be competitive in order to attract and retain the best talents in SOB and SOE boards.

78. **SOB boards have started implementing board evaluation procedures.** The majority of banks interviewed have put in place self-evaluation procedures to assess the performance of the board. Directors respond to a survey that is usually coordinated by the chairman of the board or the corporate secretary. However, the practice is very nascent and is perceived more as a formality, as not many actions have been taken by boards after the evaluation process. Only one SOB has hired the services of an external consultant to facilitate the evaluation process of board members and the work of the board as a whole. Evaluation process by external third parties (see Box 7) at least once every three years can provide useful insights in order to improve the operations of the board. Furthermore, SOB directors do not sign performance contracts<sup>53</sup> with the respective ownership entities, which makes the process of performance evaluation more difficult. Ownership entities could explore the possibility of implementing performance contract as measure of board effectiveness.

### **Box 7. Chile's board evaluation process**

SEP conducts an annual evaluation of all SOEs board members. The evaluation focuses on the board as a whole, but the Chair's role and impact on the performance of the board is a specific aspect evaluated.

The evaluations are conducted by nationally known Corporate Governance Centers; specialized companies; or auditors. The external facilitators are responsible for the preparation of the evaluation, getting the information and answers and its analysis.

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<sup>53</sup> A performance agreement describes the expectations and specific objectives agreed to by the ownership entity and the board (see Annex 1). Performance agreements are just tools that have the objective to formalize the commitment of the enterprise (represented by the board) to meet the goals and objectives set by the ownership unit.

The questionnaire is prepared by the specialized external facilitators and reviewed by SEP, in order to assure its results are comparable to past results. The survey is sent to board members and the results are analyzed by the external facilitators.

Apart from the external review, a series of other aspects are evaluated, this time only by SEP. This includes: performance of the board, attendance of board members; fulfilment of goals proposed by SEP, and performance of the SOE.

The establishment of the criteria used to measure the board's performance contains both mechanical aspects as well as performance-based measures. For instance, the evaluation focuses on: the collaboration of the board (teamwork); the flow of information; performance of the board; mechanistic elements (attendance), fulfilment of goals proposed by SEP as shareholder (for SOEs not created by law) or representative of the State (for SOEs created by law), and, performance of the SOE.

At the end of the process, the results are provided to the board, through the chair, and also relayed to the relevant share ownership entity. A report is prepared for the SEP Council and also sent to relevant Authorities.

The results of the evaluation are used for determining the future composition of the board and the continuity or change of boards.

*Source: Boards of Directors of State-Owned Enterprises, OECD (2010)*

**79. The majority of supervisory board members do not participate in training programs.** Although the majority of banks mentioned that directors participate in director induction training programs, very few offer ongoing training opportunities. Periodic training is key for board members to remain up to date on the latest developments in bank strategy and new products, risk management, the latest regulatory changes and corporate governance practices. Discussions with key staff of local director associations showed that directors of banks (not only SOBs) are not involved in corporate governance awareness events. The Russian Institute of Directors mentioned that they have more than 1000 active members; however, among them, not more than five are directors from banks. Ownership entities in coordination with the local institute of directors could develop a learning curricula for directors of SOBs to ensure that directors remain up to date on the latest developments relevant to their fields of activities or areas of focus (risk, audit, corporate governance). Good practice jurisdictions have developed training centers for directors of SOEs (see Box 8).

### **Box 8. The Directors Academy in Malaysia**

One of the main policy thrusts of the GLC Transformation (“GLCT”) Program is the need to upgrade the effectiveness of GLC Boards through learning, which led to the establishment of the Malaysian Directors Academy. The Malaysian Directors Academy aims to address board performance by equipping directors of GLCs with world class knowledge, skills and mindset to perform to a consistently high standard. To be an effective director, a number of performance criteria are critical. These include understanding the boundaries between the board and management, active problem solving with both the board and key management on strategic issues, whilst leveraging networks and managing multiple stakeholders in a proactive manner.

For new and potential directors, the transition from a management role to a director’s role and all its implications has to be addressed in a holistic manner. With the evolving strategic, operational and geographic priorities of many GLCs, directors that have deep commercial, functional, geographical and/or relevant industry skills, knowledge and experiences are required.

The Malaysian Directors Academy seeks to address this by delivering four integrated functions in a distinctive way, namely: Facilitate sharing of learning through forums, linkages and databases of best practices to build directors’ capabilities; Research and develop Malaysian-related case studies to assist directors in building knowledge on how to handle specific situations; Arrange “on-the-job” learning and coaching which will be customized to an individual director’s needs; and Enhance existing training and development programs to meet the needs of directors.

The Malaysian Directors Academy recognizes the different types of directors and the complexities of their roles and relationships. Therefore the learning interventions to be designed and developed cater for the differing roles and issues relevant to each category. The Academy seeks to provide programs which are of world-class status. To achieve this, it will collaborate with leading international institutions that specialize in designing and deploying programs at Director’s level, including the IMD– The International Institute for Management Development - based in Lausanne, Switzerland. IMD is the leading provider of executive education and was ranked 2nd in the world and 1st amongst European business schools for the overall quality of its programs in the 2006 Financial Times rankings. The Malaysian Directors Academy is also in discussions currently with other local and international institutions to identify potential areas for collaboration.

*Source: The responsibilities of the boards of SOEs (OECD 2010).*

## **V. Disclosure and Transparency**

80. **The level of disclosure of SOBs has significantly improved over the years.** According to informed stakeholders, this is one of the areas where the biggest improvements have been achieved. In addition, to preparing financial statements in compliance with the Russian Financial Accounting Standards (RFAS), all banks, including SOBs, are required to prepare their financial statements in compliance with IFRS standards. The reason for the double reporting is that the CBR still requires financial statements according to RFAS standards, since its monitoring and supervisory framework is based on local standards. RFAS standards have evolved over the years and have been, progressively, converging with IFRS standards. According to local practitioners, the major differences between the two standards are related to the system of provisions of loans.

81. **SOBs are, increasingly, publishing and disclosing more financial and non-financial information on their websites.** The level of disclosure of information varies across banks. Banks with shares listed in capital markets provide a high level of disclosure including detailed annual reports; audited consolidated financial statements in compliance with IFRS standards (including the auditor’s opinion); quarterly financial reports; description of the corporate governance, internal audit, internal controls and risk management systems; directors’ profile including other directorships; ownership structures; executive

remuneration<sup>54</sup> and conflicts of interests. However, in the case of non-listed SOBs, disclosure practices are more basic and uneven particularly in the case of non-financial information.

## **VI. Related-party transactions and lending to SOEs**

**Related-party transactions remain problematic in the Russian financial sector.** Related party lending has been an important source of bank failures in Russia and the nature of banking business in the country is conducive to related party exposure. Complex group structures and difficult identification of beneficial owners are the main obstacles to the identification of conflict of interest situations. Market participants report that at least some related-party transactions are approved as regular transactions because the final beneficiaries of the deal cannot be identified.<sup>55</sup> To address these issues amendments have been introduced since 2015 to the CBR law that streamlines the legal regime applicable to Related Parties. In particular, the law captures not only transactions with persons connected to each other in one way or another but also a person or a group of people connected to the bank. Another important progress resides in the role allocated to the Banking Supervisory Committee of the CBR in deciding about the relatedness of the persons or a group of persons to the credit institution. There are however a series of issues that have not been addressed or are not yet implemented and enforced. For example, the new regime about exposures arising from transactions of person(s) connected to the credit institutions will not be implemented before January 2017. The CBR is currently working on a new statutory ratio N25 that will set at 20% the maximum limit of risk to the bank's related party (or group of the bank's related parties). For some banks, this new ratio is posing some difficulties and thus decision was made to give them some time to decrease their claims to related parties by 2017 to meet the new statutory ratio. Furthermore, the regulatory framework for related party transactions does not require that lending to related parties be on same terms and conditions as those generally offered to the public. The CBR made recommendations in that regard but they are not binding and thus not enforceable. Additionally, the CBR lacks authority to impose penalties to directors who personally benefited from these favorable conditions. The mission did not assess this issue in detail, as this is a more prevalent problem in private banks.

**82. Transactions with state-owned enterprises are not treated as related-party transactions and, therefore, not properly disclosed to the public.** In terms of SOEs accessing capital, the Russian capital market is not deep, and is dominated by SOBs; therefore, business relationships with SOEs are prevalent (particularly in the defense, oil, gas and, in some cases, local government administrations such as municipalities). According to the interviewed SOBs, transactions with municipalities or state-owned enterprises are not treated as related-party transactions. Therefore, these transactions are managed as normal transactions, which, in the case of some banks, represent up to the 20 percent of the loan portfolio. Furthermore, the CBR regulations on major exposures and related-party exposures do not appear to capture lending to SOEs. The management of SOBs explained, however, that any loan application, including related-parties or any other government entity, go through the same strict credit approval process. If the applicant (even if it is the state) does not meet the credit worthiness and risk criteria, a loan will not be extended. Lending to SOEs in the case of SOBs can have serious implications on the financial stability of the institution if not properly monitored. Therefore, specific disclosure rules could be applied to all transactions, including with SOEs, depending on the size or level of materiality of the transaction particularly when the state banks have also minority shareholders. For example, material transactions with SOEs (e.g. transactions representing 2 percent of the assets of the company) should go through a specific

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<sup>54</sup> The disclosure practices of remuneration vary across SOBs. In some cases the director remuneration is disclosed per member in other instances in general terms. In case of the remuneration of the management including the CEO is not always individualized.

<sup>55</sup> Corporate Governance ROSC, Russia, 2013.

approval process (i.e. approved by independent directors only) and be properly disclosed in the annual report and financial statements.

## **VII. Risk Management, Internal Audit and Internal Controls**

83. **All Russian SOBs have set up internal audit and internal control functions in compliance with the law.** Regulation 242 P of December 16, 2003 (as amended) requires the separation between periodic and permanent control functions. All banks, including SOBs, are required to set up independent risk, internal control and internal audit functions.

### **Risk Management**

84. **The development of risk management frameworks has been a priority agenda for all SOBs over the last 3 years.** CBR, through its Regulation No. 3624-U of 15, April, 2015, has imposed the implementation of effective and independent risk management frameworks on banks. The 2 largest SOBs started this process before the CBR requirements were adopted, in order to comply with global good banking practices. However, smaller banks have recently implemented, or are in the process of implementing the frameworks and systems required by the CBR. All banks have set up systems to monitor and manage the following risks: credit, liquidity, operational and market. As of the day of the drafting this report, the majority of SOBs have created independent risk management units/departments, have recruited chief risk officers (mostly with professional experience in western banks), and have heavily invested in staff and systems to support this transition. The effectiveness of these systems in the medium and smaller SOBs cannot be evaluated at this point in time, since the functions have only been recently put in place.

85. **The systemic SOBs have invested heavily to develop sound risk management practices.** Systemic SOBs apply the “three lines of defense” principle in organizing the risk management framework: risk management at the business line level; independent risk management function and internal audit. Regarding credit risks, all systemic SOBs have implemented internal rating systems. These are, in some instances, unified and, in other cases, separated between individuals (models based on counterparty solvency and payment behavior) and corporate entities (based on credit history, models of predicted cash flows and industry or sector specific indicators and trends). Risk limitations and controls rely on a system of limits available for each line of business. Concentration of large credit risks are also monitored in compliance with CBR prudential rules (e.g. 25 percent related party concentration risk). Regarding liquidity risk, all systemic SOBs monitor this risk through models and stress testing to ensure compliance with the CBR’s statutory ratios. In addition, all systemic banks have established Asset and Liabilities Committees at the management level. Regarding operational risks, the largest systemic SOBs explained that they have mapped all operational risks while the smaller SOBs are in the process of mapping them in order to comply with CBR requirements. Market risk was not a direct focus of the review. However, this is an area where most of the banks are put to test, taking into consideration the current economic environment of Russia. The largest banks seem to be coping relatively well despite the current economic environment (e.g. sanctions); however, smaller SOBs may be under more pressure.

86. **The supervisory board is highly involved in the development of risk management frameworks in SOBs.** The supervisory board approves the risk appetite statement. In addition, all major risk policies, including credit, liquidity, operations and market risks policies are prepared by the risk management functions and approved by the supervisory board as recommended by global good practices.

87. **The CRO reports to the management board, and in some cases, is also a member of the management board.** The CRO meets at least twice a year with the supervisory board. The CEO is always

present during these meetings since it is also a member of the supervisory board. This could be problematic and could affect the independence of the function, since the CRO reports directly to the CEO. The CRO should meet with the board without the presence of the CEO. CROs have to comply with the requirements of Article 16 of the LoB in terms of “business reputation” test by the CBR and qualification requirements set by CBR (Article 11.1-2 of the LoB, Direction N.3223-U<sup>56</sup>). The same requirements are applied on an ongoing basis to the heads of internal control and internal audit services of a credit institution. Banks are required to notify the CBR within 3 business days of the appointment of the CRO (Article 11.1-2 of the LoB). The remuneration of the head of internal must be approved by the supervisory board. The head of internal audit receives a fixed remuneration and a small variable compensation that varies depending on the performance (not related to financial indicators).

## **Internal Audit and Internal Controls**

88. **The internal audit function is an independent unit within all SOBs.** The heads of the internal audit of SOBs are appointed by the supervisory board. The head reports directly to the supervisory board and the audit committee (when available) as recommended by global good practices. It also reports administratively to the CEO. In addition, as it has been already mentioned above, the heads of internal control have to comply with the «business reputation» requirements established by the Article 11.1-2 of the LoB and qualification requirements set by CBR (Direction N. 3223-U). Banks are required to notify the CBR within 3 business days of the appointment of the head of internal audit. The remuneration of the head of internal must be approved by the supervisory board. The head of internal audit receives a fixed remuneration and a small variable compensation that varies depending on the performance. Performance is measured against one KPI, which is compliance with the annual audit plan.

89. **The annual audit plan is prepared by the internal audit department, and approved by the supervisory board.** The largest systemic SOBs have implemented risk based approaches towards the process of audit. All the operations, departments and functions have risk ratings. The number of times that a unit will be subject to an audit is based on its risk rating. Internal audit departments are tasked with conducting audit of all units and processes in the period of three years.<sup>57</sup> Non-systemic banks are subject to less stringent requirements. Both management and the supervisory board can provide inputs on the annual audit plan. Internal auditors of SOBs have access and conduct audits of the subsidiaries of the SOBs. Moreover, the heads of internal audit of the subsidiaries have dual reporting line the supervisory board of the subsidiary and to the head of the internal audit of the parent company.

90. **The size and composition of the internal audit departments varies in function of the size of the SOBs.** The largest SOB has an audit department with more than 1000 auditors.<sup>58</sup> Smaller banks have smaller audit departments which in some instances seem to be understaffed (3 or 4 auditors only). Internal audit departments are composed of a mixture of senior and junior internal auditors. The largest banks provide trainings for young staff (“Audit University” in the case of Sberbank). However, all banks agree that staff turnover is particularly high. Retention of talented staff is challenging due to competition from private banks and audit firms. In terms of competencies, auditors seem to be qualified, and some of them have degrees from western universities. However, hiring and retaining qualified staff remains a challenge for SOBs.

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<sup>56</sup> Direction of the Bank of Russia No. 3223-U of April 1, 2014 on Demands Made on the Heads of a Credit Institution's Services for Risk Management, Internal Control and Internal Audit

<sup>57</sup> Regulation № 242-P.

<sup>58</sup> As an example, according to representatives from Sberbank, in 2015, the audit department conducted 15000 audits, identified 440 issues and close to 33000 staff were sanctioned.

91. **The independence of the audit function in the current setting has some limitations.** The head of the internal audit meets at least twice a year with the supervisory board. However, since the CEO is also a member of the supervisory board, he/she is always present during these meetings. In addition, in the majority of interviewed banks, management has access to audit reports before the supervisory board. In many instances, management provides comments and observations before the board has access to the report. The supervisory board receives only consolidated and summarized audit reports. It is therefore key to guarantee the independence of the function to be able to meet with the board without the presence of the CEO.

92. **External auditors have mixed opinions on the quality of the work of internal audit departments of SOBs.** Auditors have very positive opinions on the quality of the audit departments of the largest SOBs. However, they have mixed reviews on the quality and the audit methodology followed by internal audit departments of smaller banks. When performing the external audit of these banks, external auditors analyze the internal audit reports. However, they explained that they would rather not rely on the information contained in these reports to draw conclusions about the financial health and internal practices of banks.

93. **In addition to the internal audit department, Russian banks have a “Revision Commission”.** According to Article 85 of the JSC Law, all JSCs are required to set up a “Revision Commission”, which is a legacy corporate body from the Soviet law. The main objective of the commission is to oversee the company’s finances. The Revision Commission, in many instances, duplicates the duties of the audit committee of the supervisory board, since it is required to approve the financial statements of the bank. The members of the Revision Commission are elected and are accountable by/to the shareholders meeting. Globally, an important number of countries of soviet legal origin have eliminated this commission, and have mandated the establishment of the audit committee within the board.

94. **All SOBs have set up independent compliance functions.** As for all other functions, the level of development of the compliance function is based on the level of complexity of the SOB. The largest SOBs have large compliance departments that are independent. In the case of smaller banks, compliance departments are more nascent. The head of compliance meets once a year with the board or in case of any significant case of compliance risk. However, in smaller SOBs, the compliance function meets rarely with board. Compliance departments cover issues such as money laundering and terrorism financing, compliance with economic sanctions, prevention and settlement of conflicts of interest, compliance with CBR and other country specific regulatory requirements and counteraction of unfair practices on financial markets in the case of listed banks (market abuse and insider trading).

## **VIII. External Audit**

95. **All SOBs are required to receive an annual external audit by a professional independent firm.** Article 86 of the JSC Law and also the LoB requires annual audit of JSCs including banks. External auditors are, usually, proposed by the supervisory board, in coordination with the management board and approved by the general shareholders meeting. The review is conducted in compliance with ISA standards. SOBs use the services of internationally recognized audit firms. However, the laws regulating external audits are silent regarding rotation requirements. In practice, the same audit firm (and the same team) conducts the external audit for many years in a row. In some cases, the same firm has conducted the external audit for eight years in a row. In addition, the law does not prohibit the firm in charge of conducting the external audit of providing non-audit services to the bank. The largest international audit firms explained that the rotation and conflict of interest issues are under control in practice since the internal regulations of the audit firms follow international best practices. According to informed stakeholder many SOBs have hired their external

auditors to consult on preparation of IFRS accounts, which represents a conflict of interest for the auditors. Clear rotation rules (e.g. rotation of partner every 3 years and rotation of firms every 5 years) and conflict of interest rules (external audit firm should not be allowed to perform non-audit services for the same bank) should be included in the relevant laws (LoB and Law on Auditing) to strengthen the independence of the external audit function.

96. **SOBs are bound by the public procurement rules applicable to Russian SOEs, which requires annual public procurement procedures for the recruitment of the external auditor.** All SOBs organize annual public procurement procedures for the recruitment of the external auditor. This procedure creates a lot of instability and uncertainty in terms of the audit process since audit firms have to constantly bid and in some instances have to cut prices to keep the clients since as for public procurement procedures price is one of the key elements of gaining a tender. As a matter of practice, external audit firms' services should be contracted for terms of three years to ensure continuity and consistency in the evaluation process.

97. **The CBR has limited powers over the external audit process of banks.** The CBR does not assess the quality or reputation of audit firms through an objective set of criteria. Any audit firm is technically allowed to conduct the external audit regardless of their capacity or reputation. In addition, the CBR does not control the quality of the external audit and does not have any interaction with the external auditor during the audit process. In case the quality of the audit is questionable, the CBR does not have the powers to request a second audit at the bank's expenses.

98. **SOBs are also audited by the Accounts Chamber, Russia's supreme state auditor.** The Account Chamber is an independent government agency in charge of auditing institutions (private and public) that receive any type of government funding (budget, programs, and subsidies). The scope of the audit is mostly focused on how state funds or assets have been used by the institution. In the case of banks, the Accounts Chamber audits the CBR and also all the SOBs, VEB and DIA. In addition, private banks are also subject to audits in case they have received any government funding or are part of state programs (e.g. Bank Recapitalization Program). The Accounts Chamber conducts a general audit once a year of all SOBs with particular focus on the control and audit functions and fulfillment of mandates, and also conducts targeted periodic inspections on specific government programs (e.g. SME or mortgage programs that are part of the recapitalization program). The Accounts Chamber then prepares a consolidated annual report on all audits for the Parliament (State Duma) and recommends actions (e.g. instructions or sanctions). In addition, a report with recommendations and instructions is sent to the audited institutions for them to implement the required actions. In case the audited institutions fail to take action, they can be sanctioned. According to representatives from the Account Chambers, no major issues have been identified in SOBs.



## ANNEXES

### Annex 1: Full FSAP Recommendations

Table. Full FSAP Recommendations		
Recommendations	Leading Agency	Time <sup>59</sup>
<b>ROLE OF STATE POLICY</b>		
Continue gradual privatization of state-owned commercial banks.	MOF, CBR	NT - MT
Government to cover the cost of any subsidized activities for hybrid and development institutions in its annual budget.	MOF	I
Establish a subsidies bureau for coordination, as well as to assess the impact of the programs.	MOF	NT
Ensure that SOB lending to SOEs should be conducted on an arm's length basis and on commercial terms.	MOF	I - NT
<b>CORPORATE GOVERNANCE</b>		
<b>Legal, Regulatory and Supervisory Recommendations</b>		
<p><b>Regulatory and Supervisory Powers:</b></p> <ul style="list-style-type: none"> <li>Amend the Law on Banks and its implementing regulations to require the CBR to issue clear, objective and transparent criteria for the approval process of external auditing firms and for what constitutes an adequate external audit.</li> <li>Develop a framework to measure compliance of all banks with the new Corporate Governance Code 2014.</li> </ul>	CBR	I
<p><b>Bank Ownership – Professionalization of ownership management:</b></p> <p><b>Legal and Regulatory framework</b></p> <ul style="list-style-type: none"> <li>Develop an ownership policy applicable to all SOBs to ensure consistent approach of good corporate governance practices.</li> </ul> <p><b>Ownership Entity</b></p> <ul style="list-style-type: none"> <li>Centralize the ownership of SOBs either through transferring ownership powers to FASPM or creating a specialized ownership entity (agency or holding company) for SOBs.</li> <li>If centralization is not possible in the short term: <ul style="list-style-type: none"> <li>Create a formal “shareholder unit” within the CBR to exercise shareholder rights over Sberbank (board member nomination, performance monitoring and prepare for the general shareholders meeting).</li> <li>Develop key regulations (i.e. board nomination, performance monitoring frameworks, and dividend policies) applicable to all SOBs to ensure consistent application of good corporate governance practices.</li> <li>Review the role of the FASPM to transition from a “coordinator” of government positions to a real ownership entity in charge bringing greater clarity and professionalism to the state’s ownership role, while reducing the scope for political involvement and generating shareholder value.</li> </ul> </li> </ul> <p><b>Monitoring Performance:</b></p> <ul style="list-style-type: none"> <li>Sign performance agreements between the ownership and the supervisory board with key performance indicators to formalize the commitment of the bank to meet the goals and objectives set by the ownership unit.</li> </ul> <p><b>Selection Criteria of supervisory board members – policy measures:</b></p> <ul style="list-style-type: none"> <li>Elect SOB board members through transparent and competitive recruitment process including the use of headhunter companies for the largest SOBs.</li> </ul>	CBR, MoF, MED, FASPM	I - NT

<sup>59</sup> I-Immediate” is within one year; “NT-near-term” is 1–3 years; “MT-medium-term” is 3–5 years.

<ul style="list-style-type: none"> <li>• Reduce the number of civil servants (or proxy lawyers) serving as directors to a strict minimum and appoint more independent directors from the private sector (both national and foreigners).</li> <li>• The relevant laws and internal practices of ownership entities should limit to 40 percent the number of supervisory members representing the state in SOBs and require 60 percent of independent board members.</li> <li>• In case the pool of candidates from the private sector is limited and directors must be civil servants, they should be appointed on the basis of skills relevance, and should not serve as chairman of the board or CEO of the company.</li> <li>• The system of voting by instruction should be abolished.</li> <li>• Ban ministers and other politically exposed persons from SOB boards.</li> <li>• Build databases of potential directors. Such databases can be one of the ownership unit's most valuable tools for professionalizing SOB and SOE boards in general.</li> </ul>		
<p><b>Strengthening the Law on Banks and the Joint Stock Company Law:</b></p> <ul style="list-style-type: none"> <li>• The Law on Banks should be amended to eliminate ban the CEO from also being a member of the supervisory board.</li> <li>• The Law on Banks should be amended to ensure board members sign the financial statements.</li> <li>• The Law on Banks should be amended to make the audit committee of the board mandatory for all banks.</li> <li>• The Joint Stock Company Law should be amended to eliminate the Revision Commission.</li> <li>• The law on banks and CBR-related regulations to make the risk management committee mandatory for all systemic banks.</li> <li>• The Law on Banks should be modified to require banks to appoint the external audit firm for a term of at least three years (and no more than five years).</li> <li>• Law on banks should require proper rotation and conflict of interest rules for external auditors of banks.</li> </ul>	CBR, MoF	I
<b>State Owned Bank-Specific Recommendations</b>		
<p><b>Supervisory Board Role and Composition</b></p> <ul style="list-style-type: none"> <li>• Modify the role of the supervisory board to evolve into a leadership role away from a compliance with shareholder's position function.</li> <li>• Ensure that supervisory board members sign the financial statements of the bank.</li> <li>• Change the composition of SOBs' supervisory boards to be composed of a majority of independent members with sector specific skills.</li> <li>• Ensure board members receive induction and ongoing trainings.</li> </ul>	FASPM, CBR, all SOBs	I - NT
<p><b>Risk Management:</b></p> <ul style="list-style-type: none"> <li>• The CRO should periodically, at least twice a year, report directly to the supervisory board without the presence of the CEO, other executive board members, or management.</li> </ul>	All SOBs	I - NT
<p><b>Internal Audit:</b></p> <ul style="list-style-type: none"> <li>• Independent reporting lines directly to the supervisory board should be emphasized.</li> <li>• The chief internal auditor should periodically, at least twice a year, report directly to the supervisory board without the presence of the CEO, other executive board members, or management.</li> </ul>	All SOBs	I - NT
<p><b>Related-Party Transactions (including transactions with state-owned enterprises and other government entities):</b></p> <ul style="list-style-type: none"> <li>• Transactions with state-owned enterprises and other government entities (including municipalities) should be treated as related-party transactions and disclosed in compliance with internationally recognized accounting standards.</li> <li>• Banks should likewise be responsible for implementing a methodical system through which related parties are identified, flagged in the course of banking business, evaluated, and monitored.</li> </ul>	All SOBs	I - NT

<ul style="list-style-type: none"> <li>• The CBR should monitor these transactions and take appropriate action in case of violations.</li> <li>• Any state-directed program should be managed off balance sheet.</li> </ul>		
<p><b>Disclosure and Transparency:</b>  Disclosure standards should continue to improve. Despite strong regulation, nonfinancial disclosures in practice remain insufficient in smaller SOBs and should be expanded to address, <i>inter alia</i>:</p> <ul style="list-style-type: none"> <li>○ Transactions with state-owned enterprises and other government entities (including municipalities).</li> <li>○ Nature and compliance with the bank’s own corporate governance code</li> <li>○ Board member and management biographical information</li> <li>○ Director and senior management remuneration (direct and indirect)</li> </ul>	All SOBs	I - NT

## **Annex 2: SOB Corporate Governance: Review Methodology and Key Tenets**

This Annex offers insights into the bank governance review methodology, the importance of corporate Governance, as well as key tenets of effective corporate governance in state-owned banks.

**Bank Governance Review Methodology.** The Review Methodology was developed in response to requests by World Bank client countries to evaluate and communicate governance risks potentially affecting the performance and stability of their banking sectors. As such, the Review Methodology approaches bank governance from the perspective of a risk based policy framework that is key for the comprehensive assessment of system vulnerabilities. The Methodology is based on the Basel Committee's Principles for Corporate Governance in banking institutions and OECD Corporate Governance Principles and is also grounded in best practices emanating from the banking industry as a whole and World Bank experience. Moreover, since the scope of the review focused on SOBs, the Corporate Governance Guidelines for State-Owned Enterprises of the OECD were also used as a reference for the completion of the assessment. Using a focused questionnaire, a survey of a sample of banks was conducted. From 26 banks 11 responded to the survey. All systemic SOBs responded to the survey except for Gazprombank which also the mission did not meet despite multiple requests.

**The importance of corporate governance.** Corporate governance is commonly defined as the structures and processes for the direction and control of corporations, specifying the distribution of rights and responsibilities among the main participants in the corporation and spelling-out the rules and procedures for making decisions on corporate affairs.<sup>60</sup> Specific to banks, corporate governance is defined as the manner in which the business and affairs of banks are governed by their boards and senior management which affects how they: (i) set corporate objectives; (ii) operate the bank's business on a day-to-day basis; (iii) meet the obligation of accountability to their shareholders and take the interests of stakeholders into account; (iv) align corporate activities and behavior with the expectation that banks will operate in a safe and sound manner and in compliance with applicable laws and regulations; and (v) protect the interests of depositors.<sup>61</sup> In the case of SOBs, the corporate governance structure also captures the role of the State as owner and the process through which it fulfills its associated responsibilities.

Improving corporate governance can serve a number of important public policy objectives. Numerous studies have shown that good corporate governance practices lead to significant increases in economic value-added from higher productivity of firms and lower risk of systemic financial failures for countries.<sup>62</sup> Implementing good bank governance is of particular significance in creating a robust and stable banking sector in support of sustained financial and private sector development, and economic growth. Indeed, banks: (i) Manage a significant portion of a nation's wealth through savings and must therefore be governed appropriately in order to uphold the public trust; if governed poorly, people's livelihoods could be at stake, potentially turning public opinion against current political leadership; (ii) Provide the preponderance of financing for the great majority of enterprises and individuals, particularly in emerging markets; therefore,

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<sup>60</sup> The Organization for Economic Cooperation and Development (OECD): OECD Principles of Corporate Governance; 2004.

<sup>61</sup> The Basel Committee on Banking Supervision: Principles for enhancing corporate governance; October 2010.

<sup>62</sup> Corporate Governance and Performance Around the World: What We Know and What We Don't. Inessa Love, The World Bank Group, June 2008.

the strength and capacity of banks take on greater importance in terms of funding economic growth; (iii) May well be expected to make credit and liquidity available in what are likely to be difficult market conditions in the years ahead.

With this in mind, it is important to note that banks generally have specific governance challenges and complexities since they take on significant volumes of risk-bearing assets. Hence, weak risk management frameworks and internal controls can cause severe and rapid financial crises. The collapse of a single bank cannot only destroy shareholder value but also value for its depositors and may require a costly bail-out or liquidation by the authorities (and ultimately the tax payers). Ensuring that banks are well governed is thus of central concern to not only banking regulators, but to the Government more broadly and other stakeholders.

These country-specific and more general bank-related risks make well developed governance frameworks and practices of banks in the Russian Federation a key condition for financial market stability, judicious credit allocation, and growth.

### **Key tenets of effective corporate governance in state-owned banks<sup>63</sup>**

**Current Setting.** Evaluating and restructuring the corporate governance of SOBs in the Russian Federation, if accomplished in its entirety, will call for an evaluation of the objective and the role of the State, and therefore the role of SOBs, in the country's financial market. Some SOBs may possess questionable ability to operate as viable commercial banks with sufficient customer bases and effective business strategies. In practice, putting in place sound governance arrangements for SOBs requires a significant investment in people, processes and technology with substantial up-front and ongoing costs. When considered in the context of the government's objectives for SOBs and the problems governance arrangements are expected to solve, the costs often may not be justified or affordable. In such circumstances the answer is not to shortchange corporate governance, but rather to design alternative, more economical and efficient means for government intervention.

**Selected Elements of a State Bank Governance Structure.** Some of the key functions of a SOB governance platform include, inter alia, clarification of policy mandates and operational objectives, the state ownership function, the role of the board, chairman of the board, and the CEO. The following enumerates certain aspects to consider when evaluating and building a SOB governance arrangement:

- ✓ **Objectives of State-Owned Financial Institutions:**
  - To ensure the institution's long-run financial sustainability (i.e., ensure that it continues as a going concern, without need for extraordinary financial support from the state).
  - To achieve certain financial performance objectives (which may be defined in terms of return on equity and dividend payment targets, for example).
  - For SFIs with a mandate to pursue public policy objectives, an additional overarching objective is the achievement of those policy objectives. (See below)
- ✓ **Organizing the State Ownership Function.** Establish or review and revise the SOB ownership policy. Such a policy defines the state's overall ownership objectives, prescribes the legal forms for the given

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<sup>63</sup> Distilled from the Basel Committee's Corporate Governance Principles for Banking Organizations and relevant selected OECD Corporate Governance Guidelines for State-owned Enterprises.

institutions, defines the state's role in governance, and how that role and policy will be implemented. This includes:

- Considering whether an incorporated financial institution is the most effective means of state intervention, as compared to, for example, a more economical institutional arrangement such as a specialized government department or unit.
  - Explicitly identifying and/or assigning who is responsible for acting as the state's shareholder representative (separate government department, entity) and the method of interaction, typically with the Chairperson of the board.
  - Defining the shareholder representative's role and accountabilities.
    - Assuring professional support to the shareholder representatives.
    - Establishing and requiring separation of ownership from regulation and supervision.
    - Assigning the responsibility of board(s) appointments and defining the process:
      - Ensuring a structured, transparent process that adheres to explicit policies and procedures that seek to ensure the ability of the board to exercise its responsibilities in an independent manner, including the use of competence and experience requirements consistent with the strategy and business of the institution(s).
      - Considering limiting the number of public servants on the boards and gradually introduce and appoint an increasing mix of private, independent individuals.
      - Specifying the required mix of skills and experience of all individuals, both public and private.
      - Considering whether the CEO should be prohibited from serving as the chairperson of the board.
      - Defining the role and responsibilities of the chairperson, method of performance evaluation and remuneration (i.e. specific skills, experience required, ability to locate and hire domestically or internationally, etc.)
    - Defining, documenting, and monitoring clear objectives and performance measures and targets.
    - Periodically re-evaluating the SOB's given mandate, in part to address potential "mission creep" and redefine where evolution of markets, client needs and public policy objectives may have rendered the existing mandate no longer valid or appropriate.
    - Document such policy through the existing and/or prospective mix of laws, regulations, and state policy.
- ✓ **Role of the Supervisory Board.** The principle role of the board of directors should be to:
- Appoint key executives, evaluate management performance, and develop a succession plan for key managers (depending on the current quality and composition of the board(s) the appointment of the CEO may be introduced over time with at least the board taking the lead in the recruitment process before becoming wholly responsible for the formal appointment. The board should also establish, approve, and maintain a remuneration policy for senior executives and provide information to shareholder(s) and the public on such policy. Key committees should also be appointed including, inter alia, audit, nomination / remuneration, risk management, and corporate governance.);
  - Help formulate, monitor and approve the institution's strategy (in context of the objectives set out in the ownership policy);

- Approve key policies;
  - Ensure that internal financial and operational controls are in place;
  - Establish performance indicators and benchmarks;
  - Monitor disclosure and public communications processes to ensure financial statements and other disclosures fairly present the institution's performance, financial condition, business and risks.
- ✓ **Information, Reporting, and Disclosure Regime.** Ensuring adequate reporting at all levels requires an investment in accounting and information systems, in internal controls, and in internal and external auditing. It involves formulating and documenting policies and procedures, putting in place hardware and software systems, and recruiting and training qualified staff, among other tasks:
- The Audit Committee should have explicit responsibility for oversight of internal and external audit functions; ensuring the accuracy of required reporting to the regulatory and supervisory authorities; and ensuring management takes appropriate action in response to identified deficiencies.
  - The internal audit function should be (established and) accountable to the audit committee and have unrestricted access to the chairperson of the full board and all board members.
  - The external audit should be conducted according to international standards.
- ✓ **State Development Institutions.** For those state banking institutions that also possess a public policy / development mandate, additional organizational and governance challenges exist. Institutionalizing the means by which to make tradeoffs between policy and financial objectives and to efficiently fulfill policy mandates is a key governance challenge facing the institution. Public policy mandate must be well defined, as explicitly and narrowly as feasible, based on a thorough analysis of the market gaps they intend to address. The authorities will have to evaluate how the mandate will be financed along with the various pros and cons of funding alternatives. Once decided, the shareholder representative will need to agree specific policy, financial and operational performance targets with the board and executive management.

## **Annex 3: Brief Description of Selected State-Owned Financial Institutions in Russia**

This Annex is based on Annual Reports, IFRS statements, and Bankscope data.

### **Sberbank**

Sberbank is the largest bank by assets in Russia. It has over 16 thousand branches, and 90 thousand ATMs and self-service terminal in all of Russia's territories, about 137 million retail clients and over 1.3 million corporate clients out of 4.5 million businesses in Russia. It accounts for 39 and 46 percent of retail lending and deposits respectively, and 32 and 24 percent of corporate lending and deposits respectively. Russia accounts for almost 80 percent of the group's assets, with international operations in CIS, CEE, Turkey, UK, USA etc. CBR owns 50 percent and 1 voting share.

Sberbank loan portfolio is dominated by retail at 25 percent of total gross loans, with the corporate loan book structure led by services and trade at 26 and 15 percent respectively. NPLs have increased to 5 percent in 2015, from just over 3 percent at end 2014 – in line with the deteriorating conditions in the sector. NPL coverage stands at 1.2 times. Tier 1 and total CAR stand at 8.9 and 12.6 percent respectively, both higher compared to 2014. NIM has dropped to 4.9 percent in 2015 due to higher domestic funding market costs, but ROE increased to 12.6 percent. Sberbank's focus on operating efficiency is reflected in the cost to income decrease to 45.8 percent in 2015.

**Table. Key financials of Sberbank**

<b>Indicator</b>	<b>2015</b>	<b>2014</b>
Percent of system assets	29.6	
Percent of system deposits	34.4	
NPL ratio	5.0	3.2
NPL coverage ratio (provisions/NPL)	1.2	1.4
CAR (%)	12.6	12.1
ROE (%)	12.6	9.7
NIM (%)	4.9	5.4
Cost to income ratio (%)	45.8	50.5

Source: Annual Reports, Bankscope

### **VTB group**

VTB Group's corporate and investment banking is dominated by VTB Bank and VTB Capital, retail banking is led by VTB24 and Pochta Bank (previously Leto Bank), investment banking by VTB Capital, while the BM-Bank PJSC (previously Bank of Moscow) is present on all markets. The Group's non-banking financial services are performed by VTB Leasing, VTB Factoring and VTB Insurance.

VTB Group has the second largest presence in Russia by assets and has over 1.7 thousand retail offices and over 12 thousand ATMs. It accounts for 14 and 10 percent of retail lending and deposits respectively, and 16 and 20 percent of corporate lending and deposits respectively. VTB Group has a large international presence, with operations in 23 countries including CIS, EU, Asia and Africa. Russia accounts for about 75 percent of the group's assets. FASPM voting rights account for 60.93 percent of JSC VTB Bank, the parent organization.

VTB Group loan portfolio is dominated by corporate at 77 percent of total gross loans, led by construction and manufacturing at 12 and 11 percent respectively. NPLs have increased to 6.3 percent in 2015, from 4.7 percent at end 2014 – in line with the deteriorating conditions in the sector. NPL coverage



stands at 1.1 times. Tier 1 and total CAR stand at 12.4 and 14.3 percent respectively, lower compared to 2014. NIM has dropped to 3.2 percent in 2015, but ROE increased to 12.6 percent from negative in 2014 due to provisioning charges. Cost to income has increased to 51.1 percent in 2015.

**Table. Key financials of VTB group**

<b>Indicator</b>	<b>2015</b>	<b>2014</b>
Percent of system assets	17.7	
Percent of system deposits	16.4	
NPL ratio	6.3	5.8
NPL coverage ratio (provisions/NPL)	1.1	1.1
CAR (%)	14.3	12.0
ROE (%)	12.6	-0.6
NIM (%)	3.2	3.4
Cost to income ratio (%)	51.1	36.6

Source: Annual Reports, Bankscope

### **Gazprombank**

Gazprombank is the third largest bank by assets in Russia. It has 32 branches, over 500 outlets and over 5 thousand ATMs, with about 4 million retail clients and over 45 thousand corporate clients out of 4.5 million businesses in Russia. It accounts for 9 and 11 percent of corporate lending and deposits respectively, and is the third largest retail lender concentrating on employees of corporate clients (e.g. Gazprom Group). The top 10 borrowers comprised 25 percent of gross loans. Gazprom Group is one of the bank's largest corporate depositors, accounting for 24 percent of customer funds. Russia accounts for almost 80 percent of the group's assets, with international operations in CIS, CEE, Turkey, UK, USA etc. Gazfond (Gazprom's pension fund) voting rights account for 49.65 percent, Gazprom 35.54 percent and VEB 10.19 percent.

Gazprombank loan portfolio is dominated by corporate lending at 91 percent of total gross loans, with the corporate loan book structure led by chemicals and metals at 16.5 and 16.2 percent respectively. NPLs have increased to 2 percent in 2015, from just over 1 percent at end 2014 – in line with the deteriorating conditions in the sector. NPL coverage stands at 4.5 times. Tier 1 and total CAR stand at 10.2 and 14.2 percent respectively, both higher compared to 2014. NIM has dropped to 2.5 percent in 2015, and ROE was -10.1 percent in 2015. Cost to income decreased to 41.8 percent in 2015.

**Table. Key financials of Gazprombank**

<b>Indicator</b>	<b>2015</b>	<b>2014</b>
Percent of system assets	6.6	
Percent of system deposits	7.7	
NPL ratio	2.0	1.1
NPL coverage ratio (provisions/NPL)	4.5	4.5
CAR (%)	14.2	12.4
ROE (%)	-10.1	-3.4
NIM (%)	2.5	3.2
Cost to income ratio (%)	41.8	47.1

Source: Annual Reports, Bankscope

### **Russian Agricultural Bank (RAB)**

RAB is among the top 10 banks by assets in Russia. It has the second largest branch network with 75 branches, over 1,300 additional offices and over 3,600 ATMS, with about 6 million clients. FASPM owns 89.92 percent of RAB shares, with the remaining covered by the Ministry of Finance.

In line with its mandate, RAB's loan portfolio is dominated by agriculture at 53 percent of total gross loans, followed by individual loans at 16 percent. Overall, RAB covers about 77 percent of the Russian territory. RAB has the highest NPLs among the largest Russian banks. The NPL ratio increased from 9.9 to 11.1 percent from 2014 to 2015, mainly driven by the ageing of loans issued from 2006-2009 and the impact of droughts in 2009-10 and 2012, and unfavorable weather conditions in 2013. NPL coverage stands at 0.5 times. Tier 1 and total CAR stand at 7.7 and 11.7 percent respectively, both lower compared to 2014. The bank receives annual capital injections by the state to support growth and cover losses. NIM has dropped to 1.4 percent in 2015 due to higher domestic funding market costs, while ROE was -32.4 percent in 2015 and -3.7 percent in 2014. RAB cost to income increased from 111 to 152 percent from 2014 to 2015.

**Table. Key financials of RAB**

<b>Indicator</b>	<b>2015</b>	<b>2014</b>
Percent of system assets	3.4	
Percent of system deposits	3.6	
NPL ratio	11.1	9.9
NPL coverage ratio (provisions/NPL)	0.5	0.4
CAR (%)	11.7	13.0
ROE (%)	-32.4	-3.7
NIM (%)	1.4	3.0
Cost to income ratio (%)	151.7	111.5

Source: Annual Reports, Bankscope

## **Annex 4: Board Profile and Composition of Selected State Owned Banks Globally**

### **I. New Zealand: Kiwi Bank<sup>64</sup>**

<b>Board members: Kiwi Bank</b>	
	<b>Skills, experience and competencies</b>
Rob Morrison (Chairman)	<ul style="list-style-type: none"> <li>• Experienced investment banker.</li> <li>• Chairman and Chief Executive Officer of Hong Kong–based brokerage, investment banking and private equity group CLSA Asia-Pacific Markets.</li> <li>• Executive vice president and head of equities at Bankers Trust Australia and CEO of Bankers Trust New Zealand.</li> </ul>
Alison Gerry	<ul style="list-style-type: none"> <li>• 20 years of experience working in finance and treasury for both corporates and for financial institutions.</li> <li>• Group Treasurer for Lion Nathan, based in Sydney.</li> <li>• Worked for various financial institutions in Sydney, Hong Kong, Tokyo and London in trading, finance and risk roles.</li> </ul>
David Willis	<ul style="list-style-type: none"> <li>• 30 years of experience including in accountancy, mergers and acquisitions, banking and technology.</li> <li>• Accountant and lived in a number of countries while working in Ernst and Young’s overseas offices.</li> <li>• Chief Executive and senior executive positions with several financial services companies including Lloyds Bank, HBOS Australia and Westpac.</li> </ul>
Catherine Savage	<ul style="list-style-type: none"> <li>• 20 years’ experience in a variety of governance, corporate and investment roles.</li> <li>• Managing Director of AMP Capital Investors and is now a director of a number of companies as well as Chairman of the Board of Trustees of the National Provident Fund and a board member of the Guardians of the NZ Superannuation Fund.</li> </ul>

Source: Kiwi Bank, New Zealand

<sup>64</sup> Kiwi Bank: <http://www.kiwibank.co.nz/about-us/more-about-us/key-people.asp>

## II. Singapore: DBS Bank<sup>65</sup>

<b>Singapore: DBS Bank</b>	
	<b>Skills, experience and competencies</b>
Peter Seah Lim Huat	<ul style="list-style-type: none"> <li>• Banker for 33 years.</li> <li>• CEO of the former Overseas Union Bank in 2001.</li> </ul>
Bart J. Broadman	<ul style="list-style-type: none"> <li>• Director of Alphadyne Asset Management (an investment management firm with offices in Singapore, New York and a research office in London).</li> <li>• 14 years in Asia with J.P. Morgan.</li> <li>• Vice Chairman of Asia and head of Markets (Credit, Rates, and Equities) in Asia.</li> <li>• Ex Board of Directors of Sony Bank.</li> <li>• Citizen of the United States.</li> </ul>
Euleen Goh Yiu Kiang	<ul style="list-style-type: none"> <li>• Chartered Accountant with professional qualifications in banking and taxation.</li> <li>• Held various senior management positions in Standard Chartered Bank (21 years).</li> <li>• Chief Executive Officer of Standard Chartered Bank, Singapore from 2001 until March 2006.</li> </ul>
Ho Tian Yee	<ul style="list-style-type: none"> <li>• 30 years' experience in managing and investing in global financial markets.</li> <li>• 19 years with Bankers Trust Company.</li> </ul>
Andre Sekulic	<ul style="list-style-type: none"> <li>• Business leader with 35 years of experience in banking and financial services in Asia/Pacific.</li> <li>• Senior Vice President and General Manager of MasterCard Asia Pacific to President of MasterCard Asia Pacific, Middle East and Africa.</li> </ul>
Danny Teoh Leong Kay	<ul style="list-style-type: none"> <li>• 27 years in KPMG Member of Executive Committee, Head of Audit, Head of Financial Services, Head of Risk Advisory Services and Head of Marketing &amp; Communications. He was the Managing Partner of KPMG LLP, Singapore.</li> <li>• a qualified Chartered Accountant 30 years of auditing and advisory experience.</li> </ul>

Source: DBS Bank, Singapore

<sup>65</sup> Development Bank of Singapore (DBS) Bank:  
<http://www.dbs.com/about/management/boardofdirectors/default.aspx>