

Russia Banking Sector Corporate Governance Survey

A Snapshot on Improvements Made

Written by the International Finance Corporation's Russia Banking Sector Corporate Governance Project

Sponsored by the Swiss State Secretariat for Economic Affairs



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I. INTRODUCTION

1. The Purpose of this Survey

The main objectives of this survey are to determine:

- the extent to which Russian banks have embraced national and internationally recognized best practices in their corporate governance;
- the degree of changes in the corporate governance practices of Russian banks over the past three years; and
- the key areas of further improvements in corporate governance of Russian banks.

This survey gives shareholders and managers of banks a tool for self-assessment and cross-comparison within the industry. Banking Associations, other non-governmental organizations and educational institutions may gain directions for future educational or policy initiatives. Regulators receive confirmation for planned legal or regulative measures and investors and research analysts can focus their analysis on key aspects of banking corporate governance.

We hope to contribute to the further strengthening of the banking sector in Russia, which is crucial for achieving the nation's ambitious economic development goals. IFC would like to thank those banks that participated in this survey.

"Corporate governance is the system by which companies are directed and controlled."

Report of the Committee on the Financial Aspects of Corporate Governance (the UK Cadbury Code), London, 1992.

2. Methodology

The survey covers 82 banks that responded to a questionnaire sent to 200 banks throughout the Russian Federation. The sample of 200 banks was chosen from the top 300 largest banks by total assets,¹ applying a mix of qualitative and quantitative selection criteria. Banks that are more than 25% controlled by a foreign entity or wholly owned by the state were excluded. The poll of 82 surveyed banks covers all Russian federal regions and represents 20% of the banking sector's total assets as of September 1, 2006. Annex 1 provides more information on the participating banks.

In order to track the development of corporate governance in Russian banks, the questionnaire is built on the same concept as the survey of corporate governance in Russian banks conducted by the International Finance Corporation (IFC) in 2003 (the 2003 survey), covering 108 questions in five key categories of corporate governance:

1. *Commitment to good corporate governance;*
2. *Practices of the Supervisory and Management Board;*
3. *Transparency and Disclosure;*
4. *Internal Control and Risk Management; and*
5. *Shareholder rights.*

Some questions were amended from the previous survey to reflect changes in the legislative environment; others were newly introduced or reformulated to sharpen the

¹ *Ekspert magazine; Kommersant Daily*

focus on issues related to internal control and risk management. Twenty three banks from the 2003 survey participated again.

IFC secured the services of Media Navigator - a Nizhny Novgorod-based research company - to collect answers to the questionnaire from participating banks by individual interviews. The results of the survey reflect the banks' self-assessment of their corporate governance practices; IFC did not verify the accuracy of answers by using alternative sources of information.

The survey team commenced its work in September 2006. Banks received the questionnaire in the middle of September and data entry was closed on November 8, 2006.

3. Why Corporate Governance Matters for the Banking Sector

Banks play a critical role in economic development and prosperity. They serve an important function as providers of capital, payment and settlement agents, wealth managers and business advisors. History has shown that bad governance in banking was the main source of macro economical financial crisis in 1997-98 in Asia and Russia. A World Bank research estimated that in emerging markets, the cost of recapitalizing the banking sector after a financial crisis runs, on average, 15 percent of GDP.

It is because of the importance of banks for the economy as whole that the corporate governance of banks is so crucial. For the same reasons it is no surprise that the banking industry is among the most regulated sectors in most countries and boasts many multi-party international normative organizations.² A set of guidelines, principles and regulations aim to ensure a balance of the diverse interests of shareholders, management and other stakeholders such as depositors. These factors along with the general opacity of banks' assets, their ability to hide real business activities and swiftly change the risk profile, as well as the dependence of the business model on broader delegation of authority makes governance in banks, versus non-financial companies, uniquely important.

4. Why Corporate Governance Matters for IFC

Corporate governance is a priority for IFC because it presents opportunities for IFC to manage risks and add value to clients. In addition to the benefits to individual client companies, working to improve corporate governance contributes more broadly to IFC's mission to promote sustainable private sector investment in developing countries.

Reducing investment risks: It is in IFC's interest to reduce the risk of its investments by improving the governance of investee companies. In the worst corporate governance environments, poor standards and weak enforcement continue to be barriers to investment, even for IFC's whose mandate is to work in frontier markets. Improving the corporate governance of investee companies allows IFC to work in higher-risk environments.

Avoiding reputational risks: If IFC does not work to improve the corporate governance of client companies, then it takes on not only investment risk, but also reputational risk for involvement with companies with poor governance; in the worst cases, this leads to corporate scandals. This reputational risk is particularly serious where stakeholders and

² Among the most influential of these organizations is the Basel Committee for Banking Supervision, www.bis.org.

equity investors stand to lose from governance abuses, such as with banks and insurance companies.

Developing capital markets: Improving corporate governance in a country also contributes to the development of the public and private capital markets.³ Poor standards of governance, particularly in transparency and disclosure, have been a major factor behind instability in the financial markets across the globe.

Although the term “corporate governance” has only become widely used in recent years, IFC has worked on the key issues of corporate governance at the grass-roots level for decades - structuring client companies, appraising investment opportunities, and nominating Board members. This practical experience allows IFC to tailor global principles to the realities of the private sector in developing countries. Development banks and other investors working in emerging markets now look to IFC for leadership on corporate governance issues in developing countries.

5. The Banking Sector in Russia

The Russia banking sector has largely recovered after the 1998 financial crisis and the liquidity crisis of summer 2004, with a growing volume of deposits and loans ever since. Retail loan volumes, especially, have shown strong growth, increasing by 18% over the first six months of 2006 alone. Retail financing now accounts for nearly 24% of the aggregate loan book. The top 30 banks increased their total assets by 32% in the first 10 months of 2006 to about \$326 billion. Russian banks have been able to increase their liabilities 130% – 170% per annum⁴ as Russians have responded to a falling US dollar by transferring some of their dollar cash holdings into ruble bank deposits. Compared to other countries in Eastern Europe, however, the banking sector remains small in relation to GDP. Retail loans were only 6% of GDP last year versus 8% – 15% of GDP in Eastern Europe. Although many banks are reporting positive net earnings, overall profitability remains weak, and there is still over-reliance on earnings from fees and securities trading.

A strong economic growth rate, smaller political risks and a population that is still “under-banked” has prompted strong interest in Russian banks from investors, especially foreign financial institutions. Over the past three years, the market has seen an unprecedented number of mergers and acquisitions, with purchase prices reportedly reaching three to four times the book value. Consolidation has also been spurred by local banks looking for bigger market shares or wider geographical coverage. Structurally though, the banking sector remains fragmented and highly concentrated at the same time. Despite the recent consolidation and some forced closure of banks by the regulator, Russia still has 1,201 registered banks. The 20 largest banks control 63% of the assets in the banking sector assets.⁵ State-owned Sberbank and Vneshtorgbank (VTB) continue to dominate the sector. The share of foreign banks in the banking sector of Russia is about 12% and increasing gradually. Despite Russia’s imminent entry into the WTO, however, this share is not likely to exceed 30% - 35% in the years to come.⁶

³ Claessens, Stijn, and Laeven, “Financial Development, Property Rights and Growth,” *Journal of Finance*, June 2002.

⁴ From RusRating, in www.rusrating.ru.

⁵ From the CBR website, as of 01.09.2006. Among the top 20 banks, the five largest hold 44% of the sector’s total assets.

⁶ According to Mr. Alexei Kudrin, Finance Minister, in RIA Novosti, 21.12.2006.

Despite some announcements, the number of initial public offerings (IPOs) has been insignificant. The Central Bank of Russia (CBR) recently announced further liberalizations in the sale and trading of bank shares that should increase the attractiveness for bank IPOs, especially by foreign investors, but only state-owned VTB has publicly announced its commitment for an IPO in 2007.

Privately owned banks continue to be very closely held, typically by a few individuals as ultimate beneficial owners.

Along with the strong development of the banking sector over the past three years, there have been a number of fundamental regulatory reforms and a newly established deposit insurance system that improved banks' competitiveness and public trust. Since 2004, Russian banks have also seen a greater regulatory focus on key issues of corporate governance, such as disclosure of beneficial ownership structure and related party transactions. In 2005, the CBR introduced International Financial Reporting Standards (IFRS) and announced an increase in the minimum capital requirement to EUR 5 million by 2007. The CBR also waged a battle against opaque capital structures and money-laundering schemes, which resulted in the closure of several banks.

2005 also saw the release of CBR's "Information Letter on Approaches to the Corporate Governance of Russian Banks ." Although not legally mandatory, this 'Russian Code of Banking Corporate Governance' provides guidance on the composition and role of the Supervisory Board, transparency and disclosure, internal control and risk management policies, and the right of stakeholders other than shareholders. However, there are some thornier issues that deserve to be addressed in a more legally binding form, such as transactions with affiliated parties, fit and proper rules for members of the Supervisory Board and Management Boards, and financial disclosure. To address these issues, the CBR introduced the "comply or explain" rule for banks that required banks to declare publicly their degree of compliance with the corporate governance recommendations of the CBR.

6. About The International Finance Corporation

The International Finance Corporation, the private sector arm of the World Bank Group, is the largest multilateral provider of financing for private enterprise in developing countries. IFC finances private sector investments, mobilizes capital in international financial markets, facilitates trade, helps clients improve social and environmental sustainability, and provides technical assistance and advice to businesses and governments. From its founding in 1956 through fiscal year 2006, IFC has committed more than \$56 billion of its own funds for private sector investments in the developing world and mobilized an additional \$25 billion in syndications for 3,531 companies in 140 developing countries. With the support of funding from donors, it has also provided more than \$1 billion in technical assistance and advisory services. For more information, visit www.ifc.org.

7. IFC and the Russian Federation

Russia became a shareholder and a member of IFC in 1993. As of November 1, 2006, IFC has invested around \$2.85 billion of its own funds in 142 projects in the country across a variety of sectors. IFC's committed portfolio in Russia stands at around \$2 billion. At present, Russia is the largest country exposure in IFC's global portfolio.

In fiscal year 2006 (July 1, 2005 – June 30, 2006) IFC invested \$486 million in Russia. To support Russia's efforts to diversify its economy, IFC increased its investments in the real sector, becoming a leading investor in Russia's private infrastructure, forestry and IT. In the financial sector IFC advanced mortgage, leasing and energy efficiency finance and introduced ruble-linked loans. Investments in infrastructure and financial institutions remain a high priority because of their important role in supporting private sector development. A growing part of these investments is in Russian-owned companies – a strong vote of confidence in Russia's private sector and a signal to other investors.

In addition to its investment work, IFC, through the Private Enterprise Partnership (PEP), executes a major donor-funded program of private sector advisory work in Russia. The objectives of the program are to promote direct investment in the private sector, strengthen local small and medium-sized companies (SMEs) and financial intermediaries, and help improve the business enabling environment. Current advisory projects in Russia - apart from corporate governance - include providing expertise to Russian companies in the automotive sector, advising firms on improving production and management practices, and linking these firms as suppliers to larger producers. IFC also runs a program combining dedicated IFC credit lines for energy efficiency with advisory. A project in the housing finance sector has consolidated mortgage industry efforts by creating a multi-stakeholder working group to identify key industry issues and jointly develop solutions. For more information about IFC and Russia, visit www.ifc.org/eca.

8. The Russia Banking Sector Corporate Governance Project

In 2003, IFC conducted a survey on corporate governance in the Russian banking sector of 52 Russian banks, which indicated that corporate governance is a key area for further improvement. To respond to the banks' needs, IFC set up the Russia Banking Sector Corporate Governance Project. The main focus of the project has been on working with banks to improve the practices of the Supervisory Board and the Management Board, their disclosure and transparency policies and practices, as well as their internal control systems.

Since summer 2004, the project has contributed to the development of corporate governance practices in Russia's banking sector by:

- conducting 42 specialized seminars with over 1100 participants from 343 banks, banking associations and government agencies;
- providing 94 individual consultations to 24 banks;
- recommending revisions of 245 internal documents (e.g., Charter, By-laws);
- commenting on the Central Bank of Russia's corporate governance regulation; and
- advising the Ministry of Economic Development and Trade on new legislation on Related Party transactions, Squeeze-Out Law, and Registrars.

The Russia Banking Sector Corporate Governance Project is funded by the Swiss State Secretariat for Economic Affairs (SECO). For more information on the Russia Banking Sector Corporate Governance Project, visit www.ifc.org/rbcg.

II. EXECUTIVE SUMMARY

The past three years have left their mark on the corporate governance of Russian banks. Various initiatives by the Central Bank of Russia, as well as stricter listing requirements and tighter corporate laws, have raised the bar for good governance practices in banks. The Russian banking sector now has a good corporate governance framework upon which it can further develop.

► **Corporate governance in Russian banks is acceptable but it is not perfect**

Banks have embraced the normative changes. Some of them even went beyond mere legal requirements and adopted national and international best practice recommendations on corporate governance. The survey revealed improvements in all five key areas of corporate governance: Commitment, Board Practices, Transparency and Disclosure, Internal Control and Risk Management as well as Shareholder Rights. Banks still need to work on governance in order to reach best national and international practices. Key areas of improvement still remain, primarily in strengthening the Supervisory Board, Transparency and Disclosure, and practices related to Internal Control and Risk Management.

Board Practices:

- *The composition of the Supervisory Board is improving; in some banks it meets the best practice standards.* More than a half of the banks reported having independent directors on the Supervisory Board. On the other hand, 63% of the banks reported that they do not have specialized board committees. Only 17% of the Supervisory Boards, for example, have an audit committee, and less than half of those committees are chaired by an independent director.
- *The role of the Supervisory Board needs to be strengthened.* Only a third of banks assign management control and oversight to the Supervisory Board, and is even strictly against the idea of the Supervisory Board selecting and dismissing the CEO.
- *Potential conflict of interests for the Supervisory and Management Board members are not yet properly addressed.* Only half of the banks regulated the handling of conflict of interests.
- *Banks are still reluctant to disclose remuneration packages but are gradually warming up to this practice.* Only 40% disclose the amount paid to the Supervisory Board; 42% reveal the total salary package of the Management Board.
- *It is advisable for banks to introduce formal performance evaluation procedures for their management including key performance indicators.* Only 26% of banks use such techniques.

Transparency and Disclosure:

- *Ownership structure.* Progress has been made in disclosing the (beneficial) ownership structure to the public (66% of banks).
- *There is room for more disclosure of more material financial and non-financial information.* Only 60% of the banks currently provide information on transactions

involving more than 10% of the bank's assets by book value, and 17% of the banks do not disclose related party transactions at all. More banks claim to disclose information on corporate governance structure and material risk factors (57% and 67%, respectively). Compared to the standard set by other industry sectors in Russia (notably the telecommunication sector) or banks outside the country, a bigger engagement of Russian banks in public disclosure would be welcome.

- *Banks should review their information package to shareholders for the General Shareholders Meeting.* More supportive information for every agenda item ahead of the meeting should be standard practice.

Internal Control and Risk Management:

- *Banks have an internal audit department and appreciate its consulting and assessment services.* Unlike three years ago, banks now recognize the value an internal auditor can add beyond mere compliance and policing functions.
- *Internal auditors do not enjoy full independence from management.* In 42% of banks, the internal audit departments still functionally report to the Management Board or CEO.
- *Banks have established a risk management function.* However, a comprehensive integrated approach that includes all banking risks is still missing. The Supervisory Board also needs to become more involved in defining the risk profile of the bank.
- *A Chief Risk Officer function is almost absent.* None of the banks had installed the position of a Chief Risk Officer, who oversees all risk categories and reports directly to the CEO. Of the respondents, 14% put the Finance Director in charge of risk management – a practice that creates potential conflicts of interests.
- *Banks rarely assess corporate governance practices of their clients in their credit risk analysis.* Although as was the case in 2003 60% of banks confirm the importance of corporate governance in their client credit risk assessment, the criteria used are mainly for standard credit analyses and short of more sensitive governance principles. Banks are not yet an active promoter of good corporate governance practices among their client base.,

► Corporate governance in banks with foreign participation and listed securities tend to be better

The survey could not identify significant regional differences in governance. A minority equity participation of foreigners or listed securities, however, appears to have some positive impact on governance practices, although exceptions occur. State-owned organizations and companies that are majority controlled by foreign institutions were not included in this survey and may have led to different conclusions.

► Strong economic growth and keen investor interest in bank assets may pose a threat to further corporate governance improvements

It is difficult to sell a raincoat on a sunny day. The business environment for banks is currently favorable. Shareholders and management of Russian banks may forfeit long-term sustainable business development for short-term profits. The keen interest of investors on entering the banking market or increasing market share has led to

intensive competition with reported banks shares' purchase prices on the rise. Russian banks should remain focused and continue their vigilance for good governance practices.

III. FINDINGS OF THE SURVEY

1. COMMITMENT TO CORPORATE GOVERNANCE PRACTICES

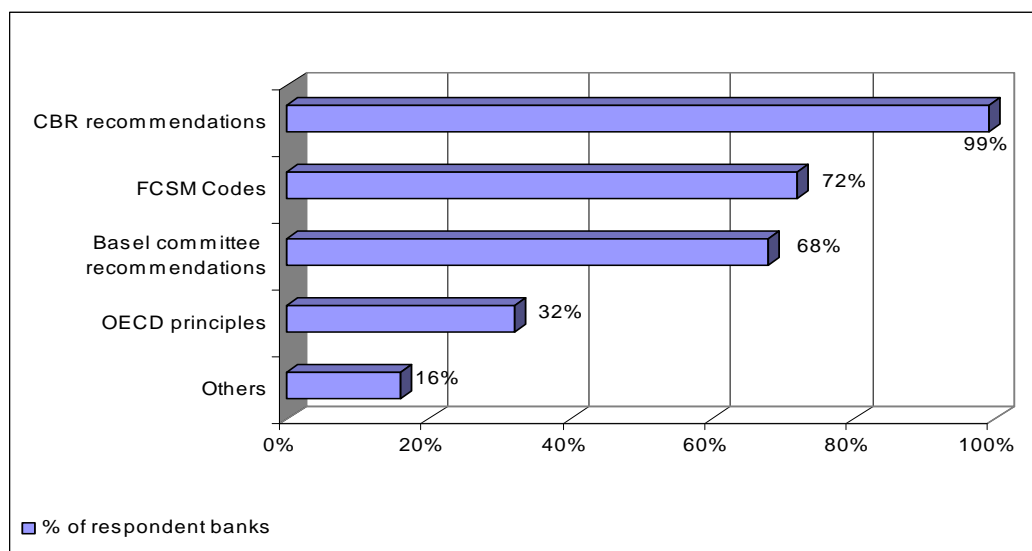
Commitment is one of five criteria that IFC looks at when assessing the level of corporate governance of its corporate clients. It is also one of the most difficult to capture and requires intensive interviews with representatives from the various governing bodies (e.g., Shareholders, Supervisory Board and Management Board). For the purpose of this survey, we looked at a few factors that may indicate a bank's degree of commitment.

Adherence to National or International Corporate Governance Codes or Principles

Almost every surveyed bank, regardless of its legal form or shareholder structure, claims to know and follow the corporate governance recommendations set by the CBR. This is certainly a success for the CBR, as it introduced its "Corporate Governance Code" only in late 2005, and not even in the form of a mandatory regulation. 72% of banks also try to adhere to the Code of Corporate Conduct as introduced by the Federal Commission for the Securities Market (FCFM). The Code of the FCFM and the CBR recommendations, together with corporate and securities laws, now provide a good national framework for corporate governance on hand that is complemented by international banking specific guidelines. It is therefore possible for banks to regularly inform their stakeholders on the extent to which their practices correspond with national or international corporate governance principles and explain reasons for deviances⁷; 68% of banks claim to do so, mainly in their annual report to shareholders. As the survey later reveals, unfortunately, this claim often remains wishful thinking.

Corporate laws and national and international guidelines are the main source of information for banks that wish to inform themselves about corporate governance. Seminars and conferences, consultants and business partners are also popular sources.

Chart 1.1 Adherence to recognized codes and principles.



⁷ Otherwise also known as the "comply or explain" rule.

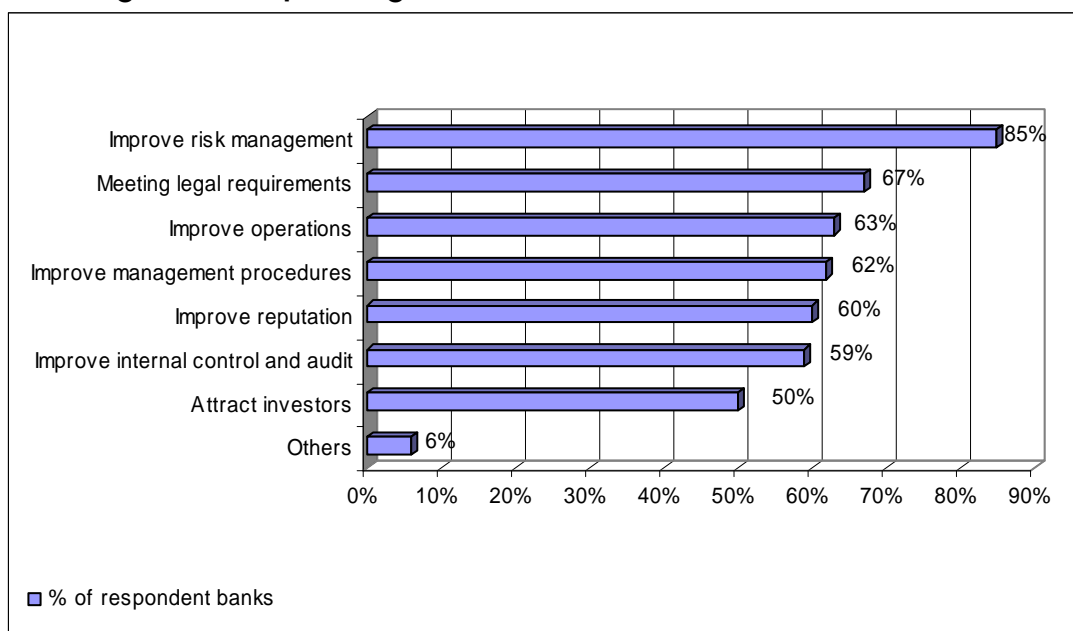
Main Goals of Corporate Governance

It is interesting to note that the main concern for banks remain their risk management system. The majority of banks (86%) pursued better corporate governance practices to help improve risk management (see Chart 1.2). This focus on risk management corresponds with the view expressed by banks in the 2003 survey. Meeting legal requirements as a goal of corporate governance gained in importance, ranking second (67% of banks voted for it) as compared to 2003, when it ranked last in the survey. We see this as an indication of the various legal initiatives by the government and the CBR in fostering better corporate governance; banks realized the need to catch up with these more stringent legal requirements. 54% of banks even admitted that new regulations were the driving force behind their corporate governance improvements over the last three years. Compliance with laws and regulations even outdid the goal of improving public reputation or attracting investors – popular objectives for corporate governance improvements in 2003.

In general, it appears that banks became more focused on corporate governance as a means to improving their operational efficiency and legal compliance, as opposed to attracting funds. While this is generally a positive trend, these results can also be attributed partly to the fact that many bankers still confuse corporate governance with operational management.⁸

Banks with listed securities set their priorities somewhat differently. These banks focused on attracting investors and improving the structural relations between shareholders, directors and the management.

Chart 1.2 Main goals of corporate governance.



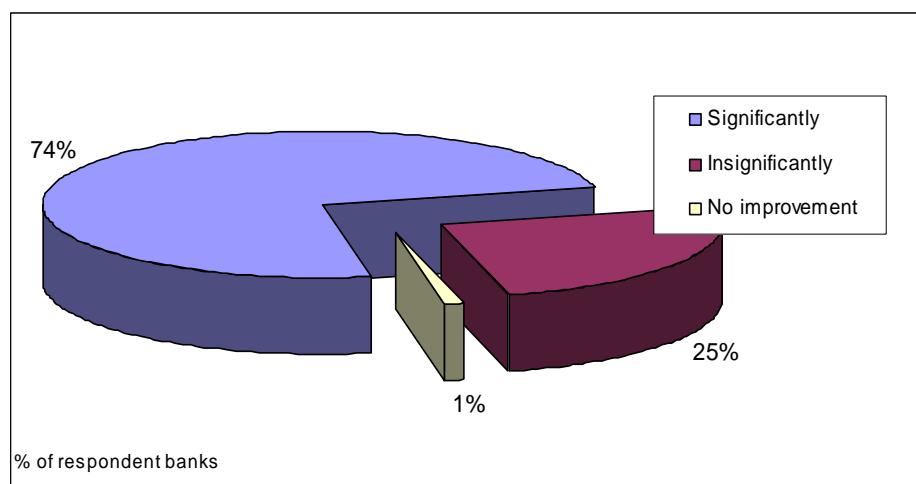
⁸ The Russian language does not have a distinctive word for corporate governance and translates it with “corporate management.”

Level of Improvement of Corporate Governance Practices

A majority of the respondent banks in Moscow and other regions reported significant improvements in their corporate governance practices over the last three years, as shown in Chart 1.3. Only one quarter of the banks stated making insignificant changes in their corporate governance. As mentioned earlier, 54% of banks credit new laws and regulations for their corporate governance improvements; 36% of banks cited the corporate governance projects of IFC as a motivating factor for introducing reforms, while 27% of banks attributed their improvements to the demand of a strategic investor.

Those banks that reported no improvements over the last three years mentioned, as among the reasons, the lack of the owners and managerial will or more burning managerial priorities.

Chart. 1.3 Improvement of corporate governance practices in 2003-2006



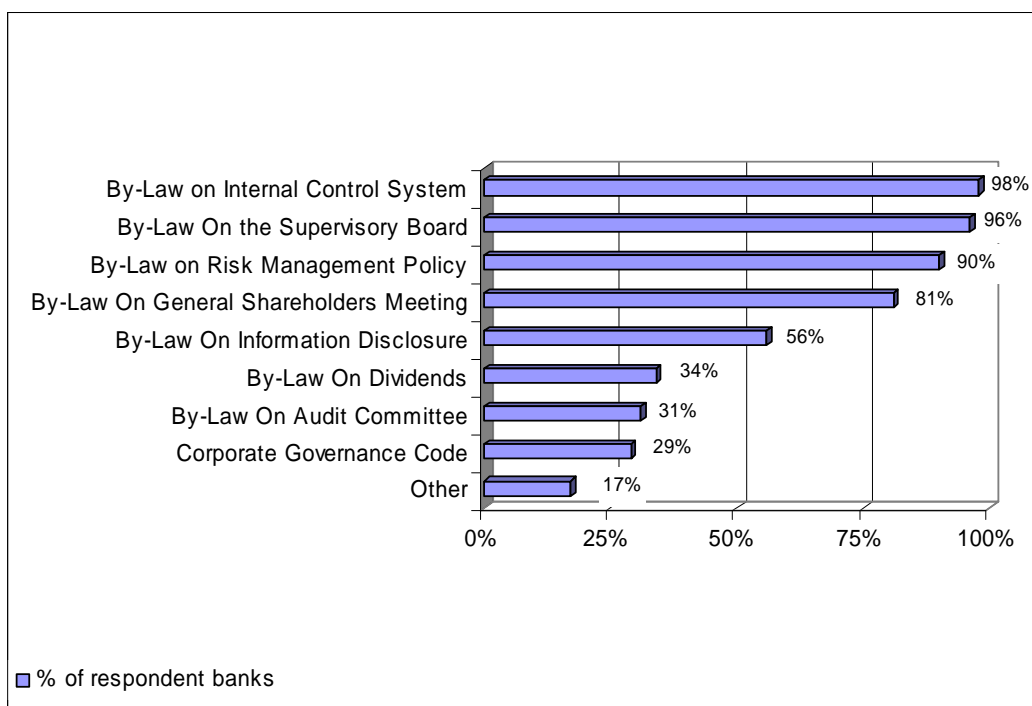
Corporate Governance Documentation

The CBR demands a certain set of corporate documents from banks, such as the Charter, By-laws on the Supervisory and the Management Boards, Internal Control Systems and Department, and Risk Management Policy. Banks are free to further specify their business and operational practices in additional By-laws and policy papers. The survey reveals that banks are reluctant to adopt additional internal corporate governance documents. For instance, only 56% of banks have an information disclosure policy or try to regulate their corporate governance practices in a separate corporate governance code (existent in only 29% of banks). Given the practice of reinvesting corporate profits, it is not surprising to see that only 34% of banks have regulated their dividend policy in a By-law. As the survey later shows, a majority of banks are also reluctant to establish specialized Supervisory Board Committees recommended as well by the CBR, such as an Audit Committee. It is therefore unsurprising to note that only 31% of respondent banks have a By-law on the Audit Committee that regulates its working practices.

Anecdotal evidence further shows that the content of corporate documents are often copies of the respective law, poorly adjusted to a bank's specific situation and barely detailed enough to be useful working documents. Corporate documents are also inconsistent -- By-laws do not reflect latest amendments to the Charter, for example.

The survey could not identify significant differences among the banks. The existence of listed securities or foreign shareholders, for example, does not appear to change a bank’s approach to its corporate documents. Compared to the results of the 2003 survey, banks now focus more on topics like information disclosure, risk management and internal control.

Chart 1.4 Corporate governance documentation (



Corporate Governance training

Corporate governance starts at the top. Members of the Supervisory Board and the Management Board should know the essence of corporate governance and act accordingly. As laws and regulations change, so do corporate governance principles and business practices. Regular trainings in latest developments – some call them “refresher courses” – should be standard for the top echelon of banks. It is therefore a positive sign that the majority of banks surveyed organize special training programs for members of the Supervisory Board and Management Board (only five banks do not). However, experience shows that the Supervisory Board is often the weakest link in the corporate governance system, with members receiving less training than management.

Legal requirements to the professional and personal qualifications of Bank Directors are minimal; banks therefore are well served to pay more attention to the training and development of their directors.

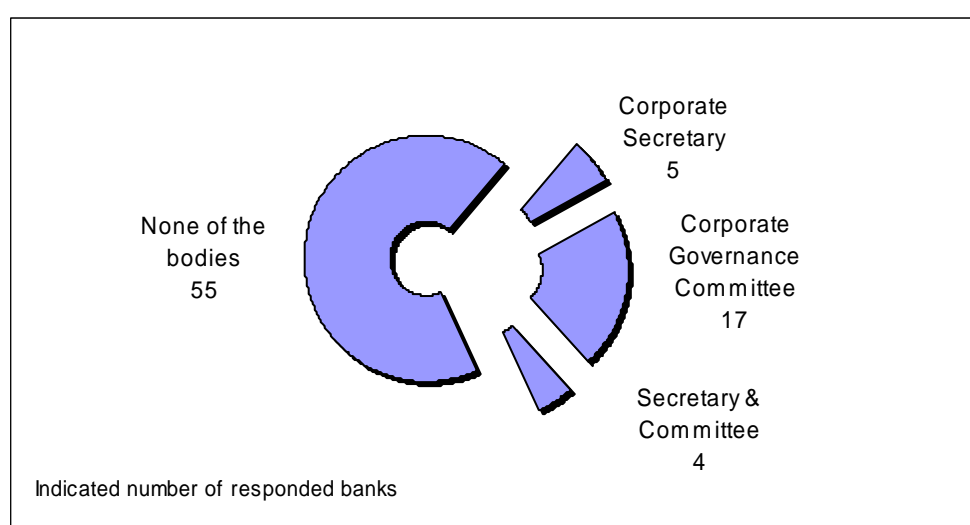
Internal Corporate Governance expertise

A Corporate Secretary who supports the work of the Supervisory Board, is an internal source of knowledge on all aspects of corporate governance and also manages the corporate document repository is still uncommon for banks as Chart 1.5 shows. More banks have now established a Committee of the Supervisory Board that takes care of

corporate governance issues (17% of banks as compared with 4% three years ago). Overall, combining the results for the Corporate Governance Committee and the Corporate Secretary, we have not noticed progress in building up internal expertise on and responsibility for corporate governance. As with the banks three years ago, only one quarter of banks have made an effort in this respect.

Surprisingly, a majority of banks with listed securities do not have any of these functions either. This is mostly likely due to a few reasons: the concentrated shareholder base of most banks, the small number of Supervisory Board members, economic reasons, and a lack of knowledge. Very often, the head of the legal department assumes the role of a Corporate Secretary; sometimes – as we have witnessed ourselves – it is the Chief Executive Officer (CEO) who officially takes over this role.

Chart 1.5 Internal corporate governance expertise



Synopsis: Commitment to Corporate Governance

The initiatives of various promoters of good corporate governance, most notably the Central Bank, have succeeded in making banks aware of the framework regulating corporate governance and the resources for information and expertise. Banks now need to institutionalize the corporate governance regulations and guidelines. They also need to realize that corporate governance is a process rather than a one-time investment. It requires regular training and the will to update and refine corporate documents and practices continuously. As the business activities and funding sources of banks become more diversified and complex, so do their governance requirements. Banks are therefore well served to strengthen their internal capacity and expertise on corporate governance in order to meet these challenges.

2. SUPERVISORY BOARD AND MANAGEMENT BOARD

2.1 THE SUPERVISORY BOARD

Russia adopted a hybrid two-tier system for the Supervisory Board (=Board of Directors) of banks. While the position of the Chairman of the Supervisory Board and the Chairman of the Management Board (=CEO) is not compatible, the banking law allows for a number of executive directors equal to one quarter of the Supervisory Board's total size. While corporate law emphasizes the role of the CEO and the Chief Accountant by holding them accountable for the accuracy of the financial reports,⁹ it is less clear on the qualification for membership in the Supervisory Board, its role and powers. The current legislation does not outline the qualification for membership in the Supervisory Board, nor clearly define its role and powers. In addition, it is a widespread trend in the Russian banking sector that the major shareholders actively manage the bank as members of the Management Board. These circumstances may have led to the traditionally weak position of the Supervisory Board in the overall corporate governance system of Russian banks – a view that was already seen in the 2003 survey and also confirmed by anecdotal evidence.

“Good corporate governance starts at the top. The Supervisory Board is the body that develops a bank’s strategies, takes the lead in establishing the ‘tone at the top’ and approves corporate values for itself, senior management and other employees. It further sets and enforces clear lines of responsibility and accountability throughout the organization.”

From “Enhancing Corporate Governance for Banking Organizations,” The Basel Committee on Banking Supervision.

Functions of the Supervisory Board

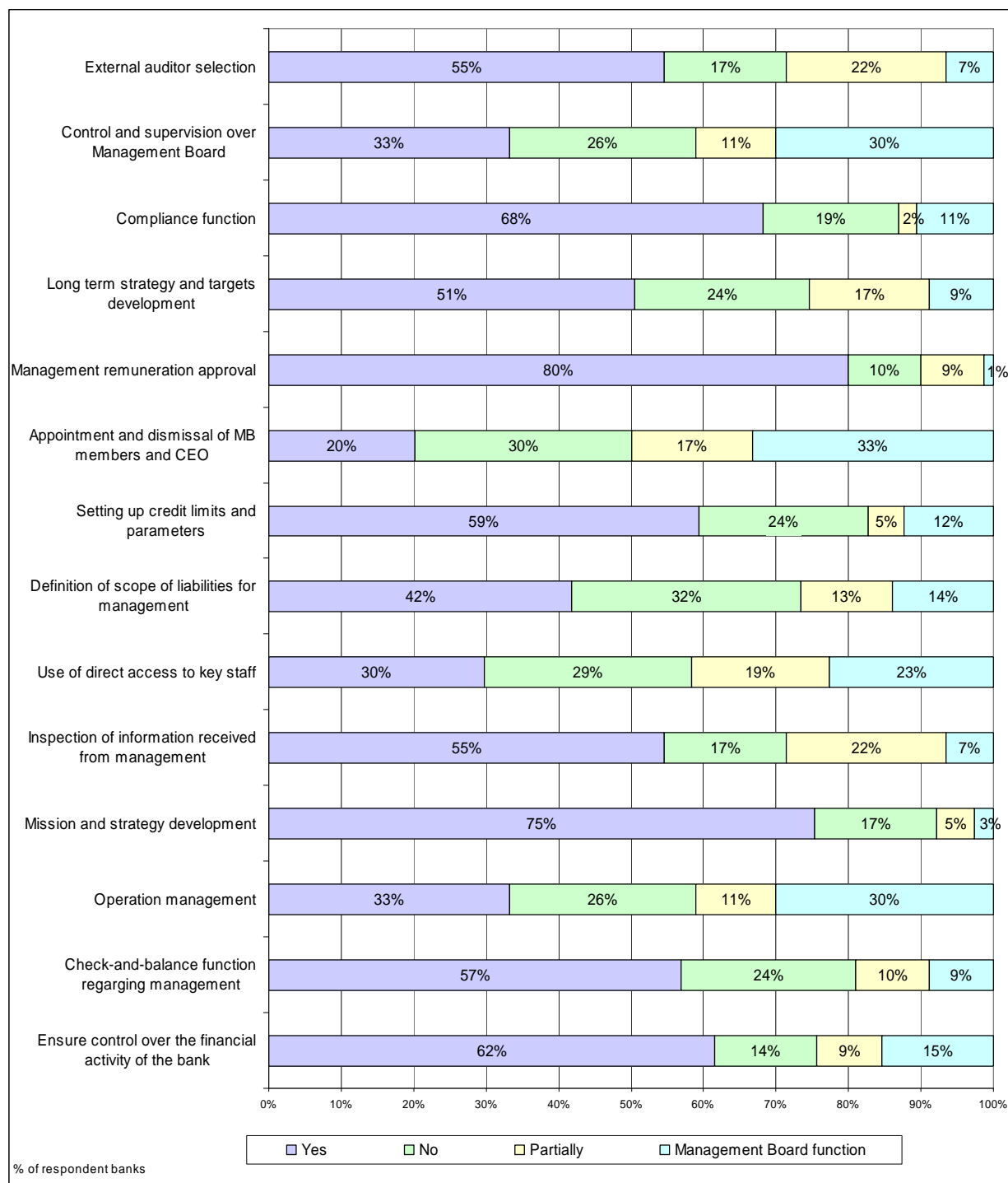
The results of the 2006 survey reaffirmed the view that Russian banks still struggle with the role and function of their Supervisory Board as shown in Chart 2.1. But it also showed progress for the better over the past three years.

Three quarters (75%) of banks now assign the development of the bank’s mission and strategy fully to the Supervisory Board. More banks now make efforts so as the Supervisory Board to take an active role in the control of the bank’s finance (70% including those banks who consider this partially). In 80% of the banks surveyed, the Supervisory Board is now responsible for determining the compensation package for the members of the Management Board, including the CEO (versus 38% three years ago).

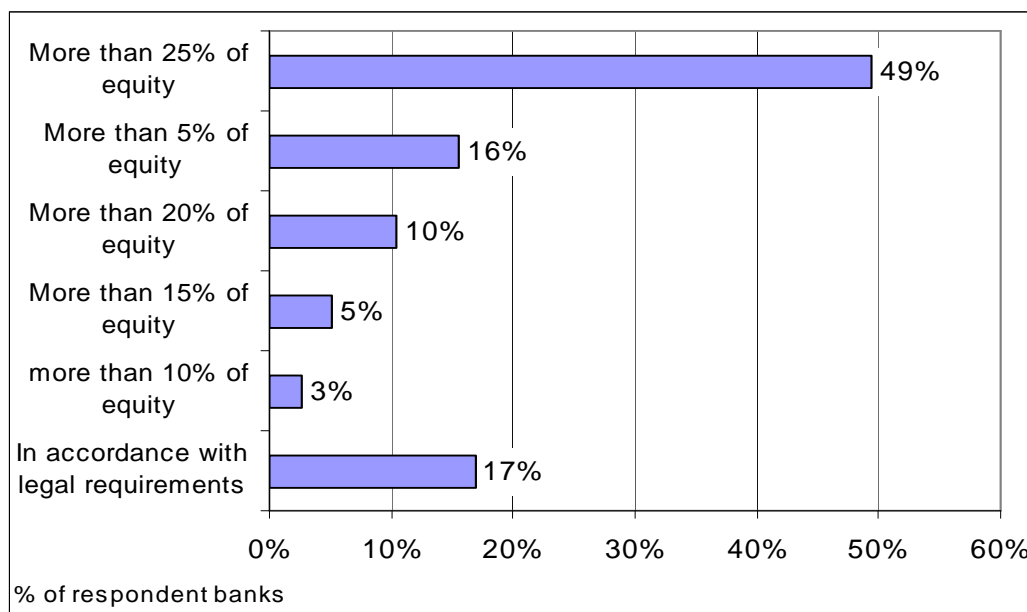
On the other hand, banks still shy away from giving the Supervisory Board too much power over the Management Board. Only 30% give members of the Supervisory Board full unobstructed access to key staff. An equally low number (33%) want the Supervisory Board to control and oversee the Management Board’s activity. About half of the banks do not find it appropriate for the Supervisory Board to challenge the management on the information received. A third of the banks are even strictly against the right of the Supervisory Board to select and dismiss members of the Management Board, including the CEO.

⁹ A legal obligation in Russia similar to the one introduced by the Sarbanes-Oxley Act in the U.S.

Chart. 2.1 Functions of the Supervisory Board



It is therefore not surprising to note that in the majority of cases, the Management Board enjoys high discretion for approval of financial transactions. The most common threshold for approval is set at 25% of the bank’s total assets.

Chart 2.2 Size of financial transactions subject to approval by the Supervisory Board

While we welcome a Management Board with sufficient power and flexibility to achieve ambitious business targets, we would equally like to see a Supervisory Board that is more engaged, aware of its role and position and not shy to assume control and oversight.

Composition of the Supervisory Board

Supervisory Boards of Russian banks tend to be small in size, with 5 to 9 members in most cases. Only 5% of banks have a Supervisory Board that has less than 5 members, the minimum recommended by the CBR, while 9% of banks have more than 9 members. A certain correlation between the size of the bank and its Supervisory Board can be made.

A typical member of the Supervisory Board in Russia is a Russian man, 44 years old, with a legal or economic background. He brings with him professional experiences, mainly from industry, commercial banking or securities trading. More than 15% of banks recruited members of the Supervisory Board from government or government agencies. Banks chiefly select their directors for their personal qualities (32% of the cases), experience in financial services (28%) and their loyalty to the major shareholder (14%). On average, a Russian director has served 3.5 years on the Supervisory Board of the bank.

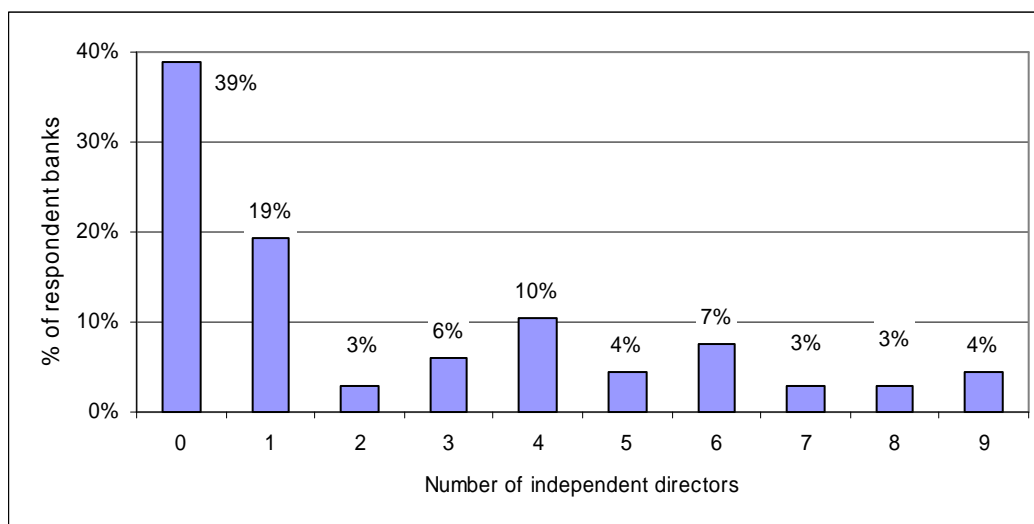
It seems that the number of women members is on the rise – 60% of respondent banks have, on average, two women on their Supervisory Boards.

Not surprisingly, the majority of Supervisory Board members represent the major shareholder. Minority shareholders are represented on the Board in only 8% of the banks surveyed.

Almost 40% of Supervisory Boards do not have any independent director. In general, Moscow-based banks and banks with listed securities made an effort to appoint independent directors to their Supervisory Boards. Chart 2.3 reveals that 4% of respondent banks reported having 9 independent directors. This is a very positive result

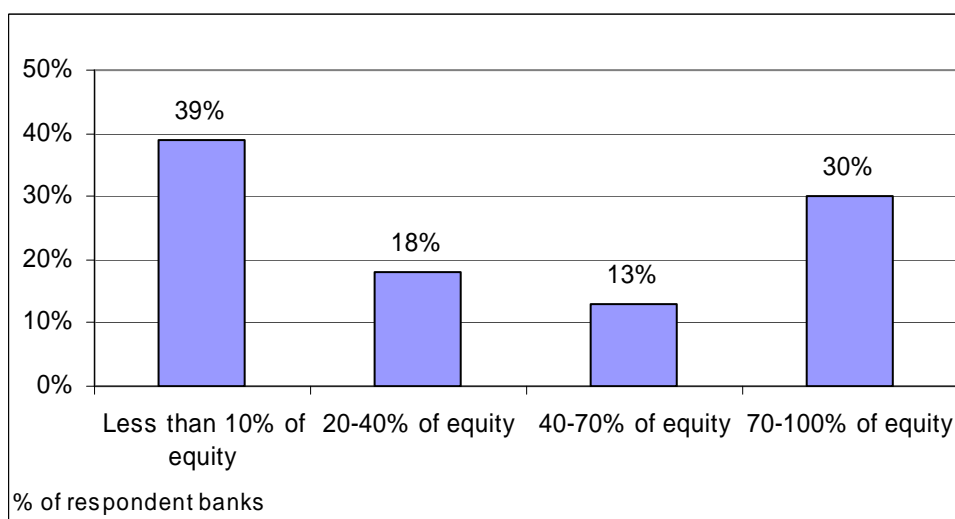
that, however, needs further assessment. Current law and corporate governance regulations still apply a different definition of “independence,” with relatively wide room for interpretation. From practical observation, most banks also do not define the criteria used for independence in their Charter. The reported figures therefore need to be taken with caution.

Chart 2.3 Number of independent directors at respondent banks



On another note, it is interesting to see how the banks are polarized when asked about the shareholdings of their Supervisory Board members. Members of the Supervisory Board either hold less than 10% of the bank’s own shares or are in full control. In almost 50% of banks with listed securities, members of the Supervisory Board own less than 10% of the capital.

Chart 2.4 Percentage of bank shares owned by Supervisory Board members



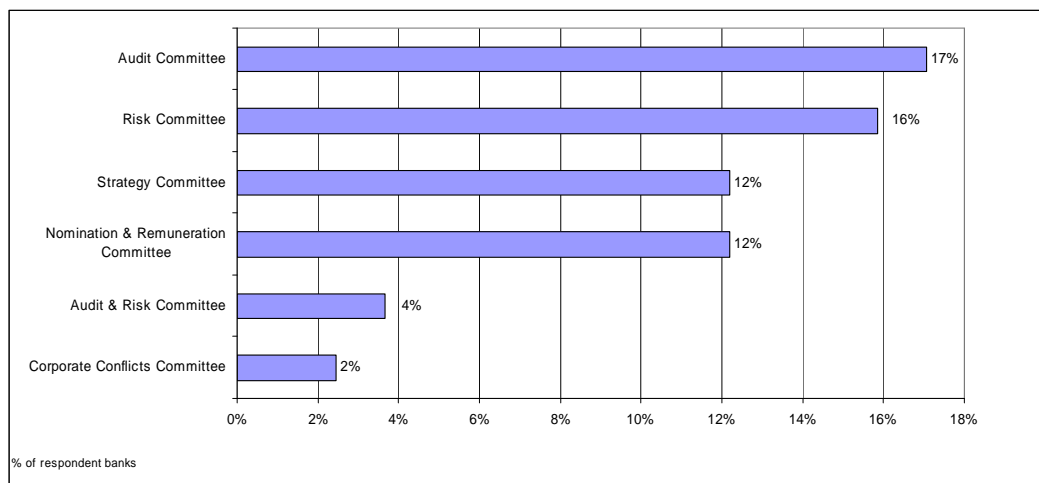
Structure of the Supervisory Board

The expectations on the skills and experience of a Supervisory Board member have been growing over the years, and not only in Russia. Equally, the banking business has become more complex and opaque. Most corporate scandals and bankruptcies

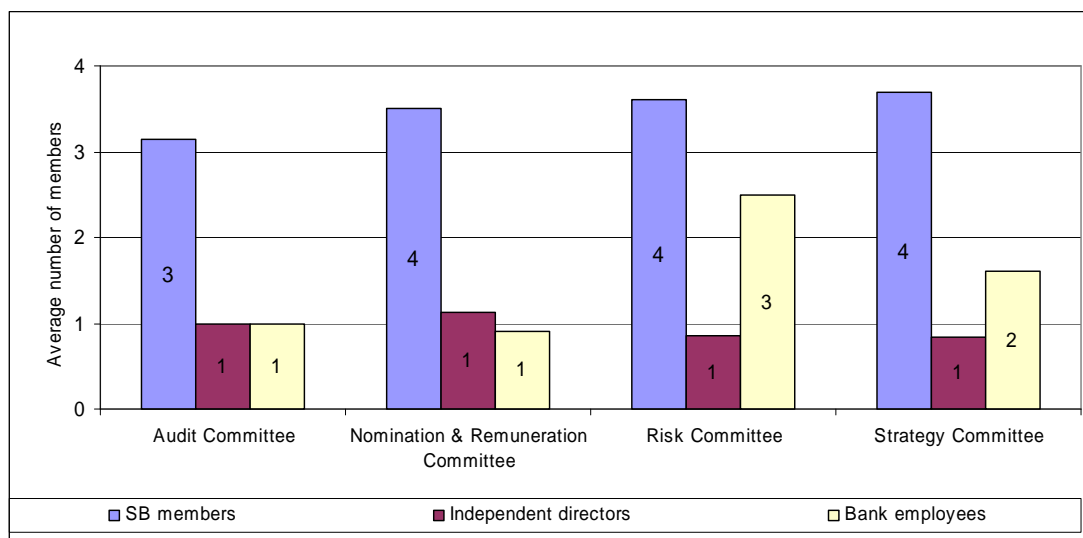
revealed a Supervisory Board that was dysfunctional and not up to the job. For these reasons and apart from a rigorous selection process, most corporate governance guidelines recommend that the Supervisory Board set up specialized committees in line with the Board's key functions: nomination and remuneration of management, strategy definition, and oversight and control on finance and risk. These committees should consist of Board members with adequate background and expertise on the respective subject. Most corporate governance sources agree that an Audit Committee with oversight on financial matters is now almost standard. For banks of a certain size, a special Risk Committee is recommended, unless the Audit Committee takes care of it as well. Other committees include the Committee for Nomination and Remuneration or a Strategy Committee. In its corporate governance recommendations, the CBR lists no less than five committees of the Supervisory Board.

As Chart 2.5 illustrates, the respondent banks have not yet embraced this recommendation to the fullest. An Audit Committee is only present in 17% of respondent banks, a Risk Committee in just 16%. However, this is significant progress from the last survey. In 2003, only 8% of respondent banks reported the existence of an Audit Committee, for example. It is interesting to note that, in general, Russian banks with foreign shareholders and banks with listed securities pay more attention to the formation of committees. The Audit Committee, Risk Committee and Nomination Committee are the most represented in those banks.

Chart 2.5 Committees of the Supervisory Board



Banks with committees of the Supervisory Board have, on average, three to four members per committee with a least one independent director and one employee of the bank – this could either be an executive director or another member of management. While the existence of independent directors on the committees is laudable, we question the practice of having non-Supervisory Board members as standing members of Board committees, unless they are there for information purposes only, without any voting power.

Chart 2.6 Average compositions of Supervisory Board committees

Working methods

It is good practice for a Supervisory Board to hold regular meetings for which members have adequate time and information to prepare for. Ideally, the Board should set key agenda items in advance (for example: strategy planning in October; compensation decision in December, etc.). Members should be able to request additional information, contact key management staff or seek outside advice if deemed necessary. Furthermore, members should have the commitment and time to attend meetings in person; the Charter or By-laws should, however, allow for voting in absentia or by circular mail.

One-third of the Supervisory Boards of the respondent banks meet on a monthly basis, 22% even more, while another third meet less frequently than once a month (see Chart 2.7). Banks with foreign participation and listed securities prefer to have less frequent Board meetings, perhaps due to distance of travel from home countries, more frequent use of circular decisions, or a greater delegation of authorities to the management. There is no final verdict on the frequency of Supervisory Board meetings – it is up to the respective Boards to decide. However, the practice of ad-hoc meetings, as reported by 9% of the respondent banks, is counterproductive. It does not allow for sufficient preparation and puts unnecessary strain on Board members as well as management.

Half of the respondent banks with specialized Committees reported holding quarterly meetings of Committees of the Supervisory Board.

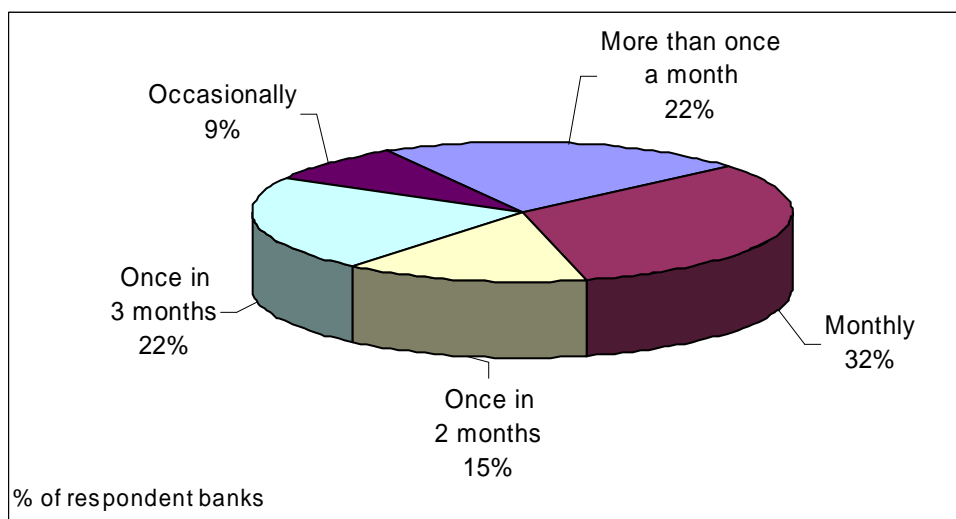
It is a positive sign that in 80% of the banks, members of the Supervisory Board can convene a Board meeting even in the absence of the Chairman of the Supervisory Board. Some banks (23%) only allow the Deputy Chairman to convene a meeting, while a minority (1%) even confers this power to the independent director.

Attendance rate at meetings of the Supervisory Board is high, with over 80% of members attending every meeting.

Chart 2.1 already revealed that a majority of banks do not want their Supervisory Board members to contact management staff directly for additional information. We cannot understand this attitude. Encouragingly, 46% of the banks allow their

Supervisory Boards to use external advisors. However, in only 39% of those banks, the Supervisory Board has its own separate budget and does not require the approval of the Management for hiring such advisors.

Chart 2.7 Frequency of Supervisory Board meetings

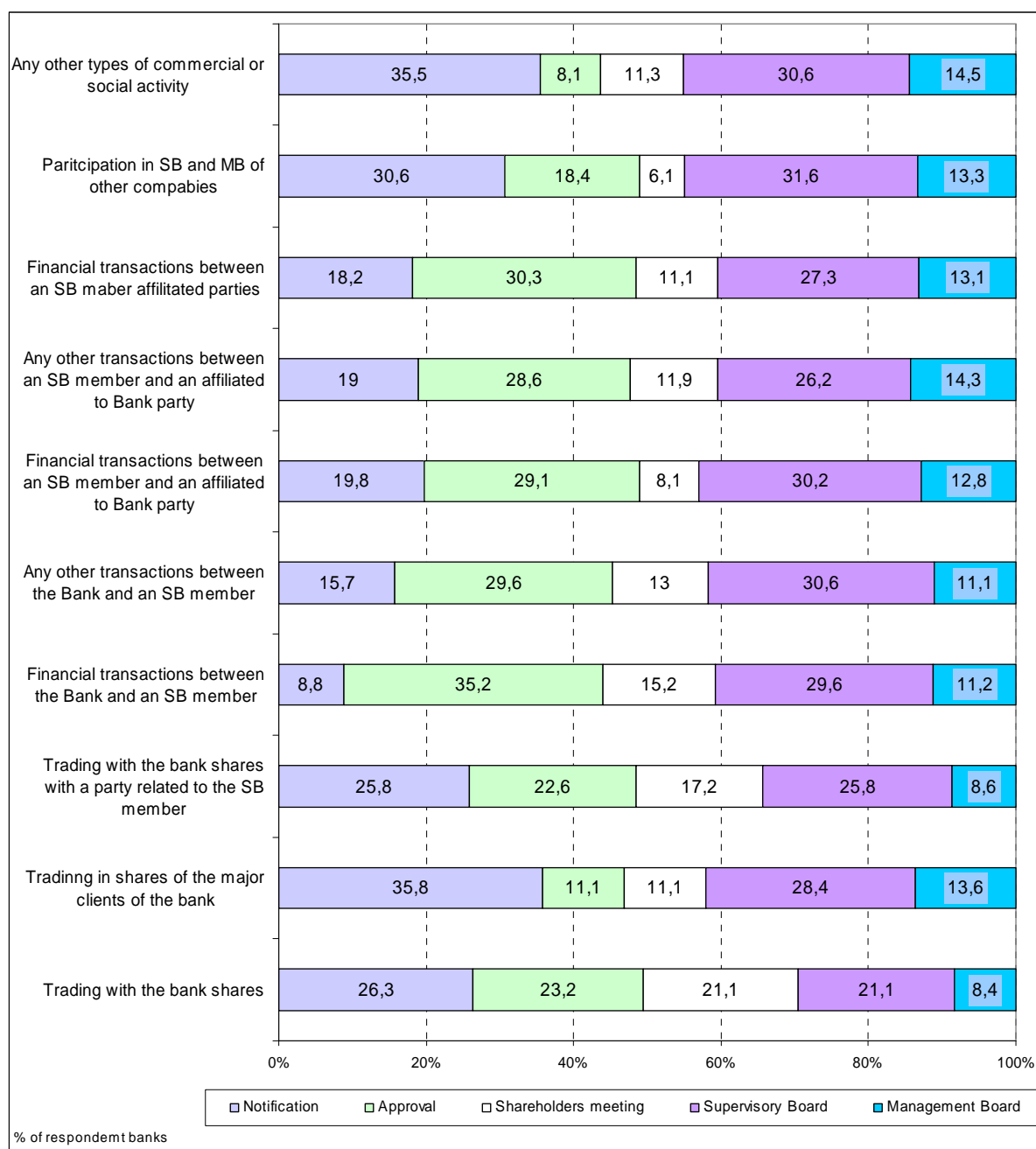


Accountability

Russia still does not have a proper law on insider dealing (i.e., the use of confidential information for unlawful personal enrichment and market manipulation). Equally, the law provides contradictory regulations on conflicts of interest, such as the business relationship between a bank, its Supervisory Board members and their immediate families. Corporate governance principles do not prohibit such business relations per se, but demand full disclosure and a proper internal notification and approval process. While only half of the respondent banks (52%) dealt with conflict of interest in their internal documents (Charter or By-law of the Supervisory Board), 69% regulated the use of insider information. Notably, banks with listed securities show a more rigorous approach to this issue. Regional banks also set out stricter rules than banks located in Moscow.

Chart 2.8 reveals the notification and approval procedure of those banks that have regulated potential conflicts of interest. It also confirms that banks in general need to address this topic more rigorously. It is interesting to note the relatively high percentage of cases in which the Management Board eventually approves the transaction. Is this another indication that the ultimate power is with the Management Board or does it simply reflect the ultimate ownership structure of the bank concerned?

Chart 2.8 Transparency of Supervisory Board members activity



In more developed markets, there is a widespread practice to provide members of the Supervisory Board (and management) with a “**Director and Officers Liability Insurance.**” As was the case three years ago, this is still uncommon among Russian banks, with 95% lacking such insurance coverage. Banks with foreign participation, however, buy such policies in 80% of the cases.

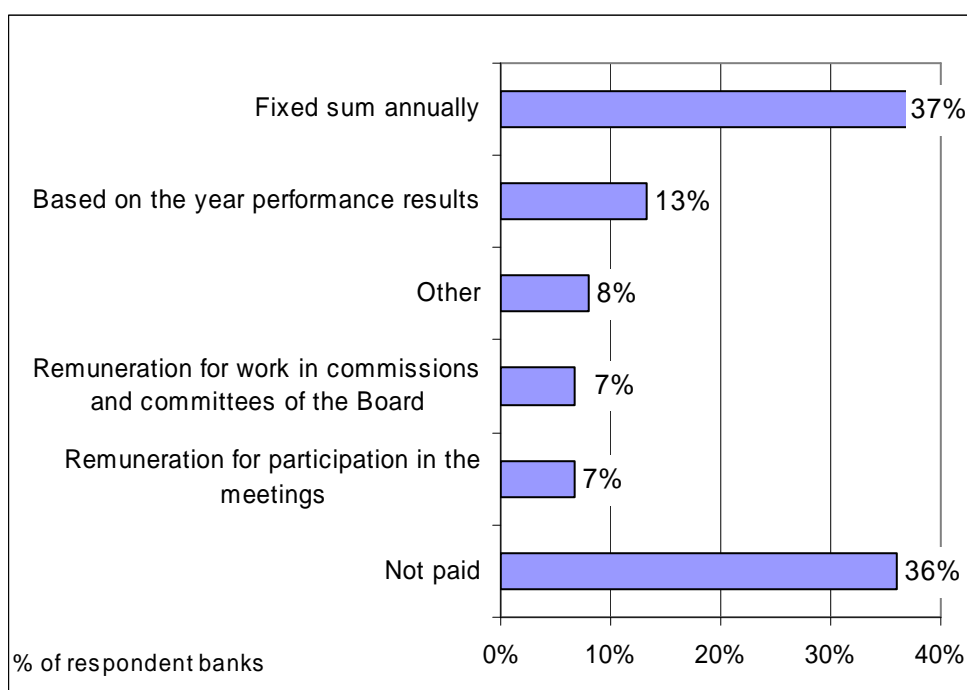
Remuneration and evaluation

According to the survey, 37% of banks pay a fixed annual sum to their Supervisory Board members; a minority pays for meetings attended and extra work as a committee member. On the other hand, 36% of the banks do not compensate their Board members for their work at all. The 2003 survey revealed a similarly low number. Board members should be compensated for their contribution, time and responsibility,

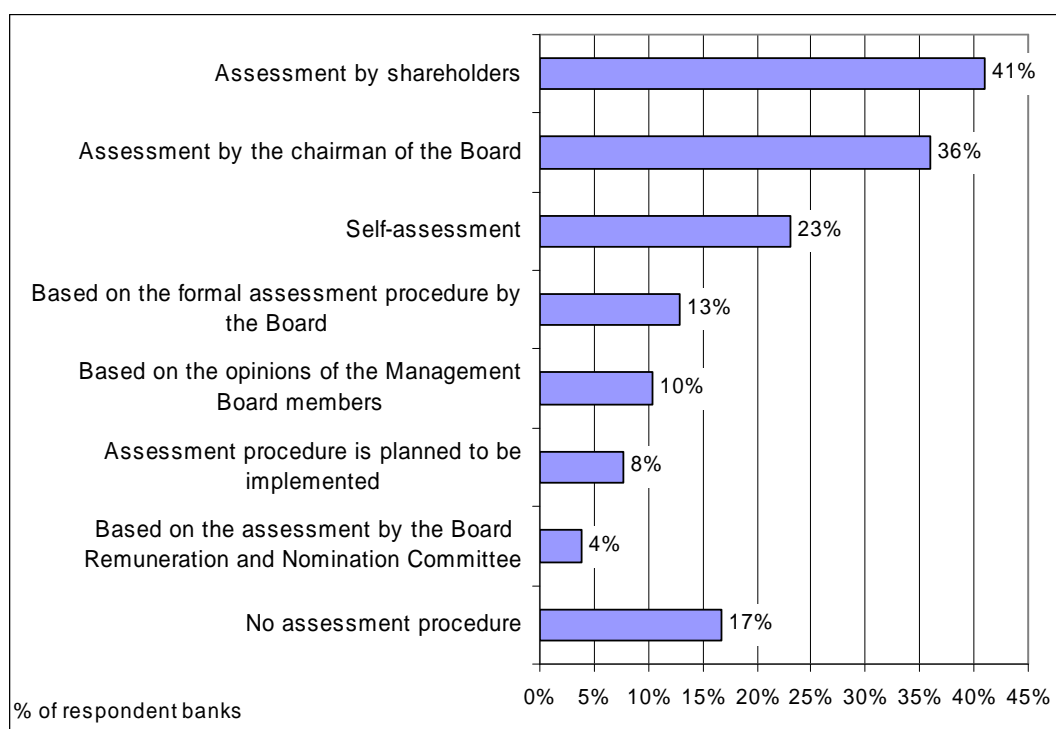
and in a transparent manner. Otherwise, there is ample room for speculation on the true motives of Board members.

Of the banks that compensate their Board members, 40% disclose the total amount paid out to the entire Supervisory Board. Only 18% of the respondents are ready to report the remuneration paid to every individual Board member -- not a significant difference in disclosure from the 2003 survey. The trend in most countries is to disclose remuneration paid out to the Supervisory Board and Management Board. It is however a thorny issue, and Russian banks are not alone in their reluctance to make such numbers public.

Chart 2.9 Remuneration paid to Supervisory Board members



Most banks evaluate the performance of their Supervisory Board members. While three years ago, one quarter of banks deemed an evaluation of performance unnecessary, this number has now decreased to 17%. Feedback from shareholders remains the most popular method of evaluation, followed by opinions of the Chairman of the Board. Self-assessment appears to be a method of evaluation gaining in popularity. A considerable number of banks still find it appropriate that the Management Board evaluates the performance of Supervisory Board members. We can only explain this again with the particular ownership situation in those banks (i.e., the major shareholders being on the Management Board). The survey did not reveal any significant regional differences in dealing with this issue, nor did banks with foreign equity participation or listed securities seem to be more active.

Chart 2.10 Evaluation methods for Supervisory Board members***Synopsis: Supervisory Board***

Banks have made progress in better integrating the Supervisory Board in their overall corporate governance. The Supervisory Board as a key governing body is now more aware of its responsibilities and assumes a more active role. At the same time, efforts have been made to improve the composition and structure of the Supervisory Board, especially with respect to independent directors and Board committees. Banks and their shareholders should continue to strengthen their Supervisory Board despite the difficulties in finding qualified and independent bank directors.

Banks do not yet meet best standards of Supervisory Board working methods. The relationship between the Supervisory Board and the Management Board needs to be further clarified – an issue already mentioned in the 2003 survey report. Most of the confusion stems from the particular ownership structure of many Russian banks, whereby the major owners also hold top management positions. In such instances, the Management Board may not regard a Supervisory Board as a real authority. Another area for further improvement is in managing conflicts of interests. Here, we expect stricter internal rules and processes that will ensure full transparency and disclosure of potential conflicts between the business interests of the members of the Supervisory Board and the bank.

2.2 THE MANAGEMENT BOARD

Russian banks by law have to establish a Management Board as the second tier in governance, which is responsible for business development and day-to-day operations. The law allows for another executive body along with the Management Board – the office of the Chief Executive Officer (CEO) or, as commonly known, the

Chairman of the Management Board. In practice, the ultimate executive power is often lies with this person.

Selection of the Management Board and CEO

In good corporate governance practices, the Supervisory Board retains the power to select the CEO. For 63% of respondent banks, this was the case. In one quarter of banks, however, the major shareholders circumvent the Supervisory Board and select the CEO directly; the Supervisory Board then formally confirms the appointment. Since the ownership of most Russian banks is in the hand of a few shareholders who also control the Supervisory Board, the line between these two parties is often blurred, which may explain this response.

The CEO then appoints his management team without involvement of the Supervisory Board in 76% of the respondent banks; 27% of banks include the Supervisory Board in the selection process. Less than a quarter (20%) asks the major shareholders for input.¹⁰

By law, members of the Management Board need to have an economic or legal education, at least three years of equivalent professional expertise in a management position and be clear of any criminal record. Candidates to the Management Board need preliminary clearance from the CBR. Based on results received from the respondent banks, a typical member of the Management Board is a Russian male resident, has a university degree in economics, is 39 years old and has served on the Management Board for 3 years. This alone is of course no guarantee for personal integrity and professional quality.

As with the Supervisory Board, a typical Management Board has 5 to 9 members, among them a considerable number of women – 32% of respondent banks have two women on the Board, while 27% have three or more.

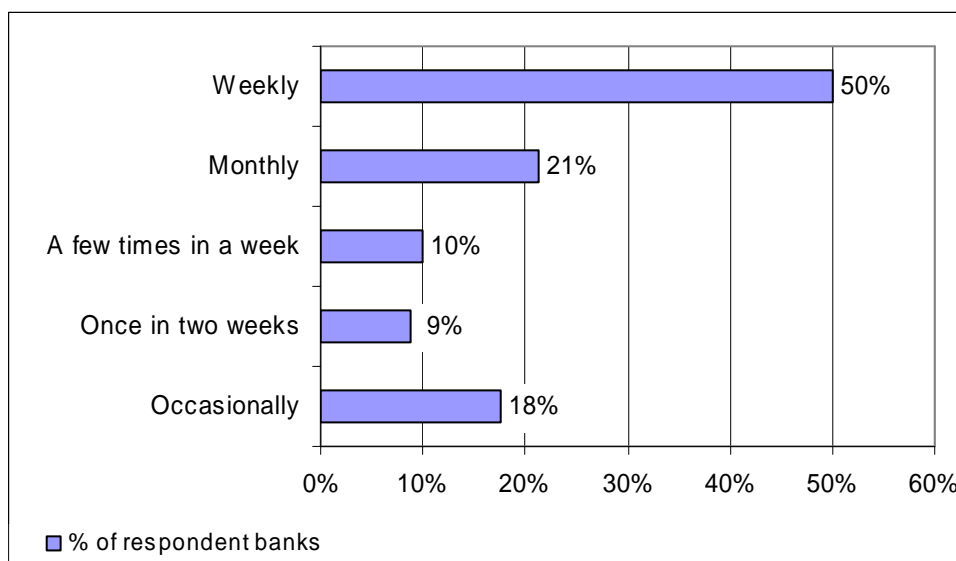
Working methods

In 94% of banks, the CEO is in charge of more than two business divisions, in addition to having overall management responsibility. For smaller banks with less diverse business operations, this internal organization may be acceptable. For larger banks or those with more complex activities, the CEO may want to delegate the management of business lines to his managers and concentrate on overall control and oversight of the business.

The frequency of Management Board meetings vary: half of the banks reported having weekly meetings, while 21% indicated that their Management Boards hold monthly meetings; 18% of Management Boards meet on an ad-hoc basis.

¹⁰ The banks gave multiple answers to the question.

Chart 2.11 Frequency of Management Board meetings



The majority (74%) of management’s communication with the Supervisory Board are conducted through written reports to the Supervisory Board, which are then discussed in person during the Supervisory Board meeting. About 38% of the banks also have only informal verbal communication between the management and the Supervisory Board.

Yet 37% of the surveyed banks say that management formally interacts with its Supervisory Board on just a quarterly basis; 14% report meeting only once a year! There is certainly room for improvement. A Supervisory Board relies on regular, well-documented information ahead of each Board meeting to be able to add value to the bank’s overall development.

Chart 2.12 Form of reporting to the Supervisory Board

	Verbal unofficial form	Verbal official form	In writing	In established written form	In writing and at the meeting
Daily	7.4	2.8	-	-	1.4
Weekly	5.9	5.6	1.5	3.3	
Monthly	14.7	8.5	10.8	6.6	5.7
Quarterly	5.9	19.7	12.3	13.1	37.1
Once in 6 months	1.5	4.2	-	1.6	7.1
Annually	1.5	4.2	4.6	9.8	14.3
At every meeting	1.5	5.6	-	1.6	8.6
Not applicable	61.8	49.3	70.8	63.9	25.7

% of respondent banks

Accountability

The responsibilities of the members of the Management Board are defined either in the By-law on the Management Board (as in 41% of banks), the Charter (34%), or in labor contracts signed with each manager (25%). Less than half of the banks outlined the disclosure of potential conflicts of interest in these documents. As with the Supervisory Board, banks need to take decisive actions to have this issue well regulated in their corporate documents.

Only a small fraction of banks (7%) provide liability insurance coverage to their members of the Management Board.

Remuneration and evaluation

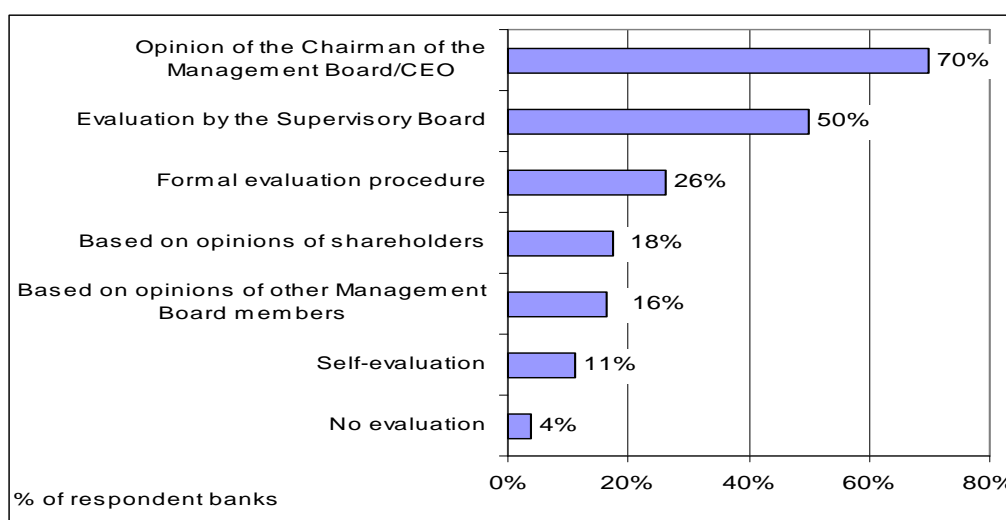
Banks show the same reluctance to disclose the remuneration package of their Management Board as they do for the Supervisory Board. Of the respondent banks, 42% prefer to disclose the total sum paid out to the entire Management Board – just 18% provide more information, disclosing the remuneration paid out to every single member of the Management Board. One third of banks consider the remuneration package confidential. Banks with foreign shareholders and banks with listed securities are more willing to disclose management compensation figures.

These two groups of banks are also more forthcoming in compensating members of the Management Board for their additional managerial responsibilities. When it comes to paying an additional annual bonus, 50% of banks with foreign participation or with listed securities pay a bonus to the management staff, as opposed to only 33% of banks in the rest of the sample.

Unfortunately, only 36 banks out of the 82 banks surveyed agreed to disclose the criteria applied for fixing the bonus amount. Only 60% of those banks link the bonus to predetermined performance indicators.

It is the CEO who in most cases evaluates the performance of his colleagues at the Management Board. The Supervisory Board, however, assists the CEO and is involved in 50% of banks – a situation unchanged from the 2003 survey results. We noted an increase in formalizing the evaluation procedure, with 26% of banks adopting a formal assessment procedure vs. 10% three years ago. On the other hand, 4% of the banks do not assess their Management Board whatsoever.

Chart 2.13 Evaluation of members of the Management Board



Synopsis: The Management Board

We cannot make a conclusive assessment of the quality of the Management Board’s composition or working methods. The personality of the CEO, his position versus the Supervisory Board and the major shareholders is decisive for the overall function and role of the entire Management Board.

There is certainly room for improvement in the communication between the Management Board and the Supervisory Board, in terms of frequency, content and forms of reporting. Banks should also introduce formal performance evaluation procedures with predefined key performance indicators for the Management Board. Equally, potential conflicts of interests need to be addressed upfront and regulated in the company’s internal documentation.

3. DISCLOSURE AND TRANSPARENCY

The extent to which banks disclose material financial and non-financial information on their governance structure and business activities is core to any discussion on corporate governance. Poor disclosure and transparency practices of the Russian banking sector were two of IFC's criticisms in its 2003 survey. These were reiterated in international rating agency Standard & Poor's latest survey on transparency and disclosure. Assessing the transparency and disclosure practices of the top 30 Russian banks, S&P stressed the need for Russian banks to pay more attention to this element of corporate governance.¹¹

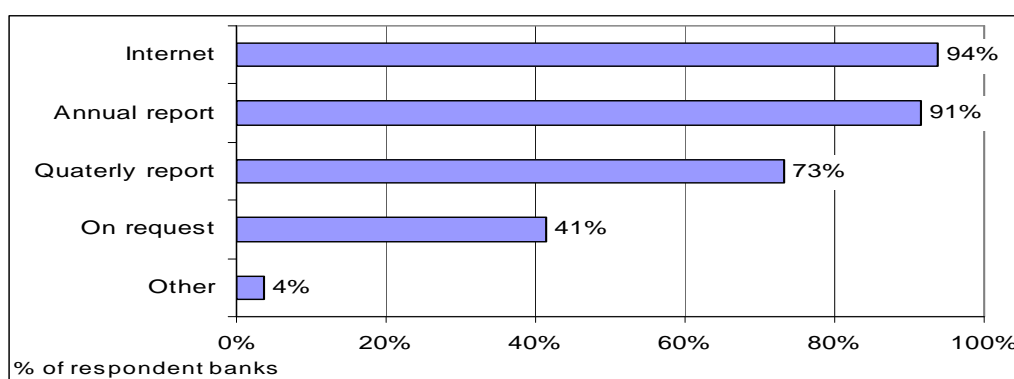
We acknowledge that different stakeholders can have different expectations on the degree and form of transparency. The Central Bank, for example, as the regulator of banks, is more concerned about the systematic risks of banks and their impact on the economy at large. It therefore requires very detailed information from banks under its supervision. Depositors are more concerned about the security of their savings while equity investors focus on the future profit outlook. We believe that banks should not restrict the amount of information released to the public, including their shareholders. The more meaningful and material information the bank provides, the better benefits it will reap in the future. Banking Supervisors around the world acknowledge the need for greater transparency and amend their national regulations accordingly. The new Basel accord on capital adequacy, commonly known as Basel II, also reinforces the need for greater market transparency.

Information tools

The survey revealed that 41% of banks have a designated person who communicates with investors and shareholders; 11% are planning to establish such a position. It appears that banks still do not regard such a position as useful, as the 2003 survey showed a similar result. It is therefore also unsurprising that only 10% of the respondent banks have a formal written information policy.

What has changed in the past 3 years, however, is the method of communication. The Internet became the favorite channel for all banks irrespective of their location, size or shareholding structure, surpassing the annual report as the banks' main means of communication.

Chart 3.1 Sources of information



¹¹ Standard & Poor's, "Transparency and Disclosure By Russian Banks," 12.10.2006.

The survey did not assess either the quality of disclosed information on a bank's Web site or its user-friendliness. The Swedish consulting firm Hallvarsson & Halvarsson, for example, compared the content of Sberbank's Web site with 25 other Russian companies from across all industries in 2006¹² – Sberbank ranked 22nd. Standard & Poor's regards Sberbank's information policy as equally weak. But in defense to Russian banks in general, S&P noted that privately owned banks fare much better than state-owned institutions in disclosing material information to the public.

Content of information

The publicly disclosed information that banks provide to interested parties is mostly information required to be disclosed by law and special regulations.

There is still reluctance by many banks to go beyond the minimum requirements. Chart 3.2 reveals what banks are prepared to disclose to the public other than shareholders. A majority of banks are hesitant to disclose essential information on the risk exposure and management of risks, as well as the accounting principles applied.

Banks are still too secretive even in relation to their shareholders. In Chart 3.3, the banks were asked about the disclosure of particular information in addition to what is required by the Central Bank. Information on their corporate governance structure or material risk factors that may have an impact on the bank's future business results are still not considered important, although more banks (57% and 67%, respectively) include corporate governance structure and material risk information in their annual reports than in 2003 (40% and 44% of banks, respectively). It is not surprisingly that banks with listed securities generally provide more detailed information.

When asked about the reasons for not disclosing more material information, banks generally indicated a lack of perceived value for such practices.

¹² For more information, see www.hallvarsson.com. Hallvarsson compared Sberbank's Web site with other leading European companies – Sberbank came in 163rd place out of 165 companies.

Chart 3.2 Type of information disclosed to the public

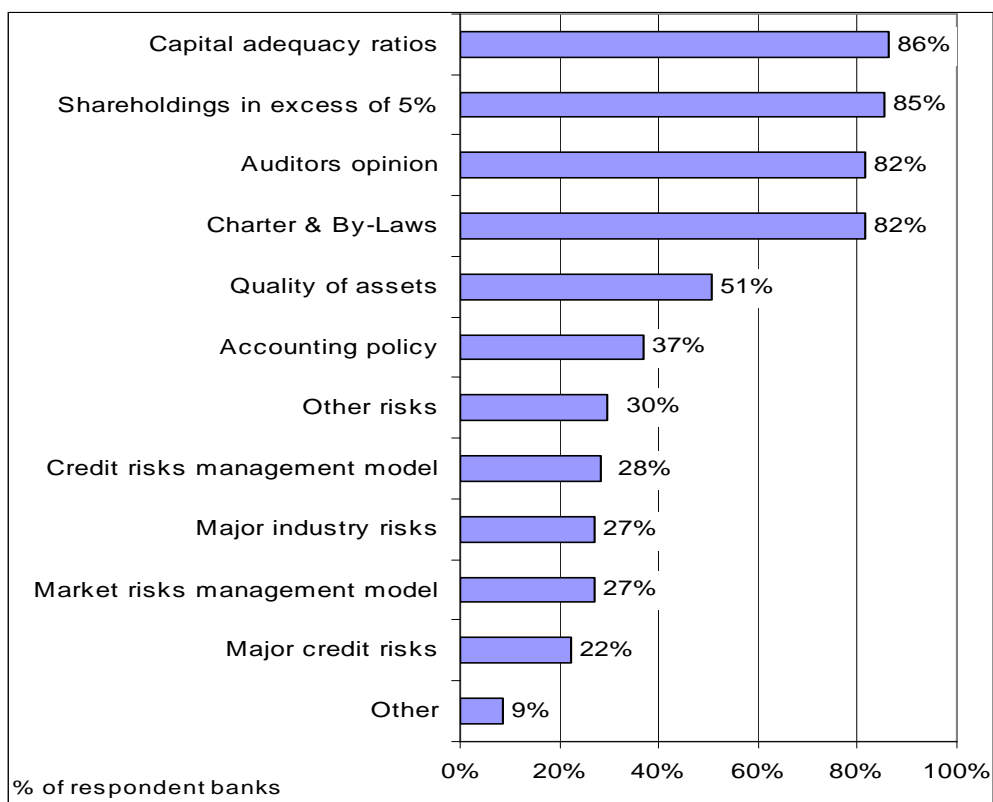
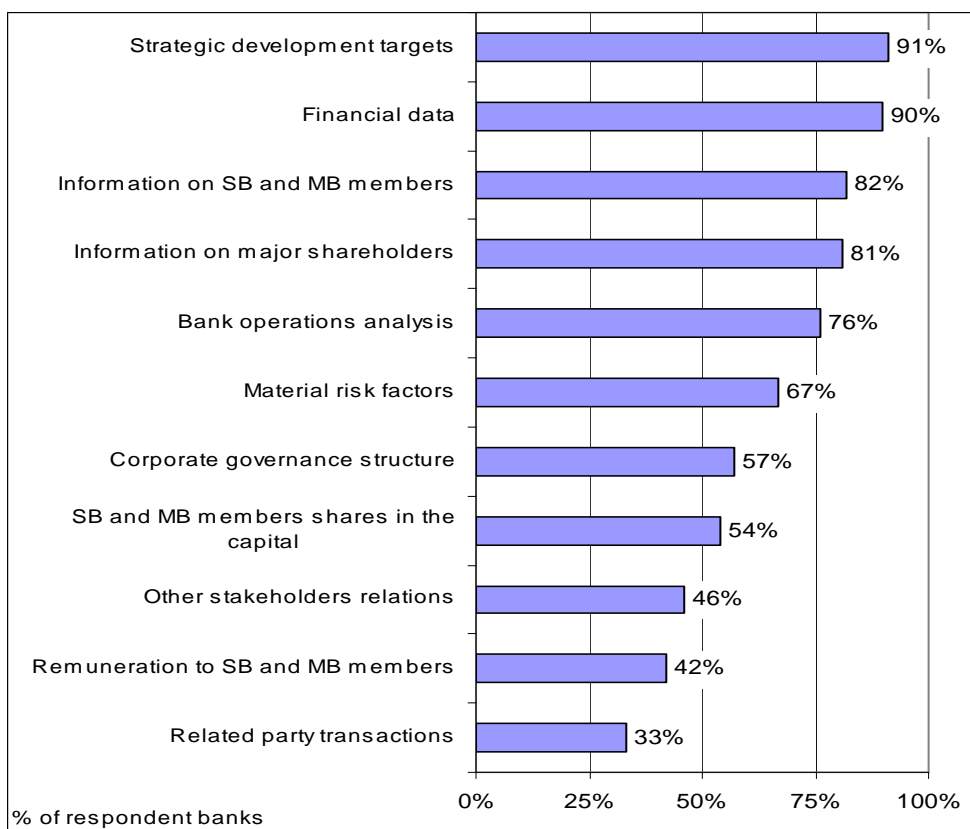


Chart 3.3 Information disclosed in the annual report beyond CBR requirements



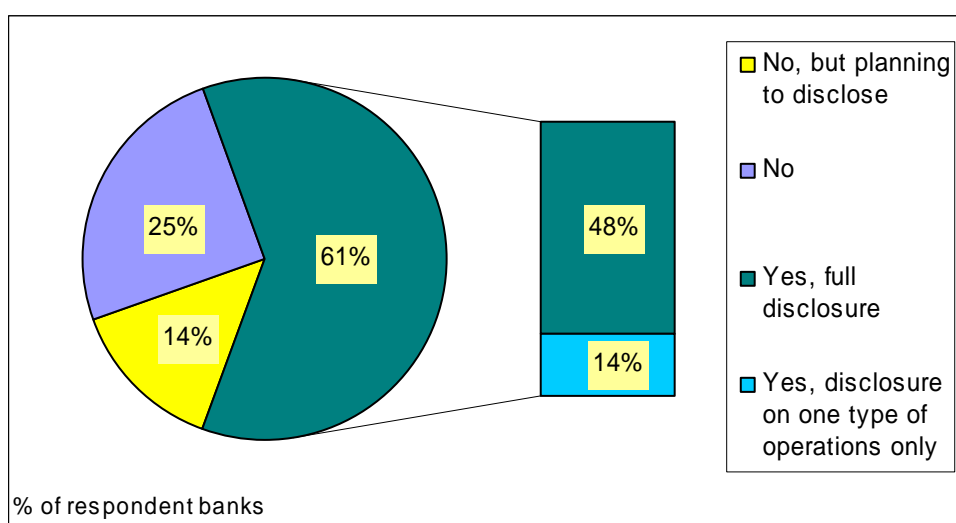
Nearly a third of the respondent banks (30%) publish information in the Russian language only, while 29% disclose information in Russian and English. The remaining banks, especially regional banks outside Moscow, prefer to publish only selected parts of their annual report in English.

Material and related party transactions

It is good practice to disclose material transactions between the bank and its stakeholders. The same stands transactions exceed 10% of the bank’s capital. Banks’ transactions between shareholders, directors and officers, as well as with other related persons and companies, therefore, should be easily available – at a minimum, stated in the annual reports. Only 48% of the respondent banks reported full disclosure of both activities, whereas 14% prefer to disclose either one of the two. The Web site is again the most preferred method of communication, with only a third of respondents referring to their annual and quarterly reports. Encouragingly, 14% of banks plan to disclose such information. Nevertheless 25% of banks refuse to do so (see Chart 3.4).

It seems that not much progress has been made here as the 2003 survey reported similar results. The lack of a legal obligation may explain this.

Chart 3.4 Disclosure of material and related party transactions



Ownership

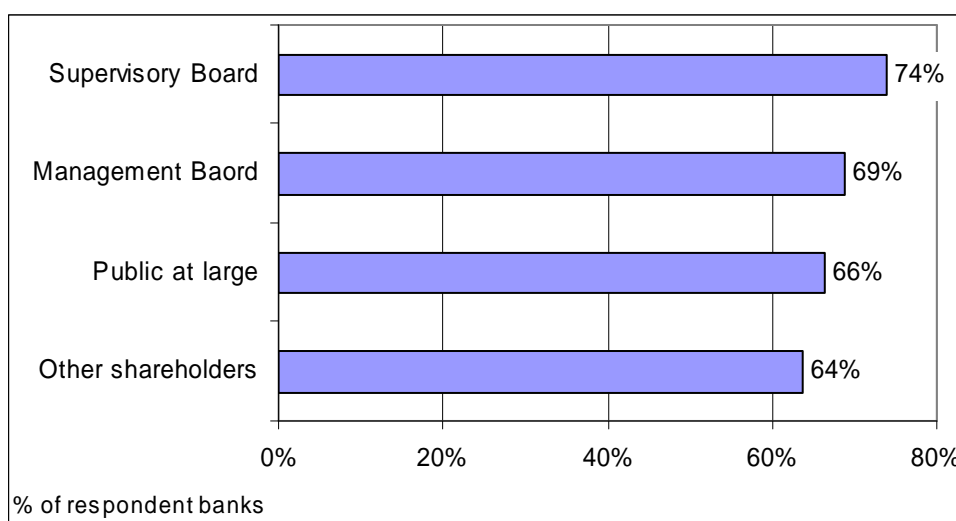
Another issue of bank transparency is the disclosure of the beneficial owners, the people behind the legal entities that are listed as major shareholders in the registrars. In Russia, the knowledge of the beneficial owners is especially important for assessing the risk profile of a bank, given the fact that ownership is concentrated in a few individuals.

In the 2003 survey, 50% of banks confirmed that the wider public did not know the ultimate major owners of the bank. The Central Bank lacked this information for 20% of the banks, and even the Supervisory Board were unaware of the beneficial owners in 14% of the cases. In response to the results of the survey, the Central Bank forced all banks to disclose beneficial owners as part of the application process for the deposit insurance introduced in 2005.

Banks have apparently made efforts to increase the public awareness of their beneficial owners over the past three years. In this survey, 66% of the banks reported that the public at large knows their ownership structure, including the names of the beneficial major owners. But we have doubts as to how accurately this high percentage reflects the actual situation. Under Russian law, the definition of a beneficial owner is still awkward, and some banks still report that the members of their Supervisory Board are unaware of the beneficial owners. Even the members of the Management Board know the ultimate major shareholders in only 69% of the cases. The participation of foreign shareholders or the existence of listed securities does not significantly change this picture.

15% of respondent banks even decided not to disclose their ownership structure at all, although 5% indicated that they will do so in the near future. This percentage may reflect the number of limited liability companies (OOO) that participated in this survey (currently not required by legislation to disclose this information). But from a corporate governance point of view, this practice of non-disclosure by deposit-taking financial institutions is unacceptable.

Chart 3.5 Disclosure of major beneficial owners



Synopsis: Disclosure and Transparency

Russian banks still have a lot to do in order to match the level of transparency that other Russian companies, notably in the telecommunication sector, have already reached. More material information on the corporate as well as financial aspects – including a bank’s risk exposure – is required. We acknowledge that there has been progress over the past three years. Stricter laws and regulations by the CBR have helped, and more initiatives in this area have been announced. There is no reason, however, why banks should wait to make those additional steps to greater transparency.

4. INTERNAL CONTROL AND RISK MANAGEMENT

Over the last years, Russian banks have undertaken significant efforts in order to ensure safe operations and establish efficient internal control systems for identifying, quantifying, assessing and managing their business risks. Banks have worked towards a systematic and independent risk management system, the separation of approval and control duties, the independence of internal auditors and better communication with external auditors. The CBR equally has moved its supervision to a more risk-based approach. The survey aims to identify the progress made and remaining gaps in the overall internal control systems and risk management of banks.

Commercial banks are in a unique position to promote good corporate governance practices in companies in their role as financial intermediary. The 2003 survey already expressed this view, which has also been taken up by the CBR in its corporate governance recommendations. This survey revisited the issue and investigated how banks apply good corporate governance criteria in the risk assessment of their corporate clients.

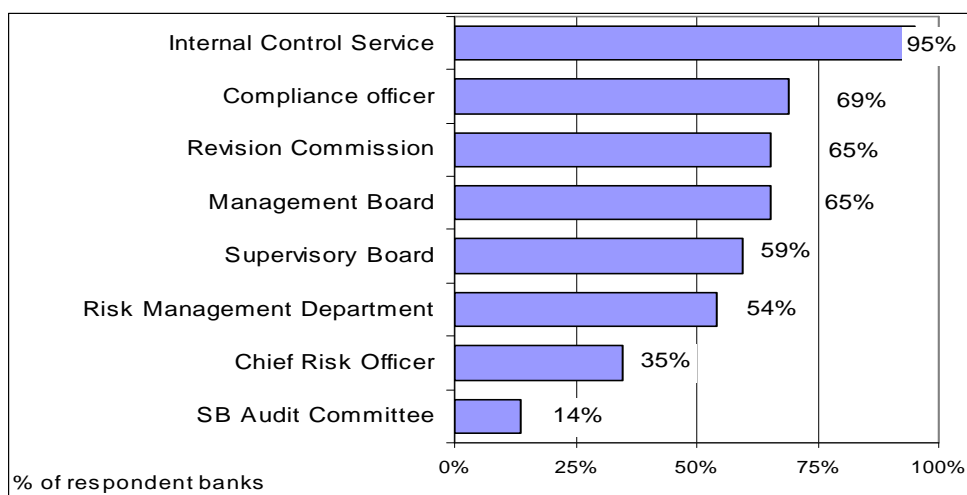
4.1 INTERNAL CONTROL AND AUDIT

The banks were asked to outline the main features and roles of their internal control systems and describe the relationships between their internal and external auditors.

Internal control system

In the vast majority of responding banks (95%), the Internal Control Service/Department is a key element of the internal control system. This includes the compliance officer (in 69% of banks) and revision commission (65%). The Supervisory Board, on the other hand, is seen as an important element of the internal control system in only 59% of banks. The almost non-existence of the Audit Committee in internal control is mainly attributed to the lack of such a function in most Supervisory Boards (only 17% of Supervisory Boards have an Audit Committee). Overall, an integrated comprehensive internal control system is still missing, and a singular “silo-approach” (i.e. fragmented approach) to control predominates.

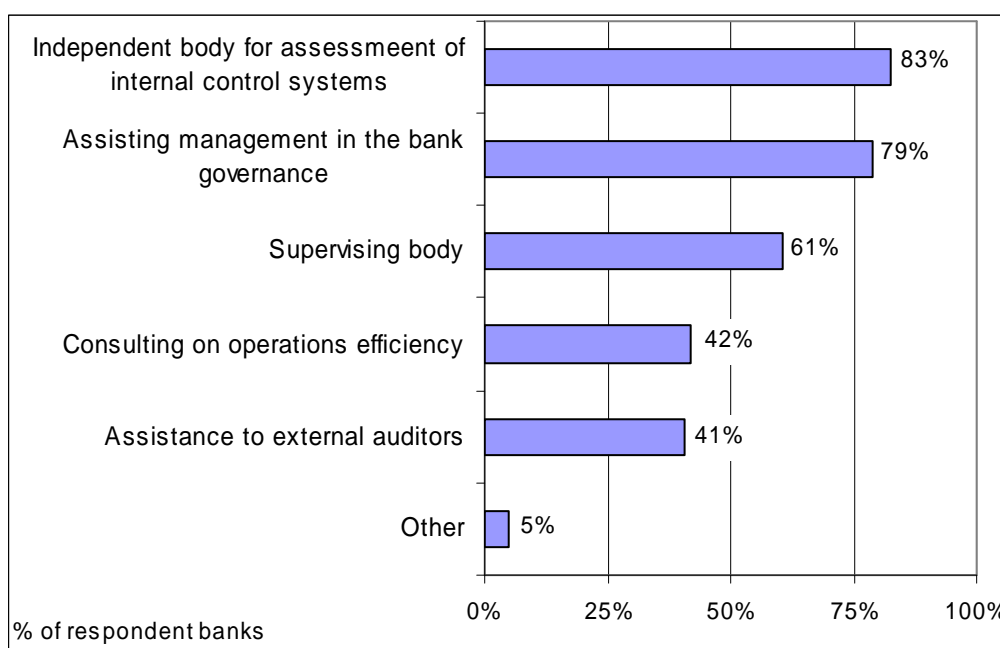
Chart.4.1 Composition of internal control system



Internal Auditor

Nearly all surveyed banks (93%) claim to have a dedicated internal audit function, regardless of where they are located. Chart 4.1 illustrates that the understanding of the role of the internal auditor has changed for the better. While in the 2003 survey, the notion of the internal auditor as a mere compliance officer or “policeman” prevailed, the banks in the 2006 survey appreciate the independent consulting and assessment function of an internal auditor. Equally positive is the strengthened notion that the internal and external auditors need to cooperate more closely in order for the bank to get the best out of their services.

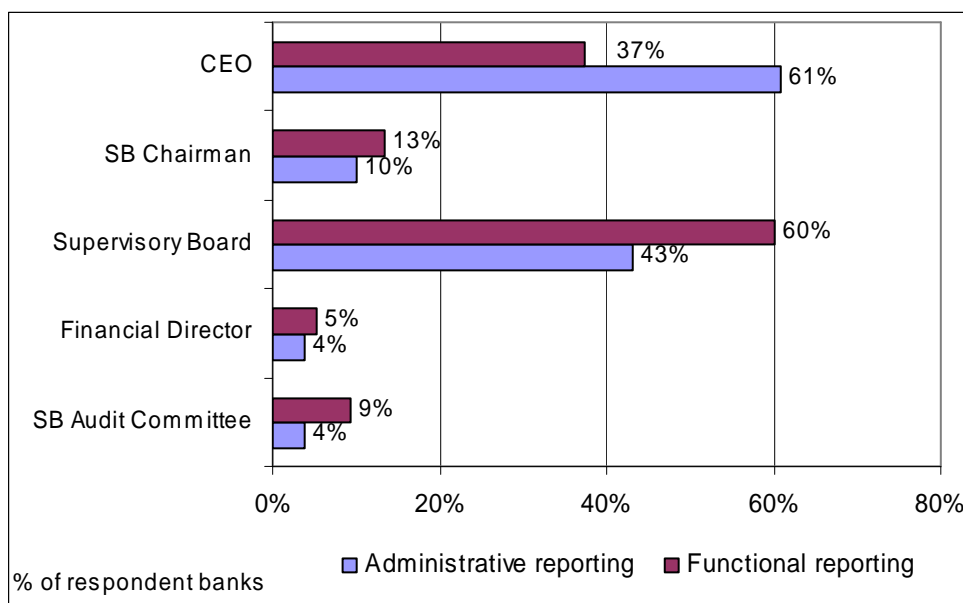
Chart 4.2 Role of internal auditors



Banks also seem to be allocating sufficient resources to the internal audit departments. The size and complexity of a bank’s business operations determine the appropriate number of staff. Given that the majority of respondent banks are considered medium size, it is positive that 48% of them allocate more than 5 people to internal audit.

Less positive is the fact that – as in the 2003 survey – the independence of the internal auditor from the Management Board is not yet fully guaranteed. According to the survey results, in 42% of banks, the internal auditor still functionally reports to the CEO or the Finance Director (see Chart 4.2). Nevertheless, this is an improvement from the last survey, when 61% of banks’ internal auditors reported to the CEO. The notion that the internal auditor needs a direct functional reporting line to the Supervisory Board (to the Chairman, the entire Board or to the Audit Committee of the Board) is now established.

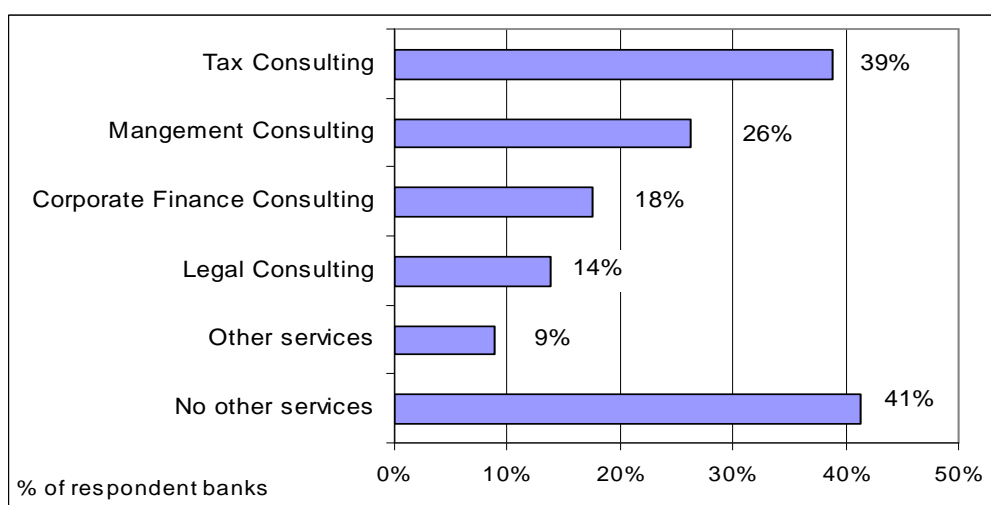
Chart 4.3 Internal audit reporting lines



External auditor

Banks should separate external audit services from other consulting mandates to avoid potential conflicts of interest and to ensure the auditor’s independence. In 41% of banks, the auditor also provided additional services, mainly in tax consulting (39%) and management consulting (26%). This is considerably lower than in the 2003 survey, where 61% of banks reported the use of the auditor for additional paid consultations. It is also positive to note that fees for additional services exceeded the audit fee in only 6% of the cases. It is probably fair to say that banks now pay more attention to the independence of their external auditors.

Chart 4.4 Services provided by external auditors

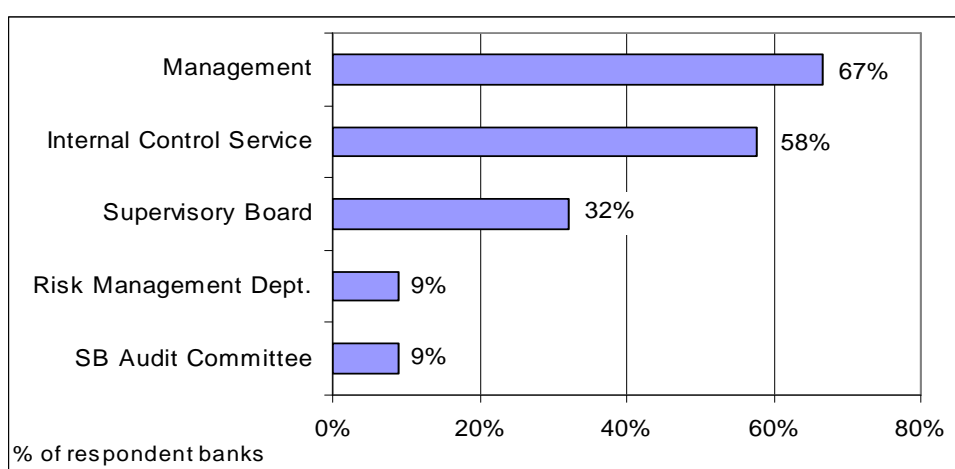


The auditor’s management letter, which contains explicit recommendations for operational improvements based on the results of the conducted audit, is regularly provided to the majority of banks. Only 4% of the banks, notably regional banks, never received such a document – it is unclear if they did not opt for this service or the

auditor did not consider it necessary. 6% of the respondent banks reported that they received the letter only once in the last three years.

Banks are well-advised to ask for a management letter from their auditors every time, as it is one of the most useful tools for improving internal control systems and operations. It is also our view that the auditor should send a copy of the management letter to the Supervisory Board directly. The Supervisory Board should discuss these recommendations with the management and have oversight over diligent and prompt implementation of the corrective measures. Unfortunately, the Supervisory Board controls the corrective work in less than half of the surveyed banks (41%), as Chart 4.5 shows. This may once again reflect the relatively minor role the Supervisory Board plays in oversight and control of the bank's activities.

Chart 4.5 Control over implementation of the management letter recommendations



Synopsis: Internal Control and Audit

The position of the internal auditor in the bank has improved. Banks still need to pay more attention to its independence by ensuring a direct reporting line to the Supervisory Board. As for the internal control system, a more systematic and comprehensive approach is recommended. The Supervisory Board, especially, is called to take a more active position in its oversight and control duties. Close cooperation with the internal and external auditor can be a first step in the right direction.

4.2 RISK MANAGEMENT

While it is the role of management to identify, quantify, monitor and plan for effective risk management, it is the Supervisory Board is ultimately responsible for oversight of the risk management system and relevant risk policies. The role of the Risk management department as well as the risk management policy in general is to develop a corporate culture of risks. It is implied that such culture should be well documented. A separate risk management department is equally important for the oversight of the bank's overall risk exposure.

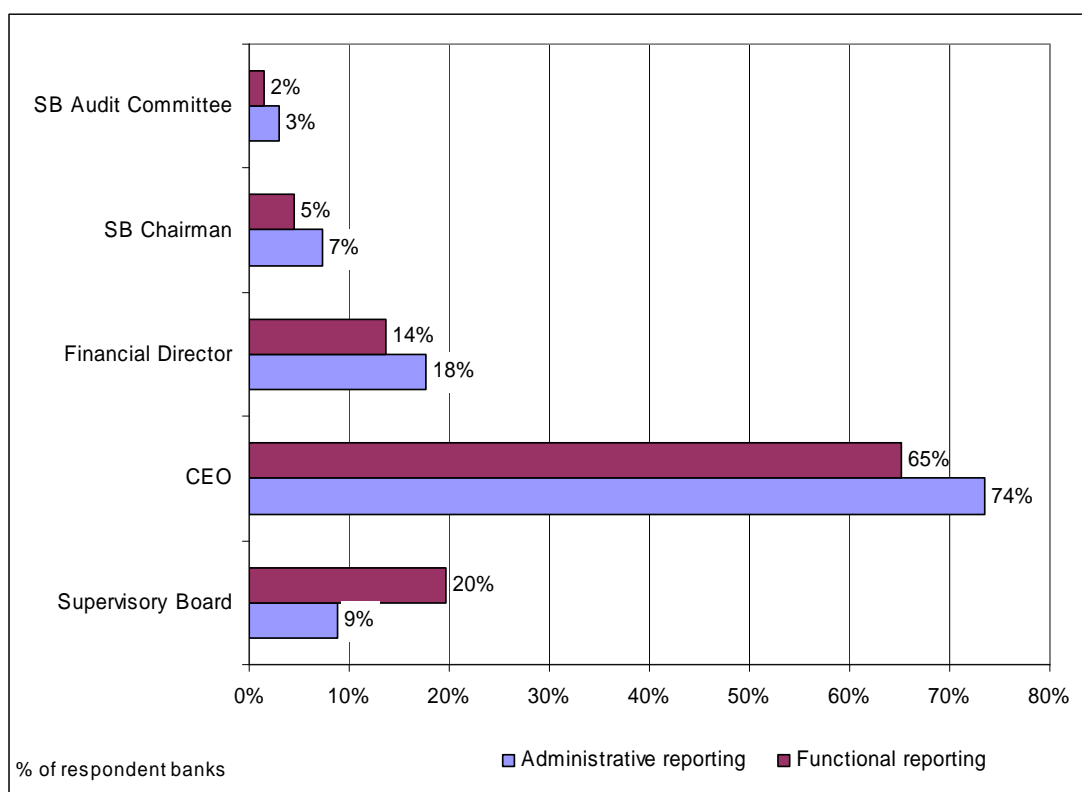
In their work on establishing an effective risk management function, the majority of the banks use the regulations issued by the CBR and, for additional sources of information, the recommendations of the Basel Committee on Banking Supervision.

84% of the banks reported that they have established a separate risk management function and 5% are planning to create such a department in the near future. Half of the banks staffed their risk management department with less than 6 people; in our view, this is suitable for small banks with straightforward business operations and a limited branch network.

However, it remains unclear to what extent this function or department oversees all inherent banking risks. In many cases, this so-called “risk management function” merely serves to collect statistical data. The position of a Chief Risk Officer (CRO), who would aggregate the work of business line risk management units and provide essential guidance to the overall risk exposure of the bank, is also missing.

This suspicion is further enforced by the stated reporting lines of the risk management department (Chart 4.6). A majority of banks have their risk management department reporting to the CEO, while 14% put the Finance Director in functional charge. Interestingly, the Supervisory Board seems to take an active role in this case – in 20% of banks, risk management reports to the Supervisory Board directly.

Chart 4.6 Risk management department reporting lines

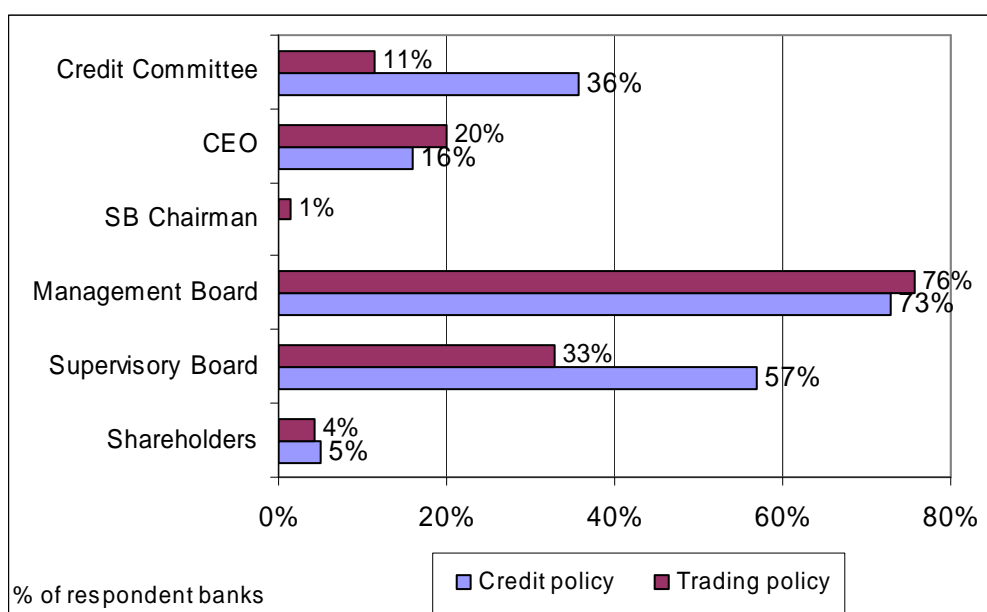


This result is surprising, since the same banks delegate a small role for the Supervisory Board in approving the risk management policies – that is, just to determine the type and extent of allowed business transactions and internal approval authorities (in our case, for credit and trading transactions). Chart 4.7 reveals that it is still the Management Board who decides on the risk taking, and very often the CEO alone. Even the design of the credit policy and approval of major transactions are left, in 52%

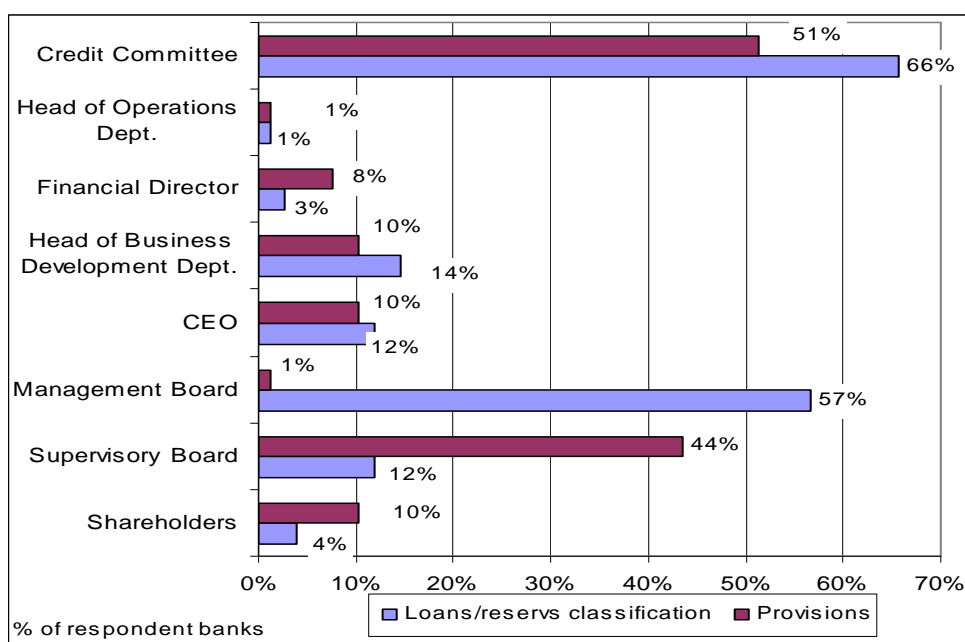
of cases, to the Management Board and CEO; the Supervisory Board is involved in only one-third of the banks.

Banks regulate their risk management practices by means of a set of documents in hierarchical order, with a general framework for risk management (i.e. the policy paper) on the top, and below that a more detailed risk management procedural documents (i.e. work manuals) or definition of risk methodology. The Management Board usually drafts these two documents; the Supervisory Board should nevertheless have a chance to control their adequacy.

Chart 4.7 Risk management: establishing credit and trading policies



The authority for classifying loans and defining credit loss provisions also showed mixed results (Chart 4.8). In most cases, a special Credit Committee makes these decisions. However, some banks delegate this role to the Head of the Business Development Department or CEO alone. This leaves the door open for potential conflicts.

Chart 4.8 Risk management: loan classification and provisions approval

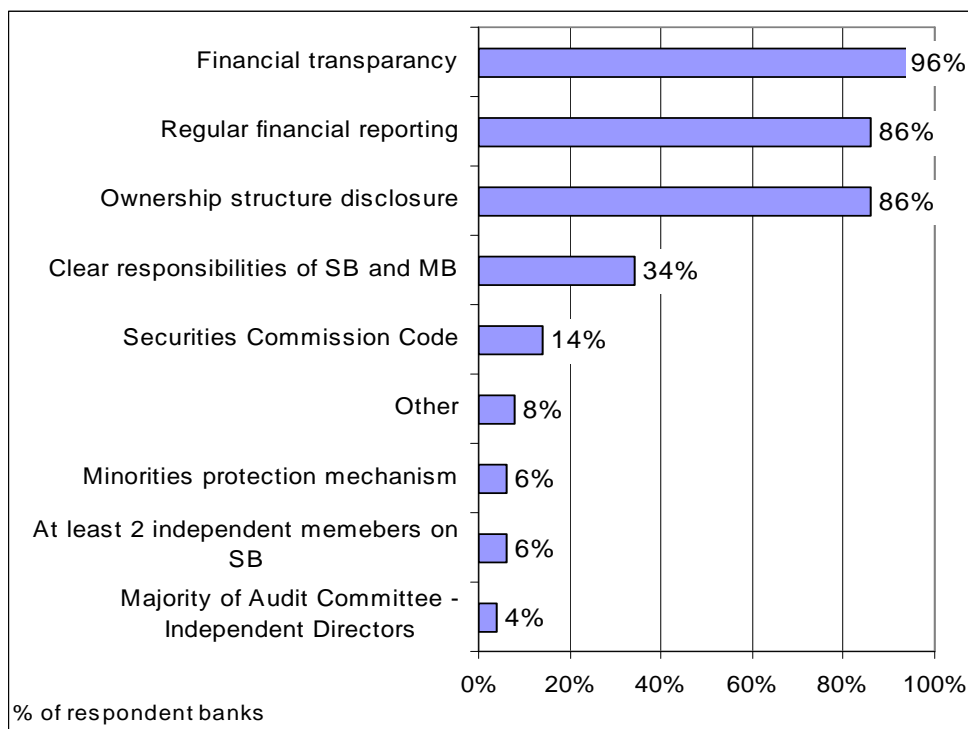
Promoting Corporate Governance to corporate clients

The assessment of a corporate client's corporate governance should be a part of the overall credit analysis for diligent risk assessment. This is a standard business practice that IFC wholeheartedly supports and the CBR strongly recommends in its banking corporate governance recommendations. Especially in times of strong economic growth, there is a strong temptation to loosen credit principles. The independent Russian credit rating agency, RusRating, warned that *"banks need to develop more effective approaches to evaluating borrower creditworthiness and weigh the advantages of careful risk assessments against convenience and attractive terms for their clients."*¹³

More than half of the banks surveyed (59%) seem to include an evaluation of the client's corporate governance in their system of credit risk assessment (Chart 4.9). But when asked about the corporate governance practices most valued in their clients, banks name financial transparency, regular financial reporting, and disclosure of ownership structure. Critics may classify these criteria as standard requirements for any credit application and may rightfully expect a 100% response rate. More "sensitive" corporate governance criteria, such as compliance with the FCSM Code of Conduct or the existence of independent Supervisory Board members, are of less concern for banks. This corresponds with the results of the 2003 survey; regional or other differences among banks were insignificant.

¹³ RusRating, August 2006, from www.rusrating.ru.

Chart.4.9 Significant corporate governance criteria for corporate clients



Synopsis: Risk Management

Almost all respondent banks have established a risk management function. The role and functions as well as reporting lines of the various units responsible for risk management issues need to be better defined –to the extent that there is an overlap of tasks and responsibilities. We are of the opinion that the CBR should improve the requirements for the risk management functions in the banking sector, as it has done for the internal control / audit function. The call for promoting stricter corporate governance practices among corporate clients went unheard. In their own interest, banks should not forgo any measure that improves their risk portfolio, especially in times of strong economic growth.

V. SHAREHOLDER RIGHTS

Russian banks in general do not have a particularly diversified shareholder base. The controlling stakes tend to be in the hands of a few individuals or Russian government agencies. These shareholders typically also have a seat on the Supervisory Board or are even members of the Management Board, thereby exercising direct control over the bank's business activities. It is therefore possible to say that in light of this situation, the protection of shareholder rights becomes a bit obsolete. Unlike in a traditional corporate governance context, major owners of Russian banks rarely need their rights protected from a potentially malicious Supervisory or Management Board. Anecdotal evidence points instead to the opposite case – the bank needs to be shielded from major shareholders pursuing their own self interests.

The survey hence focuses more on the status of minority shareholders, i.e. shareholders that typically control less than 20% of votes. Although unable to influence the major strategy of a bank, it is nevertheless important for a bank's reputation in the capital markets that the interests of these shareholders are equally respected and observed.

Shareholder meeting

Over the last three years, all the respondent banks have held regular annual shareholder meetings. More interestingly, the banks also had extraordinary shareholder meetings that were either called by the Supervisory Boards (in 59% of banks) or the Management Boards (18% of banks). Notably, in 21% of the banks, the Revision Commission initiated those meetings. We do not know the reasons for these meetings initiated by the Revision Commission, but, given the rather passive role of the Revision Commission in the overall governance system of Russian banks, the fact in itself is already extraordinary. As expected based on our experience, none of the banks reported that minority shareholders initiated an extraordinary shareholder meeting.

Minority shareholders tend not to participate in shareholder meetings in general. Although the majority of respondent banks have minority shareholders, only 30% reported a participation rate of more than 50% among minority shareholders at annual meetings over the last two years – relatively unchanged from 2003. This relatively passive attitude of minority shareholders is not unique to Russian banks and can be explained by the strong concentration of shareholdings in the hands of a few and the limited legal influence of minority shareholders. From a corporate governance point of view, however, this is still deplorable since “out of sight” (at the shareholder meeting) can quickly develop into “out of mind” for Supervisory Board and Management Board members. More astute minority shareholders, especially among institutional investors, most likely negotiate special shareholder agreements to secure their particular interests before committing to the purchase of a stake in a company. The survey was not able to verify the existence of such shareholder agreements with the respondent banks.

Information provided to shareholders ahead of the meeting

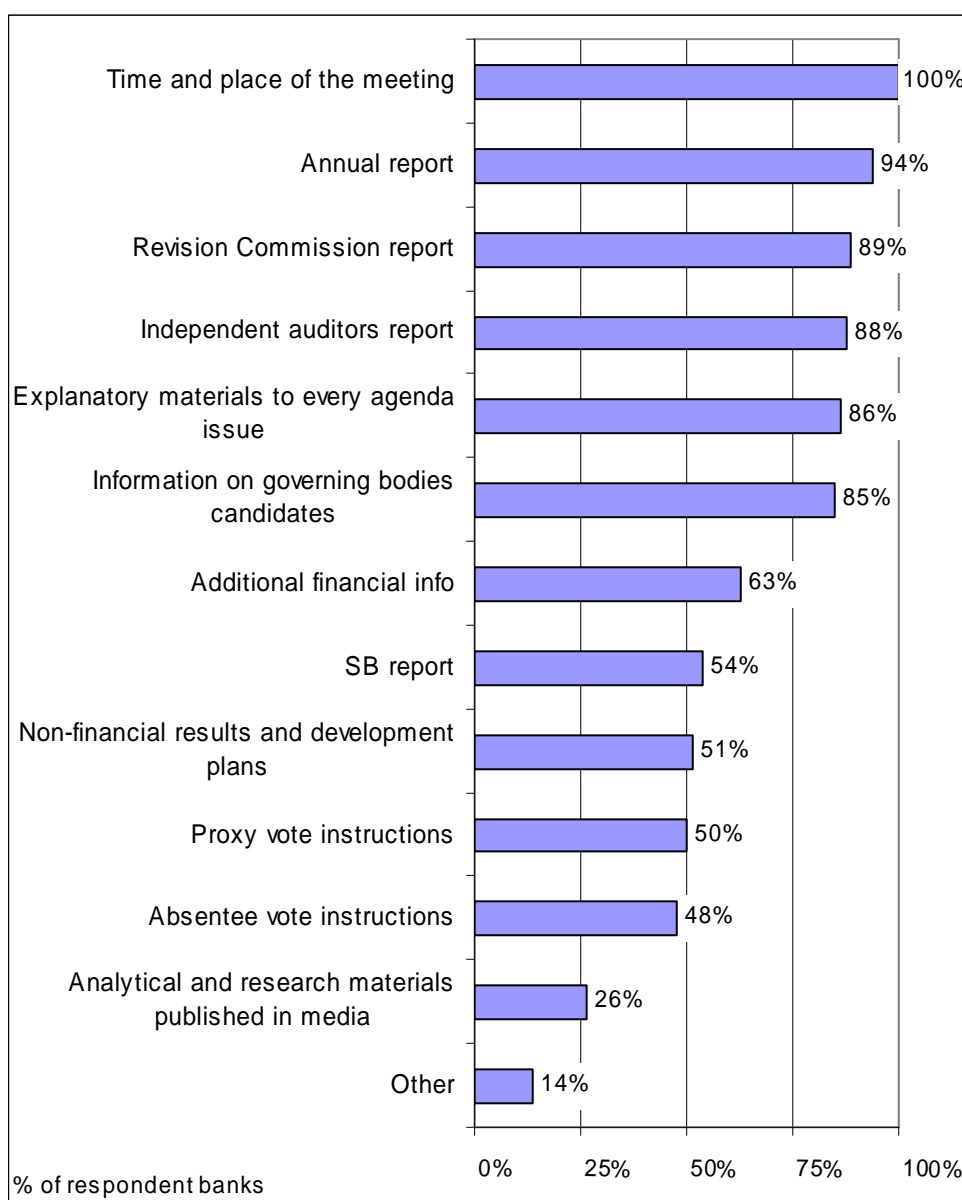
In terms of the types and extent of information that banks provide to their shareholders, respondents report almost similar results as in the 2003 survey. Depending on the standpoint taken, the results as shown in the Chart 5.1 can either be interpreted as positive (“the glass is half full”) or negative (“the glass is half empty”).

It is a question, for example, why banks still do not provide all shareholders with the report of the external auditor, explanatory materials to every agenda item or a paper

on the future strategic direction of the bank. Also, instructions for absentee voting and proxy voting are provided by only 48% and 50% of banks, respectively.

It is relatively easy and inexpensive for banks to provide all shareholders with additional information than the mere time and place of the meeting. Shareholders that are not members of the Supervisory Board, have an executive management function in the bank, or are unable to get informal business updates, would appreciate more detailed and documented information ahead of the shareholder meetings.

Chart 5.1 Information delivered to shareholders before the meeting

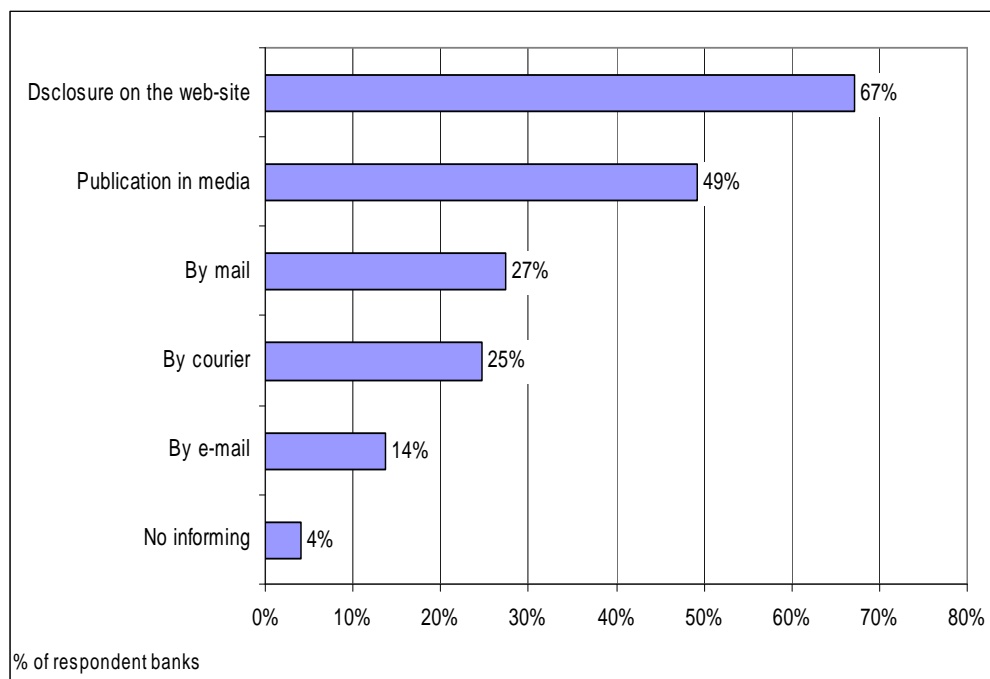


Communicating meeting results

The Internet has finally emerged as the most important communication tool for banks in disclosing the results of the shareholder meetings. As Chart 5.2 shows, 67% of respondent banks use their Web site, vs. only 20% of banks in the 2003 survey. This is certainly the most efficient way of communication in terms of time and costs. Disturbingly, 4% of the banks do not inform their shareholders at all. This may, however,

be explained by the particular shareholder structure of those banks: with less than 10 shareholders in total and full meeting attendance, banks may not regard a separate announcement as necessary.

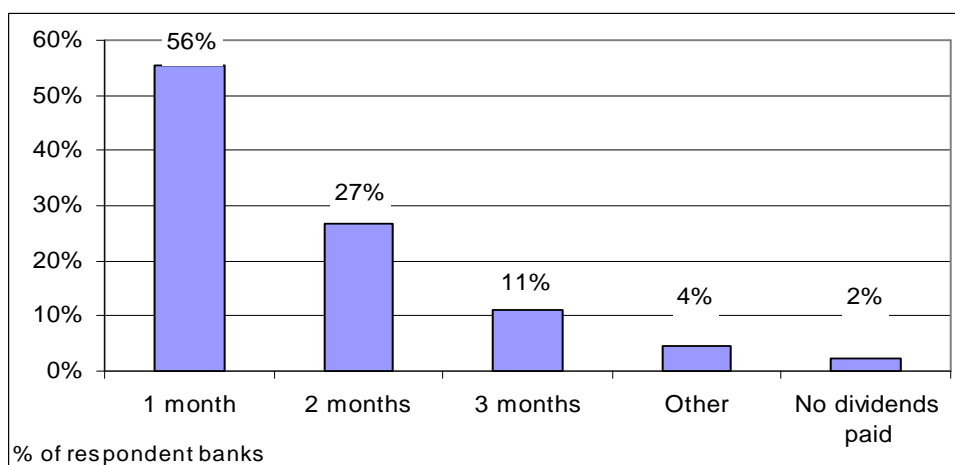
Chart 5.2 Methods of communicating the results of the shareholder meetings



With the popularity of the Web site as a communication tool, it is no surprise that the majority of banks (83%) disclose the results of their annual shareholder meetings to the public at large; this is an improvement over the situation three years ago, when only 77% of banks disclosed such meeting results to the public.

Dividends

While three years ago, 68% of the respondent banks reported to have paid dividends to shareholders, banks participating in this survey were slightly less generous – only 57% reportedly paid out some dividends during the last three years. This may be explained by the strong economic growth in general and the positive environment for banks in particular. Shareholders may have decided to reinvest profits into the business and opt for bigger capital gains in the wake of a potential sale to a strategic investor or at a stock exchange. With a very concentrated shareholder structure dominated by a few major shareholders, minority shareholders have no other choice than to accept this decision. On a positive note, those bank that paid out dividends did so within a short period of time after the relevant declaration and acceptance by the shareholders meeting. 83% of the banks reported a pay out within two months.

Chart 5.3 Dividends pay-out time**Shares buy-back**

During the past three years, only 22% of the respondent banks bought back shares from their shareholders (a decrease from one-third of banks in the 2003 survey). In 41% of those cases, the purchase price was defined by an independent appraiser – a positive development. In the other 59% of cases, the Supervisory Board fixed the purchase price. Since the major shareholders or their representatives traditionally dominate the Supervisory Board in most Russian banks, with independent directors still a rarity, this practice may be to the disadvantage of minority shareholders. Few Russian banks trade their shares at a stock exchange; minority shareholders, therefore, rarely have other alternatives for realizing their capital gains than selling their shares back to the company. Banks should use the service of independent valuers to offset any doubts on possible unfair treatment of minority shareholders. Hopefully, more banks will also have their shares listed at a stock exchange in the near future. This will not only bring greater discipline in disclosure and reporting but also more opportunities for all shareholders to realize the fair value of their bank shares.

Synopsis: Shareholder Rights Protection

It seems that on the shareholder front, not much speaks against Russian banks. Similar to the results three years ago, Russian banks observe the statutory and legal rights of their shareholders. The concentrated ownership structure of most banks and the direct influence of major shareholders on the bank's business – be it as a member of the Supervisory Board or Management Board - certainly prevent banks from acting against the interests of their shareholders.

Minority shareholders are often a negligible quantity with little influence and hence rather passive attitude. Banks on the other hand do not seem to be strongly motivated to reach out to those shareholders. Nevertheless, the survey did not reveal practices that systematically and seriously violate the rights of minority shareholders.¹⁴ The growing interest of institutional and strategic investors in a (minority) stake in Russian banks may induce a change in the relationship between the bank, its major shareholders and the minority shareholders.

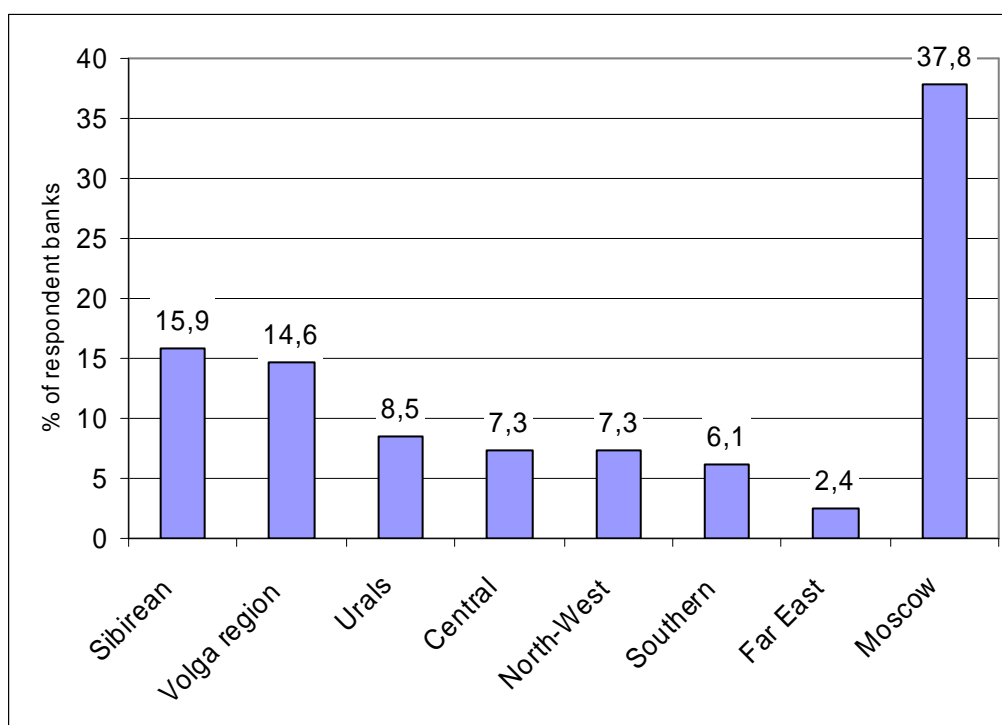
¹⁴ We acknowledge that the particular methodology of this survey – with the focus on self-reporting – may not be the ideal way of analyzing the treatment of minority shareholders. Further research may be necessary.

IV. ANNEX

1. CHARACTERISTICS OF SURVEYED BANKS

The survey results are based on responses from 82 banks from an original sample of 200 banks. The 200 banks were taken from the top 300 banks by total assets using both qualitative and quantitative selection criteria. These criteria included total assets, regulatory capital, registration and operations in Russia, commercial banking activities, and majority ownership by Russian companies or individuals. State-owned banks were excluded from the sample except those cases in which the state has a minority stake. The respondent banks represent all federal regions including Moscow. Compared with the regional distribution of the entire banking sector, the sample of respondent banks is slightly underrepresented in Moscow (38%, as compared with 51% for the entire banking sector, according to CBR data as of Sept 1, 2006). Chart A.1 shows the geographical breakdown of the respondent banks.

Chart A.1 Regional distribution of respondent banks



The respondent banks represent nearly 20% of the banking sector's total assets as of September 1, 2006, according to CBR data.

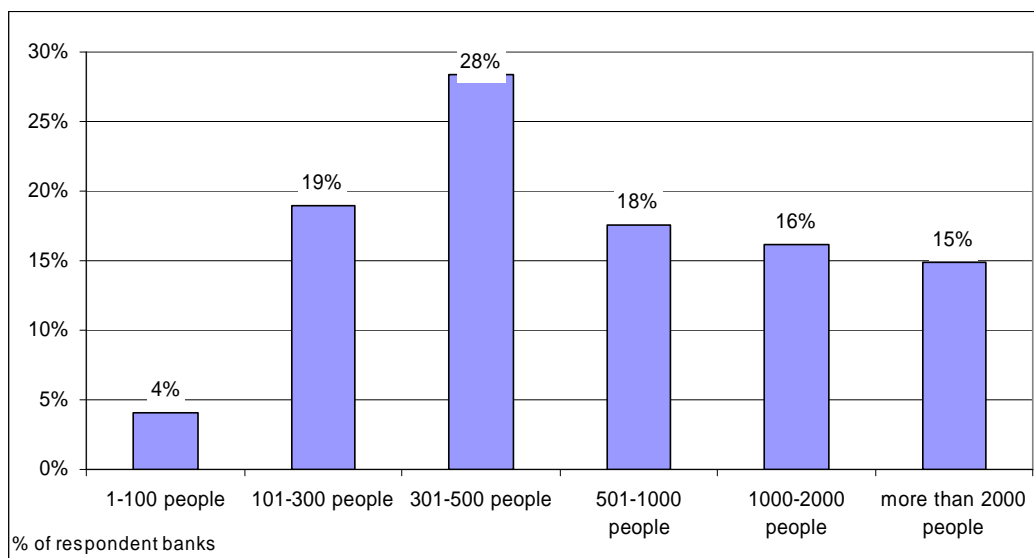
Legal form

65% of the responding banks are registered as Open Joint Stock Companies (OAO), 22% are Closed Joint-Stock Companies (ZAO), and 13% are in the form of Limited Liabilities Companies (OOO). This distribution of legal form is broadly in line with the situation in the overall banking sector.

Number of employees

The respondent banks have between 15 to more than 8,000 employees. 49% of banks have less than 500 employees. The majority of banks fall into the category of medium sized companies. A shift to bigger banks with more staff is evident from the previous survey. In 2003, only 16% of respondent banks had more than 1,000 employees.

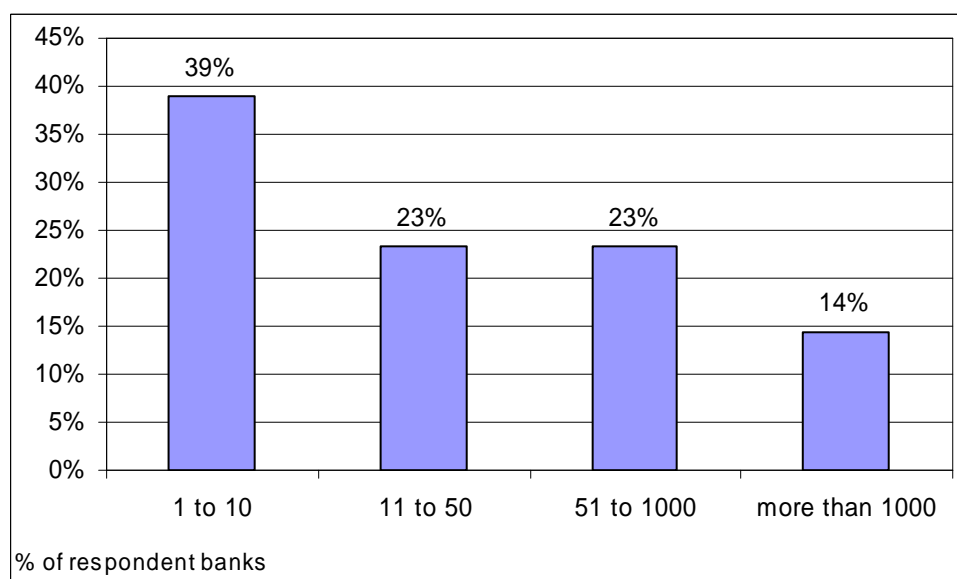
Chart A.2 Number of employees



Distribution of shareholdings and status of the three largest shareholders

Only a few shareholders control the Russian banking sector. This closely held shareholder structure is again confirmed by the respondent banks. Although the total number of shareholders in the banks varies from 1 to 110,396, 52% of the banks have less than 50 shareholders (Chart A.3), a situation that has not changed since the 2003 survey.

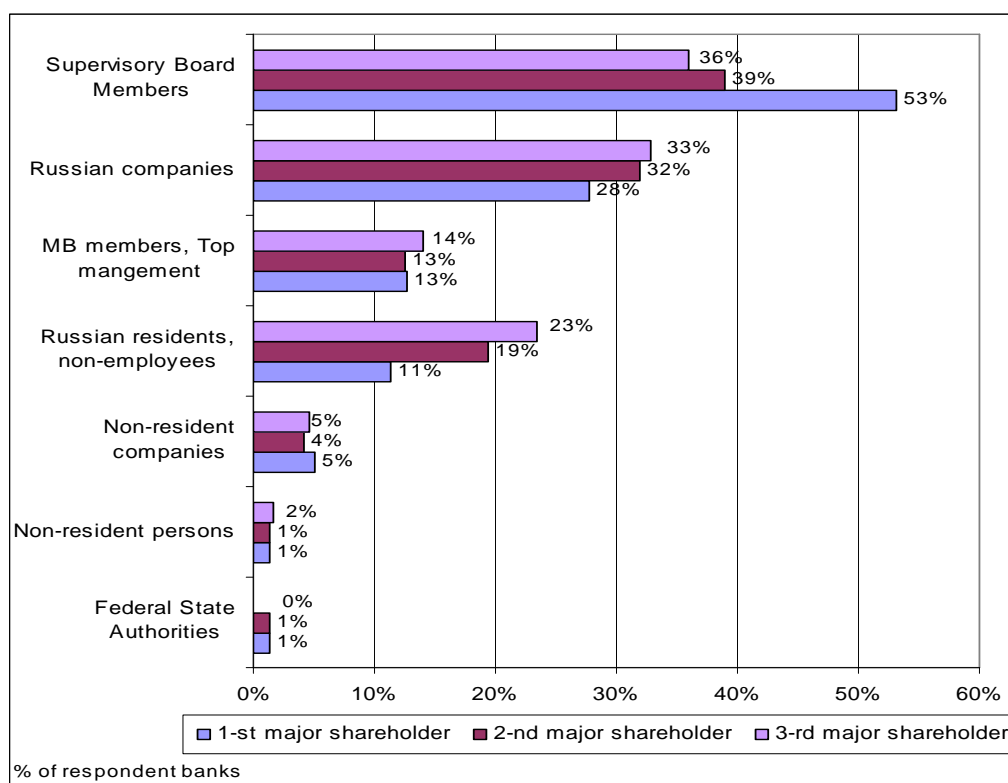
Chart A.3 Number of shareholders



Only 13 banks reported the government among their shareholders whose equity stake exceeded 2%.

The owners of Russian banks are predominantly Russian individuals resident in the country. This is also reflected by the respondent banks as shown in Chart A.4. These owners prefer to exercise direct control over the activities of their bank be it as a member of the Supervisory Board or the Management Board. The role of a financial investor who delegates business decisions to a Supervisory Board or Management Board has not gained importance over the past three years. Compared to the 2003 survey, a noteworthy shift from Russian companies being reported as the three major shareholders, to individuals occupying this position has occurred. We assume that stricter disclosure requirements as to the beneficial ownership or a more relaxed approach to this issue by the respective owners is responsible for this shift.

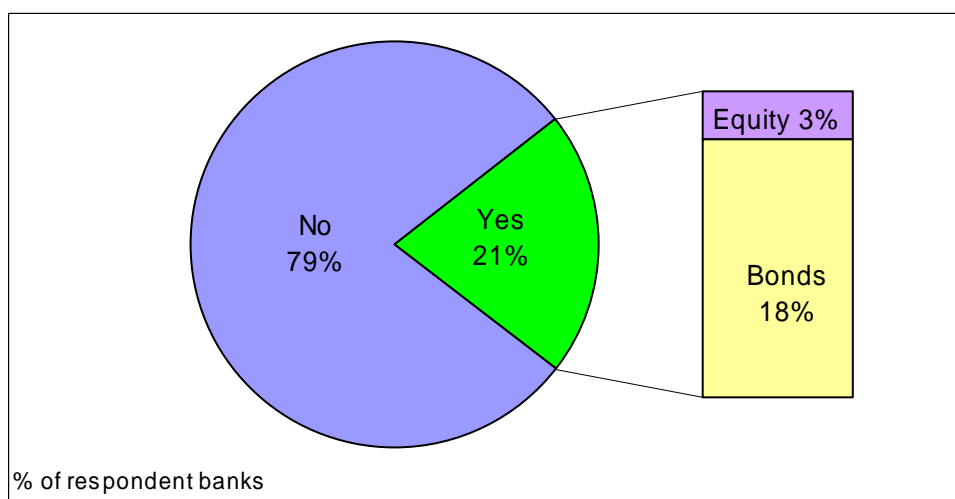
Chart A.4 Status of the three largest shareholders in the respondent banks



Listing of securities on a Stock Exchange

As in the overall banking sector, only a minority of the respondent banks have listed securities either on a Russian or international stock exchange (Chart A.5). Only 3% of banks have their shares listed. Most of the securities (82%) are listed on the Moscow Interbank Currency Exchange (MICEX) and 14% have tapped a European stock exchange, mainly the London Stock Exchange, for funding.

Chart A.5 Banks with listed securities



Encouragingly, 48% of the banks plan for a public capital market transaction within the next three years: 34% of these want to issue bonds and 14% are planning to place shares. It is also interesting to note that 50% of respondent banks prefer to finance their future growth through internal resources, private placements or other forms of funding that bypass the stock exchanges. Multinational institutions, like IFC or the European Bank for Reconstruction and Development (EBRD), are the most preferred funding sources.

Main areas of activity

The respondent banks have subscribed to the concept of universal banking, with activities ranging from corporate finance, trading, payment and settlement as well as wealth management. Like with the banks three years ago, lending remains the main activity for most of the surveyed banks, followed by trading. Less capital intensive businesses such as asset management and wealth management have not yet become a core activity (Chart A.6).

Chart A.6 Main areas of activity

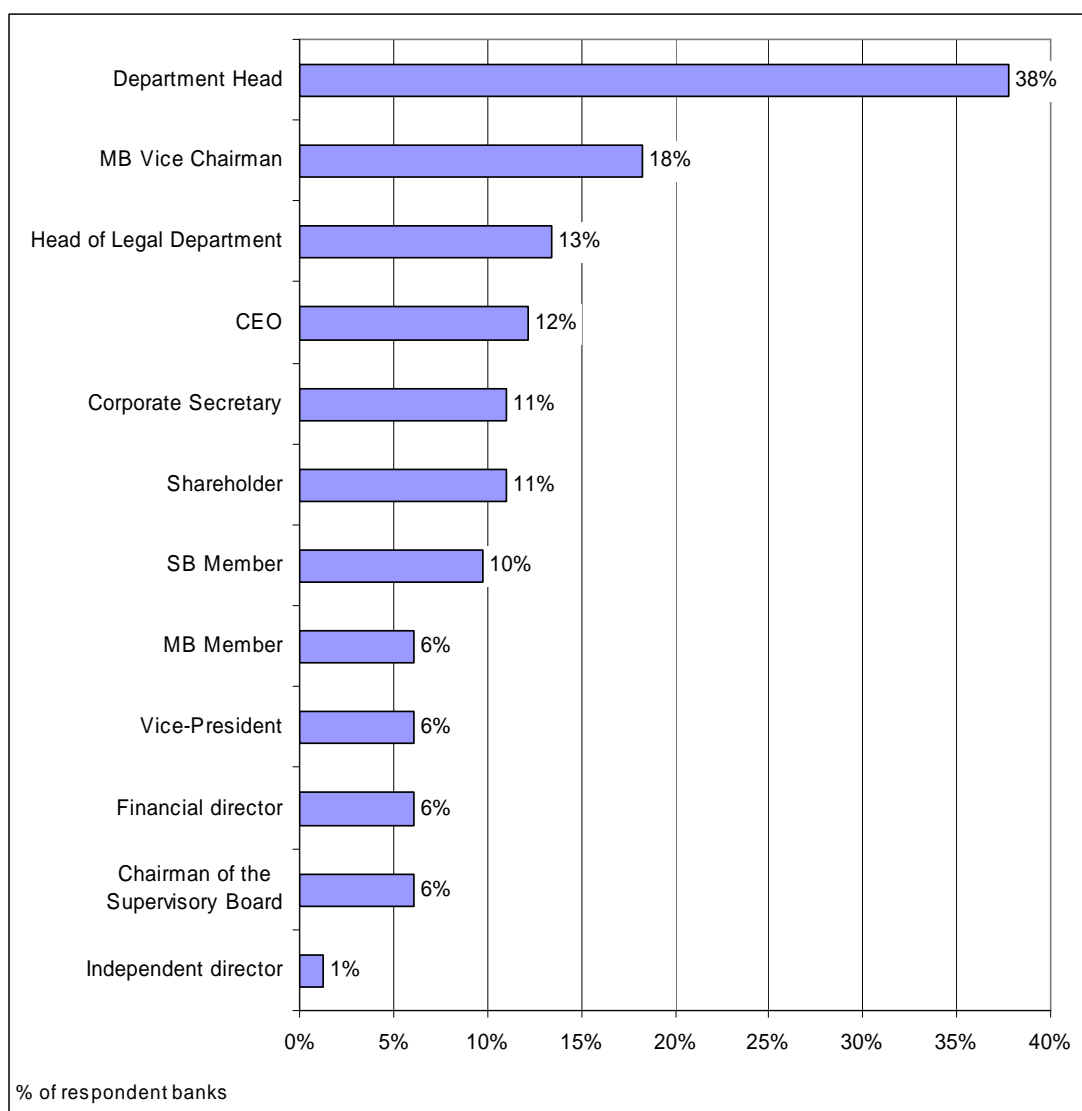
Type of activity	2006 ranking	2003 ranking
Corporate lending	1	1
Private lending	2	8
Securities trading	3	6
Investment consulting, Investment business	4	3
Cash services	5	10
Housing finance	6	7
Private banking	7	8
Plastic card issue	8	11

Trade finance	9	5
Brokerage	10	10
Asset management	11	n/a

Positions of the respondents

As shown in Chart A.7, the persons who answered the questions are predominantly members of the bank’s top management.

Chart A.7 Positions of the respondents



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