Self Enforced Mechanisms of Corporate Governance:

Evidence from Managerial Turnover in Russia

Andrei Rachinsky[†]

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[†] Centre for Economic and Financial Research. E-mail: arachinsky@cefir.ru

Abstract

Managerial entrenchment, an undeveloped market for top managerial labor force and the absence of clear market signals could prevent owners from firing management for poor performance. Top managerial turnover could improve firms' performance by introducing new human capital and providing good incentives for a new manager if the previous CEO has been fired for poor performance. We evaluate the effectiveness of self-enforced corporate governance mechanisms by determining the causes of top management turnover and estimating consequences of management turnover on the subsequent corporate performance. We track all turnovers of CEO's in the 110 largest Russian companies during a five year period (from 1997 to 2001) and classify each case of turnover according to the new position of the prior CEO and the origin of the new director.

1. Introduction

Turnovers in the top management of the largest Russian companies occur quite often and attract significant attention from society. In theory shareholders, companies' owners (principals), hire managers (agents) and hope that they will do their best to raise shareholders' value. If managers' performance does not satisfy shareholder expectations, owners can punish managers and even dismiss them. In practice everything is more complicated. It could be difficult to sack a manager since he could control stock in ownership directly or through workers, he could have special information necessary for the company's work or it could be hard to find new managers with appropriate skills in the narrow top managerial labor market. Different groups of owners, competitive companies, workers and regional and central government are often influence managerial turnover, especially in large companies. Studying the behavior of different groups of people involved in these processes could help to evaluate the effectiveness of self-enforced corporate governance mechanisms.

One needs to get a lot of information about managerial turnover to understand its causes and predict its consequences. That is why we are looking at turnovers in the largest public companies where this information is available. We are interested in turnovers of only chief executive officers (CEO) and classify cases of turnover taking into account the new position of the prior CEO and the origin of the new director. We track all turnovers of CEOs in the 110 largest Russian-listed companies during the period from 1997 to 2001. Another reason for dealing with the biggest Russian companies is the opportunity to use obligatory disclosed financial information, share prices and market capitalization as a measure of company performance.

This paper is organized as follows. A discussion of extensive literature on managerial turnover in developed countries and emerging markets and of empirical evidence is given in section 2. Section 3 contains sample descriptions and a general analysis of managerial turnovers. Detailed turnover classification and some particular cases are presented in section 4. Section 5 summaries and contains a conclusion on the efficiency of corporate governance mechanisms in Russia.

2. Literature review

There is strong evidence on negative corporate performance – turnover probability relationship. Morck et al. (1989) find that firms experiencing internally precipitated managerial turnover perform poorly relative to other firms in their industry. According to Weisbach (1988), industry adjusted performance is negatively related to managerial turnover. Kaplan (1994a) for US and Japanese firms and Kaplan (1994b) for German firms support that poor performance increases the probability of turnover. Coughlan and Schmidt (1985) report similar result for US companies. Warner et al. (1988) relates a higher probability of CEO and Board Chairman turnover to low stock returns. All this evidence is consistent with hypothesis that shareholders and the board of directors can evaluate firm performance and replace managers when firms' performance is low.

Evidence the relationship between turnover and subsequent firm performance is quite controversial. Most of the evidence comes from event studies. In this approach, the impact of a specific event on firm value is analyzed using financial market data (MacKinlay (1997)). Top managerial turnover is a good example of such an event. Although some authors report significant stock price increase (Weisbach 1988) and operating income growth (Denis and Denis 1995) following managerial turnover, others find no significant market price reaction (Warner at al. 1988) or find even opposite result (Khanna and Poulsen 1995).

These controversial findings could be explained by high heterogeneity of turnovers. Researchers distinguish forced and voluntary turnovers, turnovers resulted from internal (dismissals and voluntary turnovers) and external corporate governance mechanisms (takeovers). Much attention is paid to the origin of new director (insider versus outsider). Johnson et al (1985) show that a CEO's sudden death may lead to an increase in share prices. The effect is stronger if the founder ran the firm, therefore being able to expropriate other owners. In this case his replacement is valuable to shareholders.

Among different types of turnover, forced turnovers with outsider succession are considered to have the greatest positive effect on further firm performance (Huson et al. (2002), Khurana and Nohria). Under *improved management hypothesis,* forced turnover

increases managerial quality and therefore firm performance. Under the alternative *scapegoat hypothesis* of Holmstrom (1979), managerial quality is the same across managers and the difference in performance arises from chance. Under this hypothesis the turnover of a poorly performing manager will not change managerial quality but will revert subsequent performance to the mean level. Since it is more costly to appoint an outsider, outsiders will probably not be appointed unless their expected quality is higher than the quality of insiders. (Dalton and Kesner 1985).

A voluntary or natural turnover followed by an insider succession is the most common type of turnover. This type of turnover is not necessarily associated with poor performance. Further performance may increase since owners have an opportunity to appoint the most capable insider. This kind of turnover can also stimulate top inside managers to perform better to be elected as CEO. Overall one can expect performance improvement after this kind of turnover, that however should be smaller than after forced turnovers with outsider appointment.

Industry homogeneity, ownership structure, board effectiveness and other factors could affect the relationship between performance, managerial turnover and the choice between insider and outsider. For example, Parrino (1997) reports that the likelihood of forced turnover and of an intra-industry appointment increases with industry homogeneity. This evidence is consistent with the argument that poor CEOs are easier to identify and less costly to replace in industries that consist of similar firms. Yermack (1996) finds that a small board of directors is more effective and provides stronger CEO performance incentives from threat of dismissal. Denis, Denis and Sarin (1997) report a significant negative relation between ownership of top executives and the likelihood of top managerial turnover. Moreover, managers become entrenched at very low ownership levels.

Undeveloped financial markets and the short history of privatized firms limit the evidence on the firm performance – managerial turnover relationship in transition economies. Warzynski (2000) finds no relationship between managerial turnover and prior performance for Ukrainian firms while Goltsman (2000) finds a positive relationship for Russian companies. A possible explanation is that better performing companies are more

likely to become takeover targets. At the same time Muravyov (2001) finds “normal” negative performance-turnover relationship for Russian companies.

Several studies of transition economies indicate that managerial changes improve firm performance. The large majority of Chinese firms that hired a new manager experienced improvement in performance while no improvement was observed when the manager was reappointed (Groves et al (1995)). Claessens and Djankov (1999) find that managerial turnover is associated with higher profitability and productivity in the Czech Republic. Managerial changes together with privatization positively affect firms’ profitability in Ukraine (Warzynsky (2000)). Barberis et al. (1996) find that hiring a new manager increases the likelihood of the restructuring of Russian shops.

Among the main factors affecting managerial turnover in Russia, one can highlight managerial entrenchment that resulted from rapid insider privatization, a corrupt environment, and poor property rights protection and law enforcement.

The privatization in Russia led to massive self-dealing by managers and controlling shareholders. Black et al (2000) argue that in the absence of mature institutions that can control self dealing, privatization could not be successful. Similar to the others, Fox and Heller (2000), see insider dominance as a main source of corporate governance failures that are classified and supported by numerous confirmations from the Russian economy.

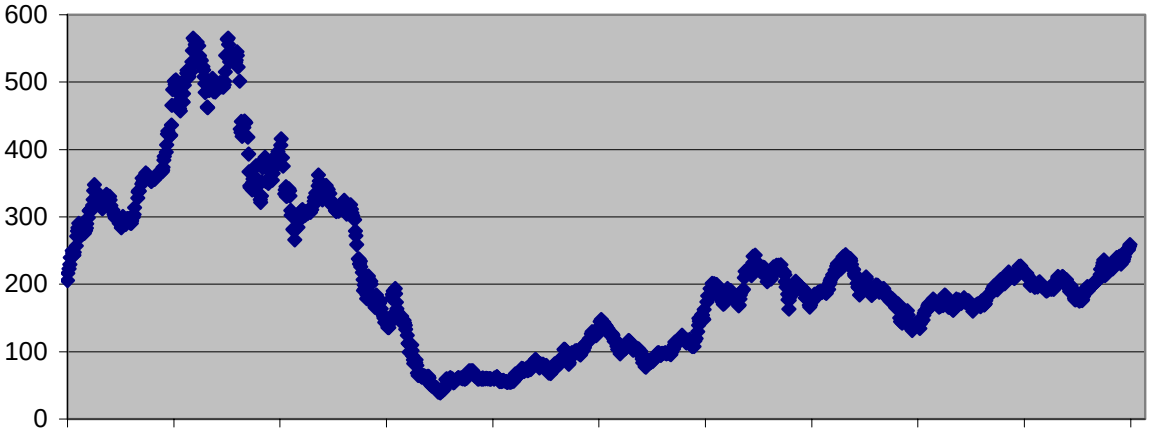
Lambert-Mogiliansky et al (2001) argue that the regional divisions of arbitrage courts are corrupt and that governors in alliance with top managers of big industrial enterprises use bankruptcy institutions as a mechanism for expropriation of outside investors and the federal government. Radygin and Entov (2001) examine a complex system of institutional corporate governance problems in Russia. Most of their attention is devoted to protection of property rights. This problem is probably the most important in Russia up to now.

3. Sample description and general turnover analysis

Sample description

We track all turnovers of CEOs in the 110 largest Russian listed companies during the period from 1997 to 2001. At that time privatization and successive massive ownership redistribution were over. The financial market developed dynamically, experiencing a boom in 1997, crisis in August 1998 and recovering in 2000-2001. RTS index dynamics are presented in figure 1.

Figure 1. Russian financial market experienced boom in 1997, crisis in August 1998 and recovering in 2000-2001



At the end of 2001, shares of about 230 Russian companies were listed on the Russian trading system (RTS) - the largest financial ground in Russia[‡]. However, most of them are illiquid. At the end of the year 2001, the spread (ratio of difference of offers to sell and offers to buy) was more than 20% for two thirds of listed companies. During the 5 years from 1997 through 2001 shares of only one-third of the companies were traded in more than 20 months. Number of regularly and actively traded shares is less than 30. Some industries are not represented in Russian stock exchange at all (for example the wood industry). We study 110 companies whose shares were traded most actively at RTS from 1997 till 2001.

[‡] Another big market for shares is Moscow Interbank Currency Exchange (MICEX). Although turnover in MICEX is almost 10 times greater than in RTS, shares of more companies are listed in RTS. Until 2000 turnover on United Energy Systems' shares was upto 85 percent of total turnover at MICEX.

Companies from this set belong to different industries and are situated in different regions. Industry classification is made using 4-digit OKONH. Data aggregated using 3-digit OKONH is given below. Most companies in our sample are regional telecommunications companies. Another big category is regional energy companies.

Table 1. Most companies in our sample are regional telecommunications or energy companies.

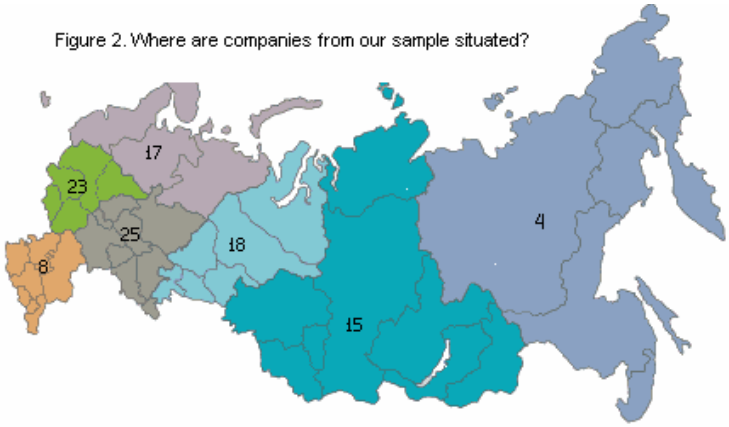
Code OKONKH	Industry	# of companies	Percentage of companies
11100	Electro energy	21	19
11200	Oil industry	16	15
12100	Black metal industry	8	7
14000	Machine building and metal working	14	13
52000	Telecommunications	37	34
	Other	14	13
	Total	110	100

Regional coverage of our sample is given in table 2 and figure 2.

Table 2. Less than one forth of companies in our sample are situated In Moscow or St. Petersburg.

Federal district	# of companies	
Far East	4	
Volga	25	
North-Western	19	
(St. Petersburg)		*(14)*
Siberia	15	
Ural	18	
Central	21	
(Moscow)		*(12)*
South	8	

Figure 2. Where are companies from our sample situated?



General turnover analysis

From 1997 to 2001 the CEOs of 69 companies changed, while in 41 companies top managers kept their position. Often managers changed more than once during that period (see table 3).

Table 3. CEO changed in most companies during 5-year period.

	No turnover	1 turnover	2 turnovers	3 and more turnovers
# of companies observed	41	40	20	9
# of companies modeled	36	45	23	6

Overall we found 113 cases of CEO turnover in 110 companies during the 5-year period. Thus managers changed approximately once in 5 years[§].

We found no long-term tendency in changing turnover intensity (see table 4).

Table 4. Turnover intensity was lower in 1999 and higher in 2001.

Year	1997	1998	1999	2000	2001	1997-2001
# of turnovers	23	22	18	22	28	113

Turnover intensity was slightly lower in 1999 and higher in 2001. The decreased number of turnovers in 1999 can be attributed to the influence of the crises. Under post crisis conditions, it was even more difficult for owners to evaluate managers' performance. Reasons for the increase in turnover intensity in 2001 are discussed below.

[1] One can model the probability of turnover with Bernoulli distribution. Estimates presented in Table 3 are made under the assumption that the probability of turnover in every year is constant across companies and equal to 20%.

More than 200 people worked as CEO in the 110 companies during the 5-year period. We know the date of birth for almost all of them therefore we can estimate the average age of managers and compare it at the beginning and at the end of the period of time under examination (see table 5).

Table 5. Since 1997 managers became younger.

	December 2001	January 1997
Average age of CEOs	50	53
Age of median CEO	50	54.5
Number of CEO older than 60 years	17	28
Number of observations	*107*	*100*

As one can see from the table, managers in general became younger, during the 5-year period. While in the beginning of 1997 more than quarter of managers were of retirement age (in Russia it is 60), at the end of 2001 only every sixth CEO was older than 60 years. Median and average age of CEOs decreased to 50 years of age.

4. Detailed turnover classification

Using public information about turnovers we can classify each case of turnover according to the new position of the prior CEO and the origin of the new director. Thus we divide all cases of turnovers into several following groups.

Honor retirements.

At the beginning of 1997 many CEOs were of retirement age. Most of them quit their jobs during successive 5-year period. We classify 24 cases of turnover as honor retirements. Honor retirements are quite predictable. In half of the cases, they take place on annual shareholders meetings. Usually CEOs use opportunity to take the vacation before retirement. In almost half cases outsiders occupy CEO position. Managers don't retire immediately when retirement age comes but on average 3-4 years later, some even

when 70 years old. Most of the CEOs spent a lot of time as CEO of their companies: only 5 men worked as CEO for less when 5 years, 10 men worked as CEO for more than 10 years. The experience they got as CEO is very valuable for companies, which is why most former CEOs take a place on the board of directors after retirement (11 cases) or even head it (7 cases). Most of honor retirements took place in years 2000 – 2001 (10 cases in year 2000 and 5 cases in year 2001). One should say that the frequency of honor retirements varies across industries. Two thirds of honor retirements occurred in the electro energy or telecommunications industries (see table 6).

Table 6. Probability of honor retirements was lower in oil and black metal industries and higher in electro energy industry.

Industry	# of honor retirements	# of companies	Probability of honor retirements
Electro energy	8	21	0.38
Oil industry	2	16	0.13
Black metal industry	1	8	0.13
Machine building and metal working	4	14	0.29
Telecommunications	8	37	0.22
Other	1	14	0.07
Total	24	110	0.22

Managers in oil and black metal industries seldom reach retirement age. We highlight two possible explanations. First, these industries are competitive, and it is easier for owners to evaluate managers' performance. Second, these industries have access to export markets, thus they are more attractive for investors. This results in higher takeover activity and turnover probability.

Sometimes a CEO is forced to retire, or his retirement is connected with a change in the controlling shareholder, as it was in following example.

GAZ is a large car producer, which experienced a lot of problems after the 1998 crises. On the 29th of November 2000 president Nikolai Pugin appointed Victor Belyaev as GAZ vice president and CEO. On the 20th January 2001 a GAZ shareholder meeting confirmed this decision and affirmed Pugin as GAZ president.

Pugin was 60 years old. In Soviet times, he was the minister of the automobile industry and a member of the Central Committee of CPSU. The new CEO is an outsider. He was supported by the financial industrial group SibAl that recently acquired a considerable stake in GAZ equity and took most places in the new board of directors.

Promotions

CEOs can be promoted either in bigger companies or in government (regional or federal). 16 cases of turnovers were promotions. The intensity of promotions during the 5-year period is presented below. Among recent promotions in government, 3 CEOs became members of the Upper Chamber of Russian Parliament and one became a regional governor.

Table 7. It became more attractive for top managers to work in government during last years.

	1997	1998	1999	2000	2001	1997-2001
Government	1	2	0	1	4	8
Business	1	3	2	2	0	8
Total	2	5	2	3	4	16

The average age of promoted managers is 52 years. On average they worked as CEO for 5 years (It is not surprising that both figures are lower than in the case of honor retirements). Promotions are less predictable then honor retirements. In most cases, insiders occupy CEO position.

On the 30th of January, 2001, the 36 year-old CEO of Norilsky Nickel, Alexander Hloponin, got 62% of votes and won the Taimyr regional gubernatorial elections. Two days before being sure in victory he appointed Johnson Hagazeev as Norilsky Nickel acting director. After one and a half year Hloponin took part in Krasnoyarsk region governor elections. On the 22th of September, he won the second stage of the elections. However his opponent, head of regional legislative assembly Vladimir Us, appealed against the election results. The problem was resolved only by

president Putin's decision. Finally, on the 15th of October, 2002, Hloponin took office as the Krasnoyarsk region's governor.

Bankruptcy procedures and external government.

Federal law #6-FL on insolvency (bankruptcy) was introduced on the 8th of January, 1998. As a result of this law, it was extremely easy to initiate bankruptcy procedures. Groups of conflicting owners actively used this law to get control of enterprises. It is generally accepted that this law was harmful for Russian industry. Finally a new version of the bankruptcy law appeared in 2002, after hot debates in Russian Parliament and government.

Although no one company from our sample went bankrupt in 1997-2001, 5 of them experienced periods of external government (2 companies in the oil industry, one company in the machine building, electro energy and food industries) with 12 turnovers of CEOs and external governors. Most of these turnovers took place in 1998 and 1999 under the federal law #6-FL. Each case is unique and has its own peculiarities and outcomes. The common thing is a conflict of several groups of owners that battle for control of a firm. This struggle results in numerous actions in law, controversial court decisions and frequent changes of external governors. For example, during a year, 3 external governors replaced each other in Chernogorneft.

Conflicts

At the same time one enterprise can have several CEOs and several board of directors that make controversial decisions. The legitimacy of these decisions is confirmed by one court and appealed by another. The extreme form of such confrontation resulted in real battles with police and special forces. Workers and the state are often involved in these corporate conflicts. We found that 9 turnovers resulted from corporate conflicts in 8 companies; 5 of them took place in 2001.

Restructuring / rearranging

We found 9 turnovers related to the changing of companies' organizational structure. If in a company, the position of president was liquidated and the positions of CEO and chairman were created, then formally we can observe turnover. Another 9

turnovers are classified as rearrangements. If one financial industrial group controls several enterprises than the CEO of one firm can be rearranged to a similar position in another firm or take position in this a FIG. These cases of turnovers are neither promotions nor dismissals. They are hardly related to CEO's performance, but to companies' evolution.

Other cases

When a new group of controlling shareholders comes to enterprise it tries to change the management team. The old management team knows this and resists takeovers together with the old group of controlling shareholders. These processes can take a lot of time (see conflicts and external government types of turnover). We found 4 turnovers resulting from takeovers.

Another 3 cases of turnover can be attributed to political reasons and confirm that regional governors have power and effect corporate decisions. First, governors can replace managers they do not like. Second, governors can prevent managerial turnover.

We failed to classify 5 cases of turnovers that took place in 1997 due to lack of information.

Dismissals

All cases of turnovers mentioned above are not directly related to CEO's performance. Only the remaining 22 cases of turnovers are dismissals. In these cases owners were not satisfied with the CEO's performance and succeeded in his replacement. However, shareholders usually do not publicly blame retired managers for poor performance. Probably it would negatively affect the company's reputation. In most cases, the official reason for turnover is neutral: health conditions, expiration of contract or no comments at all. Criminal cases are exceptions. Obviously, it is impossible to hide information about poor or even destructive actions by the former CEO in criminal cases. In our sample, only twice cases were brought before a court against former CEOs. No one was sentenced to imprisonment.

Rostselmash is the largest combine harvester producer. On the 25th of September, 1998, former CEO Vladimir Trinev and commercial director Sergei Beloglazov were arrested on suspicion of theft from Rostselmash. They headed the company from the end of 1996 untill the beginning of 1998 when they were forced to resign because of "health conditions". The new CEO Pavel Pokrovsky accused them of massive self-dealing and transfer pricing. According to Pokrovsky prices of combines were significantly lower than costs while materials were acquired at above market prices through special structures. Losses from Trinev's actions were estimated to be up to 41 bln. non denominated rubles (approximately $8 mln). Investigations took two years and finally the Rostov region Prosecutor exculpated Trinev and Beloglazov.

5. Summary and conclusions

Our examination of CEO turnovers in large Russian public companies from 1997 to 2001 indicates that managerial turnover activity was quite intensive during this period. Table 8 summarizes the turnover classifications discussed in the previous section. For each type of turnover we indicate the number of insider and outsider successions.

Table 8. The probability of outsider succession varies significantly across turnover categories.

	Total	Outsider succession	Insider succession
Promotions	16	1	15
Honor retirements	24	13	11
Restructuring	18	9	9
Dismissals	22	11	11
Politics	3	1	2
Conflicts	9	6	3
External government	12	10	2
Takeovers	4	4	0
Not identified	5	1	4
Total	113	56	57

It should be noticed that different types of turnover can overlap and this classification is rather relative. For example cases formally classified as honor retirements

can be associated with ownership changes, (see GAZ case), takeovers, and even dismissals (golden parachute story).

It is not surprising that the probability of outsider succession varies significantly across turnover categories. However, on average this probability is close to one half. It is a very high figure when compared to developed countries where it is one fifth. This implies that top managers have low incentives to perform well since their chances to become CEO are low.

Dismissals is the only category directly related to a manager's performance. Since the share of this kind of turnover in all turnovers is relatively low, one could hardly expect to observe a high performance to turnover relationship on the whole sample.

Our findings suggest that it is really difficult to dismiss managers for poor performance. Internal corporate governance mechanisms do not work properly since managerial entrenchment is high, an undeveloped financial market complicates manager performance monitoring, and the top managerial labor market is thin. The same reasons and a poor legal system and poor law enforcement hinder external corporate governance mechanisms.

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