Investment Privatization Funds, Banks and Corporate Governance in the Czech Republic and Russia

Michael Fitzsimmons MBA/MIA '03

Columbia Business School

Columbia University School of International and Public Affairs

One of the central problems facing economic reformers in East-Central Europe and the former Soviet Union in the 1990s was the establishment of effective mechanisms of corporate governance for privatized enterprises. Potential models for governance systems were plentiful among the developed economies, but analogs for the political and socioeconomic conditions of the former communist countries were not. Policymakers faced difficult tradeoffs. Privatizing to large numbers of individuals would be a fair method of distributing state property and would give citizens a tangible stake in the success of reform. But it would also disperse ownership widely, leaving a vacuum of governance. On the other hand, privatizing to foreign investors would open access to vital management and financial expertise, but would run the risk of sacrificing important national political goals in the process.

Faced with these conflicting choices, the Czech Republic and Russia chose strategies of mass privatization, whereby vouchers representing bidding points for ownership in privatized enterprises were distributed at nominal fees to millions of citizens. In both of these countries, new financial intermediaries sprung up to address the problem of dispersed ownership and corporate governance. Similar to mutual funds, these voucher investment funds, or investment privatization funds (IPFs), were designed to aggregate the capital that had been distributed to the masses. While allowing individuals to diversify their investments, the funds also enabled the concentrations of shareholdings required for good governance and enterprise restructuring.

However, while addressing one problem, the investment funds created a new one. Many of the primary actors in these nascent markets who had sufficient industry knowledge, financial expertise and administrative capabilities to create such funds were existing commercial banks. The result was that many banks became both lenders and shareholders in newly privatized firms.

Considerable subsequent debate has occurred about the prospects and performance of these investments funds, especially those affiliated with banks, for corporate governance. Analysts in the academic and policy arenas have attributed both success and failure to IPFs as effective agents of enterprise restructuring.

This paper's general purpose is to evaluate these debates and the evidence that has been collected in response to them. More specifically, it will address the question of whether in a postprivatization environment banks are likely to encourage enterprise restructuring when they hold both debt and equity in an enterprise. Its conclusion is that banks acting in such a dual role, despite significant structural impediments to their effectiveness as agents of restructuring, have demonstrated a positive influence on their portfolio firms. The key underpinnings of this positive influence appear to come not only from banks' differential access to unusually scarce capital, but also from the relative paucity of alternative investment opportunities in the transition economies.

The paper emphasizes the Czech experience due to the relative availability and quality of information. It will also consider evidence from the Russian case, but it does not attempt to provide a thorough comparison of the two. The paper is divided into four sections. The first provides a brief overview of the history of Czech and Russian voucher privatization. The second presents the main arguments in the theoretical and hypothetical debate related to voucher privatization and corporate governance. The third discusses and evaluates the results of empirical studies of IPFs and corporate governance. Finally, the fourth ties together the theoretical and empirical perspectives presented and draws conclusions about the efficacy of bank-sponsored IPFs in enterprise restructuring.

1. Voucher Privatization

1.1. Czech Republic

Between 1990 and 1996, the portion of Czech GDP generated by firms with private ownership increased from 3 percent to 75 percent (Desai 1996, 463). The majority of this value was transferred from state to private hands in two waves of privatization, together involving close to 1,700 large- and medium-sized firms and more than six million citizen voucher bidders.[1] Shares in the firms were designated to remain held by the state, to be sold to selected investors or to be distributed as vouchers to individuals. Vouchers took the form of booklets of 1,000 "points" that could be bid for shares but could not be redeemed for cash. In the end, 62 percent of the privatized shares were distributed to individuals in this manner (Kotrba 1995, 170).

This mass privatization of such a large portion of the economy was adopted for several reasons. First, involving such a large number of people (more than 80 percent of the adult population) created a wide base of interest in and support for the larger task of economic reform. Second, the system was nondiscriminatory, excluding only those unable to pay the nominal fee (~$34) for the voucher booklet. Third, the bid points were meant to create a capital market in which share prices would begin to reflect supply and demand. Fourth, the process allowed for relatively quick implementation, a factor made important by fragile political support for reform. Fifth, enterprise insiders, widely viewed as poor agents of restructuring, were denied preferential treatment in the acquisition of shares. Sixth, it

[1] Kotrba 1995, 178. Approximately 500 more Slovakian firms were included in the first wave of privatization in 1992, but are not considered here. Slovakia and the Czech Republic separated in January 1993.

excluded foreign investors, whose influence was a matter of political controversy, from gaining large blocs of equity in the privatized firms.[2]

In spite of these considerable benefits of mass privatization, the fact remained that very few Czech citizens had the necessary knowledge or expertise to value the firms being privatized, much less take on the role of active owners. To fill this role of capital aggregation and management, investment privatization funds (IPFs) began to appear as a result of both encouragement from the government and entrepreneurial activity. By the end of the first wave alone, 264 IPFs were registered with the Ministry of Privatization (Kotrba 1995, 178).

Initially, public interest in the IPFs was limited, but thanks to aggressive marketing campaigns, especially by the independent start-up fund Harvard Capital and Consulting, IPFs eventually captured 72 percent of all outstanding voucher bid points in the first wave (Hingorani, Lehn and Makhija 1997, 357). The largest IPFs were those affiliated with major commercial banks, accounting for 40 percent of voucher bid points. Also, distribution of points was fairly concentrated, with 38 percent of points managed by the five largest IPFs, four of which were bank-sponsored.[3] In the second wave, concentration of points both in bank-sponsored funds and in the largest funds dissipated to some extent.

The IPFs, though encouraged by the government, were subject to a few notable restrictions in operation. First, IPFs were not allowed to invest more than 10 percent of their capital bases in a single company. Second, and more important, one IPF could not acquire more than 20 percent of any company. This restriction was meant to mitigate potential harm brought by speculative trading and to prevent abuse of minority shareholders, but at the same it limited the funds' ability to gain dominant blocs of shares.

1.2. Russia

While investment funds played a much less significant role in Russia's mass privatization than in that of the Czech Republic, their functions as financial intermediaries between individual shareholders and enterprise management, and as corporate governors, were essentially the same. The most important difference was that, due to Russia's considerably less transparent, less regulated political process, the mass privatization there transferred a far greater portion of shares to insiders than the Czech process did.

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[2]Economically, of course, this was a dubious benefit. The majority of the literature on privatization in transition economies suggests that foreign ownership is one of the variables most strongly correlated with postprivatization performance improvement. See Megginson and Netter 2001, 352.

[3] See Desai, pp. 470–71. The four top bank-sponsored funds in the first wave were Ceska Sporitelna, Investicni Banka, Komercni Banka and Ceska Pojistovna (technically affiliated with an insurance company, not a bank). The one independent IPF in the top 5 (second largest) was Harvard Capital and Consulting.

Russian IPFs tended to be smaller and less powerful than their Czech counterparts, but together they managed to acquire 23 percent of vouchers issued in the period from 1992 to 1994.

Between 500 and 600 IPFs were active during this time, but even the largest 50 funds only accounted for 12 percent of all vouchers issued (Frydman, Pistor and Rapaczynski 1996, 194–5). Like the Czech funds, Russian IPFs were also limited as to the percentage of equity they could legally acquire in any company (25 percent). But, unlike the Czech funds, Russian funds actually owned many of the shares they acquired, since Russian vouchers were redeemable for cash and many individuals had traded them in to the funds in exchange for their estimated face value.

One final characteristic of the Russian IPFs, making them somewhat less interesting than Czech IPFs for the purposes of this study, was that commercial banks were not very active in organizing and operating the funds. Whereas in the Czech Republic banks were among the most important players, especially in the first wave, only a small percentage of Russian funds had any affiliation at all with a commercial bank.[4] As a result, Russian funds faced somewhat different issues in corporate governance than did their Czech counterparts.

2. Corporate Governance and Investment Funds

2.1. Models of Governance for Transition Economies

In a broad sense, the developed capitalist economies of the world operate under one of two systems of corporate governance: an "Anglo-American" model or a "German-Japanese" model. These labels, if not these concepts, ignore important variations among countries with similar systems, but they are useful in distinguishing fundamentally different methods for bridging the perennial gap between ownership and control.

Considerable debate has occurred in the past decade about which of these models was more appropriate for application in the transition economies of East-Central Europe and the former Soviet Union. Important preconditions required for each system were not necessarily present in these economies, leaving policymakers with no clear road map of how to proceed. Ultimately, as will be shown, Czech and Russian privatizers adopted some characteristics from each model. Before outlining these compromises, however, a brief description of the two models is in order.

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[4] Akamatsu 1995, 168–69. I estimate that approximately 10 percent of Russian IPFs were bank-sponsored, based on data presented in Frydman, et al. p. 201.

2.1.1. Anglo-American Model

The essential difference between the two models is in their assumptions about whether short-term or long-term shareholders exert greater influence on management activity. The Anglo-American model favors the short-term shareholder. In this system, the key lever of control that owners apply to managers is the threat of exit in takeover. In short, managers know that if they do not perform according to shareholder expectations, those shareholders are likely to sell out to different owners who have no stake in retaining the existing management. This relatively inactive form of governance is often referred to as "arm's-length finance."[5]

This model has the advantages of being very flexible—that is, capable of adjusting quickly to market changes—and of allowing owners to govern firms effectively without deep, costly involvement in the operation of the business. On the other hand, such a system can only work when three important conditions are present: deep, liquid securities markets; deep, liquid management labor markets; and the availability to outside investors with financial information and expertise of high quality and quantity. Without the first two of these conditions, the threat of exit and takeover loses its practicability and, in turn, its credibility as a lever of control. And without the third condition, outside investors cannot make good decisions about when to enter and when to exit.

Furthermore, a potential hazard of the Anglo-American model is speculation. Without proper regulation or discipline, the incentives to buy and sell quickly without any meaningful influence on the management of firms can subvert the very efficiency that the model is meant to facilitate.

2.1.2. German-Japanese Model

The German-Japanese model, by contrast, favors the long-term investor. According to this system, the most important governance mechanism is not exit or takeover, but "voice," or influence exerted by committed financial partners. Banks play a central role in this model, as their participation in firms both as shareholders and as lenders is meant to solidify their interest in the strong financial performance of the firms involved. As in the case of the Japanese *keiretsu,*[6] banks provide not only financing, but also management advice and links to other firms affiliated with those banks.[7]

The primary advantage of this system is the stability it provides. Markets are less volatile and subject to fewer speculative pressures. However, this stability comes at a cost.

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[5] See, for example, Berglof 1995, 67–69.

[6] For a concise description of the *keiretsu,* see Dittus and Prowse 1996, 28–29.

[7] Though the financial services and resources provided by banks in the German-Japanese model have generally been assumed to benefit companies by lowering their cost of borrowing, some recent analysis suggests that this effect may be insignificant, that firms in Germany, for example, do not necessarily borrow more than firms in the United States. See Rajan and Zingales 1998, 102–07.

Owners have less scope for making broad changes in management, since the close relationship between shareholders and managers bears directly on the performance of firms. Owners must also invest heavily in monitoring management. Furthermore, potential conflicts of interest are inherent in simultaneous ownership of debt and equity. Debt holders might prevent potentially lucrative but risky strategies. Or, conversely, equity holders might inflict significant damage on their commercial banks with risky misadventures.

Therefore, for the German-Japanese model to be successful, owners must be capable of actively monitoring management and of balancing the competing incentives of debt and equity ownership.

2.1.3. Postprivatization Czech and Russian Governance

What the Czech and Russian mass privatization programs set out to do, then, was to create a system of corporate governance that enjoyed some of the best of both models —to create an active capital market as in the United States, but also to have concentrated, stable monitoring by financial interests. Policymakers fully recognized that individual citizens would have neither the capability nor the incentive to provide any meaningful governance, so they accepted the necessity of capital aggregation in the hands of financial intermediaries. At the same time, however, they were wary of granting too much power to such intermediaries, who might prove incapable of or uninterested in significant enterprise restructuring. They saw an active capital market as a mechanism for providing some of the discipline of exit and takeover that is the key to the operation of the Anglo-American model.

The IPFs were the result of this compromise. How successful they were is a question that will be addressed later in the paper, but it is clear that IPFs were meant to be central to corporate governance in these transition economies. As noted earlier, they were much more important in the Czech case than in the Russian due to the dominance of insiders in Russia's privatization. Consequently, the subsequent discussion will focus on the Czech case, with some reference to Russia.

If the IPFs were meant to be central to corporate governance, was this a good plan? What were their prospects? In particular, how likely were bank-sponsored IPFs to be effective agents of restructuring? The following two sections outline the two sets of competing theoretical arguments about this question.[8]

[8] The arguments presented here have been collected from the broad literature on corporate governance in Eastern Europe and the former Soviet Union. In cases where points have been derived from only one source, that source is noted, but in general the arguments may be found in multiple sources, as listed in the references.

2.2. Why Bank-sponsored IPFs Should Be Good Corporate Governors

Perhaps the most straightforward rationale for allowing debt and equity financing from a single source is the concentration of interest that is generated. Increasing a bank's stake in an enterprise will simply increase its incentives to ensure strong financial performance.[9] Furthermore, the bank has an incentive to balance the conservative and aggressive strategies that may be preferred by debt holding on the one hand and equity ownership on the other.

Close ownership ties between banks and firms also promise to mitigate information problems that inevitably arise with governance from outside owners. High-quality financial and operational information, as well as the ability to interpret that information in a sophisticated way, is more likely to be resident in a longer-term financial partner like a bank than in the arms-length shareholders of the Anglo-American model.

This longer-term orientation of banks, possibly strengthened by expanded participation in both debt and equity, has another important benefit for governance. In this position, a bank can protect its portfolio companies from speculative takeovers. While the threat of takeovers may be seen as an instrument of discipline that in turn encourages efficiency, takeovers may also take the form of short-term financial gamesmanship that benefits no one except the speculator. Given its longer-term stakes in a company, a bank that is both a lender and an owner would be unlikely to engage in this kind of destructive speculation.

Another advantage enjoyed by banks in assisting their portfolio companies is providing them with access to capital. David Ellerman (1998, 5) points out that even in the Anglo-American system, equity markets are not necessarily the most important sources of capital. Financing from internal operations is the most important source of capital in the United States, the United Kingdom, Japan and Germany, and bank debt is the next most important source. In this way, perhaps bank-sponsored investment funds are preferable over other potential owners, including non-bank-sponsored funds, as agents of restructuring.

From the perspective of the banking system, it is also very possible that providing banks with the opportunity to invest in both debt and equity lowers the overall risk of bank failure. This is due to the diversification and hedging options that equity ownership opens up to banks. While this advantage is not related directly to enterprise performance or restructuring, it does contribute to the overall stability of the financial system.

As will be discussed in more detail below, one common criticism of the Czech and Russian programs is that IPFs were not allowed to acquire large enough blocs of ownership to make active monitoring worthwhile. However, Frydman, Pistor and

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[9] Such incentives are even more pronounced in scenarios where investors' legal protection is relatively weak, as was the case in the transition economies of Eastern Europe and the former Soviet Union. See Himmelberg, Hubbard and Love 2002.

Rapaczynski (1996, 213) point out in their study of Russian voucher privatization that potential upsides based on relatively minor restructuring achievements in transition economies are so high relative to incremental upsides in traditional capital markets that the free-rider problem implied by the above criticism is significantly mitigated.

In addition to these theoretical perspectives, empirical evidence from the German and Japanese economies verifies the hypothetical links between bank participation in debt and equity and enterprise performance. For example, Cable (1985, 30) demonstrated that profitability among large German firms was "positively related to the proportion of equity voting rights controlled by the three big universal banks." Similarly, Lichtenburg and Pushner (1993, 30) found that "Japanese firms with high financial institution ownership show higher levels of productivity and profitability than other Japanese firms."

Finally, one important consideration that is often overlooked in the literature is that any assessment of banks' likely performance as corporate governors must not ignore the available alternatives for governance. In other words, even in the Eastern European context, where there is reason to question whether banks have sufficient expertise and incentives to be strong monitors, these concerns alone may not be grounds for concluding that banks should not be owners. Virtually every potential owner in these economies faces similar constraints. Even a flawed system will almost certainly be preferable to a dysfunctional one, which may have been the alternative to the models actually pursued in the Czech and Russian cases.

2.3. Why Bank-sponsored IPFs Should Be Poor Corporate Governors

In contrast to the preceding arguments, much of the literature on corporate governance in East-Central Europe and Russia has taken a much more skeptical view of the ability of bank-sponsored IPFs to be effective agents of restructuring.

The first set of arguments in this regard relate to the potential conflicts of interest that may arise between the lending functions of banks and the shareholding functions, in this case the IPFs. The most important of these conflicts arises in a scenario in which a firm is struggling to survive. The interest of an independent debt holder in that firm would be to restrict credit and enforce payment of outstanding loans. An equity holder, on the other hand, would likely want to do anything possible to keep the firm from folding and thus destroying all of its equity value. These opposing interests would be resident in the same organization in the case of the bank-sponsored IPFs.

The central hazard resulting from this conflict of interests is that banks faced with the declining share prices of firms that they partly own themselves will have strong incentives to prop up the value of those shares with risky loans. In addition to adding financial risk to the bank's position, such a scenario introduces a clear form of Kornai's soft budget constraint[10] to the governance structure. Managers, recognizing that the bank will bail them out of difficult times, have weaker incentives to maximize productivity and profitability, thus directly hampering restructuring.

Other possible conflicts of interest include the encouragement of anticompetitive behavior. For example, a bank may restrict credit to a competitor of another enterprise in which it has an equity stake. Or it may share proprietary information of one of its lending customers with a competitor in which it has an ownership stake. Similarly, a bank may use its lending relationships to tie customers to the products of a partially owned enterprise. Alternatively, if the lending side of the bank holds greater power than the shareholding side, the bank may force a partially owned enterprise to borrow from its lending arm at premium prices.

Another set of concerns, apart from potential conflicts of interest, relates to bank-sponsored funds' incentives and capabilities to be effective monitors: in other words, in an environment of limited information and regulation, who monitors the monitor? In the Eastern European context, there is considerable cause to doubt that banks have the proper incentives and capabilities to play this role.

Probably the most important of the constraints on the incentives of the IPFs were the limits on the size of ownership stakes. In the Czech Republic and Russia, funds were only allowed to own a maximum of 20 percent and 25 percent, respectively, of any single enterprise. The purposes of these limits were to mitigate the potential harm brought by speculative trading and to prevent abuse of minority shareholders. But at the same time, the ownership limits put a ceiling of sorts on the willingness of funds to invest in active monitoring of their portfolio firms.

Another key constraint on banks' incentives to monitor in the Czech Republic was that IPFs did not actually own the shares they managed, because vouchers were not transferable to cash. Instead, like a mutual fund, their revenues and profits came from management fees and from trading fees. This significantly dilutes any incentive to spend costly resources on supervising management and ensuring that it is pursuing effective restructuring strategies. The representative of one IPF described the incentive structure this way: only 4 percent of profits "came from dividends and profits from share companies, and 96 percent from the [trading] business. . . . As to our expenditures, it was the opposite: 90 percent of our expenditures were to go to the share companies, and 10 percent to the wages of the [traders]."[11] With such poor returns on investment in monitoring, the IPFs would seem to face very weak incentives to actively monitor the managers of their portfolio firms.

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[10] For a description of soft budget constraints, see, for example, Kornai 1992, 140–45.

[11] Milan Jurceka, executive director of A-Invest, quoted in Coffee 1996, 156–57.

Also, bank-sponsored IPFs have an incentive to diversify their equity portfolios so as to maximize the number of firms to which they may have exposure for marketing the parent banks' financial services. This is, in fact, what happened in the Czech Republic, where the leading bank-sponsored IPFs built portfolios of a few hundred firms, while the leading private IPFs built portfolios of 40 or 50 firms.

In the Czech case, there was one additional impediment to IPF incentives for active monitoring. By law, the IPFs only issued shares at the time of the first and second waves of voucher privatization. This meant that, following the second wave, IPFs no longer issued any shares. As a result, unlike American mutual funds, Czech funds following the second wave had no market of potential buyers for which to compete with strong performance. This reduced even further the funds' incentives to maximize the value of their shares.

With regard to capabilities, it was never clear that even the biggest banks in the Czech Republic or Russia had anything approaching the necessary knowledge and capabilities for facilitating effective restructuring, even if proper incentives were in place. Bank representatives, just like managers in the enterprises in which they were investing, had spent their careers as bureaucrats in command economies and, while they may have developed industry-specific expertise, did not have any experience with the financial and operational management of a firm in a market economy.

In addition to problems stemming from conflicts of interest and the weak incentives and capabilities that were resident in IPFs, the IPFs were also poorly positioned to establish a basis for the active equity market envisioned by the privatization planners. As described earlier, for equity markets to have any positive effects on corporate governance, those markets must be large and liquid, that is, investors must be able to move in and out of investments relatively easily while incurring relatively low transaction costs. Neither the Czech Republic nor Russia developed such an equity market for a few simple reasons. First, the number of equities available to trade on these markets was always too small to provide any substantial liquidity. Second, good financial and operational information, though greatly improved recently, was not generally available to outside investors. And third, industry and managerial expertise was also largely unavailable in the pool of outside investors (except foreign investors, who were largely excluded from voucher privatization).

Finally, Ellerman (1998, 7–10) presents two further arguments predicting the failure of the Czech funds. First, he argues that IPFs not only would be ineffective corporate governors, but also actually would actively hinder restructuring by "decapitalizing" enterprises. According to this model, banks and IPFs would siphon profits and dividends from industry into the financial sector without providing efficient resource allocation in return, due to the constraints outlined earlier.

Second, he identifies another conflict of interest, this time between the IPFs and enterprise managers. The IPFs, in order to maximize the value of their shares, depend on keeping their shares "in play," or actively traded. However, given the lack of liquidity in the market, he argues, workers are likely to sell their shares early to avoid the risk of having to hold them if their value declines. As long as this situation remains, enterprise managers will then be able to buy cheap shares from workers anxious to sell off their shares. So long as managers are able to increase their stake in the firm by accumulating shares, they have weaker incentives to try to increase their stake by increasing the value of their existing shares. In short, managers will choose to grab more of the pie rather than working to expand the pie, thus hampering restructuring.

On balance, then, the weight of the arguments in this theoretical debate seems to fall on the side of skepticism. Though the German-Japanese corporate governance model offers some promise for bank-sponsored IPFs to be effective agents of restructuring, a wide variety of constraints and conflicts of interest appears to suggest that bank-sponsored IPFs, if not all IPFs, should have failed to have significant positive impacts on restructuring in the Czech Republic and Russia.

3. Empirical Results

The empirical evidence available on IPFs and enterprise restructuring is somewhat limited, especially in Russia. Accurate measures of performance are difficult to isolate methodologically, and data are often unavailable or unreliable. Also, a good case may also be made that the six-to-nine years that have passed since voucher privatization do not constitute a sufficient track record from which to draw any conclusions about the success or failure of any reforms.

Nevertheless, several empirical studies have been conducted in recent years that attempt to measure various aspects of enterprise performance and restructuring. A few of these studies specifically address the relationship between IPFs and enterprise restructuring. Five such studies will be discussed briefly in this section. Interestingly, four of the five offer evidence suggesting that IPFs—and in some cases, especially, bank-sponsored IPFs—have proven to be effective agents of enterprise restructuring. The evidence points in the opposite direction from the bulk of the theoretical literature on the subject. Possible explanations for this discrepancy are explored in the final section.

3.1. Claessens, Djankov and Pohl (1997)

This study directly addresses the question of bank-sponsored IPFs and their impact on enterprise restructuring. The authors take ownership information from approximately 700 publicly traded Czech companies in the period from 1992 to 1995 and measure correlations with two metrics of restructuring or performance. The two metrics are "Tobin's Q," or the ratio of market capitalization to book value, and profitability, defined here as gross profit divided by net fixed assets plus inventory.

The conclusion that Claessens et al. derive from this analysis is that ownership by bank-sponsored funds correlates to relatively high profitability and valuation. Even more striking, the most profitable and highly valued firms in the data set tended to be those for which the main lender had a large ownership stake, held through an IPF. From this, the authors conclude that, "banks, while potentially facing some conflicts of interest, on balance provide a positive and special role in corporate governance" (15).

3.2. Djankov and Murrell (2000)

The study conducted by Djankov and Murrell did not present new data, but rather introduced a sophisticated, quantitative synthesis of 23 other studies on ownership and enterprise performance in transition economies. As a result, the conclusions from the analysis must be more general than those of Claessens et al. but still bear directly on the efficacy of IPFs.

The authors classify owners into nine categories and then assign an indexed score of their demonstrated effects on enterprise performance relative to the best-performing category of owners. Because the scores represent a composite result, there is no single measure of performance being used, so scores may only be given on a relative basis. The strongest category of owners, not surprisingly, is foreigners, and is assigned a score of 100. A close second, however, scoring 98.1, is non-bank-sponsored investment funds. Banks score somewhat lower, at 52.9, below other outside bloc holders, managers and commercialized state owners.

For two important reasons, it is reasonable, however, to assume that were bank-sponsored IPFs in the Czech Republic and Russia split out as a separate category, they would score considerably higher. First, the category of banks in this study includes many countries where the state retained controlling interests in much of the banking sector, whereas banks were privatized relatively rapidly in the Czech Republic (Coffee 1996, 147). This is important given the historically superior performance of privatized banks relative to state-owned banks. Second, Djankov and Murrell's analysis also shows that bank ownership in Russia and the CIS demonstrated a strong correlation with enterprise restructuring.

In sum, this study finds a very strong link between non-bank-sponsored IPFs and restructuring and, at worst, average performance on that dimension from bank-sponsored IPFs.

3.3. Frydman, Gray, Hessel and Rapaczynski (1997)

This study also addresses a broader scope than investment funds, but it does yield a few important insights for their assessment. The authors use revenue growth as the key measure of enterprise restructuring.

Assessing data from several Eastern European economies, Frydman et al. find a distinct variation in performance between firms with significant ownership stakes from financial investors and those with significant ownership stakes from nonfinancial investors. They find strong revenue growth and labor productivity growth in firms with major ownership stakes from IPFs, in particular, and conclude that "privatization funds . . . are in fact much better at revitalizing the privatized companies than [nonfinancial investors]" (25). Bank-sponsored and non-bank-sponsored IPFs are not distinguished in this analysis, but the data clearly support the view that the funds are effective corporate governors.

3.4. Frydman, Pistor and Rapaczynski (1996)

This study focuses on IPFs in Russia and though it does not assemble any financial performance metrics for privatized Russian enterprises, it offers considerable evidence related to the corporate governance behavior of the IPFs.

Much of the data in this paper are derived from surveys of Russian IPFs for which the funds answered detailed questions regarding their investment priorities and activities. Overall, the picture the survey data paint is of funds that believe in active monitoring as a key to protecting their investments. More than 80 percent of funds claimed "active involvement in important decisions in at least some of the companies in their portfolio" (211). Moreover, almost 86 percent claimed that the benefits to the fund of monitoring exceeded the costs of monitoring. This particular point is not easily transferred to the Czech case because Russian IPFs, unlike their Czech counterparts, actually own many of the shares they manage, but it is still an important insight. The survey also identifies a long list of services provided by the IPFs to their portfolio companies, such as extending credit and arranging access to suppliers and customers, both domestically and abroad. The existence of such services does not prove anything, of course, but these complements of corporate governance suggest some similarity between the Russian funds and the *keiretsu* of the Japanese model.

Thus, though the measures of fund activity and enterprise restructuring presented in the paper may be somewhat limited and bank-sponsored funds are not distinguished from non-bank-sponsored funds, the paper provides more evidence for the case that IPFs have contributed positively to restructuring.

3.5. Weiss and Nikitin (1998)

The lone dissenting voice among the empirical studies is a significant one, because, like Claessens et al. it addresses the question of bank-sponsored IPFs and restructuring directly. It draws, however, the opposite conclusion: that IPFs have not been effective corporate governors at all.

The authors considered ownership data for 125 Czech firms from 1992 to 1994 and compared that data to a few different measures of enterprise performance: change in value-added and operating profit per worker and change in value-added and operating profit per unit of capital. The results of this analysis show that, while concentrated shareholding of outside investors generally is associated with enterprise restructuring, IPFs—both bank-sponsored and non-bank-sponsored—have no positive effect on restructuring.

It is curious that Claessens et al. and Weiss and Nikitin should arrive at opposite conclusions using similar data sets from the same time period. There are a few important differences in the analysis of the two studies. In two ways, Weiss and Nikitin's analysis is more rigorous than that of Claessens et al. First, while the latter use two metrics of enterprise restructuring, the former use five. Second, Weiss and Nikitin's restructuring measures are changes in performance over time, which is meant to avoid the endogeneity problem of IPF portfolio firms looking like strong performers simply because they started out that way.

Two other offsetting factors must also be considered. First, Frydman et al. (1997) also used change in performance as a measure of enterprise restructuring and drew similar conclusions as Claessens et al. Second, there is some reason to question the validity of Weiss and Nikitin's data set. Though they started with a sample of approximately 750 firms, they pared down that set for methodological reasons to 125 firms. The proportions of each category of owner in the remaining sample are quite different from the proportions in the complete set.[12] Most important, the percentage of firms where an IPF is the largest shareholder is reduced in the smaller data set from 48 percent to 30 percent, suggesting that important firms may have been left out of the analysis.

On balance, none of these arguments provides a definitive resolution to the discrepancy between the Weiss and Nikitin and the Claessens et al. studies. In light of the evidence presented by the other works above, however, it is fair to conclude that, according to the best available evidence, IPFs—including but not limited to bank-sponsored funds—were effective agents of enterprise restructuring in the Czech Republic and Russia.

4. Implications and Conclusions

Clearly, a wide gap exists between the theoretical expectations for the performance of bank-sponsored IPFs in corporate governance and their observed performance. Why has this occurred? A rigorous analytical response to this question, if possible to make, is beyond the scope of this general paper, but a few key hypotheses seem to present themselves from the preceding discussion.

One of the most difficult problems faced by restructuring enterprises is a lack of capital. And there is no doubt that a firm whose shareholders are tied to a commercial bank has a significant advantage over competitors in gaining access to capital. The scenario of a bank making high-risk loans to a firm in crisis has been considered in the theoretical literature as a serious hazard to be avoided. In the historical shadow of the command economies' gross inefficiency, the danger of introducing a soft budget constraint appears to be obviously undesirable. Another realistic outcome of such a scenario, however, is that the firm in crisis that otherwise would have had to close its doors is saved by the intimate link between its lender and its major shareholder. If such outcomes have been common in the Czech Republic and Russia, either through shrewd calculation or luck, this could help explain whatever positive relationship exists between successful restructuring and bank-sponsored IPFs.

One goal of the Czech and Russian privatization policymakers that clearly was not met was the development of active capital markets. This failure, however, may have had an unintended positive effect on corporate governance. With the limited liquidity in these securities markets, IPFs might often have a very difficult time selling shares that they expected to decline in value. They then would have been faced with the choice of holding the shares while they declined or attempting to exert some influence over the performance of the enterprise in question. In other words, if exit is not an option, then voice is the only lever left to an investor to prevent the deterioration of his investment, regardless of the cost of monitoring or the free-rider downsides of being active. If this sort of involuntary activism was a significant phenomenon, the bank-sponsored IPFs, with their access to the commercial banks' suites of financial and management services, would have been better prepared to exert influence on management than other shareholders.

Finally, perhaps another explanation for the apparent gap between the theoretical perspective and the empirical evidence on this topic is simply that the theoretical critiques of the corporate governance models adopted in the Czech Republic have not fully considered the available alternative models. From a policymaker's perspective, it is not particularly useful to argue that bank-sponsored IPFs will be poor agents of corporate governance. It may be true, but in order to derive any practical insight from the assertion, the policymaker must ask, IPFs will be poor agents compared to whom? In the case of these transition economies, the alternatives to the IPFs—namely, managers, workers, nonfinancial outside investors or the state—are likely to be worse corporate governors. Foreign investors are, according to both the theory and the empirical evidence, the only clear superior option. But for a variety of reasons, foreign investors have not been available in the quantities that would have been necessary to restructure an entire economy. Ability to restructure is essentially absent among domestic outside investors, and insiders do not tend to be effective agents of restructuring. Individuals cannot muster any governance at all. Perhaps, then, it is the relative suitability of bank-sponsored IPFs to the postprivatization environment, not their absolute suitability, that partly explains why the funds appear to have had some success as agents of enterprise restructuring. For all its risks, a little bank-sponsored governance is, it seems, better than none at all.

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