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Investment Funds in Mass Privatization

Lessons from Russia and the Czech Republic

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Investment funds have a key role to play in mass privatization. But have they lived up to expectations? This Note looks at that question in the two best-known cases—Russia and the Czech Republic, the first to experiment on a large scale with mass privatization and the only two for which enough time has elapsed and enough data are available to permit a tentative assessment.[1] The Note argues that in both cases expectations have not been met and the initial design problems in mass privatization—asymmetric information and imperfect property rights—still remain

In many transition economies, investment funds have been assigned an important role during both the implementation phase of mass privatization and the postprivatization development of financial institutions and capital markets. In the implementation phase, investment funds were expected to amass necessary data about companies and to develop the portfolio management expertise to make informed investment decisions. Moreover, endowed with a pool of voucher capital accumulated from citizens, investment funds could invest in a large number of companies and thereby diversify their own risk as well as that of their investors. Thus, investment funds were developed to help speed the process of mass privatization while ensuring that individual investors had equitable access to opportunities to invest in newly privatized companies.

Investment funds were also expected to contribute to the creation of private property rights and to capital market formation in the postprivatization environment. A potential danger of mass privatization is widely dispersed share ownership in privatized companies, which the architects of mass privatization recognized could result in a control vacuum: large numbers of investors with only small stakes in companies would be unable to monitor their management. The solution to this tension between broad participation and effective governance was to create financial intermediaries in the form of investment funds. By pooling investment capital, the funds would consolidate shares, essential for effective corporate governance.

Finally, the funds were expected to serve an important function as financial intermediaries in the newly emerging capital markets. By forming a link between productive assets and small private shareholders, the funds would represent the initial experience of the investing population in the development of new financial markets. Thriving on the returns of their original investments, the funds were expected to attract additional capital from households. Moreover, by developing the portfolio management expertise to make informed investment decisions, the funds were expected to contribute to the development of credible information about attractive investment options.

The immediate goals of mass privatization—speed, equitable outcomes, and property rights formation—form the baseline for this assessment of the role of investment funds in Russia and the Czech Republic. The Note also examines the relationship between mass privatization and the emerging domestic capital markets in both countries.

Russian voucher funds

Russia began its mass privatization in 1992. By mid-1994, there were more than 500 registered funds. But by late 1996, only about 350 active funds remained, and only 25 to 30 have an active portfolio with long-term prospects. Most of the successful funds have leveraged their portfolio investments to offer investment banking services—though the profits from these services often go to the management company, not the fund shareholders. The successful funds also usually obtained large or controlling stakes in a number of key firms so that they would be able to participate in decisionmaking and monitor their investments. Often, this meant getting around the law limiting voucher fund investment in a firm, initially to a 10 percent stake and then, in 1994, to a 25 percent stake.

But by far the majority of funds have been small and unable to maintain sufficient cash flow to meet their operating expenses and to increase their stakes in their best prospects. The illiquidity of the securities market and of the market for shares in the funds and the lack of dividends from companies have left voucher funds little opportunity to generate earnings. In addition to the economic difficulties faced by companies during transition, a key reason for the lack of dividends has been insider control. Generous privileges under the privatization program enabled insiders to secure control of an average stake in companies of 65 percent. Policymakers hoped that the size of this stake would soon dwindle, but that has happened only at the margin. In fact, the share owned by top management may have increased. This insider control has been at the heart of a survival strategy that has prevented real enterprise reform: top management discourages employees from selling their shares in return for ensured employment—though as the mounting wage arrears show, without much pay. This strategy has secured management's position and the nominal survival of firms. But it has crowded out outside investors, including funds with an interest in improving profitability. Holding less than 7 percent of a company's shares on average, funds have been too weak to exert much control and initiate much-needed restructuring.

The illiquidity of the markets has several causes. When the funds had to make their initial decisions about where to invest, their information was generally poor. Funds frequently had to make quick or arbitrary decisions and ended up with weak portfolios. Since then, the illiquid market has made it hard to unload underperforming assets. Double taxation of profits and dividends makes the funds relatively unattractive for investors. And the failure to index capital gains has undermined the economic viability of share transactions in a high-inflation environment. Also hampering funds' ability to raise new investment capital has been the public's increased skepticism, stemming from a series of scandals involving voucher funds and other financial intermediaries. Most infamous was MMM, which attracted more than 5 million investors. The government estimates that there were 2,000 unlicensed investment companies active during 1993–94, taking money from more than 80 million Russians.

These scandals and the generally poor performance have led to a crisis of confidence in investment intermediaries. In response, the government recently created a new class of mutual funds—unit trusts—to serve as the main vehicle for financial intermediation in the Russian securities market. Unit trusts will not be subject to corporate profit taxes and therefore will not face double taxation. The question is whether voucher funds will be allowed to transform themselves into new organizational forms such as the unit investment fund, or whether the 25 million new investors who purchased fund shares during mass privatization will lose their investments. Integrating the voucher funds into the new class of funds risks tarnishing the effort to rebuild confidence in financial intermediation. So most industry experts believe that voucher funds have little chance of being important players in the development of capital markets in Russia, though a few of the largest will probably remain in operation.

Czech funds

The former Czechoslovakia started its first wave of mass privatization in early 1991. The number of funds created (and the proportion of vouchers they accumulated) far exceeded policymakers' expectations: more than 400 investment funds were established in the former Czechoslovakia for the first wave, and another 221 funds for the second wave in the Czech Republic alone. Despite the many differences in design between the Czech and Russian mass privatization programs and the markedly better economic environment in which Czech funds operated, the investment funds in the two countries have encountered similar problems.

Czech funds had several advantages that gave them a better chance of being active shareholders in better companies: they were able to buy up to 20 percent of a company's shares, insiders did not gain control of large stakes, and the design of the auction system led to much better information for making investment choices. Funds typically hold the legally permitted 20 percent in a large number of companies in their portfolio, and several funds together often own a majority stake, enabling them to acquire board seats. But the strong representation has not resulted in significant shareholder activism by the funds, and there is little evidence that fund ownership and board representation have had much impact on restructuring. (A recent study suggests that bank-sponsored funds with large ownership stakes have a higher market valuation [see Note 111, forthcoming in this series]. But the study does not control for other factors that might be driving this result, such as the sector, excessive lending by banks to the firms in which their funds invest, or exploitation of arbitrage opportunities unrelated to restructuring efforts.)

There are several reasons to expect that a liquid capital market would develop more easily in the Czech Republic than in Russia: the absence of high inflation and the uncertainties it creates, the easier flow of information and lower transaction costs characteristic of a small country, and the lack of a highly distortionary tax regime. Yet even though the Czech stock market has been more liquid than the Russian market, most trading has taken place off the exchange, often through swaps between voucher funds. Czech funds have even mounted mergers and takeovers of several companies. But the market for corporate assets has been characterized by insider dealing and a lack of transparency. This may be a result of the large stakes acquired by funds during privatization, which cannot be easily liquidated on official markets without steep discounts in prices. But it could also reflect the lack of legal oversight of the capital market.

In the Czech Republic, more funds have been listed on the stock exchange than in Russia (in 1995, they accounted for 8 percent of stock market capitalization). But Czech funds have faced similar difficulties in raising additional capital and developing a secondary market for their shares. As a result, many of their investors are locked into their current holdings. Recent scandals surrounding Czech investment funds have highlighted the control vacuum—and fund managers' exploitation of it.

One of the most intriguing aspects of the Czech funds has been their close relationship with the banking sector and the degree of cross-ownership in the financial sector. The largest banks in the country are owned mostly by other banks and by investment funds, including funds established by investment companies that in turn were created by the banks. Investment fund regulations that could and probably should have been interpreted as counter to this degree of cross-ownership proved ineffective. The cross-ownership between banks and funds, and between them and the companies they own, enable the participants in this network of cross-ownership to hedge against hostile takeovers and other market adversities. But evidence suggests that cross-ownership of funds has hurt shareholders because of the heavy discount at which fund shares have been trading. And many observers doubt that banks have managed to raise firewalls between themselves and the funds. In the light of recent bank failures, that raises concerns about funds

that are directly or indirectly controlled by these banks and that frequently also hold assets in them.

Since mid-1995, several funds in the Czech Republic have been transformed from portfolio investment funds into holding companies. As simple joint stock companies, these funds are no longer subject to investment fund regulations. They may increase their stake in companies beyond the 20 percent ceiling and freely transfer capital abroad for foreign investment activities. As company owners, these funds may take on a more proactive role, but doubts remain as to whether the funds' investors will benefit.

Assessing the record

The Russian and Czech mass privatization programs have succeeded in privatizing a once inconceivably large number of companies in a short period. But if we are to take the goals of mass privatization seriously, other criteria must also be considered in assessing the outcomes. Did investment funds help to ensure equitable outcomes in mass privatization? The record on this is discouraging in both the Czech Republic and Russia. The discount at which fund shares are being traded—if they are traded at all—reflects the market's perception that the funds either have been unable to enhance the value of their holdings or have failed to share any gains with their investors. Dividends, if paid at all, have been extremely low. By and large, citizens have become owners of the worst-performing assets in Russia and the Czech Republic, while the "crown jewels" have gone to insiders. This experience in mass privatization makes small investors' lack of confidence in capital markets a rational response.

Have investment funds contributed to effective private property rights? The evidence suggests that establishing property rights is a longer and much more complicated process than nominal allocation of title. Moreover, there are troubling signs—particularly in Russia—that the property rights created in mass privatization in a hasty attempt to "depoliticize" property relations may be too weak to support sustainable property rights reform. Many new outside owners—including the funds—have been effectively frozen out by company insiders. Where new owners have been unable to establish their rights, companies remain in a control vacuum. And the government, particularly at the regional level, has continued to play an important role as a silent owner and rescuer of last resort. In the Czech Republic, the outcome has been more positive, but recent banking failures and fraud surrounding voucher funds caution against too positive an assessment of the new property rights regime.

What is the relationship between investment funds and capital markets? While markets were supplied with a large amount of equity as a result of mass privatization, they have remained undersupplied by (domestic) capital in both countries. One reason that efficient capital markets have failed to develop is the lack of an institutional framework. Investment funds had the potential to play an intermediating role in the development of new capital markets, but many have become holding companies rather than actively engaging in portfolio investment. Information asymmetries between small investors and large firms persist in both the Czech Republic and Russia, increasing the risks of investing in markets. Moreover, the negative experience of a large part of the population with voucher privatization has reduced confidence in emerging financial markets. The development of mechanisms of financial intermediation remains a serious issue in both Russia and the Czech Republic.

This Note is based on a chapter by the authors in Ira Lieberman, Raj Desai, and Stilpon Nestor, eds., *Between State and Market: Mass Privatization in Transition Economies* (Washington, D.C.: World Bank, forthcoming).

1 Other countries that have recently undertaken privatization with investment funds, include Bulgaria, Georgia, Kazakstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Poland, Romania, the Slovak Republic, Slovenia, Ukraine, and Uzbekistan.

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