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Conference Paper — Manuscript Version (Preprint)

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Suggested Citation: Rapacki, Ryszard (2000) : Corporate Governance in Poland: the Impact of Mass Privatization, VI World Congress of the International Council for Central and East European Studies, Tampere, 29 July-3 August, 2000, ZBW - Leibniz Information Centre for Economics, Kiel, Hamburg

This Version is available at:

<https://hdl.handle.net/10419/130544>

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Corporate Governance in Poland: the Impact of Mass Privatization

by

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Paper prepared for the VI World Congress of the International Council
for Central and East European Studies
Tampere, 29 July-3 August, 2000

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1. Introduction

The aim of the present paper is to discuss the role of the Mass Privatization Programme (MPP) in Poland, as a vehicle of change in the prevailing patterns of corporate governance in the emerging market economy. It is claimed that the Programme (also known as the National Investment Funds, or NIF, scheme) deserves the name of a genuine institutional innovation, as a novel way of effective privatization of firms involved coupled with their overhaul and in-depth restructuring. Unlike similar mass privatization schemes in other transition economies (e.g. Russia, Czech Republic or Slovakia) the Polish NIF Programme has had institutional guarantees built in for effective enforcement of private-like ownership rights and market-compatible corporate governance patterns.

The analysis covers the first stage of Programme's implementation, i.e. the period of approximately four years between its formal launch in December 1994 and the ultimate privatization of National Investment Funds in January 1999. During this time NIFs remained wholly- and then majority-owned by the state treasury. With a view to achieve the goals of the Programme the government contracted out private fund managers to perform the task of managing NIFs' assets (portfolio companies). As a result, in its design the NIF scheme has been a unique blend of elements coming from two different legal systems: the continental (the basic two-tier power structure of funds), mostly based on the German model, and the Anglo-Saxon one (fund managers).

Seen from the angle of its design and subsequent operation the essence of the Polish Mass Privatization Programme boils down to an effective privatization of the managerial function (both at the level of investment funds and portfolio companies participating in the scheme) without formally transferring the ownership title to private owners. In other words, it consisted in a practical split of the property rights bundle between state treasury and fund managing companies giving the latter the right to use (and – at the level of portfolio companies – also the right to exchange). It was expected that through this implant of private business incentives to formally state-owned entities (NIFs themselves and – indirectly – portfolio companies) the new,

more effective mechanisms of corporate governance will be established; as a result, both the funds and portfolio companies will start behaving like private agents and be more responsive to market signals.

2. Design of the Programme

It is perhaps worth reminding that the very idea of mass privatization, based on equal-access vouchers, was born in Poland in the late-1980s and is associated with the works of economists from the Gdansk Institute of Market Economics (Lewandowski and Szomburg, 1988). They also developed – in the early 1990s - a conceptual framework of such a scheme including the idea of establishing intermediary financial institutions to act on behalf of dispersed individual new owners and to ensure that voucher-privatized companies are restructured and run efficiently. Surprisingly enough, despite this initial competitive advantage, Poland was one of the last transition economies to embark on her mass privatization programme – the scheme was effectively implemented in the second half of 1995, i.e. four years after the first MPP blueprint was released by the government (mid-1991). The delay was mostly due to excessive politicization of ownership changes in Poland and to strong political struggles both within different coalition governments and in the parliament for the ultimate shape of mass privatization.

The Polish mass privatization programme was designed with a view to achieve two intertwined sets of goals. The primary and ultimate goal was to ensure growth of the allocative and operational efficiency of firms involved and – through spill-over effects – of the entire national economy. This was conditional upon meeting the second set of objectives, that is an in-depth restructuring of enterprises participating in the scheme and – subsequently – their ultimate and genuine transfer to the private sector. It was believed that the best vehicle for such changes to materialize would be to create dominant owners for eligible firms - owners who would have appropriate incentives to force through their restructuring and to speed up the privatization process.

Based on these premises 15 National Investment Funds were established in December 1994 and by end-1995 they have taken control over 512 firms (also called: portfolio companies) participating in the scheme. The funds were initially wholly-owned and then (until their ultimate privatization in January 1999) – majority-owned by the state treasury. To start their operations the NIFs were endowed with shares of formerly state-owned enterprises. The pattern of share allocation was as follows: each NIF received a controlling block of shares in 33-35 portfolio

companies (33% of their share capital) and minority stakes in the remaining 477-479 firms (roughly 1.93% of the share capital of each). Seen from another angle the ownership structure of a typical portfolio company included the so-called lead NIF with a 33% share and 14 other NIFs with minority stakes amounting to a combined 27%. Thus the lead NIF and minority-shareholding NIFs together accounted for 60% of share capital in each portfolio company. The remaining 40% were split between the state treasury (25%) and company employees (up to 15%).

The NIFs were to perform the role of intermediaries between individual investors (i.e. all adult Poles who decided to join the MPP programme) and mass-privatized companies. At a token fee of US\$ 8 each eligible citizen was issued a voucher (called Universal Share Certificate – PSU) being the ownership title or a claim on the assets of National Investment Funds. The latter, as was shown above, owned majority stakes in portfolio companies. Once the NIFs were floated on the Warsaw Stock Exchange (June 1997) the Universal Share Certificates could have been exchanged for funds' shares (one PSU per 15 NIF shares, i.e. one share of each NIF) and traded on the stock market. Thus, unlike in mass privatization schemes in other transition economies, individual investors in Poland owned mass-privatized companies only indirectly – through the shareholding in national investment funds.

The basic corporate power structure at both the fund and portfolio company levels rested on a German style two-tier system: the management board and the supervisory board. The first NIF supervisory boards were appointed by the government after a thorough and lengthy screening process, and survived – essentially unchanged - until the spring of 1999. During the first stage of MPP implementation (1995-1998) the supervisory boards were empowered with broad prerogatives including the task of selecting fund managing companies from the short list prepared by the government, negotiating the terms and eventually concluding – on behalf of the owner (state treasury) – the contract with a selected fund manager.

A crucial role in the design and operation of the Polish mass privatization programme was envisioned for fund managing companies (or fund managers) – an institution directly 'imported' from the Anglo-Saxon world and incompatible with the Commercial Code being in force at the time of the MPP implementation. This implant of a component of the Anglo-Saxon corporate governance model may be seen as an important novelty that (together with some other key features of the programme) made the Polish mass privatization distinct from similar schemes in other transition economies.

Based on civil contracts signed with NIF supervisory boards fund managing companies were hired to perform the task of enhancing the value of NIF assets. It was expected that the key value driver would come from restructuring of portfolio companies and triggering their development potential. Most of the fund managing companies selected for the programme were set up by consortia of private Western firms and their Polish counterparts. The former included mainly reputed international investment banks and accounting or auditing firms while the latter comprised major domestic commercial banks, insurance companies and business consulting firms.¹

Contracting out the function of managing the NIF assets entailed – as a direct consequence – a specific place of fund managers in the corporate power structure at both the NIFs and portfolio companies' levels. At the fund level, unlike in a typical continental-type company, it was not the owner who – through the supervisory board – would appoint the CEO and the management board. Instead, it was the fund managing company who was granted the right to form the NIF board of management. In practice, three solutions were adopted. The first, most widespread variant consisted in a personal union between the management of a fund managing company and a fund itself. Under the second option the institution of a proxy (as a rule, for the CEO of a fund managing company) was used. Under the third alternative, some NIF supervisory boards (e.g. NIF Octava) agreed to delegate their own nominee to the board of management with a view to alleviate the information asymmetry and principal-agent problems.

The corporate governance mechanism at the portfolio company level was devised in a slightly different way, more compatible with the Polish Commercial Code. Here the supervisory board was to play the crucial role including the appointment of a CEO and the company's board of management. In theory the fund managing companies could appoint between 40% and 44% of supervisory board members (including the chairman). In practice, however, they gained the controlling voice over the management of portfolio companies as in many cases there was an implicit agreement among NIFs that the lead NIF should also nominate the representative of minority funds to the board.

As a wrap up of this part of the discussion one important point should be stressed. The design of the corporate governance mechanism at both the NIF and portfolio company levels authorizes a tentative conclusion that the role assigned to private fund managing companies within the Polish MPP programme was equivalent to an effective privatization of the management function in entities being wholly-owned (and later majority-owned) by the state (National Investment Funds and – indirectly – portfolio companies).

3. MPP and corporate governance

As is more and more widely recognized in the literature, privatization is a necessary but not – per se – a sufficient condition for enhancing the efficiency growth and making firms more competitive. To many authors [e.g. Hashi 2000] ownership transformation is only the first step in the process of converting poorly managed, inefficient state-owned enterprises to well-managed and efficient firms capable of responding to market signals and survive in a competitive environment. The ultimate goal is to alter managerial incentives, change the behaviour of enterprises and raise their efficiency. This goal may be achieved by embarking on enterprise restructuring, which entails fundamental changes in the input bundle and output mix, production methods, organizational structure and market position. Hence, one of the most important questions to be addressed is whether or not the chosen method of privatization ensures the establishment of an effective mechanism of corporate governance.

Seen from the angle of corporate governance various mass privatization schemes implemented in transition economies tended to suffer from several serious weakness. First, they resulted in a diffusion of share ownership amongst millions of citizens while simultaneously strengthening the position of mass-privatized companies' managers. The latter, with increased discretion over the use of company resources, lacked the incentives to embark on the urgent task of enterprise restructuring (see Blanchard 1997) and might have used their superior knowledge and discretion (information asymmetry) for their own self-enrichment at the expense of shareholders (a classic principal-agent problem). Second, given the underdevelopment of financial markets and inadequate legal framework in those countries outside investors tended to feel that they did not have sufficient guarantees to invest their funds in mass-privatized companies. Finally, most of the MPP schemes failed to provide voucher holders with sufficient information required to make optimal investment (allocation of vouchers) decisions [Hashi 2000]. As a result of these failures mass privatizations in most East-Central European countries turned out to be a much less effective means of enterprise restructuring and achieving important micro- and macroeconomic goals than expected. This was even the case of the Czech 'kuponovka' where – despite of a 'grass-root' creation of investment funds – the corporate governance problems were not satisfactorily resolved.

Developed market economies rely on a number of methods aimed to alleviate these problems. In the German and Japanese model of corporate governance, large ownership stakes by banks and financial institutions enable effective monitoring of the performance of a company

and give the owners a strong voice to influence the management. In the Anglo-Saxon model, the major constraints of opportunistic behaviour by managers include a well-established legal framework protecting creditors, financiers and individual shareholders, well functioning stock market combined with a market for corporate control, and wide availability of financial information [Shleifer and Vishny 1997]. As most of these mechanisms were either non-existent or underdeveloped in East-Central Europe and – by the same token – unable to protect the interests of outside stakeholders, most observers suggested the German-Japanese model to be more suitable for transition economies [Stiglitz 1994; van Wijnbergen 1994; Shleifer and Vishny 1997].

The corporate governance mechanisms embedded in the Polish mass privatization programme display the features of both the German-Japanese and the Anglo-Saxon models. The former may be traced in the two-tier German style management structure at both NIF and portfolio company levels. For some authors [e.g. Hashi 2000] another similarity may be found also in the ownership structure of most of the fund managing companies, with a strong presence of banks and other financial institutions.

On the other hand, the Polish MPP programme has drawn on the Anglo-Saxon pattern of corporate governance. The major elements include first of all contracting out the managerial function to a specialized agent (fund managing company) and empowering it with a part of the property rights bundle, normally performed by the owner (or the supervisory board on his behalf). Simultaneously, the contractual framework of owner-fund manager relations envisioned a specially designed scheme of incentives for the latter aimed at goal alignment and alleviating the principal-agent problem.

The incentive system was based on a two-part remuneration for fund managers. The first part was a flat management fee, which was agreed separately for each Fund in the process of negotiation between the supervisory board and the fund management company – usually at the level of 2-3% of the value of assets. The fee was fixed for the 10-year life of the management contract. The second part consisted of the performance-based bonus. It comprised two elements: (i) the proceeds of the sale of 1% of shares of the Fund on an annual basis, and (ii) the proceeds of the sale of 5% of shares of the NIF upon termination of the 10-year Fund Management agreement as a ‘loyalty’ bonus. The total remuneration of fund managers amounted to 3.5%-4.5% of the value of NIF assets, quite a generous level by Western standards. It is also worth highlighting that the flat management fee tended to be much higher than the performance-based components of the remuneration.

While discussing the impact of the Polish mass privatization on corporate governance and on achieving the major goals of this programme a number of weaknesses in both its design and operation should be pointed out.

The first is due to a long delay in the MPP implementation. The uncertainty about the future ownership, lack of new investment and the absence of clear-cut development strategies had resulted in a marked deterioration of the financial standing of a majority of portfolio companies at the start of the programme.

Second, the initial period of programme implementation revealed a misfit between the skills available in fund managing companies, on the one hand, and enterprise restructuring needs, on the other. Most fund managers, including foreign partners had no prior knowledge or much experience of restructuring in transition economies. Moreover, the factors described in the previous paragraph contributed to widen this misfit even more. The poor shape of many portfolio firms in 1995-96 called for 'company doctoring' skills rather than just restructuring expertise. With the passage of time and new experience gained (learning-by-doing) this initial misfit gradually disappeared.

Third, the MPP suffered from the legal ambiguity about the objectives of the programme. According to the Law on National Investment Funds (Article 4), the aim of the programme was to increase the value of portfolio companies through restructuring. This wording is open to different interpretations and it actually gave rise to diverging views of fund managers versus those of supervisory boards. The former tended to choose policies aimed at maximizing the net asset value of their funds. This implies greater emphasis on short-term measures and on the sale of companies whenever possible. The supervisory boards, on the other hand, had a longer time horizon and were mainly interested in transforming the mass-privatized companies. This clash of perspectives was among the major reasons for frequent frictions between these two key elements of the corporate governance mechanism at the NIF level.²

Fourth, one of the major determinants of the above trends can be found in the very design of fund managers' reward system. The imbalance between the flat fee and the performance-based element (in favour of the former) embedded in the management contracts may have led managers to be less concerned with the long run health of mass-privatized companies and focus instead more on shorter term objectives. This may suggest some weak form of the moral hazard problem embedded in the design of the Polish MPP scheme.

The above weaknesses, however, seem to have been more than outweighed by other core elements of the Programme, more compatible with its main goals and conducive to achieve

expected efficiency gains. These elements, as discussed earlier, included the concentrated ownership of fund managing companies and controlling voice of the latter in portfolio companies, the effective monitoring of fund managers by NIF supervisory boards (amelioration of the principal-agent problem) and – in more general terms – institutional guarantees built in the MPP scheme for a smooth operation of the corporate governance mechanism (the presence of financial intermediaries and fund managers with well-defined roles and responsibilities).

The available empirical evidence including interviews with NIF management and surveys conducted with portfolio company employees [Hashi 2000; Rapacki 2000] unequivocally indicate that most NIFs have embarked on the restructuring of the mass-privatized companies and brought about in-depth changes in their behaviour. As a result, after four years of MPP implementation, the companies involved seem to be more responsive to market signals and capable of withstanding the competitive pressure. Selected empirical data is provided below to support this claim.

5. Empirical evidence

The first stage of the MPP implementation (1995-98) brought the whole array of important microeconomic effects. They comprised in-depth changes in management structure, output mix, input combinations and production techniques in mass-privatized companies. Overstaffing has been reduced, non-productive assets and spare capacity disposed of, many companies were sold to strategic investors or floated on the stock exchange, and some of the loss making firms liquidated or entered into the bankruptcy process.

The most important outcomes of NIFs' and their fund managers' activities during 1995-98 can be summarized as follows [NIF... 1999]:

- new private owners (mostly strategic investors) were found for 253 mass-privatized companies (i.e. for 49.4%), including 52 listed on the stock exchange,
- bankruptcy or liquidation procedures comprised 34 companies,
- in 54 companies the entire management boards were changed; in 265 firms the changes involved the CEO,
- in-depth restructuring was carried out – to various degrees – in all 512 firms (including management, organization, finance, sales and marketing, manpower, downsizing, product mix and technology),³
- new products were introduced in 455 companies, and 102 firms diversified through entering a new activity,

- 461 companies embarked on new technologies and/or upgraded the existing equipment,
- new investment in NIF companies amounted to 1.8 billion zloty (0.5 billion dollars),
- the ratio of companies generating profits increased from 40% in 1995 to 64% in 1998.

The foregoing discussion authorizes the conclusion that – despite some weaknesses – the Polish mass privatization programme seems to have better served the major goals ascribed to ownership changes in their broad sense, compared to other transition economies who embarked on similar schemes. This was mostly due to its innovative design that combined the elements of both the German-Japanese and the Anglo-Saxon models to best fit the institutional environment prevailing in Poland (e.g. the best regulated and the most transparent stock exchange in all East-Central Europe). The new corporate governance mechanism that emerged within the MPP framework – compared to other transition economies – seems to also have been fairly effective in ameliorating the principal-agent problem and imposing constraints on possible opportunistic behaviour by managers.

Another important dimension of the Polish NIF programme boils down to the fact that it entailed an effective privatization of the management function in the entities being wholly- or majority-owned by the state (fund managing companies). As a result, even before their ultimate privatization in early-1999 both National Investment Funds and mass-privatized companies started behaving like private firms and properly reacting to market signals.

5. Concluding remarks

In January 1999 the MPP programme in Poland entered its second, qualitatively new phase. The 31 December of 1998 was the deadline for converting Universal Share Certificates (PSU) into the shares of National Investment Funds. The overwhelming majority of NIF shares could have been floated since then on the Warsaw Stock Exchange, a fact that implied a full-fledged privatization of NIFs and – by the same token – of the portfolio companies. The state treasury retained only some 16% of NIF shares while the remaining 84% might have been subject to a stock market trading.

Throughout 1999 and the first half of 2000 the process of concentration of NIF ownership has taken place. The most active among the new owners were Western hedge funds and venture capital funds as well as some Polish major banks and financial institutions (e.g. BRE Bank, PeKaO S.A. and PZU insurance company). They strived to accumulate controlling stakes in a number of NIFs simultaneously. As a derivative of these trends two developments, crucial for the future evolution of the corporate governance pattern at the Fund level, should be emphasized.

The first consisted in making the NIF management process more cost-effective – in a number of cases one fund managing company was entrusted the task of managing several NIFs at a time (those controlled by the same group of shareholders). The second development seems even more important – in May 2000 two National Investment Funds (NIFs No. 3 and 11) merged giving birth to a new larger Fund (Jupiter). This may be interpreted as a symptom of the emerging market for corporate control; in the future not only mergers but also take-overs of individual NIFs seem quite likely. These new trends combined seem to bring the Polish corporate governance mechanism closer to the Anglo-Saxon model. One can argue that the corporate governance problem is now closely linked to the operation of financial markets and the market for corporate control as well as the legal framework governing financial markets, company affairs and the stock market [Hashi 2000].

In view of the new ownership structure of National Investment Funds and the divergence between the goals of new owners and the original objectives of the Programme its prospects seem unclear. Based on both officially released statements of new owners and some fund managers, and implicit evidence it is quite likely that, as a function of new strategies of individual NIFs, the restructuring process of the bulk of portfolio companies (in particular those nonviable) might be endangered [Bochniarz and Wisniewski, 1999]. Three distinct strategies with regard to NIFs and portfolio companies seem feasible under the new ownership structure:

- the strategy of aggressive cashing of the shareholder value. It will consist in a fast winding up of NIFs' activities through sales of the best-performing companies and withdrawal of liquid assets. At the same time it will entail freezing of restructuring efforts in non-performing firms,
- the strategy of gradual winding up of NIFs' operations and their eventual liquidation in the longer run. Its main components will encompass redemption of a part of equity, high pay out ratio of dividends and a substantial reduction of fund managers' fees. If this is compatible with the objective of shareholder value maximization new NIFs' policies may not rule out either some restructuring in portfolio companies or using the stock market as a vehicle of their divestiture.
- the strategy of NIFs' transformation into classical venture capital funds. It will involve growing share of investments outside the original group of portfolio companies and thus may produce dynamic synergistic effects with government privatization policy. This scenario seems more likely in case of those NIFs, which have already embarked on a similar policy and proved both capable and effective.

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Notes

¹ A detailed information on the fund managing companies and their ownership structure may be found e.g. in [Hashi 2000].

² In a number of cases these frictions came to the extreme and resulted in dismissal of the fund managers or reshuffling of one supervisory board by the state treasury.

³ As a matter of illustration, in the first step aimed at improving management operations business plans were adopted in 404 portfolio companies, regular reporting (including budgeting) was introduced (all 512 companies), cost and profit centres were identified (358), product profitability accounting introduced (512) as well as management information systems (255) and performance related pay schemes (486) established [NIF 1999].