

CORPORATE GOVERNANCE IN BANKING SECTOR IN TRANSITION ECONOMY: THE ROLE OF OWNERSHIP STRUCTURES

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Abstract

The article explores the structure of corporate ownership in banking sector in Ukraine during an after-privatization period of time from 1998 to 2003. It was concluded that the share of insiders¹ in the structure of corporate ownership in banking sector in Ukraine remarkably increased. The share of outsiders almost did not change. Thus, privatization has led to transferring the corporate ownership from the State to insiders. Development of the process of concentration of corporate ownership structure in banks in Ukraine is controlled by two groups of investors. These are management (executives) of the banks and institutional investors. Major objective of purchasing shares by management is obtaining a total control over the compensation policy. Role of minority shareholders is very weak and their rights are not protected enough to let them participate actively in corporate governance.

Keywords: corporate ownership, executives, institutional investors, privatization

1. INTRODUCTION

Corporate ownership structures in Ukraine experienced a lot of changes during the process of privatization that took place during last ten years. Process of privatization can be divided into several stages, three of

them were over by 1998.

At the same time the process of deregulation of major industries of Ukrainian economy has been initiated too. This concerned metallurgy, chemical industry and others. The state wanted to give the reins of governance in the hands of private

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¹ Those shareholders, who have an advantageous access to information about the company. They are employees and management, who own shares despite the size their stakes, and shareholders, who are not employed by a company, but who own at least a 10 percent stake at the company and, as a result, are able to place on the AGM agenda any proposals and initiate an unordinary Meetings of Shareholders.

(individual or institutional) owners.

At the first stage, privatization in Ukraine was very liberal. By a liberal feature of privatization is meant, that those banks, which wanted to be privatized, were privatized. So, the first stage was given to the will and intentions of Ukrainian banks.

Frankly said, the State wanted employees of Ukrainian banks to take a decision whether to privatize their banks or not. Regrettably, lack of effective audit firms, capable to estimate banks' values (par value, book and market values) sufficiently distorted actual "investment" value of banks and many of them have been bought by employees and management by very low expenses.

After finishing the first stage in 1995, the second stage was initiated by the state authorities. During 1995, Ukrainian parliament was troubled with finding the best methods of privatization. As a result of hesitation of Ukrainian parliament, the process of privatization slowed down.

In November 1995, the President of Ukraine, who was not satisfied with the work of parliament of Ukraine, initiated the third stage of privatization. The third stage was named as "mass" privatization. All citizens of Ukraine obtained so named "vouchers", which certified their right of ownership of the state property. By point of view of a lot of experts, mass privatization had very negative impact on development of corporate sector in Ukraine. Individual investors - citizens of Ukraine - had no skills and wishing to manage assets they own.

Moreover, legislative and institutional fundamentals for transferring corporate rights from ones to others were not still developed in Ukraine. There is still no a Corporate Law. There is only a general Law on Enterprises concerning all types of

enterprises. The stock exchanges, to facilitate transferring corporate rights, were established only in 1996. As soon as it was done, in April 1996 tender offers of the state property were initiated. The state authorities planned to attract attention of foreign investors to the state property, who could come to Ukraine with huge financial resources. Moreover, the state authorities wanted to obtain real, market value of the state property that must be privatized.

2. LITERATURE REVIEW

Probably the issue of ownership structure and corporate governance performance has been researched in the most entire content in the prominent paper by Fama and Jensen (1983a, 1983b) who introduced and developed the important problem of corporate governance named as agency problem. Ownership structure, ownership rights should be considered, with reference to the experts above, as the most important factors of corporate governance efficiency.

Morck, et al., (1988); Orhan & Yildirim (2009) and Oghojafor et al., (2010) contributed with their investigations exploring the issue of management ownership on firm performance. Results were evident confirming the point of view that ownership structure is a critical factor influencing the firm performance.

Mehran (1995) pursued the research and found even more specified results. Firm performance is positively related to the percentage of equity held by managers and to the percentage of their compensation that is equity-based. Moreover, equity-based compensation is used more extensively in firms with more outside directors.

Process of privatization in Ukraine was

investigated by a few researchers. Thus, Pivovarsky (2001) made a conclusion that privatization is followed with increase in ownership structure concentration. He underlined that there is a positive correlation between ownership concentration and corporate performance. But, at the same time, Pivovarsky did not explained the role of various groups of large shareholders, such as Ukrainian financial-industrial groups, banks, investment funds in corporate governance from the point of view of best practices. He has not found out attitudes of large shareholders in Ukraine to such corporate governance terms as transparency, accountability and responsibility.

Krakovsky (2000), well-known practitioner in corporate governance, narrated on the corporate governance worst practices in Ukraine. He insisted that large shareholders do not follow the corporate governance best practices. They do not care about transparency and responsibility. Moreover, minority shareholders are helpless, because they are not protected by the legislation, they are not equipped with knowledge of corporate governance mechanisms and they are not used to consolidate they minority power to run banks in their interests.

Repei (2000) attempted to find the most efficient system of corporate governance in economic environment with poor institutions. Ukrainian corporate sector is analyzed as a case. The data from 318 banks from different industry sectors and regions are used to test the effects of different types of ownership structure on enterprise restructuring and economic efficiency. He found that private organization outsiders with high concentration of ownership rights (in our research such kind of shareholders are insiders), govern enterprises most

efficiently. There is evidence to improve institutional structure for successful economic development.

Zheka (2003) examined the effects of different ownership structures and of the quality of corporate governance on the Farrell measure of efficiency. Data Envelopment Analysis and Limited Dependent Variable Estimations were applied to the set of Ukrainian joint-stock banks listed on the First Securities Trading System. The domestic organization ownership was found to enhance efficiency the most, while managerial ownership had a detrimental effect on efficiency. Surprisingly, and this is a paradox, foreign owned firms were relatively inefficient; however foreign ownership was found to have a positive and significant effect on corporate governance quality. State ownership and concentrated ownership rights improved efficiency. The quality of corporate governance was found to have a positive impact on efficiency of domestically owned firms.

Andreyeva and Schnytzer (2002) examined empirically the short run responsiveness of company performance to ownership and market structures, sector and regional specificity, and varying degrees of soft budget constraints. For a cross-sectional data set of Ukrainian firms, the paper provided evidence that post-privatization governance systems impact significantly on efficiency, notwithstanding the influence of privatization per se. The study reported improving short term performance with ownership concentration, which, for Ukraine, is particularly notable in manager-owned firms. Another finding was that market environment, reflected by market structure and softness of budget constraints, had a notable role in determining short run firm performance. Finally, the results

suggested a significant influence of industry affiliation and regional location in shaping firm performance in Ukraine.

Andreyeva (2006), four years later got back to this issue and found again a link between the ownership structure and firm performance in Ukraine. At the same time the bank ownership has not been explored significantly.

Melnychenko and Ernst (2002) developed an “agency problem index” for each model that reflects incentives, commitment and information asymmetry. The empirical portion of the paper tested the effects of state ownership and management of state corporate rights on enterprise performance, defined in terms of value added, and sales net of excise and value-added taxes, for a sample of 466 JSCs for 1999-2000. In addition to basic factor variables, the principal independent variables included the agency problem index, state ownership, and dummies for sectors. Both state ownership and the agency problem index had a significant negative impact on enterprise performance.

Lazarenko and Sobolev (2001) exposed a number of basic trends of development of the joint-stock capital structure in contemporary Ukraine, among which the priority was given to the: gradual reduction of the insiders’ share under the preservation of their considerable specific weight, and continued concentration of property in hands of the large shareholders. Both of these tendencies testify the process of the property concentration in hands of the enterprises’ management.

Akimova and Schwödiauer (2004) concluded that in general, Ukrainian outside owners do not have a significant effect on performance. However, stakeholding ownership by customers affect sale prices

and performance negatively. The most robust results are obtained for the effects of concentrated foreign ownership, both for levels of the respective variables in each year and for changes from one year to the other. The impact of foreign ownership on performance is significantly non-linear: its effect is positive only up to a level that falls short of majority ownership. It is concluded that this non-linearity is due to an institutional environment still adverse to foreign direct investment.

Probably, the most detailed investigations of privatization process in Ukraine have been undertaken by a group of activists at London Business School, headed by Saul Estrin (Estrin & Rosevear, 1999, 2002).

London Business School conducted research of evolution of corporate structure in Ukraine from the date of privatization of each researched company to spring of 1999. The main objective of research was to discover structure of corporate ownership. As a result of research they found that insiders own about 55 per cent of corporate ownership but there was a trend of selling of shares by employees to management of the banks.

This process was strengthened both by a strong entrenchment of management of Ukrainian banks and lack of interest of employees to own shares. Employees wanted high dividends but they had not it. Stock market was a dark territory to them because of lack of knowledge on how to trade there. So, they had only one chance to gain a return on shares – to sell it to managers, waiting for them in their board rooms.

Moreover, there was no sufficient transfer of corporate ownership from insiders to outsiders.

Thus, Ukrainian banks will have to experience evolution of the structure of

² Transformation of the structure of corporate ownership during the post-privatization period is the following: employees sell their shares to outsiders and management; the State and insiders sell shares to outsiders; outsiders become the biggest group of owners.

corporate ownership. Transformation of the structure of corporate ownership in Ukraine is still going on². There is no evidences of active concentration of corporate ownership in the hands of outsiders. The share of ownership, belonging to foreign institutional investors increased by 1999 only from 2 to 3.2 per cent. Real owners are under the shadow of nominal owners represented by financial-industrial groups. As a rule they are main players at the market for corporate control in Ukraine thanks to large financial resources they possess.

According to research mentioned above, an average Ukraine company had only 15 managers, who own its shares. Number of employees, owing shares of the company where they work, is 599. Number of legal entities, as owners, is only 6. Among them only 2 were represented by investment funds and banks.

If a change in Management Board of the company is considered as a positive factor in corporate governance, then it is possible to conclude that outsiders are more effective in corporate governance. They changed members of Management Board almost in two times often than insiders. But the most active in changing members of Management Boards was the State as owner. Almost 83.3 per cent of members of Management Boards of Ukrainian banks, controlled by the State, were changed by 1999.

All above mentioned changes in the structure of the corporate ownership in Ukraine, happened by 1999 were not accompanied with changes in corporate performance. No insiders, no outsiders demonstrated higher performance in corporate governance. According to the personal investigations by authors, number of banks went bankrupts after they were privatize, was equally distributed among

banks owned by outsiders, and those, owned by insiders.

3. METHODOLOGY OF RESEARCH AND ITS RESULTS

From the beginning of 1999, mass privatization got to gathering features of process of investment. Large foreign institutional investors have come to Ukraine with real, not virtual investments. The last stage of privatization named as "industrial" or "strategic" privatization started at the end of 1999. That time the President of Ukraine issued a fiat according to which only banks of the same industry from Ukraine or abroad could take part in tender offerings of shares of Ukrainian banks which must be privatized. Regrettably, no fundamental research had been undertaken since 1999 in the field of corporate governance in Ukraine, especially it concerns changes in the structure of corporate ownership.

To find out how "strategic" privatization influences the structure of the corporate ownership in banking sector in Ukraine, the authors have undertaken investigation of the structure of corporate ownership of 70 Ukrainian banks, whose shares are in the different levels of listings at PFTS (OTC market). We prefer to use a PFTS banks database to those, represented by stock exchanges (there are eight stock exchanges in Ukraine), because the largest banks prefer

Table 1. Structure of corporate ownership in Ukraine and Russia

Owners	Russia			Ukraine		
	1999	2000	2001	1999	2000	2003
Insiders	58	45	34	46	57	66
Outsiders	33	48	55	34	32	28
The state	5	7	6	20	11	6

to list the shares exactly at PFTS.

The period under research was from December 1998 to December 2003.

We have developed the following hypothesis to test:

1. "Industrial" privatization leads to transferring the corporate ownership of banks from the State to institutional shareholders, and from employees to management.

2. Banks, which have concentrated ownership structure, were passive in equity issuing, because blockholders do not want to lose corporate control.

3. Interests of management and institutional investors at the market for corporate control are different.

4. Management block participation of other large shareholders in corporate governance.

5. The higher concentration of corporate ownership structure by management, the lower they are concerned with size of compensation they obtain, as they have an opportunity to gain stock return and cash dividends.

6. Increase in concentration of ownership structure leads to decrease in market performance of a company because equity costs get up remarkably.

The first conclusion that must be done is that during above mentioned period of time, Ukrainian banks experienced remarkable changes in the structure of ownership (see table 1).

According to data containing in table 1 it is possible to conclude that the share of insiders in the structure of corporate ownership of banking sector in Ukraine

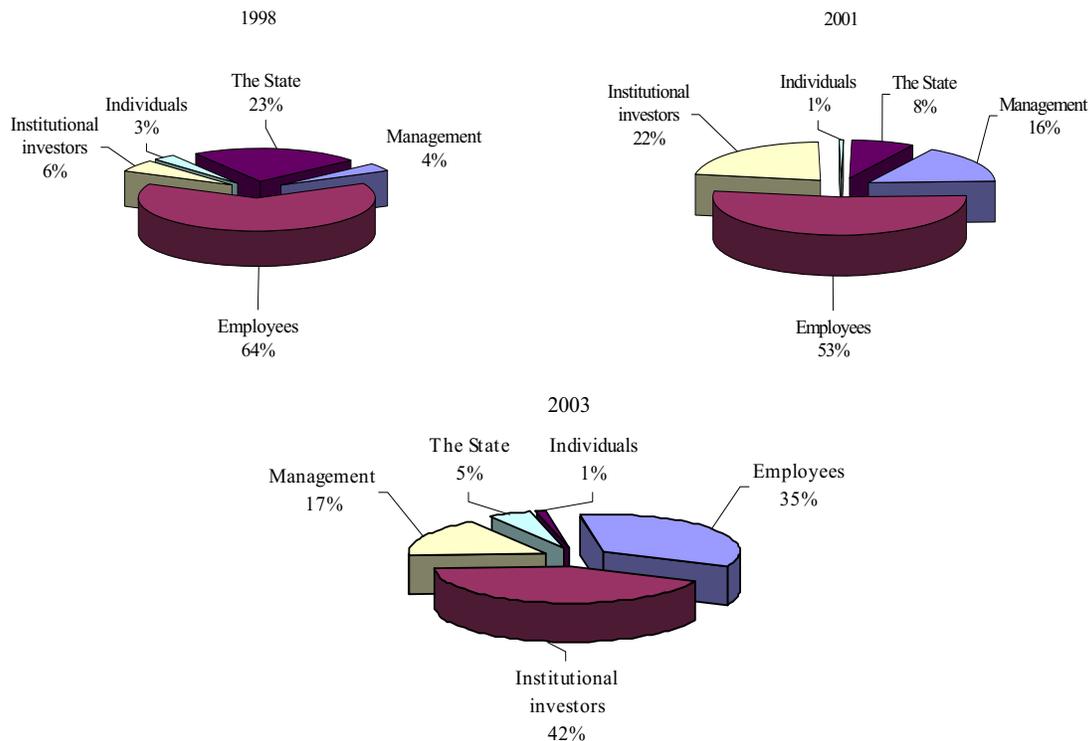


Figure 1. Distribution of corporate control in Ukraine

remarkably increased (from 44 до 57 per cent). Herewith, the share of outsiders almost did not change. That means that privatization has led to transferring the corporate ownership in banks from the State to insiders.

It is interesting to remark that in Russia the changes in the structure of corporate ownership were different. Thus, over the period from 1999 to 2001 the structure of Russian banks became less concentrated in comparison with Ukrainian banks.

Increase in the share of insiders in the structure of corporate ownership in Ukraine is explained not only with activity of institutional investors, but and with aspiration of executives of Ukrainian banks to concentrate corporate control in their hands through buying shares at employees (see fig. 1).

According to fig.1 the most active in obtaining corporate control were institutional investors and executives of Ukrainian banks. Thus, the share of executives in corporate ownership structure during 1998-2003 increased from 4 to 17 percent. Institutional shareholders increased their ownership in banks from 6 per cent to 42 per cent are at the recent time are the largest shareholders in Ukrainian banking sector. In comparison

with institutional investors, who obtained a right for corporate control from the State, executives of Ukrainian banks used levers of personal pressure on employees of the banks to make them sell their shares to executives of banks.

Thus, development of the process of concentration of corporate ownership structure in Ukraine is controlled by two groups of investors. These are management (executives) of the banks and institutional investors.

The latest trends in development of market for corporate control evidence that the State as a shareholder, leaves corporate ownership structure. This is very progressive element of development of market for corporate control in Ukraine. At the same time employees leave corporate ownership structure too. It is possible to suppose, that this is positive feature of development of market for corporate control too, taking into account that employees are not efficient in corporate governance. This supposition could be taken for conclusion, but for ways, which are used by management to force employees sell their shares. For example, if management of the company want to obtain a corporate control through buying shares, they force employees sell their shares to

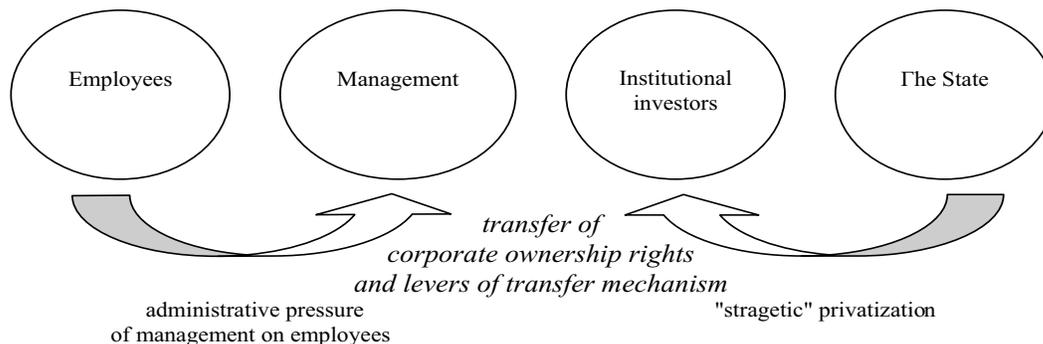


Figure 2. A mechanism of concentration of corporate ownership structure in banks in Ukraine during 1998-2003

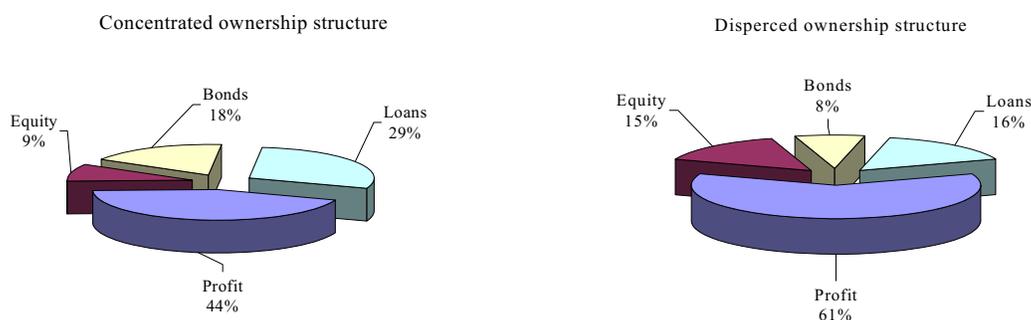


Figure 3. Structure of financial resources, attracted by banks with concentrated and dispersed ownership structures

them. If employees refuse this "offer", they will be fired. Employees got used to store their jobs but not their ownership.

Moreover, during 2001-2003, management of Ukrainian banks started to use one more mechanism to grasp corporate control – proxies voting. It is not difficult for management to force employees give proxies to management. We have accounted more than 60 cases how such mechanism works. As a rule, management come to the General Meeting of a works council, that happens before the Annual shareholder meeting, and order employees, who are shareholders, to give proxies to management. Doing in such way, management obtain corporate control with no costs. This is a management dictate.

Mechanism of concentration of corporate ownership structure in Ukraine during 1998-2001 is illustrated by figure 2.

Increase of the share of management and institutional investors in corporate ownership structure in banks in Ukraine is followed with changes in capital structure of Ukrainian banks. During 1998-2003, those banks, which have concentrated ownership structure, were passive in equity issuing. Only 9 per cent of banks with concentrated ownership structure issued equity. Banks with dispersed ownership structure attracted almost 15 per cent of financial resources

through equity issuing (Fig. 3).

As a rule, banks with concentrated ownership are much larger than those with dispersed ownership. From this perspective large banks have much better opportunity at the market for loans and bonds.

One of the most interesting findings under the process of concentration of corporate ownership structure, are dividing interests of management and institutional investors at the market for corporate control.

Thus, among 70 banks under research, management own shares in amount not less than 25 per cent of shareholders equity, at 14 banks. Institutional investors own the same amount of shares at 29 banks. Both management and institutional investors own shares in amount not less than 25 per cent of shareholders equity of the same company just in 4 cases.

Under such circumstances the hypothesis according to which management block participation of other large shareholders in corporate governance, is vital (Morck et al., 1988). Moreover, management of banks try to maximize size of assets, but not earnings of the bank.

Under circumstances of vitality of hypothesis of blocking by management, a participation of institutional shareholders in corporate governance, and absence of

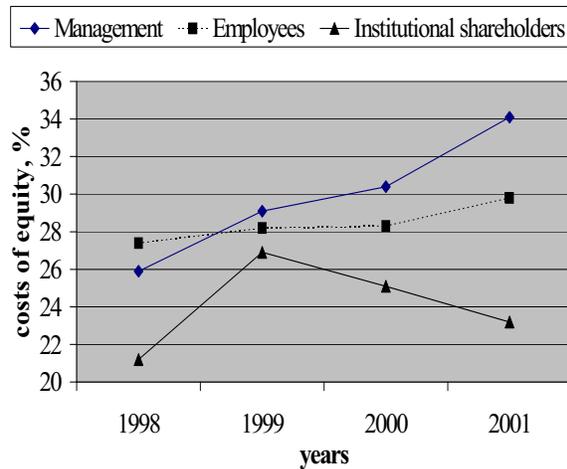


Figure 4. Dynamic of change in costs of equity at the banks which are under control of various groups of shareholders

intentions of management to finance the company activity with equity, the objective of purchasing shares by management is very interesting to know.

Thus, the main objective of purchasing shares by management is obtaining a total control over the compensation policy. At the banks, which under control of management, management can compensate their passive behavior at the stock market by fixing size of compensation to themselves at the high level.

The last finding does not support a Mehran's hypothesis, according to which the higher concentration of corporate ownership structure by management, the lower they are concerned with size of compensation they obtain, as they have an opportunity to gain stock return and cash dividends (Mehran, 1995).

That is why, at the markets under asymmetry of information, the hypothesis concerning behavior of management is named as "agents behavior, based of compensation" and sounds as the following.

At the markets under asymmetry of

information, where management try to maximize outcomes from stock ownership, but they are not equipped with knowledge how to be efficient owners, they try to use their shares not as instrument of stock return, but as an instrument of corporate control. Herewith, the main objective of obtaining by management a corporate control of bank is grasping by them a total control over the compensation system. So, maximizing compensation at the highest level, management compensate expenses, related to buying shares.

One more evidence in the favor of existence of the above mentioned hypothesis is a direct dependence of concentration of corporate ownership structure in the hands of management and costs of equity. This dependence is illustrated by figure 4.

With reference to the figure 4, it is possible to conclude that concentrating the ownership by management of banks leads to increase in equity costs. This conclusion supports hypothesis by Fama and Jensen. The hypothesis states that an increase in concentration of ownership structure leads to decrease in market performance of a company because equity costs get up remarkably.

At the same time, it is interestingly to remark, cost of debt (corporate bonds) has not increased. It was not sensitive to the above mentioned changes in ownership structure. So, it is worth of concluding that concentration of corporate ownership in Ukraine was followed with a strong separation of two submarkets for corporate investments – market for equity capital and market for debt. Players at the market for equity capital were rather controllers than investors. Debt market participants were rather investors than controllers.

Moreover, increase in concentration of

ownership structure provokes worsening liquidity of shareholders equity. Large shareholders, who are rather controllers than investors, do not intend to lose a control over the company, which can happen as a result of new equity issue.

The above mentioned hypothesis by Fama and Jensen can be slightly corrected in relation to problem of asymmetry of information. Remarkably higher costs of equity of the banks under control of management in comparison with those, controlled by institutional investors, can be explained by lack of knowledge of management of Ukrainian banks about basics of stock liquidity management, particularly in the part of initial public offerings.

Different efficiency of various groups of insiders about equity management is an excellent evidence of:

- different level of knowledge of these shareholders about basics of investments and corporate governance;
- differences in objectives of investing in the banks;
- different level of informational efficiency about recent performance and market outlooks of stock market in whole and certain company in particular.

4. CONCLUSION

Evolution of corporate ownership of banks in Ukraine neglects a number of distortions in corporate governance practices. Increase in corporate ownership concentration, in contrast to findings by many researchers, is followed with management entrenchment and a large shareholders weak transparency and responsibility.

Fight for corporate control of banks is not based on the best practices in corporate governance. Oligarchs, representing Ukrainian financial-industrial groups, promote their interests to the State authorities, when the State sells its stakes in banks. All these, so named "trade actions" are not transparent, because oligarchs want to be unknown, and as a result, not accountable and responsible, to society.

Management of banks do not want to spend their own money to obtain corporate control through forcing employees sell shares. Nowadays, management force employees give proxies to them. Thus, management grasp corporate control for no costs.

Employees, who do not know why they own shares, how to own shares and how to make these WHY and HOW responsible to society, stay apart from all these events. They are static observers of the fight for corporate control.

So, all, what Ukraine has now, when the process of privatization has almost finished, is not transparent institutional shareholders, entrenched management and passive employees.

The road ahead for corporate governance in banks in Ukraine should start from legislative measures, for example adopting a project of "Joint Stock Banks Act" by parliament, to protect rights of minority shareholders and make motives and behavior of large shareholders transparent. These measures must be accompanied by development of mechanisms, such as stock exchanges, to let shareholders sell their shares or buy it. But all these measures can be effective only if shareholders will find out WHY they own shares, HOW to own shares, and how to make these WHY and HOW responsible to society.

КОРПОРАТИВНО УПРАВЉАЊЕ У БАНКОВНОМ СЕКТОРУ ТРАНЗИЦИОНЕ ЕКОНОМИЈЕ: УЛОГА ВЛАСНИЧКЕ СТРУКТУРЕ

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Извод

Овај рад истражује структуру корпоративног власништва у банкарском сектору Украјине, током периода након приватизације (приватизација је трајала од 1998 до 2003). Закључено је да је удео домаћих власника у структури корпоративног власништва у банкарском сектору Украјине, знатно порастао. Удео иностраног капитала у власничкој структури је остао готово неизмењен. На тај начин, приватизација банковног сектора Украјине, довела је до промене власништва од државног ка приватног у рокама домаћег капитала. Развој процеса концентрације структуре корпоративног власништва у банкама Украјине, контролисан је од две групе инвеститора. То су менаџери (директори) банака и институционални инвеститори. Основни циљ куповине деоница банака, од стране менаџмента банке, је постизање потпуне контроле над даљом политиком развоја банке. Улога мањинских власника је веома мала и њихова права су недовољно заштићена да би имали удела у корпоративном управљању.

Кључне речи: корпоративно власништво, топ менаџери, институционални инвеститори, приватизација

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