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Issues of Corporate Governance in Transition Economies

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The Economic Development Institute
of The World Bank
Foreword

This EDI Working Paper will be published as one of 12 chapters in a forthcoming book entitled: Corporate Governance in Transitional Economies: Insider Control and the Role of Banks edited by Masahiko Aoki and Hyung-Ki Kim. The book will have three parts:

Part 1: Generic and Comparative Issues: Theory and Policy Implications (chapters 1-3)
Part 2: Country Studies in Comparative Perspectives (chapters 4-8)
Part 3: Relevance and Lessons of the Japanese and German Experience (chapters 9-12)
A list of titles is provided on the inside back cover of this paper.

The book presents the results of a research project on corporate governance issues in transitional economies from a new perspective based on comparative institutional analysis. A concern with three issues—the emergent phenomena of insider control, the possible role of banks in corporate governance, and the desirability of the comparative analytic approach—sets the common ground for the research presented in this volume.

The coexistence of the alternative models of corporate control in the developed countries suggests that the possible "lessons" for the transitional economies may not be so obvious. It makes little sense to judge the merits of each corporate governance model and its applicability to the transitional economies without taking into account a country's stage of development and the history of its institutions and conventions. In designing corporate governance structures for the transitional economies, economists are required to identify the specific conditions under which each corporate control model (or combination of models) works, the availability of these conditions in the transitional economies, and the most efficient approach to achieve these conditions. By pooling rich individual country studies and cross-examining and comparing their implications, we may be able to avoid premature generalizations or theorizing based on the observation of a single economy. By comparing the workings of diverse systems, we may also be able to uncover latent factors that are conducive to, or constrain, the workability of particular governance structures. Comparative analysis may thus serve in the social sciences as a kind of proxy for laboratory experiments.

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Controlling Insider Control: Issues of Corporate Governance in Transition Economies

Masahiko Aoki

This chapter identifies and discusses some fundamental issues of corporate governance in the transition economy. In the first part we present an overview of the generic tendency toward insider control in transitional economies. By insider control, we mean the capture of substantial control rights by the manager or the workers of a formerly state-owned enterprise (SOE) in the process of its corporatization. There are variations in the degree and scope of insider control across transitional economies, depending on national conditions. The tendency is generic, however, in the sense that it is an evolutionary outcome of communist legacies. We argue that the mechanical application of the neoclassical model of stockholder sovereignty for corporate governance design in the transition is not effective in coping with the insider control problem; worse, it may even prolong the transition process.

The second part of the chapter shows that there can be an alternative model of corporate governance to monitor and control incentive issues unique to the insider-controlled enterprise. The essential idea is to rely on the development of banking institutions that can selectively intervene in the insider-controlled enterprise at the time of financial distress. The model considers the problem of how the bank is motivated to monitor the insider-controlled enterprise while diversifying lending risk to some extent.

The second part of the chapter is purely theoretical; the preconditions assumed for the workability of the model do not seem to exist in transition economies. The fundamental question of which model is superior—the model of stockholder sovereignty with competitive capital markets or the model of the governance in which control rights shift from the insider to the outsider (the bank), contingent on the financial state of the enterprise—cannot be answered in isolation from other institutional characteristics of the economy, particularly the mode of internal organization of enterprises. We argue that the future course of the transition economy in this respect is too uncertain to predict. Therefore, we advocate an eclectic approach to corporate governance in the transition, including the simultaneous development of the capital markets and banking institutions. They are presumably complementary in their roles in the development of sound corporate governance in transitional economies.

It seems certain, however, that sole reliance on the neoclassical model of stockholder sovereignty will be untenable. With this in mind, the last part of the chapter discusses banking reform in transition economies.

Setting a Conceptual Framework

In order to discuss issues of corporate governance in transitional economies, let us first make clear what we mean by the transition: transition from which regime to which regime? In orthodox neoclassical economics, the latter should be something close to the neoclassical ideal of a regime of perfectly competitive markets. If all marketable factors of production are valued in competitive markets, the allocative efficiency of the economy would be assured by the maximization of residual after payments to
those marketable factors. If the claimant of residual is identified with the stockholders, who do not gain any benefits other than the residual, they would be unanimously interested in maximizing the stock value of enterprises as reflecting the discounted sum of expected future flow of residual. Therefore, what is needed is to value enterprises competitively and effectively correct the management of enterprises if their values are lowered. The corporate governance structure that assures the sovereignty of the stockholders, combined with the competitive stock market, provides the necessary and sufficient institutional framework for that purpose. The task of the transition is to jump as quickly as possible to the regime in which such a framework prevails.

This neoclassical paradigm is crystal clear in its logic and useful for some purposes, but in our opinion its mechanical application to transitional policy may not always yield good results because of its incompatibility with historical constraints. We want to propose more practical and inclusive definitions of the transition and the posttransition that allow for more diverse approaches. We believe it important to recognize two central issues in considering corporate governance.

First, the conditions inherited from the communist regime and those extant at the outset of the transition constrain the feasible options for corporate governance design in the transition process both politically and economically. Second, the neoclassical stockholder-sovereignty model of corporate governance may not be the only efficient solution. Any corporate governance structure may be in complementary relationships with other institutional arrangements of the economy—such as the internal work organization of the enterprise, the labor market and financial market institutions, and so forth—and the performance of a governance structure cannot be judged independently of how those other institutions are arranged. More specifically, the stockholder-sovereignty model can be efficient when it is surrounded by a cluster of complementary institutions of a particular kind, such as the hierarchical work organization and competitive labor and capital markets. We cannot preclude the possibility that for another cluster of institutions including the team-oriented work organization, another type of corporate governance could be more efficient. Recent results of comparative institutional analysis indicate that these two systems may not be efficiency-rankable independent of technological parameters of the economy. Accordingly, the transition path could also be diverse. We will elaborate these points gradually.

Anticipating the diversity of institutional arrangements, we begin with a less specific definition of the time-line, composed of the communist regime, the posttransition regime, and the intermediate transition process. Because our immediate concern is about corporate governance, we deal only with ownership and management of enterprises as defining factors. First, we refer to the communist regime as the period when the following conditions prevail:

- (C1) All enterprises are owned by the state, and their continuity is at the discretion of the state.
- (C2) The management (directors) of enterprises are appointed by the state organ controlled by the Communist Party.

The transition process is defined as the time period characterized by the following conditions.

- (T1) All enterprises are transformed into corporations (corporatization or "commercialization"), but their ownership structures are in the process of being defined.
- (T2) The state has lost the discretionary power to appoint and dismiss the management of enterprises, yet no definite power to do so has emerged.

Finally, the posttransition regime is defined as the one satisfying the following conditions.

- (P1) The corporate governance structure has been well defined for each enterprise and the share ownership structure has become stable in a statistical sense.
- (P2) The management of enterprises is chosen through due process, defined by the corporate law. There is a credible mechanism operating to replace poorly performing management.
This time-line construction is purely conceptual and its mechanical application to any economy may entail some classification problems. For instance, Poland introduced the State Enterprise Law in 1981, while the Communist Party still held political control. It enabled the workers to appoint the managing director of enterprises through democratically elected workers' councils. At the same time, the state retained the power to create and liquidate enterprises. In China enterprises are now being corporatized, and varied ownership structures are being tried (see the chapter by Qian in this volume). The selection of the management, however, is still placed under the personnel administration of the Communist Party. According to the above definitions, we cannot say whether or not Poland in 1981 and China today are in the transition process. Ad hoc and somewhat inconsistent it may be, but we say that both Poland after 1981 and China today are in the transition process. We expect that the mass corporatization of enterprises in China will eventually lead to depoliticization of management appointments.

Note that we do not necessarily identify the transition with the privatization of enterprises. The majority stocks of a significant number of corporatized enterprises may remain owned by the state (as in Hungary). Also note that we do not include the market control of corporate governance as a condition for the arrival of the posttransition regime (for example, we do not observe it in Japan). We intend to include in that regime cases in which the majority or minority blocks of the stock of enterprises are stably owned by the state or insiders (workers, managers, enterprise pension funds, and the like) when there is a credible mechanism to punish poor management, if not through takeover. We deem that the existence of such a mechanism is imperative for an economic system to be viable without discretionary state intervention.

One of the purposes of this chapter is to inquire: If insider control is likely to evolve in many enterprises in the transition process because of conditions prevailing at the demise of the communist regime, what public policies would be desirable and politically feasible for transiting to an efficient posttransition regime? This inquiry will inevitably entail another important question: Is it possible for a posttransition regime to include a significant number of enterprises efficiently controlled by insiders?

Emergent Insider Control in the Transition

Insider control (either by the manager or the worker) appears to be a generic potential in the transition process, evolving out of inheritances of the communist regime. When the stagnation of communist regimes deepened in the 1970s and 1980s in Central and Eastern Europe, central planning bureaucrats tried to cope with the problem by relinquishing most of the planning instruments to the management of SOEs. The directors built up an irreversible jurisdictional authority within their own SOEs. The gradual retreat of the central planning authority ended with its sudden dismantling. The managers of the SOEs who had already carved out substantial controlling rights from the planning apparatus further enhanced their rights in the vacuum created by the collapse of the communist state. There seems to be nobody who has obvious legal or political power to dismiss the managers of ex-SOEs while they have the support of their workers.

The other quality of the communist regime that constrained the worker's freedom of job choice was their de facto job security. They were provided with medicare, child care, leisure facilities, housing, pensions, and so forth by the employing SOEs or the state. Workers had strong stakes at the employing enterprise. After the collapse of communism and the end of its "egalitarian" ideology, the workers were threatened by the possibility of losing those vested interests. Their fear may be greater the more uncertain the outcome of corporatization of their enterprises. Their possible opposition to massive privatization may have to be overcome by virtually giving them a substantial portion of enterprise assets.

Needless to say, the actualization of the potential of insider control varies across economies. We define insider control as a majority or substantial block-holding by the insiders in the case of
privatization, or strong assertion of insider interests in strategic enterprise decision-making when the enterprises remain owned by the state. Among possible factors conditioning the extent of insider control, the most important ones are the degree of management autonomy and the workers' strength against communist control in the final stage of the communist regime, and the political autonomy of the privatization authority against the various interest groups in the transition process.

At one end of this continuum, there is Poland. As already noted, even before the fall of the communist regime, the workers councils, composed of fifteen members elected by the employees, had attained a powerful position analogous to the board of directors in capitalist corporations, including the right to appoint the director and approve the annual plans of the enterprise. Once the transition phase began, the workers quickly moved to capture control of the assets of the enterprises before any market-based privatization plan was to be put into effect. The most common form of state property transformation worked as follows. Rather than corporatizing, the viable SOE was "liquidated" and a new company, in which the majority of the workers of the liquidated SOE became stockholders, leased or bought the assets. The much-publicized massive privatization through state-sponsored investment funds, an artifact of the neoclassical dogma of stockholder sovereignty, has thus been virtually defeated by the coalition of workers and managers of the better enterprises.

Russia is a case of strong manager control. The director of the SOE, who had already built a virtually autonomous empire in the communist regime, became almost invincible after the dismantling of the party and its planning apparatus. For any privatization plan to be implemented, it would have had to recognize this de facto control power of the director (see the chapter by Litwack in this volume). The State Committee on Property Administration (GKI), which was charged with mass privatization, has become the most politically successful reform authority in Russia through its generous accommodation of insiders' interests.

The details of the scheme are described in the chapter by Akamatsu in this volume. Simply put, according to the scheme the privatization of the SOE proceeds through three stages. In the first stage, mandated by a Yeltsin decree of July 1991, the SOEs were to be corporatized and made legally autonomous entities, although all the shares were held initially by the state (the Federal Property Foundation) and administered by GKI. In the second stage, the insiders (the workers) chose an option for their privatization benefits from three variants specified by GKI, and the local committee of GKI approved an adopted plan. At this stage, the managers and the workers obtained a large share free-of-charge, or a majority share purchased at discounted value, depending on the adopted variant. In the third stage, the remaining shares were auctioned for vouchers that had been given to every citizen of Russia, sold in a package to investment tenders, and kept by state control for the next several years.

The full implications of the scheme have not been worked out yet, but so far the insiders have overwhelmingly selected an option to guarantee them a majority share—that is, the option that gives managers and workers together individual ownership of 51 percent of the equity at a low purchase price (at 1.7 times the July 1992 book value of assets). The managers can also increase their shares by purchasing vouchers in the market or by buying back shares from their own workers and markets (the workers are now given incentives to sell their shares tax-free). At the same time, investment funds that participate in voucher auctioning are limited initially in their ownership in one privatized SOE to 10 percent (raised to 25 percent after January 1994). The board of directors of the newly privatized SOE, before the first meeting of shareholders (which has to take place within one year after privatization), is composed exclusively of the general manager and worker representatives, except for representatives of the local GKI and the Property Foundation. As a result, the insiders, particularly the managers, have built solid controlling power in their enterprises.

At the other end of spectrum is East Germany, whose privatization process under the centralized privatization authority, the Treuhandanstalt (THA), is described in detail in the chapter by von Thadden in this volume. Even in East Germany, however, asset stripping by the insiders was an imminent danger...
at the time of the demise of the communist regime. The only factor that prevented the subsequent
development of insider control was the authority given to the THA. von Thadden shows that the
institutional commitment to complete privatization by the end of 1994 prevented the THA from being
susceptible to influence by the insiders. The recruitment of professionally capable THA managers from
West Germany is also a positive factor unique to East Germany. The privatization of the SOEs was to
be completed predominantly through the partial or whole acquisition of assets by West German
corporations. In that sense, the privatization in East Germany may be said to be comparable to a takeover
in capital markets, although it was mediated by the centralized privatization agency. Even in this case,
however, the end result of the transition would be the absorption of the SOEs into the West German
corporate governance structure, which is different from the neoclassical model of stockholder sovereignty.
This governance structure is characterized by insider (worker) participation in the supervisory councils
through the legal requirement of codetermination.

The Czech Republic and Hungary provide intermediate cases. The insiders were weaker in the era
of the communist regime in comparison with Poland or Russia, and the political power of the state (the
privatization agency) in the transition process is weaker in comparison with East Germany. As a result,
the tendency toward insider control has not been clearly resolved. Privatization in the Czech Republic
is widely viewed as an ideal example of an approximation of the neoclassical model of outside
stockholders' control through "voucher" privatization. The matter does not seem to be so simple,
however. The privatization process is initiated with the decentralized submissions of a "privatization
project," which can be done by anybody. The Ministry of Privatization has the centralized power to select
a project. The Ministry has a political preference for projects including the competitive bidding of shares
for vouchers. Nevertheless, project proposals for direct sales of assets to a new company formed by a
group of insiders are also possible. According to data from the Ministry of Privatization, and quoted in
Frydman, Rapaczynski, and Earle (1993, p. 84), only 53 percent of the total book value of privatized
enterprises have gone to vouchers. The first preference of managers who were able to submit the most
informative plans is said to be buyout (Frydman, Rapaczynski, and Earle 1993 p. 81). The tendency
toward insider control surely exists, but has been moderated by the centralization of project selection.

In Hungary, a self-management system similar to the 1981 Polish scheme was introduced in 1984
(Law on Enterprise Councils), although the relative authority of managers in relation of the workers was
stronger. The free-market-oriented postcommunist government adopted a decentralized privatization
scheme that gave the initiative to privatize to the enterprise councils, subject to approval of the State
Property Agency (SPA). In contrast to the semicentralized Czech approach, this scheme seems to have
provided more room for maneuvering by the managers to retain control and to fend off "outsider"
intervention. Privatized enterprises tend to be cross-owned by other enterprises, banks, and the state
(SPA). Unfortunately, because of the unavailability of data, the extent of cross-holding is not precisely
known, but something similar to the corporate grouping in Japan may be emergent.

Thus, although there is a variation in its degree, the tendency toward insider control is manifested
everywhere in Eastern and Central Europe except for the newly emergent entrepreneurial enterprises and
joint ventures with foreign corporations. This is an evolutionary outcome of legacies of the communist
regime, which can be moderated only by a strong privatization agency. But an attempt to introduce
outside stockholder control does not seem to effectively counteract this tide. Privatization of SOEs is ex
ante constrained by the legacy of socialism, and in most it is cases ex post constrained by the weakness
of the privatization agency in relation to the inside interest groups (see the chapter by Roland in this
volume).

This lesson may be instructive for China, which has now begun experimenting with various corporate
governance structures. Even in China, where the Communist Party has retained solid control over the
personnel selection and dismissal of management of the SOEs, the evolutionary tendency toward insider
control is not unknown. The chapter by Qian illustrates this point in detail. One commonly observed
method for enhancing insider control is the spin-off of subsidiaries by the management of the SOEs and
the leasing or sale of assets to these subsidiaries, created for this purpose. The “non-state-owned”
enterprises thus created, together with smaller township and village enterprises, constitute the essential
carriers of vital entrepreneurial initiatives in present-day China. This state asset stripping by insiders is
often regarded as illegitimate by citizens and, unless placed under a transparent due process, this
“privatization” process may provoke political backlash. The mechanical application of the neoclassical
paradigm, however, such as voucher privatization by investment funds, does not seem to be an alternative
solution. We next present theoretical reasons for this.

Inadequacy of the Investment Fund Scheme for the Transition

Many economists have argued that the creation of investment funds (IF) that hold a substantial block of
shares of the privatized enterprise may serve as an effective external check on insider control. The hope
is that the IF would be interested in capital gains made possible by efficiency-enhancing restructuring,
while at the same time being capable of exercising sufficient pressure or control over the management
to implement the restructuring (see the chapter by Akamatsu for a detailed description of the IF in Russia
and a comparison with those in the Czech Republic).

Nevertheless, it generally seems to be the case that the effectiveness of IFs in external monitoring
has been limited. First of all, facing a substantial insider holding of shares, even a block of shares held
by the IF may not be sufficient for effectively controlling the privatized SOE (as in Russia). To advance
the case for the active role of the IF in corporate governance, a well-known proposition by Shleifer-
Vishny, which points to the importance of a blockholder, is often mentioned. What the proposition
asserts, however, is that the existence of a blockholder is “necessary” for overcoming free-riding by
small, passive shareholders in disciplining inefficient management by a takeover. Differing from the
presumption of the Shleifer-Vishny model, the Russian situation is characterized by the existence of a
large body of inside shareholders. How can the minority IF overcome this imbalance of power at a
critical moment when the possible dismissal of the inside managers (and massive labor shearing) should
be placed on the agenda?

Second, the IFs were formed as privatization intermediaries and funded primarily by vouchers that
were entrusted by investors or purchased by the IF. They are therefore under pressure to realize
reasonable dividends for investors. If the markets for shares develop, however, they paradoxically may
not be interested in monitoring and restructuring individual enterprises. By investing in the market index,
like funds in developed, securities-oriented economies, the IF would be able to perform at least as well
as the market (this possibility is also emphasized by Phelps and others 1993). To respond to this concern,
it has been proposed that the range of portfolio selection of the IF be restricted. But such a move would
be inconsistent with the IF function of expected profit maximization, and it would effectively transform
the IF into a holding company. The next issue raises a question about the ability of the IF to function as
a holding company.

Third, the privatized SOE may be in desperate need of additional funding for restructuring, but the
IF, as a share redistributing intermediary, may not be able to readily mobilize financial resources to meet
such needs. Even if the IF could mobilize new financial resources, the insider majority control may imply
tremendous agency costs for equity financing. The management and the workers may be interested in
consuming on-the-job potential residual before it is distributed as dividends. The IF may be able to
mediate bank loans because the IF is often controlled by a holding company that also controls a bank (as
in Russia) or is owned by a bank (as in the Czech Republic). In this case, however, the conflict of
interest issue needs to be addressed (see the chapter by Akamatsu). For example, the assets of the IF may
have been heavily invested in a failing enterprise and the holding company/bank may be interested in funneling funds to salvage it at the depositors' risk.

These discussions are not intended to deny any role for the IF in the governance structure in the transition process. On the contrary, it may be an indispensable institutional component in counteracting the ill-effects of insider control. The point is to argue that the IF alone may not effectively resolve the problem of corporate governance design in the transition process posed by the evolutionary tendency toward insider control. To attempt to rely solely on the IF may actually prolong the transitional process by encouraging inefficient influence of insiders to reduce outside intervention. The management may sabotage restructuring by colluding with the workers to fend off the outsider intervention. Further, public policy that may be needed to foster the development of other institutions, such as the banks, may lag behind.

The transition economy has to face the evolutionary tendency toward insider control, and to do so an application of the abstract neoclassical model or the straightforward transplant of the Anglo-American model seems to be of limited value. In the next section, we propose an alternative model of external control of the insider control enterprise based on the idea of "selective intervention." Following the presentation of the theoretical model, we discuss whether it suggests any public policy approach toward the insider control problem in the transition process.

A Bank Syndication and Contingent Governance

The insider-controlled enterprise may have unique incentive problems, even if it is potentially productive. The management may try to borrow to build an empire (in the case of management control), to spend on nonproductive projects to enhance worker benefits, or to construct plants excessively equipped with machines to increase per capita outputs, while staying away from risky entrepreneurial projects (adverse selection problems). The workers may shirk to free ride on each others' efforts when team work is involved (moral hazard problem). The insiders may have incentives to consume as much of the revenue of the enterprise as possible on the job or in the form of supracompetitive compensation before repayments to lenders or dividend payments to shareholders are made. Poor management may be tolerated out of collegial compassion.

To cope with the possible inefficiencies of such incentive problems, some external agents must play active roles in monitoring the insider-controlled enterprises. To facilitate the following discussion, it is useful to distinguish conceptually three phases of investors' monitoring in reference to the timing of investment: *ex ante* monitoring, in which potential new projects and/or new clients are evaluated to cope with the problem of adverse selection; interim (ongoing) monitoring, to uncover moral hazard problems arising from the divergence of interests between outside investors and the insiders, as well as free-riding among the insiders; and, finally, *ex post* monitoring, to verify the true financial state of the enterprise, to assure the (re)payment of debts or dividends, and to punish the management in the event of a failure to do so.

This section presents a purely theoretical model of corporate governance that resolves incentive problems of insider control by integrating the three stages of monitoring by a single bank, while other investors can diversify risk. The model is derived by a modification of the bankruptcy procedure proposed by Bebchuck (1988) and Aghion, Hart, and Moore (1992), which attempts to strike a balance between the merits of equity and debt contracts as controlling instruments. The novelty of the model presented below is to explicitly consider the incentives of the monitor—in this case, a bank—to monitor the insider-controlled enterprise in an integrative way, while preserving the essential feature of their model.
Suppose that when the viable insider-controlled enterprise is in need of external long-term investment funds, a bank that has had a long-term relationship with the enterprise organizes a loan syndicate with many other banks. This lead bank (LB) may own a minority share of the borrowing enterprise up to a certain limit (say, 5 percent). The LB is assumed to perform the commercial banking function by running the major payment system accounts as well as the deposit accounts of the borrowing enterprise. These two attributes may provide the information advantage necessary for the bank to be an LB. The question is how this advantage can be utilized for the reduction of agency costs of the external financing and monitoring costs, rather than allowing the LB to exploit its private benefits at the cost of other banks and investors.

Suppose that the LB is limited to provide only a minority share, say 20 percent, of the syndicate loans, but the LB must guarantee the repayment of the claims of other member banks (this stringent requirement will be relaxed later). This imposes a heavy responsibility on the LB. In return, however, the LB may charge a syndicate management premium, as well as enjoying the benefits of running the payment settlement and deposit accounts of the borrowing enterprise. Meanwhile, the IF and other investors may be active in share markets, evaluating the performance of the enterprise through trading on the basis of their own interim monitoring.

When the enterprise becomes unable to meet repayment obligations, the LB is obliged to buy the defaulted claims of syndicate member banks. The LB then completely writes off these debts and converts them into new equity. The LB either auctions off the new equity rights to reorganization specialists or holds them for a specified period of time (for instance, three years). In the latter case, the LB is engaged in restructuring the defaulting enterprise by replacing the managers, laying off workers, liquidating some assets, and so forth. If the insiders refuse to cooperate, the LB could threaten to invoke the liquidation procedure. After restructuring within the said period, the LB may sell the amount of shares beyond the normal limit (5 percent, for example) for possible capital gains from restructuring. In either case, the restructured enterprise would be transformed into an outsider-controlled enterprise, while the insiders are penalized for debt default by the loss of their share values, and possibly the loss of employment continuation values as well. If there is no prospect for capital gains from restructuring, the LB may decide to liquidate the enterprise. In this case the uncovered value of debts would be born by the LB.

The scheme has merit. First, in contrast to the Aghion-Hart-Moore model, the postbankruptcy procedure is administered by the LB rather than by the court, which may lack expertise in ex post management of the bankrupt enterprise. The LB is clearly advantaged in information useful for ex post management, but prevented from using it at the expense of other creditors' interests because of its repayment guarantee.

In our scheme the LB is also responsible for ex ante monitoring to cope with adverse selection of the borrowing enterprise and for interim monitoring to control its moral hazard. The LB would be motivated to earnestly perform ex ante and interim monitoring in order to avoid the heavy costs of liquidation and/or restructuring arising from debt guarantees for other member banks.

Second, generally speaking, from the point of view of the bank, there are tradeoffs between the diversification of lending risk and incentives to monitor. An arm's-length relationship between the bank and the borrower may allow the bank to diversify risk, provided that risk is distributed independently of bank action. But risk diversification may dilute the incentives of the bank to monitor the enterprise ex ante and interim. At the same time, the exclusive lending relationship will not only expose the bank to idiosyncratic risk, but may also dilute its commitment to ex post monitoring because once lending is made, the continuation of the enterprise may become ex post desirable even for the bank.

As noted above, in our scheme the LB is certainly motivated to monitor. But what about the risk diversification opportunities of the LB? Does the proposed scheme not amount to the same thing as the LB bearing full risk costs, as in exclusive relational lending? That is, is the LB not exposed to the same degree of idiosyncratic risk as the relational bank? Why then is syndication worth the trouble?
Suppose that a sufficient number of qualified banks that have the required monitoring capability exist to allow for workable competition among them (roughly, the number is not too small nor too large). Suppose that each of them has a mutually exclusive group of customer enterprises for which they function as LBs. These banks become ordinary syndicate members for nonaffiliated enterprises for which other banks act as LBs. In other words, there is “reciprocal delegation of monitoring” (Sheard 1994) among the banks. Other minor banks may participate in any syndicate as ordinary members. Responsible monitoring by the LB saves the duplication of monitoring costs, particularly by minor banks.

Now let us modify the described scheme in such a way that the group of qualified banks mutually agree to rebate a fraction of the LB’s guaranteed repayment to them in case the revenue of the LB from liquidation of assets or the prerestructuring auction falls short of a certain level. Such reciprocal arrangements may spread the cost of risk-bearing among qualified banks, while somewhat diluting the incentives for the LB to monitor. The modified syndicate arrangement is a device to strike a balance between the conflicting requirements of risk diversification and incentive provision.

The third advantage of the scheme is that the risk of bad performance by the borrowing enterprise is not distributed independently of insider and bank actions. The risk may be reduced by more intensive ex ante and interim monitoring of the LB. The requirement of syndication severs qualified banks from exclusive relationships with the borrowing enterprise. This would reduce the hazard of the banks being captured by the interests of the customer enterprises and make them more independent in their judgements at the ex ante monitoring stage.

Fourth, after the initial investment is sunk, the continuation of a bad project might become ex post profitable, if bad debt were written off. In such a situation, if the relationship between the bank and the enterprise is that of the exclusive relational bank, they would be induced to renegotiate. The enterprise’s insiders may have strong motives to negotiate for the survival of the enterprise to save the loss of employment continuation values if the labor market is imperfectly competitive. The bank may be induced to accept an insider’s concession, while keeping the insider’s control intact. Such a prospect would dilute the ex ante and interim incentives of the insiders. In our scheme, the shift of control rights can be automatically triggered by a debt-equity swap when the insider-controlled enterprise defaults. Insider control is maintained contingent only on the financial viability of the enterprise. The corporate governance structure implied by the scheme may thus be called contingent.

The LB or the reorganizer (IFs, or another enterprise) that acquires the shares in the restructuring auction has incentives to restructure for capital gains. As opposed to the creditor rescue operation, the restructuring agent can secure future returns to restructuring costs without fearing the emancipation of the rescued enterprise. Thus, premature liquidation (Type I error) may be avoided, while the threat of punishing poorly performing insiders is made credible. This is the essential feature of the Aghion-Hart-Moore model.

The fifth major advantage of the scheme is that the contingent governance structure may have positive incentive effects on the insiders. The contingent governance implies that as long as the insider-controlled enterprise is financially healthy and able to repay its debts without any problem, the insiders remain as residual claimants. If they always remain residual claimants, regardless of the financial state of the enterprise, the moral hazard of free-riding among insiders would become a problem, or sheer bad luck might make the insiders lose large asset values (in financial and human capital) in liquidation. These possibilities may be prevented by the participation of the LB, which may restructure the failed yet viable enterprise, but imposes harsh penalties when the postbankruptcy situation is hopeless.

If the contingent governance is efficiently designed, the insiders may develop incentives to accumulate the internal financial resources to become autonomous from possible external intervention. The relative autonomy of the enterprise from external loans would in turn stimulate insiders’ incentives for greater effort, because the fruit of their effort would accrue to them as residual claimants. Thus, once the contingent governance is put in effect, the virtuous cycle of insider control and enterprise growth may
be generated up to a certain threshold point. (The possibility of such dynamics, together with the efficiency property of the contingent governance structure, is analyzed in Aoki 1994.)

A eclectic Approach—Probably the Best in the Transition

We have shown a theoretical possibility of a governance structure that can cope with the unique incentive problems arising from insider control. But we have assumed that the insider control enterprise is viable and that there is a banking sector comprising a sufficient number of banks capable of assuming the heavy responsibility of lead banks. These last two conditions do not hold in the transition process. The privatized enterprise may need to be restructured, for which outside financing is needed. Nevertheless, incentive problems of insider control may be rampant and any bank may consider it too risky to assume the responsibility of the LB. First of all, no bank may have either the financial resources to bear the responsibility or the capacity to monitor.

The merit of the theoretical exercise in the last section was to show that a corporate governance structure alternative to the neoclassical model of stockholder sovereignty is conceptually possible in the post-transition regime. The contingent governance structure may not be just a passive reaction to the insider control problem. Rather, it may have an active raison d'être: to facilitate the development of a team-oriented production organization characterized by lateral cross-functional coordination, joint task responsibilities, mutual help, and the like in which worker skills and shared knowledge become specific to the organization. According to a recent achievement of comparative institutional analysis, we cannot unequivocally rank the team-oriented work organization and the traditional hierarchical organization according to efficiency criteria. The former may perform better in an industry where coordination among tasks is relatively more important because tasks are complementary, while the latter organization may perform better in the industry where flexible reallocation of scarce corporate assets among tasks is important (Aoki 1994b).

The kind of financial institution that would be desirable to develop would depend on the prevailing work organization. If workers' skills and shared knowledge become organization-specific, and thus not individually marketable, stock value maximization may not be consistent with internal and allocative efficiency. This is because the value maximization criteria presupposes that all factors of production other than fixed factors are market valued. If the insiders constitute an immobile factor of production as a team, the enterprise ought to strike a balance between insiders' interests and outsiders' interests. Games between them may no longer be zero-sum, however, and there may be gains from cooperation (Aoki 1984). Insiders' shared rights of control in corporate governance (as in West Germany) or outsiders' selective intervention through the contingent governance (as in Japan) may facilitate an approximation of the cooperative solution. Thus the bank-oriented financial system may be complementary to the team-oriented organization, while the market-oriented financial system is complementary to the hierarchical organization, as the neoclassical paradigm asserts.

In what direction will the evolution of the transitional economies lead? One scenario may be that the hierarchical aspect of the work organization in the SOE would reform itself so that task assignments in the organization are made more on the basis of individual skills. For this direction, the complementary development of the capital market institutions would be necessary, because the efficiency of such an organization can be best valued by residual after competitive payments for individual skills. Another scenario may be that the collegial aspect of the work organization in the SOE would develop into an efficient, team-oriented work organization. For this direction, the development of banking institutions might be complementary. Still other scenarios may be feasible. The transition economy may take advantage of the latecomer being able to develop a hybrid by combining the two types of organizations. Or, if the transition economy fails to develop proper governance and financial institutions, it might be
locked in permanent stagnation. Nobody seems to be able to predict with certainty which scenario is the most likely.

We may posit that an eclectic approach is an option in the transition process. That is, instead of pursuing solely the possibility of external control of the enterprise through the development of capital markets, or that of banking institutions, it is better to foster their simultaneous development in the transition. Only spontaneous development of organizations through competition would determine the dominant system in the posttransition regime.

Other Reasons to Develop Banking Institutions in the Transition

In the model of syndicate lending presented above, ex ante, interim, and ex post monitoring of the enterprises are all integrated and delegated to a single LB. In contrast, in a highly advanced securities-oriented financial system, such as the Anglo-American economy, these three phases of monitoring are dispersed among various intermediaries, information-processing agents, and corporate and legal institutions possessed of different specialized expertise. For example, ex ante monitoring is performed by investment banks for large enterprises, venture capitalists for entrepreneurial start-ups, and commercial banks for smaller firms; interim monitoring is performed by rating firms, commercial banks, funds of various types, market arbitrageurs, and so forth; ex post monitoring is done by accounting firms, the bankruptcy court and reorganization specialists, takeover raiders, LBO partners, and the like. In general, the transition economy that has evolved from a state of an absence of financial markets initially lacks the accumulation of such diverse monitoring resources. The integrated delegation of the three phases of monitoring to a single bank is a way to economize in the use of scarce monitoring resources.

Further, there is a positive reason for the integration of the three phases of monitoring, rather than their decentralization, to bring about better results. In the transition process, ex ante monitoring of the corporatized SOE, if not that of a new, innovative start-up, would be unlikely to require highly sophisticated project analysis. The urgent problem with the corporatized SOE, privatized or not, is to restructure itself rather than to initiate new projects at the technological and commercial frontier. If this is so, the relevant ex ante monitoring would be more on the organizational capability of the corporatized SOE to absorb, adapt, and improve the existing organizational, engineering, and commercialization know-how. For that, the bank that would maintain a long-run relationship with the borrowing enterprise may be in an informationally advantageous position because it can feed back information available from interim monitoring to the assessment of relevant organizational capability.

It may also be the case that ex ante monitoring and interim monitoring are complementary to ex post monitoring. Even if the financial state of the enterprise is critically worsened, the IF may be less adept at finding the problem when the accounting methods are not very informative and disclosure requirements are lax. Even if they are competent enough to find problems at an early stage, they may encounter resistance in the insiders to yielding control power. In contrast, the bank would mediate daily payment settlements for the customer enterprise as well as roll over short-term loans or discount trade bills necessary for financing working capital. Such operations would give the bank a power similar to that of being able to partially open the books. At the time of automatic transfer of control triggered by debt contracts in the event of repayment default, the bank may utilize knowledge accumulated through interim monitoring to exercise its judgement of whether the enterprise has a chance to survive or would be better served by liquidation.

The merits discussed of the integration of the three phases of monitoring presume that a single bank would credibly commit ex ante to interim and ex post monitoring. Such a commitment is not credible in the highly developed, market-oriented system where debt instruments are easily marketed. The initial
investors may get rid of their claims in the market rather than bear bankruptcy or rescue costs ex post if they are in a position to find possible problems with borrowers at an early phase.

As already noted, however, the necessity of developing a sound banking sector should not be taken as precluding the simultaneous functioning of financial markets. On the contrary, competitive and informative financial markets can be complementary to bank monitoring. Instead of the formation of syndicates, the bank may underwrite and guarantee bond issues of the customer enterprise. The price formation of the securities of the enterprise in the market can compete with the interim monitoring of the bank, pointing out its mistakes or remedying possible moral hazard. If the IF develops restructuring expertise in the posttransition regime, it can bid for the equity that the LB auctions off after the debt-equity swap operation. The point is, however, that the role of a sound banking sector, composed of a reasonable number of qualified banks, could not be fully substituted for the financial markets when the magnitude of insider control is substantial.

Banking Reform Needed in the Transition

Although the case for the development of a sound banking system in the transition process appears to be strong, the current state of banking institutions in transition economies seems to be far from that needed to perform the kind of tasks suggested above. Is there any hope that they will develop the capacity and incentives to do so? What kind of banking regulations are to be instituted in the transition process to encourage such developments?

In transitional economies, most of the banks are either successors or spin-offs of the former state banks or newly established agent banks of corporatized SOEs. Large commercial banks in Central Europe were created in the last few years with the split of the former state monobank into a central bank and a number of commercial banks. The loan portfolio was distributed to the new commercial banks along regional (Poland) or sectoral lines (Czech Republic, Hungary). Most of the deposits are with specialized savings institutions, channeled to commercial banks in the form of refinancing credits through central banks. The spin-offs of the former state banks are still owned by the state and their privatization is under preparation (Poland, Hungary), or their majority ownership has now been privatized (Czech Republic). Private commercial banks have been established recently, yet the former state banks are still dominant in assets. In Russia there are now approximately 1,700 independent commercial banks (see the chapter by Belyanova and Rozinsky for a detailed account of the present-day Russian banking institutions). Among them, about 700 banks, including most of the larger banks, are spin-offs of the former Soviet specialized banks, which are now primarily owned by former SOEs. For these banks the sets of shareholders and borrowers are the same.

The state bank in the centrally planned economy was not an autonomous financial institution, but an administrative instrument of centralized planning to control the SOE. As is well known, one of the most important causes of the failure of centrally planned economies was the soft budget constraint on the SOE because of the lack of commitment by the state bank not to refinance ex post inefficient projects. Financing the existing SOE became automatic because of the political necessity of maintaining employment (latent insider control problem), the rising bargaining power of managers, and possibly because refinancing made economic sense once the initial investment was sunk. Insolvency criteria did not exist in the communist regime, and thus soft credits could not be distinguished from outright giveaways. A possible problem with the spin-offs of former state banks is the continuation of soft credits as a form of inertia. Half of all commercial bank loans extended in 1992 in Russia were in the form of directed credits funded by the Central Bank or the budget and channeled through these banks (World Bank 1993, p. 2).
The newly created agent banks may have their own problems. In Russia more than 1,000 agent banks have been created from nothing since 1990. They were usually created by enterprises or by groups of enterprises to manage their cash flows and to perform payment system transactions on their behalf. These banks also make loans, primarily with funds from enterprise deposits and interbank markets, as well as funds in the process of collection. A possible problem with the agent bank is that, as with most relational banks in developing economies, they are captured by the interests of the parent enterprise and cannot act as independent sources of monitoring. Their credits may be exposed to risks that are too idiosyncratic.

For banks to operate on a sound basis, it is necessary that their assets are sufficiently diversified. When the funding basis of the bank is thin, however, as is the case with most agent banks, it is difficult to diversify lending while meeting the funds requirements of the parent enterprises. The formation of a loan syndicate may be a possible response. The difficulty is that the sheer number of agent banks and their small size seems to prevent the development of syndicates, because the question of which bank ought to bear the responsibility for syndicate organization (ex ante monitoring), interim monitoring, and how to set the priority for claims cannot be settled easily.

In spite these problems, however, the banking sector in transitional economies appears to be gradually evolving as a viable institution. Peter Dittus (1994) recognized the increasing spread between the deposit and lending rate and the recent noticeable decline of net lending to enterprises in Central European economies. By careful examination, he tentatively concludes that the decline of lending is not a result of a credit crunch from the government deficit, and it can be regarded as a hardening of budget constraints for the enterprises. He cautiously notes: "clearly, the environment in which banks are operating and their behavior have changed much more than seems to be commonly acknowledged. It has also become evident, however, that the difficulties remain to be overcome are substantial" (p. 34). The chapter by Belyanova and Rozinsky in this volume indicates that the difference between better spin-offs of the ex state banks and newly created banks are beginning to be blurred, and some of them seem to be evolving as viable institutions in spite of the problems.

What difficulties are to be overcome in order for better banks to evolve into active monitors of insider control? Let us try to identify some basic problems to be addressed.

The first is the dilemma between risk diversification and monitoring. In order to be free from soft credits and the excessive exposure to idiosyncratic risks associated with relational lending, it is desirable that the bank diversify its loans. As noted earlier, one method to achieve this is to form syndicates. At the same time, the formation of loan syndicates may dilute incentives for the bank to monitor. How can we resolve this dilemma?

The second problem is related to the social costs of bankruptcy. As we have hinted, one possible advantage of a bank-centered monitoring mechanism is that the default of debt repayment can trigger the automatic shift of control rights from the insider to the creditor bank, even if the latter does not own a block of shares. The mechanical application of bankruptcy procedures would be unproductive given the current state of transitional economies. The newly corporatized SOE seems to need outside financing, and sometimes subsidies, to be viable and perform the necessary restructuring. How can such finance and subsidy be made without perpetuating the soft credit relationship between the bank and the enterprise?

As previously noted, there are some 1,700 banks today in Russia. This number is simply too large, and the average size of banks is too small to induce risk diversification and delegate responsible monitoring to single banks. Nevertheless, that more than 1,000 banks devoid of the traits of the old state bank system have emerged from scratch in only a few years may be considered as a positive sign of the potential for vigorous evolutionary change. It is said that some of the new banks were organized and run by young, competent people (see the chapter by Belyanova and Rozinsky in this volume). Such a situation may suggest that, once a prudent and competitive regulatory framework is provided and a stable macroeconomic policy environment is set, some of the existing banks may be given an opportunity to develop as banks accountable for external monitoring.
To emancipate banks from fragmented, exclusive relational banking, there is a need to drastically increase the minimum capital requirements of banks. Such regulation would provide an impetus for acquisition and mergers among banks. Further, it would be desirable to limit the lending of the bank to a single enterprise—for example, to one-quarter of the bank’s capital. Such measures would induce banks to restrain the volume of relational lending. Nevertheless, our purpose is not to promote arm’s-length banking. If portfolio diversification by banks were merely to accelerate arm’s-length relationships, a vacuum would remain for external monitoring of the insider control enterprise. Because many banks are now owned by (a group of) enterprises, the movement toward arm’s-length banking following the Anglo-American system may not be likely. Through the process of merger and acquisition, originally close bank-enterprise relationships may be diluted, but maintained with some distance. The enterprise would likely hold major payment system accounts only with a few banks. Those banks would be likely candidates for the role of lead banks if lending diversification should lead to organized syndication.

In the process of past hyperinflation, bad debts of enterprises appear to have been largely wiped out in Central and Eastern European transitional economies, but it has not solved the recapitalization problem of banks. On one hand, enterprises appear to rely upon intricate networks of trade credits rather than banks credits. Default on trade credits by one large enterprise may trigger chain reactions. On the other hand, banks appear to rely on lending based on interbank markets and funds in the collection process, but they have not acquired a solid deposit basis yet, except for deposits by foreign currencies. Spin-offs of state banks also rely upon the central bank’s directed credits as lending sources. One solution to cope with all these problems may be to induce the development of an interbank payment settlement system based on trade bills drawable on partner banks by enterprises. The central bank should then gradually limit its capital infusion to the banking sector to “neutral” rediscounting of eligible trade bills at the window rather than directing credits to particular enterprises by discretion. Such a development would not only resolve the problem of supplying money on a sound basis, but also increase the capacity and incentives of the banks to monitor customer enterprises. Nevertheless, necessary state subsidies should be made through the budgetary process, separated from the commercial banking sector. Only through such a neutral stance of the central bank and insulation of the commercial banking sector from discretionary subsidization can the soft credits of banks be reduced.


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1. In a decree issued by Yeltsin on December 24, 1993 (N2284), some measures were introduced to curb the tendency toward strong insider control. Requirements for worker payment for benefit options were made somewhat stringent (for example, the amount of the first installment for stocks bought with a discount was increased). It was also stipulated that the number of representatives of employee-stockholders may not be more than one-third of the board of directors, and that managers or workers may not sit on the board representing the interests of the state. That these provisions were thought necessary may suggest that such practices had been widespread, without check.

2. Factors pointed out by many authors as working against the mechanical application of the bankruptcy procedure in the transition: without a sound payment system, many viable enterprises may be forced into bankruptcy by a mere chain reaction; the asset registry does not exist and private ownership in land is not legally well defined; the bankruptcy procedure may involve costs of maintaining a system of commercial courts; and the lack of expertise and discipline in receivership, and the absence of clear rules regarding claim subordination, may also incur additional social costs of bankruptcy.
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