Report

Analysis of the benefits and mechanisms of concentrating ownership of investment funds in privatized companies in Bosnia-Herzegovina

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Advisory Services to Banja Luka Stock Exchange and Sarajevo Stock Exchange

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in Consortium with

CAPMEX
CAPMEX – The Capital Market Experts
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# List of Content

List of Content .................................................................................................................................................. 2  
List of Abbreviations .......................................................................................................................................... 3  
Executive Summary of Key Recommendations ................................................................................................. 4  

1. Introduction ...................................................................................................................................................... 6  

2. Economic Structure in Bosnia-Herzegovina .................................................................................................... 8  
   2.1 Structural Reforms ........................................................................................................................................ 8  
   2.2 Efficient Capital Markets and BiH PIF ........................................................................................................... 10  

3. International Comparison ................................................................................................................................... 13  
   3.1 Czech Republic ........................................................................................................................................... 13  
   3.2 Poland .......................................................................................................................................................... 14  
   3.3 Hungary ..................................................................................................................................................... 15  
   3.4 Slovenia .................................................................................................................................................... 15  
   3.5 Slovakia ..................................................................................................................................................... 16  
   3.6 Estonia ...................................................................................................................................................... 16  
   3.7 Bosnia-Herzegovina ................................................................................................................................... 16  
   3.8 Initial Comparison Case: Czech Republic and Poland .................................................................................. 18  
   3.9 Background Conclusion ............................................................................................................................. 19  
   3.10 Recommendations ................................................................................................................................... 20  

4. Major Problems of Post-Privatization Development ....................................................................................... 21  
   4.1 PIF/Investment Funds .................................................................................................................................. 21  
   4.2 BiH Investment Funds .................................................................................................................................. 22  
   4.3 Stock Exchange Development ..................................................................................................................... 22  
   4.4 Recommendations ..................................................................................................................................... 24  

5. The Present Role ................................................................................................................................................. 25  
   5.1 Scope of Problem and Hypothesis ................................................................................................................ 25  
   5.2 Ownership .................................................................................................................................................. 25  
   5.3 Internally Sponsored Restructuring ............................................................................................................. 26  
   5.4 Externally Sponsored Restructuring ........................................................................................................... 27  
   5.5 Securities and Exchange Commission Action ........................................................................................... 28  
   5.6 Recommendations ..................................................................................................................................... 29  

6. Conclusions ......................................................................................................................................................... 30  
   6.1 Concrete Suggestions to the BiH Government .............................................................................................. 30  
   6.2 Strategic Independent View ....................................................................................................................... 31  

List of Appendices .................................................................................................................................................. 32  
Bibliography .......................................................................................................................................................... 33
List of Abbreviations

Throughout the Report, a number of abbreviations are used for convenience. Below is a list of the meanings of these acronyms.

- BATX: Country Index Bosnia and Herzegovina
- BiH: Bosnia and Herzegovina
- BLSE: Banja Luka Stock Exchange
- CEE: Central East Europe
- CG: Corporate Governance
- CMF: Capital Market Forum
- CMR: Capital Market Representative
- ECSPF: Private and Financial Sector Development Department, Europe and Central Asia Region, World Bank
- EUR: Euro
- FBiH: Federation of Bosnia and Herzegovina
- FIRST: FIRST Initiative
- FR: Final Report
- IF: Investment Funds
- IFC: International Finance Corporation
- IR: Inception Report
- MNC: Multi-National Corporations
- NIF: National Investment Funds
- PIF: Privatisation Investment Funds
- QR: Quarterly Report
- RFP: Request for Proposal
- RS: Republica Srpska
- SASE: Sarajevo Stock Exchange
- StC: Steering Committee
- SEC: Securities Commission
- SEE: South East Europe
- SOE: State owned enterprises
- TL: Team Leader
- ToR: Terms of Reference
- USD: US Dollars
- VPF: Voucher Privatization Funds
- WB: World Bank
- WBAG: Wiener Börse AG – Vienna Exchange
- WS: Workshop
Executive Summary of Key Recommendations

While PIFs faced constraints with respect to the ownership structure of firms and the economic and legal environment in which they had to operate, some important commonalities emerge. Most importantly, the development of PIFs into portfolio managing investment funds appears to have been hampered by a lack of regulatory oversight and investor protection that has undermined the credibility of capital markets and restricted the funds’ ability to raise new capital on the market.

Ultimately, it remains to be seen whether another midstream adjustment to Bosnia’s privatization process – which should include a greater emphasis on institutional development - will bring increased private sector investment. Increased private sector investment should contribute to restructuring in the productive sectors and, ultimately, lead to sustainable economic growth in the medium term. However the key opportunity and challenge for BiH is to make steady progress in its economic recovery, thus moving from a foreign aid-dependent to a self-sustaining economy.

Bosnia, like the world, desperately needs a big-think financial doctrine. Today, the core problem is a lack of trust in the financial system, the issues of capital and liquidity being secondary mechanism issues. The financial institutional community in Sarajevo and Banja Luka needs to adopt nothing less than a financial architecture, and apply the recommendations for improving post-effects of the “voucher privatization“- concentration of ownership issues and appropriate legal incentives, including 21st century mechanisms for the IF’s and Stock Exchanges.

Summary of Key Recommendations
Recommendations marked with “**” were already included in the Report “Bosnia & Herzegovina-Investment Climate Assessment” issued by World Bank in June 2008

<table>
<thead>
<tr>
<th>Recommendations</th>
<th>Involved Key Institutions</th>
<th>Priority/Status</th>
</tr>
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<tbody>
<tr>
<td>*Implement an analysis unit to examine PIF financial condition and develop prospective information for restructuring/turnaround</td>
<td>Ministry of Finance, SEC</td>
<td>Medium/High</td>
</tr>
<tr>
<td>*Develop evaluation criteria for restructuring candidates and short list of PIFs ready for ownership change and restructuring</td>
<td>SEC, Ministry of Finance, SASE, BLSE</td>
<td>High</td>
</tr>
<tr>
<td>*Estimate financing amounts and sources for debt relief and equity of PIFs that are good prospects for restructuring</td>
<td>Ministry of Finance, SEC</td>
<td>High</td>
</tr>
<tr>
<td>*Implement vehicles for restructuring including equity funds, agencies, or Development Bank programs</td>
<td>Ministry of Finance, SASE, BLSE</td>
<td>High</td>
</tr>
<tr>
<td>*Implement government debt for equity swaps in PIFs with heavy arrears to the government, to allow short-term government shareholdership for managing restructurings</td>
<td>Central Bank and SEC</td>
<td>Medium</td>
</tr>
<tr>
<td>Recommendations</td>
<td>Involved Key Institutions</td>
<td>Priority/Status</td>
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<td>*Workforce downsizing in PIFs, consistent with labour code</td>
<td>Dept. of Labour</td>
<td>High</td>
</tr>
<tr>
<td>*Modify securities laws to allow special funds (private, venture, other) to assist in enterprise restructuring process</td>
<td>SEC, Ministry of Finance</td>
<td>Medium</td>
</tr>
<tr>
<td>Capital Market Development Forum to drive development of BiH securities markets (road map) represented by a Capital Market Representative</td>
<td>Ministry of Finance, SEC, SASE, BLSE</td>
<td>High</td>
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<tr>
<td>A major effort to promote the stock exchanges (The Sarajevo Stock Exchange and Banja Luka) with the public, and an equal effort with brokers to list private companies, either by nationals (such as Fratello Trade a.d IPO in Banja Luka) or foreigners</td>
<td>SASE, BLSE, SEC</td>
<td>Medium-High</td>
</tr>
<tr>
<td>The IFs should move to active management, rather than remain passive. The SEC needs to change the IF Law with the intention to convert the closed-end funds to open-end funds.</td>
<td>SEC</td>
<td>High</td>
</tr>
<tr>
<td>Revise fund management training and licensing (Fund managers were licensed app. 5 to 7 years ago). SEC and Exchanges should develop and administer the same Test</td>
<td>SEC, BLSE, SASE</td>
<td>High</td>
</tr>
<tr>
<td>Change IF fee structures, as current IF’s management fees indirectly “support” passive fund management.</td>
<td>SEC</td>
<td>High/ Medium-Term</td>
</tr>
<tr>
<td>Propose regulation to eliminate conflict of interest as IFs are partly majority owned by management companies.</td>
<td>SEC</td>
<td>High/ Medium-Term</td>
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1 Introduction

This report addresses the issues of the incomplete agenda of the Bosnia and Herzegovina (BiH) PIF (Privatisation Investment Funds) in the hope that it will contribute to government officials accelerating reforms and removing structural constraints in the Enterprise sector with regard to privatization, under-performing State owned enterprises (SOE's) and PIFs. In order to ensure that the business environment is predictable and transparent, as proposed in the Foreign Investment Council (FIC) White Book Report, recommendations are presented.

The following review sections set out a range of recommendations to address the issues and impediments presently inhibiting further development of privatization in Bosnia-Herzegovina. The order in which strategies are implemented is as important as the strategies themselves.

Market failure and structural weaknesses are important contributors to financial instability. The latter includes issues such as accounting and disclosure, banking soundness and prudential supervision of market intermediaries. In order to minimize the risks associated with market failure, it is important that financial sector restructuring be pursued with due care. In implementing remedial strategies considerable thought must be given to the need for orderly and timely implementation of reforms. Correct sequencing is significant in ensuring the successful realization of financial market development.

(1) This is a Desktop Review Analysis and Report addressing the issues of the unfinished agenda of the BiH PIF (Privatisation Investment Funds). The report will comment and present suggestions based on the experience in transitioning countries and on-site BiH investigations of the performance of the voucher privatization program and, based on the analysis, to develop concrete suggestions for Government of BiH.

(2) The report should identify major problems, which may include some corporate governance issues; however, the report should not be designed as another corporate governance report;

(3) An appropriate analytical methodology should be adopted. This does not include financial analysis of the investment funds (IF) and their respective portfolios;

(4) Through desktop analysis and experience, the report should review present international comparisons and present practical examples from other countries;

(5) Recommendations for improving voucher privatization, which includes concentration of ownership issues and appropriate legal (or lack of) incentives. The report should propose best practices with regard to ownership;

(6) Present a strategic independent view which may include “hybrid funds”, “active management funds”;
The suggested deliverable time line as agreed with the representatives of World Bank is:

1. End January 2009 - First (1st) draft for review by IFC
2. Beginning of March - IFC Comments
4. End of April – Final Report Version

The research method used was similar to a "Likert Scale" measurement of attitude, where, in place of a numerical scale, the answers to our interview questions ranged from complete agreement, on one side, to complete disagreement, on the other side. There does not appear to be any neutral opinion. Between November 24 and December 12, we were limited to 15 days for: on site observations (including 2 days report preparation time), for holding discussions with officials and management at the Sarajevo and Banja Luka Stock exchanges, conducting a series of interviews with (3) listed companies, (1) candidate for IPO, (4) exchange brokers, officials of the World Bank Group, USAID and BiH Foreign Investment Promotion Agency and (4) investment fund managers, and regulators in Sarajevo and Banja Luka. (See the attached Appendix 3: Field Visits)

We supplemented field research with surveys conducted on and off site by CAPMEX personnel in Bosnia, thus completing the Advisory Services to Baja Luka and Sarajevo Stock Exchange project (FIRST Grant Project).

Our "exploratory research" showed a pattern of attitudes and beliefs, with no definitive value, that form a qualitative hypothesis point of view represents a result of “causal hearsay evidence”. Investment Fund (IF) management does not actively manage portfolios and therefore the BiH privatization process has stalled. This led to the more focused, research question: that without the correct fund management team and a portfolio of “going concerns” of privatized entities, financial statements are generally meaningless without first establishing accounting and governance standards benchmarks.

Based on the literature and field interviews, we believe that PIF IF management, despite inactive portfolio management, are not singularly accountable for the lack of progress of the BiH privatization program. The list also includes issues related to Government policy-making departments.

Of course, most qualitative research benefits by some form of quantitative data, although the overall focus is still highly qualitative even when the overall focus is highly qualitative. We recommend the construction of an analytical framework that can propose the study of possible administrative changes that should lead to increasing the efficiency, responsiveness, flexibility, enhanced risk-taking capacities of PIF companies, and create the emergence and growth of new strategies and investment vehicles.

It is hoped that by providing a more systematic approach to the subject, through the review, conclusions and recommendations in this report, a contribution can be made to the better understanding of how the impact of PIF can be assessed and improved, despite their failure in BiH.

This report includes the key findings developed during of the Inception Stage, 18th November 2008 to mid January 2009 in Banja Luka and Sarajevo.
2 Economic Structure in Bosnia-Herzegovina

BiH is making steady progress in its economic recovery from an aid-dependent to a self-sustaining economy, as reported in the WB Country Partnership Strategy, November 2007 for the period 2008-2011: “Economic expansion and growth have remained robust over the last few years, despite slow reform implementation. However, much remains to be done in order to achieve long-term, sustainable, private-sector led growth.” The private sector’s contribution to the gross domestic product (GDP) stands at 55 percent in BiH, which is below regional averages. Serbia had an equivalent private sector contribution to GDP in 2005, Croatia's 60 percent and FYR Macedonia’s 65 percent are relatively close, but Bulgaria and Poland with 75 percent or Hungary and the Czech Republic's 80 percent of GDP produced by private sector are far ahead. The current high share of public expenditure to GDP is crowding out the private sector.

BiH is a small economy. According to the Central Bank of Bosnia and Herzegovina, official GDP reached around EUR 9.2 billion in 2006, which would be approximately 85 percent of pre-war level. The services sector accounts for a large part of the economy, 64.9 percent of GDP, while industry accounts for 24.7 percent and agriculture for 10.4 Percent of GDP. Bosnia and Herzegovina is a very open economy, where the ratio of exports and imports of goods and services to GDP in 2005 equalled 87 percent. However, the high ratio is driven mainly by imports. The European Union (EU) is the main trading partner, accounting for 69.4 percent of Bosnia and Herzegovina’s exports and 60.20 percent of its imports. In 2009/10, a grim growth outlook is forecast for the Balkans and Central Europe, including Bosnia, as weakening demand from the recession-hit euro zone takes its toll.

2.1 Structural Reforms

Privatization has made some progress in the Republic of Srpska, but it remains limited in the Federation. The size of the public sector remains large and reluctance to transfer competencies from entities to state political/administrative level persists. Coordination and efficiency problems remain, and improvement is needed at all levels. A few institutions and functions have been transferred to state level, for example a state ministry of defence and a state-level Indirect Taxation Authority (ITA) were created.

However, according to the 2007 World Bank Group (WBG) enterprise survey, there were some 34,000 companies registered in BiH in 2005, with a further 800 yet to be privatized (of which, some 130 are strategic companies). In 1999, the Government adopted a voucher privatization program, supported by the international community, (USAID, IFC (WBG), EBRD) resulting in large numbers of privatized small and medium size enterprises (SMEs). The program resulted in fragmented ownership and did not introduce new management or access to new capital. Many of these companies will need further restructuring in order to become commercially viable and attractive to private buyers. Public and private companies alike have poor and deteriorating business performance. Productivity and capacity utilization is relatively low, export levels are still significantly below that of imports and many companies are indebted. Privatization of the approximately 130
remaining SOE’s and corporate restructuring are urgently needed to release the productive assets tied up in these companies into the economy.

The banking sector has continued to expand significantly and total assets increased. While PIFs faced markedly different constraints in the two countries regarding the ownership structure of firms and the economic and legal environment in which they had to operate, some important commonalities emerge. Most importantly, the development of PIFs into portfolio managing investment funds appears to have been hampered by a lack of regulatory oversight and investor protection that has undermined the credibility of capital markets and restricted the funds’ ability to raise new capital on the market. We particularly believe that the relationship between free-market mass privatization and capital market development needs to be more fully examined from 58 percent of GDP in 2003 to 80 percent in 2005. The banking system is one of the sectors in BiH where the most rapid reforms and structural transformation have taken place. State ownership in this field substantially declined as a result of privatizations. Banking supervision is conducted by two separate entity-banking agencies and is coordinated by the Central Bank.

The Central Bank, serving as fiscal agent, has efforts underway to create a State-level government securities market. This market should provide an instrument for banks to manage excess liquidity, much of which is currently being recycled to Germany, Austria, and Croatia. Consumer lending has grown rapidly (although not as fast as deposits), but appeared to level off in 2003. Overall credit continues to expand, with the trend in 2004 pointing to a rise in credit to businesses. However, growth is hampered by the lack of an appropriate legal framework.

On the eve of the G-20 in London, to no surprise, the global economic crisis has spread onto the BiH scene. On March 18, the government of the Federation of Bosnia and Herzegovina (FBiH) had secured $140 million in syndicated loans from banks to cover part of its 2008 budget deficit. Observers say an IMF deal is a necessity to prevent social unrest in BiH.

The 12-month syndicated loan, from the Bosnian branches of Unicredit SpA, Intesa Sanpaolo SpA, Raiffeisen Bank, ABS Bank and NLB-Tuzlanska bank, would be at an annual interest rate of 7.99 percent.

This follows an announcement by EBRD on February 27 that The European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), and World Bank will provide a combined 24.5 billion euro ($31.3 billion) to Central and Eastern Europe in the next two years to support the banking sectors and to fund lending to businesses in the region hit by the global economic crisis.

Economic activity had remained robust in recent years despite slower implementation of reforms. As a result of earlier reforms, higher metal prices, and generally favourable external conditions, GDP growth increased to around 6 percent in 2006 and even accelerated to 6.8 percent in 2007. The growth of FBiH exports in recent years has been remarkable, surpassing that of all other countries in Balkans region. Exports growth was 36 percent in 2006, 15 percent in 2007, and will probably reach 17 percent in 2008. While exports are still dominated by steel and aluminium, the shares of more
technologically sophisticated products have been increasing, as evidenced by rapid growth in exports of machinery, car parts, and furniture.

Confidence in the currency has weakened along with other Euro zone Eastern European transition economies. However, the Bosnian State Parliament adopted a law in October that will almost triple the state's current guarantee for net capital inflows exceeding the large current account deficit, foreign exchange reserves have increased, although at a somewhat slower pace of accumulation recently than in the past; nevertheless, the current 5-month of imports worth level of foreign reserves provides little cushion against external shocks.

The change in the law was designed to recover public trust in domestic banks, as the crisis continues. The Bosnian Central Bank proposed in October an increase in state guarantees for deposits of up to 7,700 Euros, but the government has since decided to raise the figure to 10,256.

The federation is in a difficult situation after it recorded a deficit of 260 million BAM in 2008, mostly because of generous social benefits to war veterans, invalids and demobilized soldiers. It needs 140 million BAM in urgent funding from international lenders to cover the gap.

An example of how this plays out in practice is provided by the FBiH demobilized soldiers’ benefit that was introduced in October 2006. In the period 2004-2006, prior to the introduction of the aforementioned benefit, the number of unemployed demobilized soldiers registered with the Employment Bureau in FBiH had been around 60,000. Between September 2006 and December 2007, the Employment Bureau in FBiH had recorded a 46 percent increase in the number of people registered as unemployed demobilized soldiers - from 60,000 to nearly 90,000. It is truly hard to believe that 30,000 demobilized soldiers lost their job during that period, when other official statistics were showing the economy was actually creating jobs.

A regional free trade agreement negotiation process to join the World Trade Organization (WTO) is underway in BiH. Bosnia and Herzegovina is part of the regional free trade agreement concluded in the framework of an enlarged and amended Central European Free Trade Agreement (CEFTA). Bosnia and Herzegovina benefits from autonomous trade measures introduced by the EU in September 2000, which allow more than 95 percent of all exports (including agricultural products) to enter the EU, duty and quota free.

### 2.2 Efficient Capital Markets and BiH PIF

Bosnia-Herzegovina desperately needs a big-think financial doctrine. Today, the core problem is a lack of trust in the financial system; the issues of capital and liquidity being secondary mechanism issues. The financial institutional community in Sarajevo and Banja Luka needs to adopt nothing less than a financial architecture, and apply the recommendations for improving post-effects of the “voucher privatization”- concentration of ownership issues and appropriate legal incentives, including 21st century mechanisms for the IF's and Stock Exchanges.

Larry Summers said, “Financial markets don’t just oil the wheels of economic growth – they are the wheels” (Wall Street Journal, December 8, 1997). Local stock exchanges are the keystone of the financial market-centered model of national economic growth hinted at by Summers’ quote, and
opening a stock exchange is perhaps the most visible sign of conformity to this model, HOWEVER, capital markets remain underdeveloped in Bosnia-Herzegovina.

The Sarajevo Stock Exchange and the Banja Luka Stock Exchange have both created their own modern stock market infrastructure (trading, clearing, settlement). However, factors such as the small size of the market, lack of current progress on privatization, and public mistrust of previous voucher privatization programs have impeded the development of a healthy market for shares. In Bosnia and Herzegovina mostly closed-end investment funds (PIFs) exist, which have been the process for privatization of SOE's (state property).

These PIFs were never conceived of as an essential condition or measurement for the success of the voucher privatization plan. In mass or equal-access voucher privatization, the government generally gives away, or sells for a nominal fee, vouchers that can be used to purchase shares in enterprises. This technique was rarely used elsewhere in the world before the transition started in the Balkans, Central and Eastern Europe.

Voucher privatization helps to overcome the shortage of domestic capital. At the outset of transition, voucher schemes were politically popular because they addressed the perceived unfairness of other approaches and avoided the charges of a sell-out of national assets to foreigners. The difficulties associated with valuing enterprises before privatization are also avoided.

However, the Privatization Act created a solution that prohibits the PIFs from techniques of privatization other than that of voucher privatization. Thus, the PIFs played an important part in the popularization of the voucher scheme of privatization because they contributed greatly to the overall acceptance and popular support of the scheme, and became an important factor in the emerging, post-privatization capital market. The voucher privatization contributed substantially to the successful transfer of a significant part of state property into the private sphere.

A previous report suggested evidence of a dynamic adjustment of the SOE ownership structure through the PIF and that, contrary to the concern of the critics of the BiH mass privatization programs; it was not the most inefficient way of transferring assets from the state to the public sector. PIF's are intended to mitigate the risk of a dispersed ownership structure and conversely lack the focus and power to direct effective corporate management. In Bosnia, the repeated phrase in the research interviews is that the PIFs do not have adequate management, control, and supervisory powers and that corporate management can and do deprive them of essential information which scares off potential new sources of capital, especially international private equity and institutional investors.

In reality, the Security and Exchange Commission (SEC) never perceived PIFs to be active owners SEC's failed strategy was to keep them as conduit and passive owners, as if BiH market had a well-developed and liquid market. Management fees for PIFs and their management companies did not stimulate active ownership, but promoted a simple strategy of sitting on assets passively and
waiting.

Through desktop review and analysis, the report will present international comparisons and practical examples from other countries divided into two categories: (See Appendix 5)

a. Immediate Stock changes: Czech Republic, Poland (early stage)
b. Gradual Stock changes: BiH, Romania, Hungary, Slovenia, Slovakia, Estonia
3 International Comparison

3.1 Czech Republic

The main method of privatization in the Czech Republic was ‘voucher privatization’ through which some 1700 companies were privatized in two ‘waves’: 1991–1992 and 1992–1994. The shares of these companies were transferred to either individuals or to privatization investment funds (PIFs) in exchange for vouchers. PIFs set up by manufacturing companies, private individuals and institutions as well as state-owned banks and insurance companies actively participated in the process as financial intermediaries. Adult citizens received vouchers, which they could exchange for the shares of companies in the scheme either directly or indirectly through privatization investment funds. In the latter case, they could entrust their vouchers to investment funds and become shareholders of these funds (which were joint stock companies) or unit holders in unit trusts. The funds, in turn, could use vouchers collected from their members to bid for shares of their preferred companies. Understandably, given the prevailing information asymmetry and risk aversion, the majority of citizens opted for the second alternative and entrusted their vouchers to investment funds. In the first wave, 72 percent of investment points available were used by funds and 28 percent by individuals directly. In the second wave, the percentages were 64 percent and 36 percent, respectively. The bulk of investment points controlled by funds were concentrated in the hands of a small number of funds set up by banks and financial institutions (Hashi 1998).

In the first wave, these funds were all close-end funds but in the second wave many of them took the form of unit trusts. Later on, as part of the reform of the financial system, close-end funds were required to convert themselves to open funds by 2002. Initially, the funds were allowed to hold up to 20 percent of the shares of each company in the scheme, though they quickly found ways of bypassing this constraint. The funds’ maximum holding in each company was later reduced to 11 percent.


The shares of mass privatized companies and PIFs were immediately listed on the stock market without the requirement of prior approval and the publication of a prospectus. The process of buying and selling of shares, and the reorganization of funds’ portfolios, quickly followed the two waves– a process generally referred to as the ‘third wave’ of privatization. Investment funds, despite their large overall stakes, were generally not in controlling position of their portfolio companies. Many funds had ended up with shares of too many companies and wanted to reduce the size of their portfolios. Many individual shareholders, preferring cash to risky shares, also entered the secondary market, selling their shares, thus further pushing down share prices. A major feature of the so-called third wave of privatization was the take-over of investment funds. Given that PIFs, especially those set up in the first wave, were joint stock companies with a large number...
of shareholders, they were easy targets for aggressive bidders. It was estimated that up to one-third of individuals who had obtained shares in the voucher scheme sold their shares in the early post-privatization period. (For details, please review Claessens, S. and S. Djankov, Ownership Concentration and Corporate Performance in The Czech Republic. CEPR Discussion Paper.1999)

3.2 Poland

The scale of the Polish mass privatization was less spectacular than the Czech scheme. It included 512 companies and 15 National Investment Funds (NIF), which were set up by the Government. The management of these funds was initially entrusted to special consortia of Western and Polish partners (commercial banks, investment banks, consulting firms) selected through an international tender offer. The implementation of the program was delayed by at least four years (1991-95) for political reasons, mainly the absence of a consensus in the government and the parliament about the final list of companies in the scheme, the precise share of different beneficiaries and the specific arrangements concerning corporate governance of the NIFs. The equity of 512 companies was transferred from the state to new owners according to a common scheme: the majority of shares of each company (60 percent) were given to the 15 NIFs, with the remaining 40 percent going to employees (15 percent) and the Treasury (25 percent). For each company, one of the 15 NIFs received 33 percent of shares and thus became the ‘lead fund’ for that company. The remaining 27 percent were divided between the other 14 funds (each holding just under 2 percent of shares). This uniform scheme sharply contrasted with the Czech program where the outcome of the bidding process was completely unforeseeable and any number of funds; individuals and other beneficiaries could end up as new owners of the companies.

Foreign financial institutions were invited to participate in the program and bid for the management of NIFs under lucrative remuneration arrangements together with Polish institutions. The aim was to bring in the fund management know-how and expertise and ensure that Polish institutions learn from their foreign partners. At the same time, foreign institutions with international reputation were expected to follow the same practice as in their own countries, and not to engage in opportunistic behaviour, insider dealing and shareholder expropriation which their inexperienced Polish counterparts may have been tempted to embark on. Many foreign institutions did take part in the program and most NIFs started to be managed by consortia of foreign and Polish institutions.

Looking at a variety of performance indicators in 6,300 firms, in seven countries, up to the end of 1995, Gerhard and all found that privatization was "the key to restructuring" as divested firms registered much higher rates of productivity growth, investment, and positive operating cash flows than SOEs in the sample. (Pohl, Gerhard, Robert E. Anderson, Stijn Claessens, and Simeon Djankov. Privatization and Restructuring in Central and Eastern Europe: Evidence and Policy Options. (Technical Paper No. 368. Washington, D.C.: World Bank. 1997).

This study also concluded that any form and method of privatization, other than giving ownership to workers, produced these positive results. Note: The highest percentage of strongly performing privatized firms in this study are found in the Czech Republic; the principal author also states that an
updating of the data base shows this still to be the case as of the end of 1997.

Frydman, Gray, Hessel and Rapaczynski reviewed the effects of privatization on corporate performance (“Quarterly Journal of Economics, Vol. 114, No. 4, November, pp. 1153-1191 “When Does Privatization Work? The Impact of Private Ownership on Corporate Performance in the Transition Economies,”) in a sample of 188 Czech, Polish and Hungarian firms (half privatized, half state); the data examined were drawn from the years 1990 through 1994. They found that private ownership, except for cases where workers become owners, "dramatically improves the most essential aspects of corporate performance," particularly in terms of revenue generation. Moreover, in their sample, the privatized firms laid off relatively few employees in the early days of transition, and "generate significant employment gains relative to state firms." Indeed, the authors argue that "privatization is the dominant employment strategy in transition." This study also tested for the presence of selection bias and found none, indeed the opposite: Where insiders obtained better firms they tended to manage them badly; outsiders tended to get below average firms but turned them around, as measured by later revenue performance.

3.3 Hungary

Hungary's privatization efforts, reviewed by Papp, Long, Kopanyi and Mihalyi, “Privatization Restructuring Property Rights in Hungary” (Washington, D.C: World Bank) found them far from faultless, with neither income to the seller nor competitive forces being generated to the extent feasible (but note that Hungary has earned more than US$8 billion from privatization sales, more than any other transition country in Central Eastern Europe (CEE) and the Former Soviet Union (FSU). The overall conclusion was that privatization has led to better asset management and corporate governance to greater efficiency in production restructuring and modernization of older enterprises to the production of new and improved products and to a greater export orientation financial and operating performance and ownership form.

3.4 Slovenia

Ownership is a particularly tangled issue in Slovenia because of the Yugoslav heritage of the "social capital" concept. Six ownership categories were examined: private firms (but not privatized); foreign owned firms, firms majority privatized to insiders, firms majority privatized to external buyers, non-privatized (socially owned), and state firms (mainly public utilities).

The results: Foreign owned firms (few in number) are doing the best, averaging a respectable 5.4 percent return on equity in this period, versus 3.9 for private firms, minus .03 for internally privatized, 1.2 for externally privatized, minus 4.6 for non-privatized firms, and minus .60 for the state firms 0.55. When one adds profit margin, the foreign and private companies remain much better than companies from other ownership categories followed by international and external companies, while non-privatized and state companies are pretty much under water. While their performance is hardly outstanding, Slovenian privatized firms are doing much better than the companies that remained in the category from which they escaped, which is the poorest performer
by just about every measure. This is an important point: the standard against which privatized firms should be measured is the performance of the non-privatized sector from which they were drawn, and not some theoretical ideal.

3.5 Slovakia

Slovakia privatized large firms and the researchers Slovakia, Djankov and Pohl found generally improved performance, even though most of them had been turned over to the old managers; that is, to the very insiders whose ownership is so often hypothesized to account for poor performance elsewhere. Much indirect evidence suggests that liberalizing reform, in general and privatization, in particular produce good results.

3.6 Estonia

Estonia privatized the vast bulk of its enterprises in quite short order (mostly to external investors); vouchers were used in a minority of cases, in each instance to divest a minority of shares. The country returned to positive GDP growth quite rapidly, and sustained it. Estonia is the only transition country to register some double-digit growth rates, and is still growing at a high rate despite the world and Russian crises.

Estonian reform on labour found that in the early days, following the separation from the Soviet Union, "job destruction dramatically increased, but later in transition, hires and job creation surged as well." The layoffs tended to take place in large manufacturing and remaining state-owned firms. Job creation took place in smaller, service-oriented private companies. "These results suggest that Estonia's liberal and radical reforms enabled huge worker and job reallocations without producing massive unemployment." Much of the job creation came about in new entry firms, but the privatized companies contributed to the growth as well. Thus, there is a fair amount of evidence to suggest that privatization in CEE and the Baltic states works in principal, and works well, and that the portrait of privatization drawn at the end of section II is excessively negative and critical, at least in this part of the transition world.

3.7 Bosnia-Herzegovina

One key difference between Bosnia-Herzegovina’s privatization process and those of other Eastern European states is the absence of a local political constituency committed to the process. John Nellis, argues in his May 1999 IFC Discussion Paper No. 38 “Time to Rethink Privatization in Transition Economies?” for a necessarily slower and less dramatic form of case-by-case or tender privatization, aimed at creating, from the bottom up, the climate in which core, competent investors can and will take over the presently stagnant and recapitalized firms”

However, BiH's privatization program proceeded with speed and was principally developed under the guidance of the U.S. Agency for International Development (USAID). USAID officials originally envisaged a transparent and rapid privatization process to be largely completed within a two-year
period. Given the well-known difficulties of privatization elsewhere in Eastern Europe’s weaker transition states (among which Bosnia must surely be counted) there is a strong case to be made for “a necessarily slower and less dramatic form of case-by-case or tender privatization”. The consequences resulted in the head of the Privatization Agency being sacked and USAID suspending the program after a May 2000 report on Bosnian corruption by the U.S. General Accounting Office which raised a red flag over the issue of corruption within the privatization process, noting that the majority of already privatized companies belong to the nationalist parties.

The initial response was the establishment of an international advisory group on privatization, which brought together most of the large international agencies, including USAID, the EU, OHR, the World Bank, IMF, and the European Bank for Reconstruction and Development. In recognition of Bosnia’s troubled privatization process to that point, the group recommended setting aside some 140 ‘strategic’ enterprises – 86 within the Federation and 52 within the RS – for which international investors would be sought. In order to ensure transparency, international consultants were to be assigned to each file. However, by the end of 2001, shares in some 850 enterprises in the RS and over 1,000 in the Federation were made available to either individual voucher holders or to privatization investment funds (PIFs), which are managed pools of privatization vouchers, with disappointing results in terms of economic revitalization. There is little concrete evidence, however, that the new approach has been any more effective in attracting major foreign investors to Bosnia-Herzegovina. There are good reasons why foreign investors will remain wary of BiH. Bosnia remains a small and fragmented market.

Timothy Donais at York University writing in Southeast European Politics vol. iii, no. 1, June 2002 pp. 3-19 “The Politics of Privatization in Post-Dayton Bosnia” describes the lessons learned:

- First, the initial emphasis on early and rapid privatization appears in retrospect to have been clearly misguided, as it ignored the political complexities of post-Dayton Bosnia, the recent history of privatization in other transition countries, and the risks of undertaking privatization in an institutional vacuum.

- Secondly, indifference on the part of the international community to both abuses of the voucher privatization process and to the fact that the nationalist parties and their allies were, at least in the early stages of the process, gaining control of virtually everything that was privatized.

- Third, expectations regarding foreign investment in Bosnia were – and to a great extent remain – overly optimistic.

- Fourth, the economic and political tracks of the reform agenda in Bosnia have been insufficiently integrated. Even today, international officials and agencies working on economic issues approach Bosnia’s problems more from a technical than a political perspective, while those with specifically political mandates tend to lack a consistent focus on economic issues.
3.8 Initial Comparison Case: Czech Republic and Poland

The base comparison case is Czech Republic and Poland and the difference between the two countries appears when we consider how past performance affects the increase in ownership concentration. It turns out that the impact of past performance is positive in the Czech Republic and insignificant or even negative in Poland. This suggests that in Poland shareholders believe they can obtain some benefits of control and do not fear increasing their holdings in less profitable firms while in the Czech Republic less profitable firms are considered as too risky and shareholders prefer increasing their equity holdings in better performing firms.

Despite broad similarity of their reform programs, Poland and the Czech Republic embarked on two different variants of mass privatization.

Various political and social considerations played a role. Most importantly, the choice was determined by the policy makers’ understanding of the role of privatization in the market processes. In Poland, privatization was seen as a means of improving firm incentives. Its real objective was firm restructuring. More orthodox methods of privatization, such as IPOs, negotiated sales, auctions, were seen as more efficient from that point of view, but it soon became clear that privatization would be too slow if it were to rely exclusively on such methods. Therefore, the National Investment Funds (NIF) program was initiated to supplement other methods and speed up the process. The design of this program was dominated by the concern about corporate governance arrangements favouring enterprise restructuring. In particular, a concentrated ownership structure was imposed on firms and the funds were to be managed by highly experienced Western specialists.

In the Czech Republic (and before that in Czechoslovakia) privatization was understood as the precondition for the emergence of a market environment. Voucher privatization was seen as the most rapid and the least unfair way of transferring assets from the public sector. It was expected that under competitive pressure the initial ownership structure would gradually evolve towards a more effective structure.

The impact on regulations and the two different philosophies underlying the two mass privatization programs are reflected in the design of the regulations of securities markets in the two countries. Poland is usually given as an example of a good regulatory strategy while the Czech Republic is blamed for the weakness of its regulatory framework.

In Bosnia-Herzegovina, like in Poland, it appears that the regulatory authorities were concerned with the proper development of financial markets in general, and the Sarajevo Stock Exchange in particular, and focused on the creation of an IOSCO like "best practices" for the stock exchange listing requirements.

In the PIF programs and the remuneration scheme for fund managers lacks evidence of being carefully designed to ensure the transparency of the process and to avoid expropriation of minority
investors. Additionally, avoiding excessive dispersion of ownership appears to have provided companies with ineffective owners/managers. We recommend regulators, stock exchanges and investment managers to revisit the question of the potential danger of private benefits of control and the percent limits ownership including caps for fund managers.

The post privatization process in Bosnia-Herzegovina is similar that implemented in Poland. The shares of mass privatized companies and privatization investment funds were listed on the stock market meeting the exchange requirements and without the publication of a prospectus. The process of buying and selling shares, and the reorganization of funds’ portfolios, quickly followed the two phases – a process generally referred to as the “third phase of privatization”.

Investment funds, despite their large overall stakes, were generally not in a controlling position of their portfolio companies. Most funds had ended up with shares of too many companies and wanted to reduce the size of their portfolios. A number of individual shareholders, preferring cash to risky shares, have entered the secondary market, selling their shares, thus further pushing down share prices. Unlike Poland, take-over of investment funds has not occurred in Bosnia, although originally the PIF’s were not joint stock companies and could not be easy targets for aggressive bidders. Does this mean that the strategy and framework were wrong, or that subsequent changes in regulatory environment didn’t happen and thus prevented transformation?

### 3.9 Background Conclusion

The lessons learned from examining the literature include:

1. Any privatization is better than none, regardless of whether a stable, competitive environment has been established first or not.
2. However, the key opportunity and challenge for BiH is to make steady progress in its economic recovery moving from a foreign aid-dependent to a self-sustaining economy.
3. Economic expansion and growth have remained robust over the last few years, despite slow reform implementation.
4. Much remains to be done in order to achieve long-term, sustainable, private sector led growth.
3.10 Recommendations

In Bosnia-Herzegovina, where the political conditions did not allow for a choice of different strategies, a slower, institutionally sound strategy was not developed. The consequence was an attempt to create the PIF first and then provide the institutional underpinning for the market at a later stage, including market regulations and institutions secondary to the expansion of the market through rapid privatization. This strategy endangers the entire privatization process because of the speed with which it unfolds.

1. Complete privatization of key strategic companies and large utilities, including power, telecommunication, railways etc. In addition to restructuring, successful privatization will also require sound legal and regulatory frameworks, tariff reform and improved corporate governance.

2. The private sector should also be encouraged to participate in major infrastructure investments through public-private partnerships. Review the FIC White Paper published in December 2008.

3. Although reforms in the banking sector have advanced reasonably well, compared to other sectors, progress in advancing non-bank privatization has been slow in BiH. A consolidation of the banking sector might be appropriate and would support the establishment of non-bank financial institutions, such as micro finance, leasing, and housing co-ops.

4. A major effort to promote the stock exchanges (The Sarajevo Stock Exchange and Banja Luka) with the public, and an equal effort with brokers to list private companies, either by nationals (such as Fratello Trade a.d IPO in Banja Luka) or foreigners.

Note: In CEE, FSU privatized companies dominated by insiders are shown to be the least efficient and productive, but even these regularly do better than state enterprises.)
4 Major Problems of Post-Privatization Development

4.1 PIF/Investment Funds

In the a written and published report of the Croatian and Slovenian Mutual Funds and BiH Investments Funds, *Czech Journal of Economics and Finance*, 57, 2007, (Appendix 2), the tentative findings suggest that contrary to expectations, the majority of PIFs have not developed into viable financial intermediaries or key agents of corporate governance. While PIFs faced markedly different constraints in the two countries with respect to the ownership structure of firms and the economic and legal environment in which they had to operate, some important commonalities emerge. Most importantly, the development of PIFs into portfolio managing investment funds appears to have been hampered by a lack of regulatory oversight and investor protection that has undermined the credibility of capital markets and restricted the funds’ ability to raise new capital on the market. We particularly believe that the relationship between free-market mass privatization and capital market development needs to be fully examined. PIFs were specifically developed to overcome a number of market imperfections in the creation of new financial markets by gathering and disseminating information about privatized firms and monitoring the property rights of new shareholders. However, we have shown that PIFs do not necessarily evolve into financial intermediaries, which provide these market-building services. Therefore, the initial design problems identified in the design of the implementation of mass privatization--asymmetric information and imperfect property rights--still remain in the capital markets of Bosnia. Moreover, the negative experience of a large part of the population with the investment of their privatization voucher appears to have enhanced these problems by decreasing confidence in the emerging financial markets.

Our preliminary findings suggest that a model more along the lines of the Regulated Market Model may have several important advantages over the Free Market Model. However, in Bosnia, where the political conditions did not allow for a choice of different strategies, a slower, but institutionally sound, model emerged.

As such, the economic reform process is inevitably intertwined with the country’s unresolved ethnic conflict, which has largely monopolized the energies of Bosnia’s own political elites and of the international agencies struggling not only to keep Bosnia together but also to transform it into a modern market democracy.

We argue that a sustained privatization program represents a major test of political commitment to market oriented reforms and to safer private property rights. The evidence suggests that progress in privatization gradually leads to increased confidence as measured by perceived policy risk. Moreover, increased confidence has a strong effect on local market development and excess returns. We conclude that, while liberalization is a necessary condition for market development, the resolution of policy risk resulting from successful privatization has been an important source for the rapid growth of stock markets in emerging economies.
Thus, a slower but institutionally sound strategy could not be developed. The consequence was an attempt to create the PIF first and then provide the institutional underpinning for the market at a later stage, including market regulations and institutions secondary to the expansion of the market through rapid privatization. This strategy endangers the entire privatization process because of the speed with which it unfolds. Similarly, others including Grzegorz, Kolodko, in his book From Shock to Therapy: the Political Economy of Postsocialist Transformation, New York: Oxford University Press, 2000 have suggested that more important than speed is the establishment of an appropriate competitive environment and the institutionalization of mechanisms to ensure effective corporate governance of assets, whether privatized or unprivatized.

4.2 BiH Investment Funds

The performance of Bosnian open-end investment funds is limited and the total number of investors is also very limited, estimated at less than 5,600. In Bosnia and Herzegovina it is not easy or straightforward to incorporate funds. Firstly, the funds are only allowed to invest in assets traded on the Sarajevo Stock Exchange (2006), which rules out the ability to invest in non-liquid assets, such as property and private equity. At present, the possibility of investment in foreign markets is also ruled out. Secondly, privatization investment funds (PIFs), financial institutions and state-controlled companies dominate the domestic market. Access to companies that are not controlled by the state appears to be dictated by PIFs. This leaves little space for collective investments in the company selection process. However, there are four close-end investment funds companies: MF Global, Hypo, Ilirika, and EuroHouse Invest. As far as return is considered, for the three-year period, among funds, CROBIH, BONUS, FORTUNA, and HERBOS, have exhibited excellent performance until 2008. (See Appendix 2)

Vanco Balen at the Department of Mathematics, University of Zagreb, Zagreb, writing in Czech Journal of Economics and Finance, 57, 2007 calculated the different risk adjusted performances. He ranked all the funds according to the Sharpe Ratio where we find that three funds outperform the benchmark for the past three-year period. A similar ranking according to the Treynor ratio with deviations was found for BOSFIN and PROPLUS. These two funds are characterized by smaller values. From the values calculated for the Information ratio, we see that four funds exhibit better performance than the benchmark, as far as return is concerned.

4.3 Stock Exchange Development

Many countries pursued a policy of stock market development in the early stages of transition (Claessens, S. and S. Djankov, “Politicians and Firms: Evidence from Seven Central and Eastern European Countries”, mimeo, World Bank 1997). A group of countries, including the Czech and Slovak Republics, Lithuania, and Romania, made heavy use of stock markets to transfer ownership through mass privatization. The number of firms listed on these stock exchanges increased dramatically, but after an initial phase of high trade volumes, most stocks became and remained illiquid. Over time, many companies have been de-listed, and the number of shareholders fell as
ownership became increasingly concentrated. Regulation of stock exchanges has been minimal. In the Czech Republic, a formal regulator was not even established until 1999.

A second group of countries, including Estonia, Hungry, Latvia, Poland, and Slovenia, developed their stock exchanges mainly through a small number of initial public offerings. Trading in most of these shares remained relatively high. A third group of countries that were formerly part of the Soviet Union, including Russia and the Ukraine, developed stock markets through both privatization and initial public offerings.

All these countries had mass privatizations, but the exchange of vouchers took place outside the official stock markets. Six transition countries, Albania, Belarus, Bosnia-Herzegovina, Georgia, Tajikistan, and Turkmenistan, established stock markets as late as 2000. Despite these marked differences in policies with regard to financial architecture, it is a remarkable fact that the financial systems in the more advanced transition countries have converged and now share three key features.

In "Privatization, Political Risk and Stock Market Development in Emerging Economies“ an article published by Perotti, E.C. and P. van Oijen in the Journal of International Money (2000) the three outcomes listed include:

☞ First, the financial sector of the successful transition economies is strongly dominated by banks, which lend primarily to governments and other financial institutions. Banks provide some working capital finance to the corporate sector, but so far have played a limited role in financing investments. Investment finance comes almost exclusively from retained earnings, and most external finance comes through foreign direct investment.

☞ Second, ownership structures in individual firms are concentrated and turnover of shares is low. Only the stock markets in Czech Republic, Estonia, Poland and Hungary have capitalization-to-GDP ratios comparable to other emerging markets (23, 37, 36, and 20 per cent, respectively). But most exchanges are very illiquid, with trade concentrated in a small number of firms (See 3.1.b. above Claessens, Djankov and Klingebiel). The number of listed firms has decreased as a result of foreign acquisitions, domestic mergers and delisting. The best firms show limited interest in listing on local exchanges, preferring instead the quality stamp and liquidity of the international stock markets in Europe and the United States. At the end of 1999, 72 corporations from transition economies were listed on the New York Stock Exchange or Nasdaq, and companies listed in Germany accounted for most of domestic market capitalization in Hungary and the Czech Republic. Turnover is, however, still mostly concentrated in local exchanges. The long-term sustainability of some of these exchanges is nevertheless in doubt, given the growing integration of financial markets in Europe and the world.

☞ Third, bank spreads - that is, the difference between lending and borrowing rates-have declined significantly in level and volatility in most countries of Central and Eastern Europe
(CEE). Nevertheless they remain high by the standards of developed market economies (corresponding levels for the United States and Sweden in 1999 were 2.7 and 3.9 per cent, respectively.)

### 4.4 Recommendations

1. The World Bank Group led national strategic discussion (i.e. the fundamental relationship between domestic savings and domestic investment for sustained economic growth) and realized a Government/private sector plan on how privatized firms are going to raise the capital needed to engage in required restructuring.

2. The World Bank Group led foreign investment seminars and discussions (i.e. the secondary relationship between domestic savings and international investment for sustained economic growth)

5 The Present Role

5.1 Scope of Problem and Hypothesis

This section on ownership proposes a second hypothesis; the first stated a qualitative hypothesis, of rating privatization success and examines the scope of the problem of how Bosnian country characteristics, such as legal protections for minority investors and the level of economic and financial development, influence firms’ costs and benefits in implementing measures to improve their own governance and transparency. Further, privatized firm characteristics explain almost none of the variation in governance ratings in less-developed countries and that access to global capital markets sharpens firms’ incentives for better governance. This research is particularly important for countries with relatively low protection of minority investors, such as BiH, and where expropriation of minority shareholders occurs by extensive shareholder controlling. This expropriation may take various forms, such as misappropriation of investment resources, related-party transactions, use of transfer pricing, assets stripping and other forms of ‘tunnelling’ of assets and revenues from firms. As a result, the primary problem in such an environment is not the failure of professional managers to satisfy the objectives of diffused shareholders, but rather the expropriation of minority shareholders by the large-block shareholders with large-block share ownership and concentrated shareholders resisting the dilution of their equity stakes even in the long-run. This, in contrast to the earlier "exploratory research" which discovered a pattern of attitudes and beliefs, with no definitive value, formed a qualitative hypothesis in which, as a result of “causal hearsay evidence,” Investment Fund (IF) managements do not actively manage portfolios and therefore the BiH privatization process has stalled. In an environment of poor legal enforcement, the value of control rights is generally greater than that which controlling shareholders could hope to gain by selling out shares to equity investors. Thus, a rent-protection theory develops a corporate ownership structure, suggesting that when private benefits of control are large, concentrated ownership is the only viable arrangement.

5.2 Ownership

The initial ownership structure created in BiH is similar to the Czech Republic and Poland, which were transitory schemes and rapidly gave way to new configurations without due regard for legal protection of investors.

The citizens of BiH did not become direct shareholders of companies in the PIF but received vouchers (or certificates) which entitled them to shares in each of the 13 Funds in RS and 11 in FBiH, thus becoming indirect shareholders of privatized companies. The stated aim of the program was for IFs to restructure their portfolio companies, turn them into market-oriented firms and sell them to either strategic owners and list the funds on the stock exchanges.

Following a buoyant initial market, and the large-scale sale and purchase of shares, the role of the government began to decline and private owners began to dominate the IFs. However, we need to
survey and measure whether members elected by new private shareholders have replaced members of the supervisory boards, who were initially appointed by the government. Privatization in BiH relied on ‘wholesale’ methods to transfer assets from the state to the private sector (holds true in theory for CEE countries). This strategy consisted of a free transfer of equity of a large number of firms to large segments of the population. However, the implied main concern of the Government was avoiding excessive dispersion of ownership while still providing companies with ‘effective owners’, capable and willing to enforce control over management and undertake profound firm restructuring.

In the different mass privatization schemes in two transition economies, Poland and the Czech Republic, we find that despite important differences in the design of the two programs and despite different quality of legal and regulatory framework, ownership structure in the two countries has rapidly evolved and the emerging ownership patterns are remarkably similar. This suggests that private benefits of control are large and the quality of investor protection regime is low in both countries. However, looking at the relationship between the change in ownership concentration and firm performance, we find an interesting difference between the two countries: in the Czech Republic, the increase in ownership concentration seems to be less likely in poorly performing firms. In Poland, the quality of past performance does not affect investors’ willingness to increase their holdings. However, if we look at the actual change at firm level, it turns out that the effective reallocation of property rights has been quite extensive and that the ownership concentration has significantly increased.

We need to explain how ownership concentration and the type of controlling shareholders have changed in the Czech and Polish model and whether this applies to Bosnia and thus beg the question on the potential determinants of ownership concentration.

5.3 Internally Sponsored Restructuring


Restructuring of FSOEs encompasses both short-run or “defensive” actions and long run or “strategic” measures. The results of restructuring may be measured by employment, sales, productivity, and profitability, but care is required in the selection and interpretation of performance indicators. In the restructuring of FSOEs, foreign strategic investors have many advantages over domestic investors. Foreign acquisitions of SOEs, and other types of FDI, play an important role in expanding transition economies’ participation in the globalization of production.
The RS government has effectively gutted its voucher privatization program by issuing an order stating that even though an investment fund can acquire as much as 55 per cent ownership in a privatized company, it can only name two members to the company’s governing board (typically made up of eight to ten members). As the International Crisis Group noted in a recent report, by preventing majority owners from exercising effective control over a company, “this latest ruling might as well have been crafted with the express purpose of sabotaging the privatization of state-owned enterprises in the RS”.

In our first White Book (White Paper 2007), we identified two key areas of the business environment that are ranked by the World Bank survey. These were starting a business and registering property – which is critical to the construction sector. We observed that in the 2006 survey, BiH ranked last among all the countries of Southeast Europe in both of these categories. Unfortunately, two years later, BiH has shown no improvement in the ranking in these two areas and in the most recent 2008 survey, it is again in last place.

However, the ability of many enterprises to improve or expand the capital stock was severely constrained by the lack of finance from internal or external sources. Little new investment could be financed from internal sources, such as amortization allowances, retained earnings, and proceeds from the disposal of surplus assets. Among the potential external sources, bank credit was limited for several reasons. Government anti-inflationary monetary policies restricted the growth of the money supply and kept interest rates high. Government efforts to harden enterprise budget constraints discouraged automatic rollovers of loans, and indeed pressed bankruptcy programs to clear up companies’ bad debts to banks. Also, the banks themselves preferred to provide short-term commercial credit rather than longer-term loans for plant and equipment. Most firms had little possibility of raising funds by initial public offerings or bond issues floated on the domestic or Eurobond markets. Only foreign-controlled enterprises were able to finance their restructuring easily, through funds from the multi-national corporations (MNC) parent or bank loans obtained on favourable terms because of the parent’s guarantee.

5.4 Externally Sponsored Restructuring

Morris Berstein, Ph.d, Department of Economics, University of Michigan, Ann Arbor writing in “Economics of Transition”, Vol. 5, No. 2, .2000 on Post-Privatization Enterprise Restructuring surveyed with the EBRD and World Bank 506 mid size manufacturing firms in the Czech Republic, Hungary, and Poland found that the restructuring performance of foreign strategic investors was not significantly better than that of domestic “outsider” owners. The author speculated that the period studied was too short to observe the results of the foreign owners’ transfer of managerial know-how and technology. Foreign direct investors have strong advantages over domestic outsider and insider to-date technology in production processes and products. However, MNCs often demanded preferential investment incentives, such as tax holidays, accelerated depreciation, exemption from VAT and duties on imported equipment, and the possibility to carry losses forward to future tax periods. Also, foreign-controlled firms are commonly larger than domestic enterprises, and the size differential can help explain the superiority of the former in restructuring. Finally, one should
consider the spill over effects of FDI on domestic firms such as changes in corporate governance, organizational structure, management personnel and compensation, labour inputs and remuneration, the capital stock, technology, and the composition, quality, of the products. All types of foreign-controlled companies trained managers and workers who later moved to domestic enterprises.

In conclusion, regional experience shows that the ideal situation is when state assets are sold to foreign strategic investors. If privatization sometimes fails, or its results are sub-optimal, this should not be a deterrent: in such situations, state ownership is also likely to fail, and the hidden social costs are generally higher in this latter case.

Finally, economic research shows that increased firm competitiveness, innovation, technological capability and export potential have a strong correlation with foreign ownership. In this context, outside investors as well as foreign business partners should be encouraged, as they can supply know-how, capital, skills and the opening of markets, which overall, would help BiH industries expand, modernize and become more competitive. Analysis shows that firms counting on foreign direct investment are more likely to have greater exports in proportion to their total sales, as well as having access to new technologies. Thus, even a pilot program to restructure PIFs and attract new capital could help to demonstrate other benefits of using external partners and scaling up the private enterprise sector so as to multiply productive capacity.

5.5 Securities and Exchange Commission Action

It is widely understood the SEC is not very satisfied with IF performance and believes they are very passive portfolio managers. Currently, there are no obstacles for IFs and The Investment Fund Law is very similar to Croatia, where the IFs are more active. The converse would be the adoption of a fee and incentive structure that supports active management and sanction passive management. In RS, in response to the passive activity, the SEC plans to change the IF Law with the intention to convert the closed-end funds to open-end funds. It is expected that the amendments will be submitted in the 3rd Quarter 2009 and potentially they will come into force in the first half of 2010.

The major criticism of IF management is levied at the fund management personnel. The current fund managers were licensed approximately 5 to 7 years ago, and like other jurisdictions the SEC should adopt a program of training and upgradation of skills involving fund managers.

A disconnect exists, in that the current IF’s management support passive fund management but it is not a problem of the regulatory/legal environment, but rather a problem of skill levels, an possible fee and incentive structures. The issues of the structure of the IF, which are majority owned by the management company, remains an issue.
5.6 Recommendations

1. The Securities Commissions should review, and address limitations imposed to active ownership or concentration of ownership, the composition of supervisory boards and establish guidelines, benchmarks and compliance schedules to incorporate "IOSCO best practice" board structures.

2. We recommend assessing whether and how ownership structure affects IF (PIF) performance.

3. We recommend the players (stock exchanges, IF, securities commissions) adopt the theory stressing the importance of the quality of investors' protection by adopting and enforcing corporate governance.

4. As inherited debt is a source of tension as IFs become owners of formerly state-owned enterprises, many of the newly privatized enterprises immediately face the possibility of bankruptcy; the Government needs to address debt forgiveness of privatized companies.

5. Introduce amendments to the Investment Funds Law to convert IFs from closed-end to open-end funds

6. The staff of the Securities Exchange Commission should review management fee structures, calculations of management fees to enable restructuring of IF’s. In this regard, IF fee structures support active management and sanction passive management, the lack of management skills might be corrected.

7. *Implement an analysis unit to examine PIF financial condition and develop prospective information for restructuring/turnaround

8. *Develop evaluation criteria for restructuring candidates and short list of PIFs ready for ownership change and restructuring

9. *Estimate financing amounts and sources for debt relief and equity of VPEs PIFs that are good prospects for restructuring

10. *Implement vehicles for restructuring including equity funds, agencies, or Development Bank programs

11. Implement government debt for equity swaps in VPEs PIFs with heavy arrears to the government, to allow short-term government shareholder ship for managing restructurings

12. *Workforce downsizing in PIFs, consistent with labour code

13. *Modify securities laws to allow special funds (private, venture, other) to assist in enterprise restructuring process
6 Conclusions

This report reviews the previous range of strategies to address the issues and impediments presently inhibiting further development of privatization in Bosnia-Herzegovina. As important as recommendations for alternative strategies, is the order in which the strategies are implemented. That is, it is essential to implement strategies in the appropriate order or sequence. Market failure and structural weaknesses are important contributors to financial instability. The latter include issues such as accounting and disclosure, banking soundness, and prudential supervision. In order to minimize the risks associated with potential market failure, it is important that privatization sector restructuring be pursued with due care. In implementing remedial strategies considerable thought must be given to the need for orderly and timely implementation of reforms. Correct sequencing is significant in ensuring the successful realization of privatization sector development.

6.1 Concrete Suggestions to the BiH Government

✓ Information creation and wide dissemination to all participants, stock exchanges, securities commissions, IF, investors critically impacts the efficient functioning of financial markets as well as privatization system integrity. The implementation of relevant recommendations by IF managements, company managements, the Stock Exchanges (the drivers) should be taken at an early stage to lay the groundwork for Government policy actions in areas such as a continued privatization framework aimed at increased market liquidity.

✓ An active securities market, including greenfield new issues, is a precondition for a continuing Government led privatization and disposal of SOEs. In turn, privatization development depends on the soundness of IF management companies (open and close end) and financial institutions and requires that counter parties be able to assess creditworthiness on the basis of timely disclosure of reliable, accurate, financial information - such disclosure being supported by high quality accounting standards and an strong industry enforcement body.

✓ In addition to the BiH securities market's adopting IOSCO “Best Practices” for stock exchange operations it must be coupled with reform measures in the banking sector as well as with the introduction of a full disclosure regime and adoption of IAS 32 and 39 which are hence fundamental to supporting growth of new products, market making and liquid secondary markets.

✓ New investment products, including the expansion of open-end funds sector can only be introduced once the supporting framework is in place including more liquid primary and secondary securities markets and banking sector reform.

✓ The next step, based on the principles outlined above, it is recommended a stylized Roadmap be developed setting out time lines for implementation of key actions and detailing appropriate sequencing for the range of reforms. In reviewing the roadmap, it is critical to ensure that
coordination across agencies is necessary for undertaking reforms. Close co-operation and co-
ordination between different agencies is essential.

### 6.2 Strategic Independent View

The final chapter of BiH’s privatization story remains to be written, and its outcome may do much to
determine whether as Tie Sosnowski, wrote in the FIC *White Paper* “mark the beginning of a new era
in Bosnia and Herzegovina and that government officials will accelerate reforms in order to ensure
that the business environment is predictable and transparent.” However, it is not clear if change of
course will represents a shift towards a ‘contingency approach’ to the problems of privatization in
Bosnia, or whether it is simply a re-shuffling of orthodox transition strategies.

This, of course, requires an activist state-led industrial development strategy promoting and
directing investments with the well-managed and successful IF's (both PIF and the new open-end
funds), and worker retraining, entrepreneurship.

a. The strategic initiatives should have included, for example, an insistence on the creation of a
single, multi ethnic, state wide privatization agency in place of the dozen party-controlled
agencies that exist.

b. Another initiative is rigorous international oversight to prevent abuses within the voucher
component of the program including transparent standards to scrutinize potential buyers. It is
a more nuanced approach and it is balanced both politically and economically.

Finally, there are the arguments of Dragoljub Stojanov, Professor of Economics, University of
Sarajevo, in 2001, quoted by Timothy Donais at York University writing in *Southeast European
Politics vol. iii, no. 1,June 2002 pp. 3-19* “ The Politics of Privatization in Post-Dayton Bosnia”, “that
the rigid macroeconomic stabilization policies currently in place in Bosnia stifle any opportunity for
domestic-led recovery, and make economic revitalization unnecessarily dependent on external
capital and conditioning restructuring on privatization virtually ensured a prolonged unemployment
crisis in Bosnia.

Therefore, we recommend the construction of an analytical framework that can propose to study
possible privatization administrative changes with the effect to increase PIF (IF) company's
administrative efficiency, responsiveness, flexibility, enhanced risk-taking capacities, and create the
emergence and growth of new strategies and investment vehicles.

We recommend regulators, stock exchanges and investment managers revisit the question of the
potential danger of private benefits of control and the percent limits ownership including caps for
fund managers.
List of Appendices

Appendix 1: World Bank Corporate Governance Country Assessment Bosnia and Herzegovina, June 2006

Appendix 2: Croatian and Slovenian Mutual Funds and Bosnian Investments Funds, Czech Journal of Economics and Finance, 57, 2007

Appendix 3: Field Visits, November 24, 2008 - December 12, 2008

Appendix 4: Corporate Governance in the Federation of Bosnia-Herzegovina. Presentation to SASE. October 2008

Appendix 5: Transition in CEE: institutional framework and Typology, Pavel Ptáček, Department of Geography, Palacký University, Olomouc, Czech Republic

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