OECD Advisory Group on Privatisation

Thirteenth Plenary Session
Privatisation, Capital Market Development and Pension Systems Reform

Executive synthesis

The thirteenth meeting of the OECD Advisory Group on Privatisation (AGP) took place in Paris on 21 and 22 September 1999 on the subject of "Privatisation, Capital Market Development and Pension Systems Reform". The meeting brought together high-level privatisation officials and policy makers from non-member countries (Argentina, Bolivia, Bosnia-Herzegovina, Brazil, Chile, Estonia, India, Lithuania, Romania, Slovak Republic, Slovenia, Russian Federation and Thailand), experts from international organisations (Inter American Development Bank, IFC, IMF and WB) with senior privatisation officials and other representatives from 21 OECD Member countries (see attached final List of participants).

The topic of the meeting proved to be very timely. Seven papers focused on areas, such as post-privatisation performance of corporations, indirect effects of privatisation on capital market developments through resolution of political risk and the link between privatisation and pension systems reform. All presentations generated a lively discussion and provided the audience of policy makers and senior officials with a perspective on important issues, which are likely to shape privatisation developments in the future.

A number of conclusions can be drawn from the above presentations, panel interventions and the general discussion that ensued:

Privatisation and the changing landscape of global capital markets

- The privatisation process has significantly contributed to the on-going globalisation of the financial markets. In many countries, capital market development was an explicit objective of privatisation. Coupled with the broader desintermediation trend, it resulted in much deeper and more liquid capital markets, playing an increasingly important role in financing the corporate sector. In addition, the development of high-yield bond and derivative markets have led to the strengthening of the market for corporate control, allowing for post-privatisation restructuring to take off.

- Privatisation-related offerings on European equity markets have been the most important factor in equity market growth throughout the last decade. The capitalisation of certain European stock exchanges during the last five years grew by a factor of 2 to 4 due to privatisation. Major reasons for the underlying increase of demand are a benign macroeconomic climate, low interest rates and a switch from bonds into shares. As a result, the number of IPOs in the European countries of the OECD has now reached unprecedented levels, with approximately half of them related to privatisation. Moreover, in terms of market capitalisation and trading volume, privatised companies are among the largest ones in Europe, with an increasing number of large deals in the pipeline.

- Most privatisation-related offerings have had a strong retail component, which resulted in a significant increase of the number of small shareholders. Participation of retail investors in privatisation was a part of the capital market development policy objective, aiming to generate support for privatisation. Retail success was also helped by conscious underpricing and extensive incentives for retail investors. As markets grew and deepened, proceed maximisation objectives were consistently pursued together with the aim of building strong retail interest toward privatisation.

- Privatisation has contributed to innovation in global capital markets. Privatisation was *inter alia* responsible for the development of techniques like block trading and book building. Furthermore, privatisation has boosted advisor competition for major offerings; as a result, the market share of the leading banks has increased, whereas the fees paid by governments have fallen. At the same time, syndicates have become smaller and transactions have taken an increasingly global nature.

- Privatisation has helped change corporate finance patterns and along with desintermediation towards more market-based finance, it is changing the heavy reliance of European enterprises on banks. By tapping more liquid and deeper equity markets, companies acquire not only financing in a more cost-effective manner, but also a market value expressed in their share price. This allows them added flexibility in the way they approach other corporate finance sources and in the way they strategically position themselves in the changing industrial landscape.

- Privatisation changed not only individual company behaviour, but also the whole corporate governance environment. Privatised enterprises became more transparent in soliciting shareholders support, while on the other hand, residual shares owned by governments did not lead to interference on a day to day basis. Deep and more efficient capital markets and the rise of corporate bond markets have made more contestable the European markets for corporate control after privatisation. Privatisation is thus perceived as a driving force for the increased number of mergers and acquisitions in Europe, which has included take-overs of privatised companies themselves. The earlier reliance on "core shareholder" structures in many OECD countries seems to be fading. The stability *noyaux durs* used to provide is now, to a greater extent, ensured by domestic and foreign institutional investors.

- In contrast to the experience of OECD countries, the focus of privatisation on capital market development is less obvious in emerging economies. In most of these countries, direct sales to strategic investors are the dominant privatisation method. In transition economies in particular, privatisation has had little effect on capital market development. The non-traditional approaches, such as mass privatisation schemes did not yield the expected results in terms of market development. Privatisation funds and other market intermediaries did not develop to become effective players in an emerging primary market. On the contrary, countries like Poland and Hungary, which did not link capital market development to privatisation but focused on its role as a primary source of long-term corporate finance on the basis of a solid regulatory framework, have had more success in building equity markets.

Privatisation and pension systems reform

- The primary objective of pension reform is the provision of adequate, long-term benefits to the retired population. Promoting higher efficiency and growth of financial markets is an additional objective. Pension reform and the promotion of private pension funds requires a small core of sound, prudent and efficient financial institutions, such as banks and insurance companies. Together with macrostability, and an effective regulatory agency, these preconditions are important for the successful implementation of pension reform.

- The shift from pay-as-you-go to funded pension schemes implies considerable transition costs. Advocates of such radical policy change have been looking for ways of decreasing this burden, hence, the idea of explicitly linking privatisation with pension reform agendas. In Central and Eastern European transition economies, the financing of radical pension reform with privatisation proceeds was perceived as a historical opportunity, given that state-owned property had largely been built up by the efforts of the elderly and those who are now approaching pension age.

- Linking privatisation to pension reform can take various forms. Proceeds from privatisation can be earmarked to cover transition costs and channelled to the public scheme; they can also be credited to individual accounts in private pension funds; alternatively, there may be a transfer of securities to the new funded system.

- Bolivia developed a new approach of combining pension reform with the privatisation and capitalisation of state-owned enterprises. The government sold 50 per cent of the public enterprise shares to capitalise the companies and retained the other half for a "collective capitalisation fund" to finance the new privately managed system and pay out an annual basic pension to all elderly. The latter is managed by the same fund management companies and subject to the same investment rules as the pension funds, established in the framework of the reform process.

- Both the Bolivian precedent of direct use of privatised assets and schemes for crediting privatisation proceeds to individual pension fund accounts lead to an explicit, highly visible direct link between both agendas. This is not the case when privatisation proceeds are only earmarked in the budget to lower transition costs to a fully funded pension system. The Polish case has shown that there may be difficult choices between enabling citizens (i.e. future retirees) to tangibly profit from privatisation, and designing a fiscally sustainable transition to a funded pension system.

- In certain countries, privatisation provided pension funds with a broader range of equities for diversifying their stock portfolios. Pension funds have also emerged as important corporate governance players. In Chile, for example, the underlying regulatory and market conditions have led to a more active corporate governance role of pension funds, especially in shareholders meetings and in the election of independent board members. The corporate governance role of pension funds was, to a great extent, related to liquidity constraints (i.e. the difficulty of exit) and was particularly important for the protection of minority shareholders.

- Privatisation and especially pension reform programmes have important, long-term economic and political consequences. Therefore, linking both reforms, should be done after a careful consideration of the following questions: does the proposal help creating a sustainable and secure system of old age provision and covering the transition costs related to the introduction of a funded system; does it foster the main aim of privatisation, i.e. strengthening corporate governance and creating an efficient allocation of property rights; what are the distributive consequences, i.e. who are the winners and who are the losers?

- In conclusion, linking privatisation and radical pension reform might be attractive in the short term, but may hide important pitfalls further down the line. That is why there has been much discussion, but very little practical policy progress regarding the integration of both programmes. Privatisation and pension reform are two separate agendas with different objectives, that overlap only partially. Awareness of potential trade-offs is crucial when considering and designing a linkage between both reforms.