

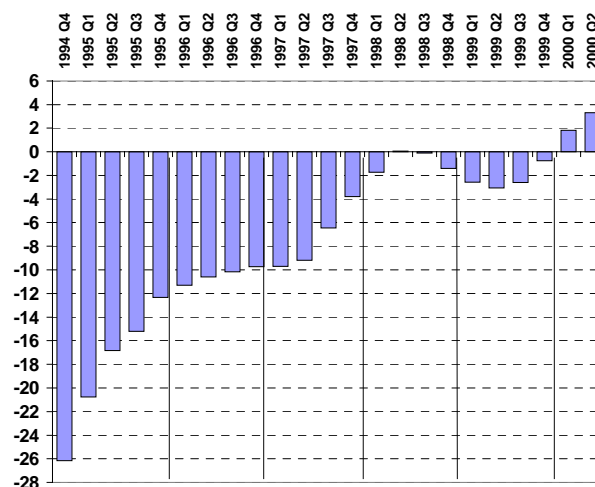
OECD
THE CORPORATE GOVERNANCE ENVIRONMENT IN UKRAINE
AND ITS IMPACT ON CORPORATE PERFORMANCE AND FINANCE

by Kostiantyn Shkurupiy

1. *The general economic context*

The year 2000 is the first one for the past 9 years when Ukraine managed to restore its economic growth (figure 1). Notwithstanding the scope of shadow economy that makes hard measuring the GDP, its officially reported level is only about 40 percent from the respective level in 1989. Economic decline in Ukraine was severe due to its heritage of energy-intensive industries exacerbated by huge budget deficits resulting from a slow pace of reform at the microeconomic level and government's tendency to live beyond its means. Although hyperinflation of the first years of independence was overcome in 1995, a combination of tight monetary and loose fiscal policies of the following years translated into rather fragile stability. In 1996-1998 the Ukrainian government has cut budget deficits and limited deficit financing from the central bank, although at the expense of substantially increased public debt and accruing budgetary arrears. As a result inflation fell to 10 percent in 1997 helping to slow the economic decline and the first symptoms of economic growth appeared in the second quarter of 1998. However, on August 17, 1998 the Russian crisis undermined the first signs of fragile stability and growth.

Figure 1. Ukraine: GDP growth, 1994-2000

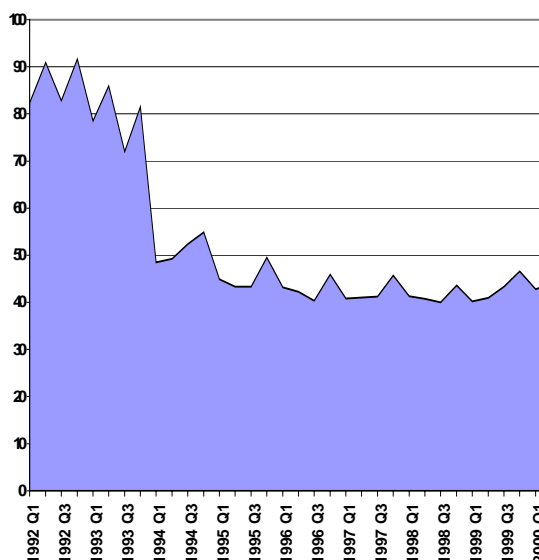


In the following weeks the exchange rate band that has already been under significant pressure since the beginning of the year moved from 1.8-2.25 UAH/USD to 2.5-3.5 UAH/USD, and in two weeks it reached the upper end of the new range. Along with devaluation, inflation increased significantly reaching about 20 percent for the year and output turned out again. Economic decline became inevitable and by the end of the year attained the level of 1.7 percent. Although debt-servicing crisis, devaluation, increased inflation and economic decline were provoked by the Russian crisis, in its nature it was the Ukrainian crisis of a short term public debt that revealed an underlying lack of structural reforms in the country. In the end Ukraine managed to work out with its creditors a restructuring scheme for the most of the debt, reducing the debt-servicing burden to more sustainable levels, at least for 1999.¹

¹ See "Ukraine. Restoring growth with Equity: A Participatory Country Economic Memorandum", World Bank Country Study, Kyiv, 1999.

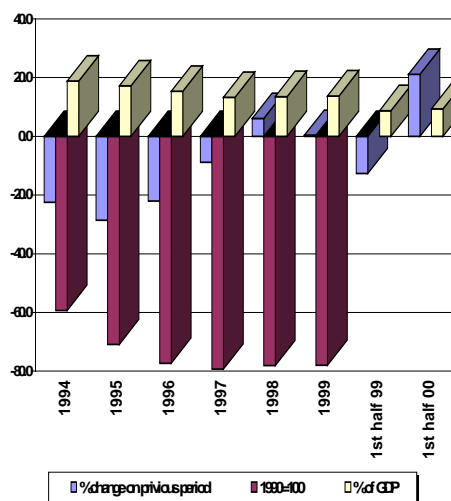
Results of the first half of 2000 reveal a continuation of a positive tendency of industrial output growth that started at the end of 1999. While just 4 out of 10 major manufacturing sectors demonstrated positive growth by the end of 1998, there were 6 growing sectors in 1999 and 8 according to the results of the first quarter of 2000 (figure 2). High growth rates were characteristic for such export-oriented sectors as non-ferrous metallurgy (23.2%), ferrous metallurgy (16.4%) and chemical and oil refineries sector (8.2%). For the first time such sectors as mechanical engineering and machine building revealed positive growth rate (6.9%). Constantly increasing growth rates are observed in light industry (31.8%), food (30.8%) and wood processing industries (33.8%).

Figure 2. Industrial output, 1992-2000



Investment activities for the first 7 years of independence were constantly shrinking and in 1997 accounted for only 21.7 percent of the level of 1990 (figure 3). Since then investments started to expand both in real terms and as a share of GDP. In the first half of the year 2000 the scope of investments increased by 21.1 percent in compared to the same period of the last year, and the share of investments in production sphere increased from 69.4 percent up to 73.9 percent. At the same time, the share of investments in manufacturing in the total amount of investments has been constantly increasing and reached 48.1 percent in the year 2000 starting from 37.2 percent in 1995.

Figure 3. Capital investments



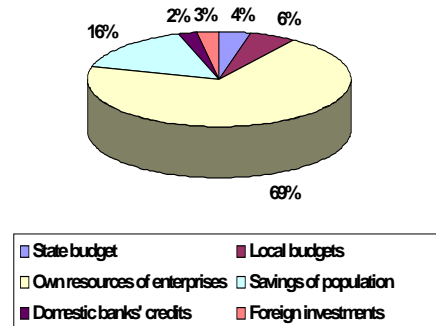
The main source of capital investments for enterprises was and still is their own revenues (figure 4). Increasing scope of overdue payables and receivables in the economy uncovers the fact that capital investment is being financed through accrued debts for investment goods and expansion of barter schemes. Only 3.8 percent of investments were financed from the State budget (for comparison, in the first half of 1999 – 7.8 percent), which could be explained by predominant spending of scarce budgetary resources for debt servicing and financing social programs. Amount of

credits provided by commercial banks increased both in absolute terms and as a share of total financing up to 2% in the 1st half of 2000 from 0.8 % in the same period of 1999.

Secondary issue of shares of joint stock companies becomes an important source of funds for some enterprises.

As of March 1, 2000 there were 78 new issues of shares with total value of 889 mln UAH. Enterprises in this way managed to raise funds up to 119.9 mln UAH, which is 4.9 percent of total registered volume shares. The biggest issues of shares were made by two mines – 112 mln UAH and 107 mln UAH respectively, and one metallurgical plant – 240 mln UAH.

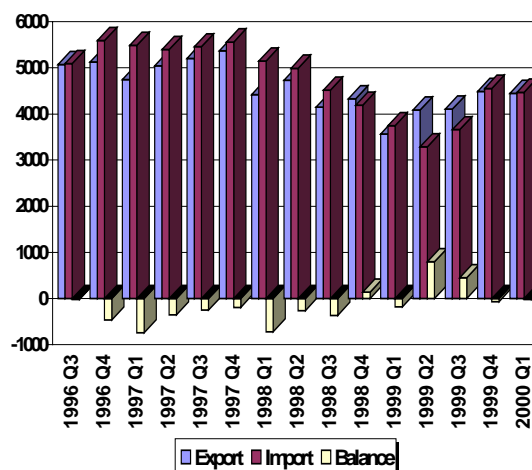
Figure 4. Structure of investments by source of funds, 1st half of 2000



Flow of foreign direct investments in Ukraine started to gain speed in 1999 only. As of January 1, 2000 the stock of FDI accounted for 3247.9 mln USD and it increased by more than 60 percent just in the course of 1999 (for comparison, by January 1, 1999 it remained at the level of around 2 bln USD). In the first quarter of 2000 245.3 mln USD of FDI have been already attracted, which is 1.5 times more than in the same period of the last year. However, it is still several times less than Poland or Hungary both in absolute terms and on per capita basis. The fact that in 2000 Ukraine witnessed substantial increase in the scope of foreign direct investments is one of the important positive signs since the financial crisis of 1998.

Foreign trade is one of the most dynamic sectors of Ukrainian economy. During the period of 1994-1997 the turnover of foreign trade was steadily increasing. Thus, export increased by 22.3 percent and import by 21.6 percent. For the last two years (1998 and 1999) Ukraine witnessed decline in foreign trade. In 1999 the volume of export of goods and services was lower than in 1994 by 407 mln USD, while the volume of import – by 2770 mln USD. Due to

Figure 5. Foreign trade balance, 1996-2000



a substantially larger reduction of import one can see a positive balance of trade at the very end of 1998 and 1999 for the first time since 1994. It was partially due to Hryvnia's devaluation as a result of a financial crisis of 1998.

The first quarter of 2000 was rather favorable for foreign trade in Ukraine: export of goods and services totaled 3507 mln USD and import – 3935 mln USD, which means that volume of export increased by 24% compared to the respective period of 1999 and volume of import grew by 19.4%. However, commodity structure of the Ukrainian export deteriorated. The dominant position in export belongs to metallurgical sector (42.3%), mineral products and chemicals. At the same time, together with economic growth Ukraine's dependence on import of manufacturing products escalated. While in 1999 the ratio of import to output was 44.45 in the first quarter of 2000 it amounted to 61.5% and in the first half of the year – 62.1%. It happened mainly due to a substantial raise in the volume of imports of fuel relative to domestic production.

Ukraine's trade links with CIS countries and mainly with Russia contributed to its economic problems after the financial crisis of 1998. Although Ukraine has diversified its exports and imports since the breakdown of the Soviet Union, Russia remained an important trading partner. More than 55% of import is coming from the CIS countries and export from Ukraine to those countries comprises about 30%. Out of that Russia is still a major trade partner with a share of 78% of import and 55% of export. More important than the initial Russian devaluation in 1998 were the impact of the Russian default on global capital markets and the impact of economic decline in Russia on its demand for imports from Ukraine.

2. *Historic perspective of corporate governance in Ukraine*

Ukrainian corporate governance patterns originate from earlier nineties and inherit many negative features from the environment of transition period.

The Soviet law on enterprises of 1987 gave considerable freedoms to enterprises, mainly to their managers and to the working collectives. Public (or ministerial) control had gradually subsided. Civil control was formal and weak, and in addition it was not supported both institutionally and legally. Meanwhile, enterprises continued to operate under the conditions of soft budget constraints and of stable state order, which guaranteed the enterprises an access to very cheap inputs and financial resources. State banks enthusiastically provided enterprises with credits without guarantees of their repayment from future income. Enterprises also received direct financing from the budget and state subsidies in various forms. Budget expenditures for the support of enterprises and industries in Ukraine in 1991 constituted 45.8 per cent of expenses of the consolidated budget of Ukraine (or 15 per cent of GDP). In line with socialist traditions, enterprises purely fixed costs and profit in accounting reports and profit in documents gave no tangible advantage for them, while losses did not change their behavior. Motivation of labor in industries in contrast to cooperatives and joint ventures with foreign firms was very weak.

Declaration by Ukraine of its independence in 1991 and subsequent adoption of a number of legal acts by the Ukrainian parliament, which largely comprised of the “red directors” and their supporters, had radically changed existing system of governance.

Firstly, Ukrainian enterprises were no longer subordinated to Soviet ministries in Moscow. At that time many key industries of Ukraine had neither their own ministries nor resources to institute them and to provide their efficient functioning. Management and control for such enterprises were vested into national regulatory bodies, which ultimately failed to successfully accomplish their mission. Secondly, liberalization of prices in January 1992 synchronously with the Russian one and other dramatic changes in economic life meant the beginning of transition to market economy. Enterprises understood that the government sooner or later would force them “to live within their means”, i.e. to take decisive measures aimed at creation and observation of hard budget constraints. Thirdly, liberalization of foreign trade, which formerly was strictly controlled from Moscow, opened new horizons for enterprises and management especially in view of subsidized production system and existing exchange rate policy. Fourthly, one of the first decrees of the Parliament of independent Ukraine was to liquidate the Workers’ Control Committee – the only remaining at that time national institute of civil control for the management of enterprises. Fifthly, it became evident that the revolutionary reform of the property rights system is on the agenda of time.

Principal-agent model: implications for transition economies. The whole notion of principal-agent model in transition economies has rather perverse nature. In comparison with the former Soviet Union with its overwhelming control over the management exercised by the state, the whole idea of who is the “principal” and who is an “agent” in terms of corporate governance remained rather vague in Ukraine. In the previous system, where administrative methods were predominant, it was quite clear for the top managers of enterprises who were their principal and what type of system of remuneration and punishment did it imply. First and foremost, managers were supposed to fulfill and overfulfill plan targets set by proper ministry on behalf of the state. A complicated system of remuneration allowed top managers not only to receive decent salaries and high bonuses, but also to have an appropriate apartment, to be exposed to high quality recreation facilities, and to become people’s deputy at local or even central level as the highest benefit. Second, they knew what would have happened if they failed to fulfill those plans, namely, they would have been fired and maybe even expelled from the Communist party, which would have meant a termination of their carrier path. Third, there were three types of control over the management in their work exercised by the state itself, by party leader and by the KGB representative. In addition, there was a so-called People’s Control, which was in fact another form of state control. All these types of control ceased to exist for Ukrainian enterprises once they have been privatized and were supposed to be replaced by private owners’ control. However, under the conditions of a dispersed ownership and small packages of shares allocated free of charge, managers perceive themselves as the “only true owners of plants and factories” and do not treat their employees with small packages of shares as “principals”. Lack of control on the side of the state over the corporate behavior of managers and on the side of the new owners led to the situation when “red directors” managed to acquire *de facto* overall control over the companies and started to substantially benefit from their operation.¹

In this situation “red directors” were gradually becoming *de facto* masters (having right to dispose) of assets and profit of enterprises, launching the era of shadow economy and corruption in Ukraine. Probation of “schemes” for self-serving, self-dealing via leech firms, stripping of assets, dubious bartering, flowing of capital

abroad, etc. took place at that time. Understandingly, that part of gained capital was used to corrupt government officials and as pay to criminal and semi-criminal groups, which provided protection and support to businesses as well as contract enforcement.

In such an environment the political decision on mass privatization and corporatization of enterprises was finally made. No doubt, it was uneasy decision in view of correlation of forces in the Parliament and in the society. Long and dramatic process of privatization in Ukraine has created qualitatively new situation when the former “red directors” had to choose between preserving *status quo* in a new corporate dress or to try to introduce new form of economic organization – the corporation.

3. *Ownership structure and patterns of control*

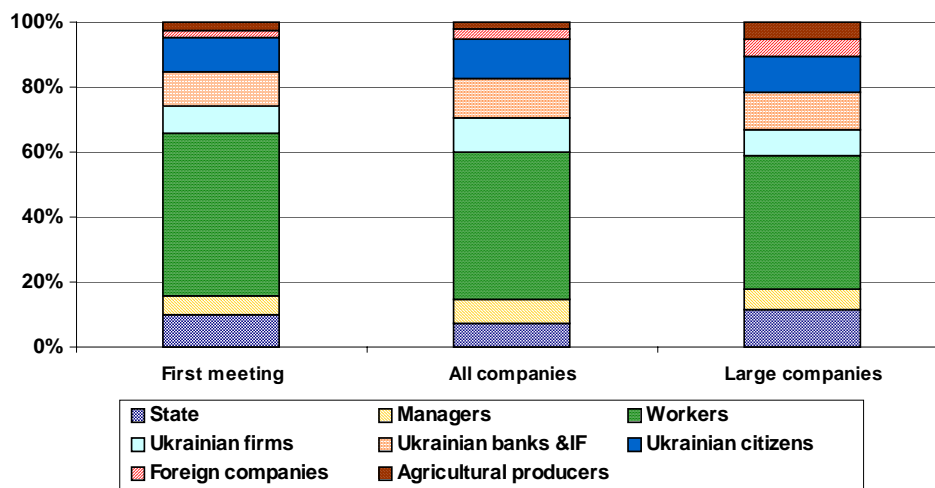
Ownership structure of Ukrainian companies emerged as result of privatization processes of the last 8 years with all its peculiarities and deficiencies. The process of privatization in Ukraine could be divided into stages, the first three of that were almost finished by 1998. At the first stage, privatization was carried out on a rather trial basis only at those enterprises that were willing to be privatized. Then, the parliament suspended *de facto* privatization. The second stage was further used for discussing the ways of carrying out privatization. This indecisiveness ended when the president through presidential decrees of November 1995 pushed privatization into its third stage, mass privatization. The next stage of privatization was focused on attempts to substitute “voucher” privatization with the sale of state property for cash, to encourage significant investments both local and foreign, and to improve the fiscal situation in the country. The first attempts to carry out cash privatization started in April 1996 with commercial and non-commercial tenders, cash auctions and sales for cash at stock exchange. This process contributed to determining the real market prices estimation of which sometimes was distorted by the discretionary asset valuation.

The most recent survey of 250 enterprises conducted by London Business School jointly with the Institute of Reforms allowed to explore evolution of the ownership structure of medium- and large-size companies in Ukraine since the first shareholders meeting until the spring of 1999, a period which covers the Russian crisis of August 1998 (Fig. 6). The most important question is whether insiders or outsiders dominate in the ownership structure of the Ukrainian companies and whether there is any major shift towards one or another dominant owner. These issues are crucial for the following analysis of corporate governance and corporate behavior of companies in transition economy of Ukraine. The above mentioned survey provides evidence for the fact that insider ownership remained on average virtually constant at 55%, although there is some indication of the fact that workers are either selling their shares to managers or keeping their shares as they change job (hence becoming “former workers”). However, there is no overall shift from insiders to outsiders and only a very small shift from the state to outsiders. The evolution in ownership structure that Ukrainian firms probably need to see² before we get widespread restructuring has not begun yet according to the survey.

² The typical movement in ownership structure of post-privatization companies would have been along the following directions: workers selling their shares to outsiders and managers; insiders selling shares to outsiders; state selling to outsiders; concentrated majority outsider ownership emerges as strategic blocks of shares change their hands.

Moreover, there is a little evidence of increasing concentration of ownership by outside owners. In fact investment funds on average now have less shares than at the

Figure 6. Ownership structure of Ukrainian companies



time of the first shareholders meeting, though other Ukrainian firms and citizens have increased their share in ownership structure of companies in the sample. There is, however, some increase in the average shareholding of foreign firms, which is an encouraging sign, though only from 2% to 3.2% on average.

If ownership structure of all companies were compared to the one of large companies³, it would have become clear that on average state retains slightly higher share in large companies, and insider ownership is on average 47.4 percent, which is more than 7 percent less than for the whole sample. Foreign companies possess much higher share in large companies than in an average Ukrainian firm. It is partially due to the fact that Ukrainian oligarchs acquired those shares through their own offshore companies. The very limited role played by Ukrainian banks in enterprise corporate governance is also highlighted in Attachment 1, namely, their share increases slightly but remains on average below 1.

The survey also provides additional evidence on corporate governance and strategic ownership. It was found that in the average firm, the number of managers holding shares is around 15, while the number of workers is 599. Holding by Ukrainian citizens and firms are also highly dispersed, at 1065 and 616 shareholders on average respectively. However, the typical number of shareholders, which are banks, foreign individuals and foreign companies, is one, and of investment funds is two.

Finally, if we regard changing senior management as an important element in effective corporate governance, there is clear evidence that percentage of companies that changed general manager is rather high. It is worth mentioning that outsider ownership yields more effective governance than insiders with a considerably higher proportion of firms having changed their general managers since 1994 (57.95% and 39.20% respectively). The state also appears to impose effective control over the

³ Defined as companies with more than 1000 employees.

firms with majority state ownership with the vast majority of general managers having been changed since 1994 (83.33%).⁴

Another important dimension of corporate finance refers to investment activities of companies in the sample (See Table 1). Irrespective of their type of ownership, 17% of the companies did not invest in fixed capital since 1992 at all. Those that have been investing reduced substantially the scope of investments and only few increased it in relative terms. With respect to the preferences for the future it is clear from the survey that retained earnings is the most favorable source of funds for investments. Foreign direct investments and bank loans follow it and there are clear reasons why enterprises refuse to finance their investment activities using loans from the banking sector (mainly short-terms credits are offered by banks with exceptionally high interest rates). Only few enterprises are planning to raise funds through issue of equity or bonds. It is interesting that those companies that prefer to issue equity or bonds have either very substantial power of insiders in the ownership structure (between 60 and 98 percent) with a solid managerial share (up to 18 percent) or are dominated by outsiders (Ukrainian firms or Investment funds) that possess up to 67 percent of shares.

There is a wide spread hypothesis that companies with insiders', especially managerial control, under the fear of outsiders' interference refuse even to consider issue of shares as a way to raise capital for investments. There is no clear evidence either for this hypothesis or for the alternative one in our sample. Those several companies with predominant insiders' ownership that admitted issue of shares as possible way of raising capital most likely are just exceptional cases, and cannot be used as a tool for rejecting hypothesis. Moreover, sometimes managers possessing a much larger stake through a spin-off company than the one directly registered as managerial block of shares are interested to issue additional shares and to buy them on behalf of that company in order to gain control over the enterprise. In general, it is clear that in majority of cases issuing shares or bonds in the Ukrainian context is extremely cumbersome procedure with extremely high transaction costs and, finally, the one that most likely would not yield required resources. There are several reasons behind that fact. First and foremost, there is no demand for corporate securities in Ukraine at large and, second, a lack of skills to advertise and place them properly adds to the problem.

Table 1. Preferable sources of investments for the Ukrainian companies, percentage of companies

Retained earnings	13.2%
Issue Equity	3.3%
Issue Bonds	2.4%
Bank Loans	7.1%
Foreign Direct Investment	10.4%

⁴ See S.Estrin, A.Rosevear "Ownership Changes in Ukraine and the Implications for Government Policy", Economic Essays, Issue 1, Kyiv, 2000.

The absence of an effective owner in many enterprises that have been already privatized is the price of the politicization of the process of fast privatization to insiders. Diffuse ownership can be an obstacle to good corporate governance as the ability of outside owners to influence the enterprises' management increases with the size of share holdings. There are several indicators of rather modest restructuring of enterprises irrespective of their ownership type. However, patterns of corporate behavior are slightly different for insider- and outsider-dominated firm. Table 2 reports on changes in corporate behavior across various activities on a scale from 1 (no change) to 5 (everything has changed) by ownership.

Table 2. Restructuring by ownership since 1991

	State owner dominated	Private owner dominated	Insider owner dominated	Outsider owner dominated
New investments or change in technology	1.92	2.23	2.25	2.26
Changing suppliers	3.42	3.15	3.23	3.05
Disposing of social assets	1.04	1.22	1.56	1.89
Disposing of assets (other than social assets)	2.00	1.45	1.38	1.56
Closing of plant/shop	1.75	1.42	1.33	1.52
Changes in management structure	2.75	2.31	2.18	2.53
Changes in management personnel	3.08	2.44	2.40	2.56
Change in composition of Board of Directors	2.45	2.07	1.98	2.29
Seeking foreign investors	2.75	1.99	2.00	2.01

Where: 1-no change; 2-small amount of change; 3-moderate change; 4-a lot has changed; 5-everything has changed.

Data in Table 2 reveals the fact that in 4 out of 9 activities companies on average are doing less than “a small amount of change” irrespective of ownership type (e.g., disposing of assets and social assets, closing of plants). Only in changing suppliers all the companies demonstrate more than moderate changes. It is worth mentioning that with respect to changing management structure, personnel and composition of Board of Directors companies with state prevalence are the most active ones, followed by outsider-dominated firms. It is obvious that insiders as owners are the most conservative in this area.

Official data of the State Securities and Stock Market Commission (SSSMC) for 379 companies is another source of information that provides evidence on ownership structure of the Ukrainian companies. According to the data one can see the following significant owners: physical person, foreign company or bank, Ukrainian enterprise or bank, Ukrainian investment fund or holding company and the Ukrainian state. Table 3 reflects the ownership structure of these companies and share of the most significant owners (who possess at least 5% of shares)⁵.

⁵ See A.Pivovarsky, How does Privatization work? The Evidence from Ukraine. August 16, 2000

Table 3. Significant Owners of Ukrainian Companies

Type of owner	Largest Significant Owner		Large significant owners of large companies	
	Number of firms	% of total	Number of firms	% of total
Managers	NA	NA	0	1.63%
Physical person	30	7.92%	0	0.77%
Foreign company or bank	26	6.86%	6	17.06%
Ukrainian enterprise	4	1.06%	0	0.20%
Ukrainian bank	2	0.53%	0	0.00%
Ukrainian investment fund or holding company	25	6.60%	1	2.58%
Other Ukrainian company	61	16.09%	2	11.84%
Ukrainian state	183	48.28%	11	32.14%
Dispersed ownership	48	12.66%	8	33.77%
Total	379	100%	29	100%

Ownership structure of 29 large companies and the one for the whole sample presented in Table 3 are quite different. First of all, foreign company or bank possesses much bigger stake in large companies, which corresponds to the same fact for the survey of 250 companies. Second, according to the data of SSSMC Ukrainian state retains much smaller stake in large companies than for the whole sample and dispersed ownership is much higher for the large companies, which is self-explanatory. It is worth mentioning, however, that dispersed ownership in this case refers to all the owners that have less than 5% of shares. Third, Ukrainian investment funds and holding companies possess smaller stake in large companies than in the whole sample. Finally, there is no single case when a physical person possesses any significant stake in a large company.

4. *The role of major shareholders*

Designers of privatization program planned that on certain stage major shareholders would occur. Among larger shareholders they saw, first of all, investment companies and investment funds, banks, trust companies, working collectives, managers, business partners, foreign investors and newly established companies. Reformers hoped that they would play dominant role in corporate governance, undertake and implement needed restructuring of enterprises, in other words become effective owners, but as a whole it did not happen. Trust companies after collecting vouchers and savings of population disappeared. Investment companies and investment funds of enthusiasts, which exchanged their certificates for vouchers, invested them in a number companies, which under the conditions of economic crisis needed expensive restructuring. The best in such situation that could be done by those investment

companies and funds without sufficient financial resources was to take wait and see position in a hope for better future. With a few exceptions, Ukrainian banks had no sufficient financial and human potential to be involved in serious restructuring of enterprises. In cases, when banks had no majority control in companies, they preferred to play the role of ordinary portfolio investor or simply to sell their blocks of shares.

Managers of privatized companies, who recently desperately fought for the right to acquire 5 per cent in their enterprises, didn't change their behavior and did their best to preserve *status quo*. In some enterprises more flexible and market oriented management succeeded to use lease-buyout way of privatization. Taking advantage of hyperinflation working collectives acquired significant share in their companies for nominal price paying with devaluated money. Moreover, in some of them in fear that workers resell their shares on secondary market management established joint stock companies and shares of working collective were invested to form their statutory funds. The objective of these newly established companies was to exercise centralized management of these privatized enterprises. In many cases performance of such enterprises was much better than of the rest. In one of the largest Ukrainian companies - Mariupol metallurgical plant Illycha – newly established joint stock company Staly-Illich that exercises management on behalf of the majority of workers succeeds in that and is lobbying in the Parliament a special law, which allows to sell the remaining 50 per cent block of shares to this JSC. Closed joint stock company “Working Collective of Mykolaiv Alumna Plant” controls 26.4% of one of the most attractive alumna producing factories and holds its important role in management even after strategic investor came.

Fast process of initial accumulation of private capital, which began in the late eighties after cooperatives appeared and was accelerated after the fall of the Soviet Union, initiated the formation of financial and industrial groups in Ukraine. Cooperative and criminal capital, stripped funds and skimmed profit of enterprises as well as grabbed budgetary resources were channeled to the statutory funds of investment companies and investment funds, trust companies, banks and newly established companies. A great deal of this capital has come in legalized form from abroad mainly from offshore zones. Not being officially formed as financial industrial groups on the basis of formal criteria they are in fact typical banking-industrial holdings. Main objectives of such amalgamations were to take control over group of enterprises or sectors of industry and their financial flows. Control has been achieved by acquisition of shares in privatization and at the secondary market, accesses to the management of the state holdings in these companies, by transfer of their accounts to affiliated banks, by acquisition of assets during the bankruptcy procedure, etc.

Dubious history and their initial capital, past and present technology of work make these groups conceal any kind of information regarding them. It is extremely difficult to figure them out clearly in horizontal and vertical planes, to assess accurately their financial might, spheres of their control and all affiliated entities. Negative perception of these groups by the society could be illustrated by informal label stuck to them - clans and oligarchs. According to different informal estimates these industrial and financial groups control 30-40 per cent in some industries. The most attractive sectors for the activities of these groups are energy generation and distribution, gas and fuel supply, metal production and mining, in some segments of engineering and

agricultural sectors. The role of financial and industrial groups in corporate governance in Ukraine may be at present evaluated in the range from very positive to extremely negative depending on many factors in every case, such as sector of industry, regulatory environment, tasks and ways of their achievement, etc.

As a rule very important role in these industrial and financial groups belongs to banks. Analysis of banking activity in Ukraine shows that Ukrainian banks still do not play a significant role in corporate ownership. The share of banks' holdings in stock companies comprises not more than 1 per cent and the share of their capital invested in equities does not exceed this figure either. Total investments of Ukrainian banks in corporate securities at the beginning of 2000 were 1.917 billion UAH, 891.66 million of which were in form of long-term investments while the rest amount was invested for speculative operations with the securities. Banks that are part of corporate groups own large stakes in enterprises connected with banks' principals in their activity. Currently members of these financial and industrial groups practice additional issues of shares and issues of corporate bonds since in this case they have a chance to find support of other members and their bank that would guarantee underwriting for these securities. For instance, during 1999 the State Securities' Commission registered additional issues of shares for the total amount of 1.474 billion UAH only (the larger part of issues belongs to banks themselves, since they are under permanent pressure of the National Bank of Ukraine to meet the requirements on the size of their statutory capital), while corporate bonds were not issued at all.

Tables below illustrate the amount of speculative and long-term investments of banks into corporate securities.

Table 4. Bank speculative investments into corporate securities
(million UAH, January 2000)

Name of bank	Amount	Rating
Ukraina	74.14	1
Privatbank	71.83	2
Nadra	67.19	3
Aval	35.79	4
Ukrkomunbank	19.4	5

Table 5. Bank long-term investments into corporate securities
(million UAH, January 2000)

Name of bank	Amount	Rating
Slov'yanskiy	85.14	1
Oshchadbank	84.48	2
ING Bank Ukraina	29.82	3
Prominvestbank	27.97	4
Ukraina	15.09	5

Foreign strategic investors are considered to be one of the most effective types of owners in Ukraine. Many of them practically demonstrated impressive results even in not the best time for Ukrainian economy. They brought revival in the whole sectors of production such as tobacco, soft drinks and beer, to some extent in food industry, confectionery, etc. Such investors as a rule make big investments in their companies, bring advanced technologies and implement substantial restructuring of their enterprises. They are considered to be fair taxpayers and law-abiding business entities. From the point of view of corporate governance their role is extremely important since they show to the Ukrainians that even in such a situation successful and fair business is possible.

Meanwhile, there were also attempts of some world producers to remove local manufacturers from the market and to destroy them by taking control through affiliated offshore companies and Ukrainian entities. In such cases it was too hard to prove that the target of acquisition was to destroy a Ukrainian competitor. To avoid this problem the Program of privatization for 2000-2002 gives priority to “case-by-case” privatization and to so-called “industrial” investor (foreign or local manufacturer, or consumer, or supplier, other than offshore company, interested in preserving the share of privatized enterprise on the market and the one that has been producing the same products for more than three years). Apart from this, in some cases strategic foreign investors, primarily from Russia, bring into Ukraine poor corporate culture and unacceptable standards that spoil weak Ukrainian corporate governance.

The role in corporate governance of other institutions such as insurance companies and pension funds is extremely minimal. The point is that Ukrainian Parliament has not adopted new laws on pension reform, which envisage creation of a new two-pillar pension system with private pension funds as a voluntary element. Until now so-called private pension funds operated primarily as insurance companies and are affiliated with large companies and banks. Their direct investments in corporate equities are very insignificant and as a rule are made through the main bank. Peculiar feature of Ukrainian reality is that these insurance companies and pension funds lobby the rules, which allow them to invest more in real estate and banking sector and minimize requirements to invest in corporate securities. For this reason their investments in corporate equities are so far very low and role in corporate governance is almost invisible. Current situation and existing trend does not correspond to the large potential of insurance companies and private pension funds in corporate ownership.

Credit unions are non-profit deposit and credit institutions for owner-members. They are essentially cooperatives in which the members lend money to themselves. They offer low-end services to individuals and small-business, and maintain smaller spread between loan and deposit interest rates than do commercial banks. Credit unions operate under supervision of the National Bank of Ukraine and are not allowed to invest in any securities, including corporate ones.

The biggest large owner in Ukrainian corporations remains to be the state. The system of exercising the state's management and control in joint stock companies is rather complex and not transparent. This management and control is exercised by several state institutions and lacks coordination, unified strategy and transparency. For instance, management is exercised by the State Property Fund of Ukraine (SPFU), in some cases this right is given to the local branches of SPF or to the local government, in some cases blocks of shares are transferred to the state holding companies and to other legal entities. The process of transferring and objectives of transfer itself very often are neither clear nor transparent. Control for the use of transferred property has not been efficient. The state practices general but not individual approaches to enterprises. For instance, this year government ordered all enterprises with state's stake to allocate 50 per cent of their net profit for dividends regardless of plans and position of the rest of shareholders. In many cases decisions on transfer and management of state property are issues of corruption of government officials and cronyism. On the other hand, in case of unprofitable and unattractive companies officials very often simply forget about their existence, do not attend shareholders meetings and do not participate in the work of corporate bodies. Some regional leaders do their utmost to get such a control and force managers of these enterprises to finance and participate in different local projects and social programs. Even in the cases with large companies managed directly by the SPFU officials sometimes pursue their short-term bureaucratic interests that are absolutely different from the objective of corporations – maximization of profit. For instance, in view of the latest oil crisis in the world the government cancelled oil auctions and ordered Ukrainian natural oil producer Ukrnafta to sell its oil to the State Reserve for fixed price. Such a decision of the largest shareholder of Ukrnafta being politically correct in general does not coincide with the position of the rest of shareholders that insist on maximization of profit. This is a typical conflict of interest, which occurs at almost all the enterprises with the state's stake.

To be objective, we must note that in some companies where the state retains its stake the level of corporate governance is rather high and performance of these enterprises is comparatively good. This phenomenon is explained by the situation, when management sees the way to survive in playing fair game with the state and in respecting interests of the rest of shareholders.

5. *Corporate behavior, finance and restructuring*

At present the process of corporate groups formation is only in its initial phase. For the case of Ukraine it seems to be natural that formation of corporate groups follows the creation and upgrade of strong corporations. Existing corporate groups in form of state holding companies, for instance NAK "Naftogaz Ukrainy", "Ukrzaliznytsya", etc., can not be considered as valuable corporate groups since they have been created artificially, undergo the permanent process of reorganization and restructuring and exist to service state interests. Last year Ukraine witnessed the process of the beginning of corporate group formation around companies, which had passed certain period of maturing in their development. River shipping company "Ukrrihflot" started to purchase river ports in the cities on Dnipro and Desna rivers. Chemical factory "Stirol" bought the stake in Tripilyvskiy biochemical factory. In the city of Mariupol four joint stock companies decided to form corporate group "Azovmash".

Formerly these companies were united in one production and research amalgamation and were split into separate legal entities in the process of privatization. After several years of separate functioning they decided to form a group to restore their position on the market. The same process is going on in metallurgical, coal and iron ore mining, coke industries as well as in food processing and soft drinks industries.

General rule of return on equity, which is an amount, expressed as a percentage, earned on a company's common stock investment for a given period and calculated by dividing common stock equity (net worth) at the beginning of the accounting period into net income for the period after preferred stock dividends but before common stock dividends is not applicable for Ukraine now. The reason is that the majority of Ukrainian joint stock companies, which were devastated by a long period of privatization and economic crisis, are at present loss makers or just begin to show small profits. That is why such an indicator can not characterize how effectively money of investor worked. Normally investor in Ukraine estimates an expected return on equity, which refers to the nearest future.

The State Securities and Stock Market Commission (SSSMC) provides with official data on the Ukrainian stock market. According to the Report at the beginning of 2000 there were 35.260 joint stock companies, including 11.850 open JSC (33,6%) and 23.410 closed (66,4%), in Ukraine Capitalization of the stock market in nominal value of shares was 31,021 billion UAH. *Emerging markets Factbook 1999* presents data on market capitalization of listed companies in Ukraine as a percentage to GDP, which is more or less comparable to such countries in transition as Slovenia, Slovak Republic, Poland and Latvia.

In the course of the last years the sources of financing the corporations have not significantly changed. The largest providers of capital to corporations in Ukraine are commercial banks, which by the beginning of 2000 issued loans to the corporate sector in the amount of UAH 21.131 billion (compare with additional issues of shares for the total amount of 1.474 billion of shares and no issues of corporate bonds in 1999 at all). Meanwhile, overdue loans to companies amount for UAH 3.615 billion, deferred loans amount for UAH 1.766 and bad loans amount for UAH 692 million. Besides this, companies are seeking other forms of attracting capital. In additional financing of companies very important are budget expenditures for the national economy although their amount has declined from 21.8 per cent of GDP in 1994 to 6.9 per cent of GDP in 1998. Besides direct financing from the budget, Ukrainian companies in a number of sectors could receive additional financing from the sectoral funds of financial regulation, which have been formed at the expense of additional taxes and collections or at the expense of reduction of taxed profit. State support to enterprises is often provided from the innovation funds. In accordance with the Regulation on state innovation fund one of its functions is to render financial, material and technical support to the enterprises in introduction of new technologies and new products, assistance in reconstruction of enterprises aimed at production of competitive goods, creation of new jobs. Meanwhile, this support is provided to selected enterprises based on rather subjective criteria. Another widespread form of financial support from the state is the use of reserve stock from the State Material Reserve and stock of the state resources. According to the Ukrainian legislation, one of the functions of the Reserve is to provide state support to selected sectors of national economy, enterprises and organizations in the event of temporary disruptions

in supply of raw materials, food staff, fuel and energy resources, in the event of occurrence of supply and demand imbalance in the domestic market. Another important form of attracting capital are targeted credits of commercial banks authorized by the government (e.g. to enterprises in sugar, coal and shipbuilding industries), and granting government guarantees for foreign loans. In 1992-1998 the amount of foreign export credits received by the government or under government's guarantee constituted more than USD 2.5 billion. By September 1, 2000 areas of enterprises to the budget for such credits amounted to around USD 974 million. According to some estimates state payments constitute around 90 per cent on guaranteed loans. The biggest share in the total amount of credits under guarantee of the government belongs to the companies in agriculture, in agricultural machine building sector, in machine building and chemical sectors. In order to change behavior of debtors the government plans to start in November 2000 special auctions on bad corporate debts to the government with the discount of 50 per cent. In addition to all of this, companies also seek financing from the State Property Fund of Ukraine, from the State Fund on Employment of the Population in Ukraine, from the Fund of Social Protection of Disabled, foreign donor organizations, etc.

Analysis of impact of the financial crisis of the year 1998 on corporate governance shows positive trend and even some improvements. Speculative foreign capital, which fled from Ukraine, left local investment institutions without extra profits from speculative operations with the securities. Trying to survive in this situation institutional investors were forced to concentrate their attention on the performance of their companies, to carry out restructuring and to ensure their profitable operation. For concentration of shares in companies institutional investors started to create investment pools with the task of making restructuring and corporate reforms. Financial crisis forced the majority of companies to change their financial and investment strategy. It became clear that the source of attracting capital through additional issues of shares or bonds was no more realistic for at least next two-three years. Banks, which severely suffered from the financial crisis as well (most of all after restructuring of t-bills and devaluation of Hryvna) had to look at enterprises and cooperation with the new eyes. It became clear that there is no alternative to the process of restructuring. Structural reforms of the Ukrainian national economy would require a lot of efforts, resources and time. At the same time, operational restructuring of companies and improvement of corporate governance can bring results to the owners and to the national economy in general very quickly.

6. *Conclusions*

Efficiency of corporate governance and performance of joint stock companies in Ukraine can not be directly linked with the corporate ownership structure. All types of companies can demonstrate good governance and performance regardless of their corporate ownership structure. Under the conditions of weak legal, institutional and regulatory framework even "effective owner" may become an "effective theft" and terminator to the corporation. Therefore, orientation exclusively on strategic investors in anticipation that only they would alter the situation in corporate governance is as illusive and erroneous as was the idea of mass privatization, which according to its designers had to resolve all controversies at microeconomic level and to bring efficiency.

Mass privatization did not bring impetus to corporate governance improvement, ineffective dispersed ownership still dominates in many companies and secondary stock market is almost dead. We are asking ourselves, why corporations in the USA and the Western Europe with bigger dispersion of shares work well without any “strategic investor”, and why some corporations with good potential and absolute control by one strategic owner in Ukraine and Russia for years are on the verge of disaster? Or, is it enough to pass a new law on joint stock companies with a dozen of additional regulations in order to improve corporate governance, while dysfunctional judicial and institutional systems remain untouched? Perhaps, we must admit that there is no ready receipt for the solution of corporate governance problems in transition economies. We understood once that experience of the developed countries can not be successfully mechanically transplanted into Ukrainian environment. We must all admit that there is no easy solution to this problem. Transition economy requires transition and intermediary solutions on the way to a well-functioning corporate governance model.

In my view the solution of this issue is in systemic approach to the problem of corporate governance in Ukraine. All interested parties, including Government of Ukraine, international financial organizations and other foreign organizations which provide technical support to Ukraine, must undertake an extensive analysis of the whole system in which corporate governance exists, identify its deficiencies, develop strategy and implement comprehensive corporate reform. This reform should involve all branches of power under supervision of the President of Ukraine, should include strong institutional components and affect many branches of law and should be supported by strong public campaign. Reform strategy must have features of internal logic and complementarity so that only taken together reform measures would lead to success.

Attachment 1.**Shareholding by Ownership (%)**

Shareholder type	1999			First Shareholders meeting		
	All firms	Insider owned firms	Outsider owned firms	All firms	Insider owned firms	Outsider owned firms
State	7.6	2.7	7.1	10.1	5.3	11.7
Workers collective	55.1	82.2	22.6	55.8	78.9	27.2
Of which:	7.5	10.3	3.8	5.8	7.5	3.6
Managers						
Workers	34.1	50.4	13.9	44.0	61.8	21.5
Former workers	13.2	19.7	4.8	6.8	8.7	4.4
Ukrainian firms	10.8	2.3	23.4	8.0	2.2	16.9
Ukrainian banks	0.8	0.4	1.7	0.5	0.0	1.1
Ukrainian investment Funds	7.3	1.7	15.5	8.8	3.0	15.9
Ukrainian citizens	12.7	7.2	21.6	10.8	5.8	18.8
Foreign individuals	0.2	0.7	0.4	0.2	0.0	0.4
Foreign companies	3.2	1.9	4.7	2.0	1.5	2.6
Agricultural producers	2.1	1.6	3.1	2.7	2.3	3.5

Ownership structure of Ukrainian companies

