The impact of OFE investment policies on the politics of Polish corporate governance

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Changes in market expectations, and changes in the mentality of companies in the area of corporate governance, are slow but unavoidable. They are not a result of artificial requirements set out by the law, but the effect of the transformations taking place in the global economy, including an increase in the competitiveness of capital markets.

In the rapidly changing and uncertain environment that companies and investors operate in, effective risk management is one of the key tools for securing a company’s business strategy, understood as an obligation to the stockholders and other stakeholders. The market increasingly understands that transparency of companies in the area of risk management and internal control is an important factor for protecting the interests of the stockholders. Given the rate of change in the business environment, a “set & forget” approach to the management of a company is not possible. Business structures are constantly changing along with the environment they operate in.

A properly operating risk management and internal control system is of critical importance to both managers and investors. Managers who have ensured that the systems in these areas operate efficiently and effectively within the company will find it easier to defend themselves against a charge of negligence. For investors, high standards of corporate governance in companies constitute a fundamental mechanism for securing against the incorrect actions of board members or company employees arising from a lack of knowledge or information, overstepping competence or simple human dishonesty.

This proprietary report, drawn up by a team selected through the contest of Ernst & Young’s Better Government Programme, demonstrates that institutional investors can make a significant contribution towards improving the current situation.

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Content

Abstract .............................................................................................................. 5
Introduction ........................................................................................................... 6
1. Corporate governance .................................................................................. 9
2. Literature review .......................................................................................... 11
3. Theory and hypotheses .............................................................................. 14
4. OFE Pensions .............................................................................................. 17
5. OFE pension funds and Polish corporate governance ................................. 23
6. Why isn’t there a larger pension fund impact on Polish corporate governance? .......................................................................................... 32
7. Conclusion and recommendations .................................................................. 41
Appendix ............................................................................................................ 44
Endnotes ........................................................................................................... 49
References ......................................................................................................... 52
Our reports ......................................................................................................... 56

Tables and figures

Figure 1. Sequence of moves ......................................................................... 15
Figure 2. Aggregate OFE portfolio as a % of GDP .......................................... 19
Figure 3. Percentage of market cap accounted for by individual funds ............ 20
Figure 4. 2005 OFE ownership and PFCG score ............................................ 29
Figure 5. 2003-2005 changes in OFE ownership and PFCG scores ................. 30
Figure 6. Corporate governance and OFE holdings ........................................ 31
Figure 7. Herding behavior among commonly held shares ......................... 36
Table 1. OFE as WSE shareholders ............................................................... 21
Table 2. Important Feature of the best practices code for the Warsaw Stock Exchange .................................................................................. 27
Table 3. Compliance with the best practices code for the Warsaw Stock Exchange .................................................................................. 27
Table 4. 2002 portfolio allocation across asset classes .................................... 33
Table 5. 2007 portfolio allocation across asset classes .................................... 34
Table 6. OFE’s aggregated assets ................................................................. 39
Abstract

In this report we ask: What role has the Polish OFE pension system played in Polish corporate governance and why? This is neither a purely academic question - corporate governance practices and the political-economic conditions that impact them have real implications for financial market operations and economic growth - nor is it a question with implications only for Poland - pension reform worldwide has been motivated ex-ante and justified ex-post in part by its supposed positive impact on corporate governance. By examining aspects of the Polish case, we hope to contribute to the larger question: what sorts of conditions make it more or less likely that pension funds will play a constructive role in national corporate governance issues. Our core findings are as follows: 1) the OFE pension system has not played a large role in Polish corporate governance, 2) this lack of influence is quite rational in light of the regulatory infrastructure in place, and, 3) extant models of corporate governance policy making can be useful in explaining this outcome.
Introduction

Corporate governance - the rules that determine the balance of power among minority shareholders, majority shareholders, managers, directors and other stakeholders in corporate decision making - has become a topic de jure among policy makers, business leaders and international financial organizations. The consensus among these groups is that corporate governance rules that empower minority shareholders help discipline management and/or majority shareholders, make equity investment safer for smaller investors and in turn help draw in investment capital and develop stock markets as an engine of corporate finance. Many economists see the development of capital markets as a key factor for long-term economic growth. Despite this, corporate governance standards vary widely across firms and across countries. What political and economic factors promote higher corporate governance standards and thereby catalyze some of the benefits noted above?

One possible answer to this question involves institutional investors, particularly pension funds. Pension funds can aid corporate governance at the firm level by following a voting agenda that is presumably in favor of investor rights, and by forcing firms to compete on corporate governance policies to attract investment capital (ex. Coffee 2002). At the policy level pension funds can lobby policy making bodies for higher corporate governance standards and, by credibly threatening to move their capital to markets with more stringent corporate governance policies, create incentives for policy makers to retain pension fund capital in the domestic market through investor friendly policies (ex. Bebchuk and Neeman forthcoming, Gourevitch and Shinn 2005, Pagano and Volpin 2005). Recent history is replete with examples of pension funds acting in all of these roles. Pension funds such as CalPERS, TIAA-CREF, Hermes, a variety of US based union-based pension funds have lobbied policymakers, pressured management and threatened to withdraw funds from emerging markets with poor corporate governance policies, all in an effort to improve the investment environment in their home countries and abroad (ex. Jacoby 2007, Hebb and Wójcik 2005, Carelton, Nelson and Weisbach 1998, English Smythe and McNeill 2004). Similar corporate governance impacts have been noted as a result of pension fund privatization in Sweden (Gianetti and Laeven 2009), Chile (Lefort 2007, though Allen and Gourevitch 2007 suggests otherwise) and Malaysia (Gourevitch and Shinn 2005), among others. On the other hand, the majority of pension funds have not chosen to pursue an aggressive pro-shareholder agenda at the firm or the policy level (Choi and Fisch 2008).
Corporate governance has been a priority for Polish financial markets, as it is in most emerging markets. Since the beginning of this decade, Poland has experienced an active effort to strengthen the corporate governance of firms traded on the Warsaw Stock Exchange (WSE), most notably through the drafting of corporate governance codes of best practice. At the same time, pension funds created by Poland’s 1999 pension reform - the OFE pension funds (Otwarty Fundusz Emeraltainy) - have become the largest class of institutional investor in Poland and collectively own significant portions (up to 40%, in some cases) of many of the largest Polish firms listed on the WIG 20. They have also become politically active through an industry-wide lobbying organization established in order to promote policies favorable to pension fund interests.

The purpose of this report is to examine why OFE pension funds have not had a stronger effect on Polish corporate governance. To do so we draw on a theoretical model used in Kerner (2009), which reflects insights from Hirschman’s (1970) formulation of “voice” and “exit.” In this formulation, a pension fund’s willingness to engage in corporate governance promotion at the policy or firm level hinges on its ability or willingness to use its “voice” as a shareholder or as a lobbyist. Pension funds’ ability to influence political priorities hinges on the credibility of their “exit” option to take their investments elsewhere in lieu of better corporate governance policies in the firm or in the market as a whole.

In practice, OFE pension funds use neither their voice nor their exit option to influence corporate governance in a meaningful way. We argue that the use of an internal benchmark and the capital controls on pension fund assets can explain why OFE pension funds have been docile in corporate governance matters. The impact of capital controls has the most straightforward impact. The severe limits on foreign investment preclude OFE pension funds from leveraging “exit” as a vehicle for the promotion of more shareholder-friendly corporate governance public policy. The impact of the internal benchmark - OFE pension funds’ performance is evaluated relative to the performance of all other OFE pension funds - is more subtle, but perhaps even more influential. First, no individual pension fund has an incentive to invest in the corporate governance of the market as a whole, because such an investment would only move the internal benchmark, rather than improve a fund’s position relative to the benchmark. Moreover, the herding behavior that results from the use of an internal benchmark means that any investment in the corporate governance of an individual firm will benefit the entire pension fund market rather than the pension fund making the investment in corporate governance. As such, there is little incentive for any pension fund to exercise its “voice.”
We make three contributions in this report. First, this report is one of the few evaluations of the impact of pension reforms on corporate governance, and the first of which we are aware that evaluates a case in Central Europe. Second, along with evaluating the applicability of our own theoretical framework, we probe the validity of several assumptions linking pension funds to corporate governance outcomes that have become more or less accepted in the academic corporate governance literature. We find that these links, while plausible in many cases, are by no means inevitable and are virtually absent in the Polish case. Third, our analysis implies suggestions for policy makers who wish to achieve corporate governance improvements as part of their pension privatization. Our study is relevant in particular for policymakers who continue to refine the legal architecture that Polish pension funds operate in, and for countries that have yet to institute their own pension privatization scheme.

The remainder of this report is structured as follows. Section 1 provides background to the subject of corporate governance and illustrates its importance to investors and national governments. Section 2 reviews the literature on the politics of corporate governance reforms, with particular focus on theories that highlight the role of pension funds. Section 3 describes our theoretical framework (in non-technical terms, with a full model included in the appendix) and the associated hypotheses. Sections 4 and 5 describe the Polish pension system and the state of the Polish corporate governance regulatory environment, respectively. Section 6 explores the validity of our theoretical framework in reference to the Polish case. Section 7 concludes with some implications for Polish policy makers and for future academic theories of corporate governance politics.
1. Corporate governance

Corporate governance determines who has decision-making power within the firm, how much and what quality information is disseminated to shareholders, the procedures through which management and directors are appointed and replaced and a variety of other critical issues. Examples of corporate governance policies include accounting rules, insider trading laws, rules concerning board composition and the protocols of shareholders’ meetings. For each policy area, the policies put in place define a division of authority (and, potentially, wealth) between minority shareholders and corporate insiders, i.e. managers and majority shareholders. One can therefore characterize the level of corporate governance as being relatively friendly or unfriendly to minority shareholders. Policies that, for example, curb insider trading, ensure accurate and timely release of financial information, make it easier for minority shareholders to meaningfully participate in shareholders’ meetings, and ensure the presence of independent board members all favor minority shareholders by decreasing insiders’ abilities to operate a firm without proper regard for their financial interests.

Naturally, many investors seeking non-controlling shares are drawn to firms with high (i.e. investor-friendly) corporate governance standards. Investing in these firms rather than those that give insiders a freer hand increases the likelihood that investors will see a positive return on their capital. This intuition is borne out by empirical findings. Gompers, Ishii and Metrick (2003) find that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, and lower capital expenditures. Klapper and Love (2004), among others, find a similar relationship.

The impact of high corporate governance standards is not only a matter of firm-level rules and performance, but also of national policy and national economic performance. Many aspects of corporate governance require standards-setting and enforcement taken at a level above the firm. Even firm-level solutions to many corporate governance related agency-problems are only credible to the extent that violations of these policies are (a) expected to be adjudicated fairly by the court system or (b) likely to lead to a private sanction by the hosting stock exchange or other body. The extent to which countries can hope to attract foreign capital, retain domestic savings and encourage public firms to issue securities on local markets is deeply tied to the corporate governance policy choices made by government and civil society. Attracting this capital onto financial markets has crucial implications for national economic performance. Investors tend to prefer investing in countries with credible, investor-friendly policies. Empirical findings in the economics literature show that protecting investors leads to larger
initial public offerings, higher share prices, more liquid capital markets, and more entry by new firms (ex. La Porta et al. 1997, 1998, 2000, Rajan and Zingales 2003, Castro, Clementi and MacDonald 2004, Tiberghien 2007, Bebchuk and Neeman forthcoming, Perotti and Volpin 2004, 2007, Beny 2005). Other economists, including Demirguc-Kunt and Maksimovic (1998), King and Levine (1993), and Levine, Loayza and Beck (2000) have shown that the financial development engendered by high levels of corporate governance leads to long-term economic growth. Unsurprisingly, the task of improving corporate governance in order to realize some of these benefits has become a paramount issue for parts of civil society, national governments and international organizations around the world.
2. Literature review

If high levels of corporate governance are so beneficial, why doesn’t every firm and every country enact policies that protect investors? The most commonly cited reason that some countries have more pro-shareholder corporate governance policies than others is that different legal systems – civil law vs. common law – tend to provide different levels of protection for outside shareholders (La Porta et al. 1997, 1999, 2000). This approach has been criticized for a variety of reasons (ex. Rajan and Zingales 2003, Roe 2003, Spamman 2008) but most pertinently because it ignores the distributional conflicts that underlie the often contentious politics of corporate governance. Moving towards more stringent corporate governance rules implies a transfer of decision-making authority, and the associated rent-seeking opportunities, towards minority shareholders and away from corporate insiders. Not surprisingly, those whose rent-seeking abilities are hurt by this transfer often oppose measures that improve corporate governance, both within the firm and in public policy.

Many analysts have suggested alternative, more explicitly political theories of corporate governance in reaction to the explanatory limitations of legal heritage (ex. Roe 2003, Rajan and Zingales 2003, Gourevitch and Shinn 2005, Pagano and Volpin 2001, 2005, Bebchuk and Neeman forthcoming, Perotti and Volpin 2007, Kerner and Kucik forthcoming, Allen and Gourevitch 2008). These political theories typically suggest that whichever group – managers, majority shareholders, minority shareholders, the public, etc – holds the greatest sway with policy makers will be able to achieve their desired policy outcome. As such, these theories of corporate governance reflect distributional conflicts that have long been a staple of political economics.

2.1. Pension funds and public policy

One of the challenges preventing individual shareholders from playing a large role in the policy process is that they face severe barriers to collective action (Olson 1971). They are too diffuse, and their individual financial interests are too small to justify taking on the expense of organizing into a meaningful lobby group. Institutional investment offers a remedy. Where institutional investors are strong, shareholders have the potential to overcome barriers to collective actions and meaningfully impact policy. Pagano and Volpin (2001, 2005) and Bebchuk and Neeman (forthcoming) each present formal models that rely on strong lobbying efforts by institutional investors. Among the major classes of institutional investors, however, pension
Institutional investors

Pension funds

funds are the largest class of institutional funds that are typically thought to minimize conflicts of interest that limit corporate governance activism on the part of mutual funds and insurance companies (Black 1990, Gourevitch 2007). Accordingly, Gourevitch and Shinn (2005) and others argue that pension funds play a key role as an interest group representing investor interests in policy debates.

An alternative link between pension funds and corporate governance policy that has been made in the literature is that the presence of large pension funds can move the political equilibrium by generating a politically salient “public interest” in corporate governance standards. These arguments come in two basic varieties. Some argue that the public, when they are widely invested and financially savvy, will explicitly demand that politicians implement pro-shareholder corporate governance policies (ex. Perotti and Volpin 2007). Kerner and Kucik (forthcoming) argue that such an explicit case need not be made. Rather, the influence of the public interest may emerge indirectly through retrospective economic voting.

Finally, pension funds often constitute one of the largest, if not the largest, source of institutional investment capital on national stock exchanges. As such, pension investments in domestic securities often constitute a major fuel for growth in the domestic economy. In an economic environment in which capital is mobile and can seek safer investments abroad, satisfying pension fund managers by maintaining investor friendly corporate governance policies can be a way for governments to help ensure that a sufficient amount of productive capital remains in the country (ex. Hebb and Wójcik 2005).

2.2. Pension funds in the firm

effect,“ whereby the targeting of management by CalPERS leads to an increase in stock price.3

The credibility of exit threats is also important at the firm level. There is a significant literature noting pension fund’s abilities to shift firms’ corporate governance simply by making a credible threat of taking their money elsewhere. Admati and Pfleiderer (2006) and McCahery Saunter and Starks (2008), stress the role of “exit,” arguing that institutional investors can affect corporate governance at the firm level simply by selling (or threatening to sell) shares in companies with poor corporate governance rules.
3. Theory and hypotheses

While the above arguments are quite diverse, they can be neatly incorporated into a single theoretical model based on a game of “common agency,” which is a variant of principal-agent models used most notably by Grossman and Helpman’s (1994, 1996, 2001) work on trade policy. Bebchuk and Neeman (forthcoming), Perotti and Volpin (2007) and Kerner (2009) have all used variations of this theoretical model to explain corporate governance policy outcomes. While this model focuses on policy decisions made government in light of lobbying efforts by corporate insiders and investors, the intuitions, particularly those relating to pension fund behavior, can be applied more widely to corporate governance codes that emerge from within civil society and firm level corporate governance. In what follows we walk through the theoretical model intuitively and enumerate the associated hypotheses that are relevant for this report. Interested readers are encouraged to note the formalized model that we have relegated to the appendix.

In the model, shareholders and corporate insiders each lobby government to promote policies that are in their own interests. For shareholders, such policies are assumed to be corporate governance policies that improve the returns on their portfolios, while corporate insiders are assumed to lobby for policies that maximize their abilities to collect rents from their insider status.

The sequence of action in our model is represented in Figure 1. In the first stage insiders and pension fund lobbyists declare a contribution schedule – the size of the contribution they are willing to give in exchange for any given policy choice made by the government. The utility function of the interest groups is both a function of the size of their contribution and the utility associated with a particular policy outcome. The way interest groups balance the value of contributions against the value of policy is a function of the weight that interest groups place on corporate governance policy as well as the extent of free riding – i.e. the extent to which non-contributing actors benefit from the lobbying efforts of others. As free riding increases, the interest group lobby is less able to capture the fruits of their lobbying efforts and their incentive to lobby is accordingly lower.

In the second move of the game the government chooses a policy and collects the associated contributions. In the third move the economy reacts to the policy choice. This reaction could take the form of capital flight or capital inflows, with the attendant impact on domestic share prices and economic growth. In the final move of the game, voters cast
their ballots in accordance with perceived changes in their individual welfare. Thus, governments that oversee poorly performing economies are more likely to face public sanction. The core tension faced by politicians is therefore how to balance the contributions of interest groups against their own electoral interest in the economic welfare of the voting public.

**Figure 1. Sequence of moves**

<table>
<thead>
<tr>
<th>T=1</th>
<th>T=2</th>
<th>T=3</th>
<th>T=4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investors, Insiders</td>
<td>Government Chooses</td>
<td>Economic Effects</td>
<td>Election</td>
</tr>
<tr>
<td>Announce Contribution Schedules</td>
<td>Policy and Collects Contributions</td>
<td>are Realized</td>
<td></td>
</tr>
</tbody>
</table>

Source: Own compilation

**H1:** Corporate governance will be more shareholder-friendly when pension funds place a greater intrinsic value on corporate governance policies.

**H2:** Corporate governance will be more shareholder-friendly when pension funds face less free riding and are more able to overcome barriers to collective action.

**H3:** Corporate governance will be more shareholder-friendly when corporate governance policies have a greater impact on economic outcomes, which in turn should be higher if pension funds can credibly threaten to move their assets abroad.

Our intention in this report is not to test these hypotheses so much as probe their applicability to the Polish case. Indeed, the dependent variable we are most concerned with in this report is pension fund behavior, rather than corporate governance outcomes per se. Nonetheless, examining the behavior of Polish pension funds can shed considerable light on the validity of the theoretical model in understanding the politics of post-pension reform corporate governance.

**3.1. Overview of empirical methods**

The bulk of our insights into the role of Polish pension funds came from a series of interviews and questionnaires conducted between January and April of 2009. We interviewed a variety of subjects, including senior
executives at several OFEs, Polish economists, lawyers, pension-fund-appointed independent board members, politicians, regulators and corporate governance professionals. All interviews were conducted in English, which is our native language. To buttress the qualitative evidence gathered during these interviews, we also gathered and analyzed quantitative data made available by the KNF, The Warsaw Stock Exchange, the Polish Forum for Corporate Governance, and the Polish Directors Institute. Because of the breadth of topics covered by the subsequent sections of this report, each section contains its own discussion of its relevant analytic methods.
4. OFE pensions

4.1. The spread and rationale of privatized national pensions

From the late 19th century through the end of the 1950s virtually every European country and most of the Western Hemisphere had adopted some sort of defined-benefit public pension system funded by a pay-as-you-go (pay-go) mechanism, in which the retirement benefits of current pensioners are paid from the contributions of current workers, or funds taken from general taxation revenues (Orenstein 2008). Despite the manifest popularity of national pension systems, calls for major reforms began almost as soon as these systems took hold. The most commonly cited and well-understood rationale for moving towards fully funded, defined-contribution systems are a related set of demographic and fiscal pressures. One of the side effects of the second half of the 20th century’s prosperity gains around the world has been a rising life expectancy. As life expectancy rises, so too does the cost of providing a pension for a country’s elderly population. Add to this the impact of the global post-war baby boom and dropping fertility in much of the developed world, and governments were left with a severe imbalance between pension liabilities and the revenue to fund them, with the shortfall to be made up by higher taxes, spending cuts in other areas or increased borrowing. The potential impacts are grim. As the World Bank, one of the most consequential backers of pension privatization, noted in 1994, “[unreformed public pension systems] may actually hinder growth - through high wage taxes, which cause evasion and push labor into the less inefficient informal sector; through rising fiscal deficits, which fuel inflation; by squeezing out growth promoting public spending, such as education or health services for the young; or through a combination of all three.” (World Bank 1994: iv). Moreover, many publicly administered pay-go systems were and are politically mismanaged, with favored constituencies receiving pension benefits far in excess of what can be justified by their contributions. In the face of these demographic and fiscal pressures, many countries have opted to fully or partially substitute their defined benefit pension system with a funded, defined contribution alternative.

4.2. Wave of reform

The first country to enact such a reform was Chile in 1981. Facing the insolvency of its pay-go system, Chile opted to privatize their pension system using the design of then Secretary of Labor and Social Security, Jose Piñera. Following Chile’s adoption, Great Britain enacted a pension reform of its own in 1986, though the British reforms were more
modest than those in Chile. The real cascade of reforms came in the 1990s, in part due to the same fiscal crunch that instigated the Chilean reform, and in part through the energetic and increasingly global influence of Mr. Piñera and the “The International Center for Pension Reform”, which Piñera created in 1994 to organize his policy advocacy efforts. In 1993 Peru adopted reforms along the (more limited) British model, followed in 1994 by Argentina and Colombia. Also in 1994, Sweden, then headed by a socialist government ideologically quite far from Pinochet's Chile, introduced a more ambitious set of reforms closer to the Chilean model. Over the next several years reforms took hold across Latin America and, particularly, in Eastern Europe and Central Asia. Some form of pension reform has been enacted in Hungary (1998), Kazakhstan (1998), Poland (1999), Latvia (2001), Bulgaria (2002), Croatia (2002), Estonia (2002), Russia (2002), Kosovo (2003), Lithuania (2004), Uzbekistan (2004), Slovakia (2005), Macedonia (2006), and Romania (2008).

4.3. Pension privatization in Poland

Poland began a national conversation about pension reform in 1991, almost immediately after the fall of communism, though this conversation was brief and World Bank experts initially squashed the topic of pension privatization (Orenstein 2008). Poland had rising pension liabilities due to a low retirement age (57), and overly generous benefits, particularly for politically privileged interests, such as agricultural workers (Chłoń et al. 1999, Orenstein 2008). While the demographics were not as unfavorable in Poland as elsewhere, they were nonetheless daunting. Spending on pensions in Poland by 1994 amounted to 15.3% of GDP, much closer to the continental high (Italy) than the continental low (Ireland) (Chłoń et al 1999). As baby-boomers began to retire, Polish economists foresaw a yawning gap in the dependency ratio and a pension system that would be effectively insolvent by the end of the decade.

The Polish government sought short-term solutions via ad hoc tweaking of indexation and benefits, but this was ruled unconstitutional in 1994 forcing the government to consider a more sweeping remedy. The reform camp was split into those who wanted to maintain a defined benefit pay-go system, with adjustments made to the retirement age and to the formula for calculating benefits in order to reduce outlays and render the system solvent, and those who wanted to scrap the system in favor of a funded alternative. Leszek Miller, then minister of labor under the SLD-PSL coalition supported the more modest approach. Miller’s conservatism was met by Grzegorz Kołodko's ministry of finance, which preferred reform along the Chilean model. This standoff would continue until Andrzej Bączkowski, a supporter of
Chilean-style pension reform, replaced Miller as labor minister under a SLD government in 1996. This newfound consensus resulted in Security Through Diversity, a pension reform plan that was nurtured by Bączkowski’s successors Jerzy Hausner and Ewa Lewicka. The pension reform package was debated and passed into law during 1997 and 1998. In August 1998 licensing began for potential fund administrators and the new pension system began operations on January 1, 1999.

4.4. Security through diversity

As the name suggests, the guiding principle of the Polish pension reform was to provide greater security to the retirement system by diversifying pension fund assets over multiple, distinct pillars, reducing exposure to volatility in any particular sector. The first and third pillars are not particularly relevant for our purposes, with the former being a modified version of the pay-go system, and the latter being a relatively small system of optional occupation-sponsored pensions.

The second pillar of the pension program created by Security Through Diversity is a mandated pillar through which a percentage of a worker’s earnings are collected by the Social Security Institution (ZUS, which also administers the first pillar pension scheme) and invested in personal accounts managed by one of the several funds managers. These funds operate as open mutual funds and are accordingly referred to as the Open Pension Funds (Otwarty Fundusz Emerytalny, or OFE). As in the Chilean system, workers buy an annuity from their pension administrator at the time of their retirement to serve as their retirement income. The size of the annuity that can be purchased depends on both the amount of money that has been contributed by the worker over their career and the performance of the portfolio it was invested in.

Figure 2. Aggregate OFE portfolio as a % of GDP

![Graph showing the aggregate OFE portfolio as a % of GDP from 2002 to 2007.](image)
The funds that comprise the OFE pension system are administered by various PTEs (Powszechne Towarzystwo Emerytalne, or Universal Pension Societies), each of which manage a single OFE fund. PTEs are comprised of a variety of financial institutions, including transnational insurance companies (e.g., Aegon, AXA, Nordea), Polish financial institutions (e.g., PZU, Skarbiec Emerytura), and various consortia of Polish and international financial institutions (e.g., ING, Pozycyjion). There were initially 21 licensed PTEs, though this number has been reduced to 15 through mergers and exits.

Collectively, the financial assets of the OFE system are quite large. Figure 2 shows the growth in OFE holdings as a percentage of Polish GDP from 2002-2007. OFE pension fund holdings have increased substantially, reaching 12% of GDP by 2007, and are projected to rise considerably in the future. Pertinently for the purposes of this report, much of these assets are held in domestic equities, making the OFE pension system a major player on the Polish stock market, collectively owning up to 10% of the stock market over the years from 2002-2007. While this makes the Polish pension fund industry smaller than their American counterparts in terms of ownership of the domestic market, the prevalence of insider ownership in Poland makes this figure a bit misleading. It is estimated that the OFE pension system controls over 30% of free float on the Warsaw Stock Exchange, which is more comparable to the American pension industry (Grajewski 2009).

**Figure 3. Percentage of market cap accounted for by individual funds**

![Bar chart showing the percentage of market cap accounted for by individual funds](image-url)

Source: KNF 2006 annual report, CALpers 2006 annual report, WDI
Table 1. OFE as WSE shareholders

<table>
<thead>
<tr>
<th>Firm</th>
<th>Total OFE ownership</th>
<th>% owned by largest OFE shareholder</th>
<th>largest individual shareholder</th>
</tr>
</thead>
<tbody>
<tr>
<td>ELEKTROBUDOWA S.A.</td>
<td>56.65</td>
<td>11.07</td>
<td>ING</td>
</tr>
<tr>
<td>VISTULASWÓLCZANKA S.A.</td>
<td>39.13</td>
<td>18.09</td>
<td>PZU</td>
</tr>
<tr>
<td>COMP SAFE SUPPORT S.A.</td>
<td>38.97</td>
<td>8.37</td>
<td>AIG</td>
</tr>
<tr>
<td>POLIMEX-MOSTOSTAL S.A.</td>
<td>36.54</td>
<td>9.10</td>
<td>Commercial Union</td>
</tr>
<tr>
<td>GRUPA KĘTY S.A.</td>
<td>36.38</td>
<td>11.74</td>
<td>ING</td>
</tr>
<tr>
<td>ECHO INVESTMENT S.A.</td>
<td>35.53</td>
<td>8.98</td>
<td>Commercial Union</td>
</tr>
<tr>
<td>ALMA MARKET S.A.</td>
<td>32.16</td>
<td>17.02</td>
<td>PZU</td>
</tr>
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<td>SANOCKIE ZAKŁADY PRZEMYSŁU GUMOWEGO SOMIL SANOK S.A.</td>
<td>32.06</td>
<td>8.65</td>
<td>Commercial Union</td>
</tr>
<tr>
<td>POLSKA GRUPA FARMACEUTYCZNA S.A.</td>
<td>31.66</td>
<td>7.84</td>
<td>ING</td>
</tr>
<tr>
<td>LPP S.A.</td>
<td>29.64</td>
<td>8.97</td>
<td>Commercial Union</td>
</tr>
<tr>
<td>WYDAWNICTWA SZKOLNE I PEDAGOGICZNE S.A.</td>
<td>28.24</td>
<td>14.87</td>
<td>AIG</td>
</tr>
<tr>
<td>CERSANIT S.A.</td>
<td>28.01</td>
<td>8.61</td>
<td>ING</td>
</tr>
<tr>
<td>ZELMER S.A.</td>
<td>27.25</td>
<td>11.60</td>
<td>Commercial Union</td>
</tr>
<tr>
<td>POLISH ENERGY PARTNERS S.A.</td>
<td>24.25</td>
<td>9.95</td>
<td>Generali</td>
</tr>
<tr>
<td>MOSTOSTAL-WARSZAWA S.A.</td>
<td>24.06</td>
<td>19.84</td>
<td>PZU</td>
</tr>
<tr>
<td>ATM S.A.</td>
<td>23.68</td>
<td>9.95</td>
<td>Polsat</td>
</tr>
<tr>
<td>SFINKS POLSKA S.A.</td>
<td>23.27</td>
<td>11.57</td>
<td>Commercial Union</td>
</tr>
<tr>
<td>PBG S.A.</td>
<td>22.67</td>
<td>7.09</td>
<td>ING</td>
</tr>
<tr>
<td>FARMACOL S.A.</td>
<td>22.61</td>
<td>7.47</td>
<td>ING</td>
</tr>
<tr>
<td>TETA S.A.</td>
<td>21.78</td>
<td>8.24</td>
<td>AIG</td>
</tr>
<tr>
<td>AMREST HOLDINGS N.V.</td>
<td>21.78</td>
<td>7.03</td>
<td>Commercial Union</td>
</tr>
<tr>
<td>ASSECO POLAND S.A.</td>
<td>21.55</td>
<td>5.68</td>
<td>ING</td>
</tr>
<tr>
<td>INSTAL KRAKÓW S.A.</td>
<td>21.39</td>
<td>14.62</td>
<td>PZU</td>
</tr>
<tr>
<td>EMPERIA HOLDING S.A.</td>
<td>20.98</td>
<td>9.55</td>
<td>Commercial Union</td>
</tr>
</tbody>
</table>


The size of the OFE funds vary greatly. Figure 3 shows the equity holdings of individual pension funds, expressed as a percentage of total stock market capitalization for the year 2006, with CalPERS share of the US market included as a point of comparison. As can be seen, many of the individual pension funds, particularly the very largest - Commercial Union, ING and PZU - have Polish equity holdings that are considerably larger relative to the Polish market than CalPERS’ domestic (US) equity holdings is to the US stock market. This suggests that the larger Polish funds have more than sufficient equity stakes to justify a considerable amount of corporate governance activism at the policy level. At the firm level, pension fund ownership can be even larger. Table 1 shows the extent
of OFE pension fund holdings in 2007 for the 24 firms with the highest level of pension fund ownership. As can be seen, OFE pension collectively own considerable blocks in some of the largest firms in Poland. Cersanit, Polimex, Grupa Kęty, PBG, and Assecco are all current or recent member of the WIG20, and many of the other firms listed in table 1 are current or former members of the WIG 40. OFE pensions collectively own a greater than 10% stake in many other major Polish firms including PKN Orlen, Agora, KGHM and ING Bank Śląski. Many of the largest individual pension funds have stakes in excess of 10% in individual firms. PZU has ownership stakes approaching 20% in several firms.

4.5. Other features of Polish corporate ownership

Beyond pension funds, dominant shareholders play a major role in Polish corporations. The dominant shareholder in Polish firms holds at least a majority of shares in 75% of companies listed on the WSE. 27% of WSE listed companies have dominant shareholders with greater than a 75% share. The median size of the largest voting bloc in WSE listed firms is 38-40 per cent (Aluchna 2009). This is roughly on par with European averages (Gourevitch and Shinn 2005; table 2.1 pg 18), but stands in sharp contrast to the US and UK. The marked ownership concentration that is present in Polish firms has increased substantially over the past 10 years (Aluchna et al. 2007). Despite ongoing privatization efforts, and a private economy that encompasses 80% of GDP, the Polish Treasury maintains significant ownership of many firms, including many of the strategically important firms that comprise the largest share of the WIG 20.
5. OFE pension funds and Polish corporate governance

5.1. Corporate governance in Poland – laws and regulations

Corporate governance in Poland mixes hard law with soft law. The foundation of Polish corporate governance in hard law can be traced back to the Act on the Privatization of State Enterprises (1990), which mandated a supervisory board for newly privatized Polish firms (Aluchna 2008). The first hard law addressing the securities market was drafted in 1991 and adopted regulations modeled heavily on Western European and American law, including the establishment of an independent and relatively empowered securities and exchange commission (Polish Securities and Exchange Commission, or PSEC) (Frankowski and Bodnar 2005). The Law on the Public Trading of Securities was enacted in 1997 to update the original 1991 act. The Commercial Companies Code (CCC) was enacted in 2000 in order to replace the Commercial Code of 1934, which, understandably, had fallen out of step with the needs of a modern economy (Frankowski and Bodnar 2005). CCC reinforces the dual tier board structure for Polish companies, sets minimum rules regarding the participation of shareholders in a shareholder’s meeting, regulates the adoption of anti-takeover devices and addresses a variety of other issues.

These hard law measures are a large reason why Poland has been viewed as being among the more investor-friendly markets in Central and Eastern Europe since the beginning of capital market operations in the region in the early 1990s. The establishment of a centralized and empowered regulator along the American model helped ensure that Polish markets were considerably safer for investors than in regional peers, particularly the Czech Republic, where tunneling was a major fact of life for investors during the 1990s (ex. Coffee 1999, Glaesser et al 2001, Pajuste 2002). Other reporting agencies corroborate this view of Polish corporate governance. The World Bank’s “Doing Business Report” ranks Poland 38th globally in its protection of investors rights. This puts Poland considerably ahead of Hungary (113), Czech Republic (88), Lithuania (88), Ukraine (142), on par with Romania and Bulgaria, but behind Slovenia (18).

Not all reports are positive, however. Tamowicz and Przybyłowski (2006) note that Czech-style tunneling was indeed present on the Polish market during the 1990s, with notable companies such as Agros, one of Poland’s largest food producers, and Stomil Olsztyn and Stomil.
Dębica, two of Poland’s largest tire manufacturers, being accused of funneling profits to their foreign owners. Bergloff and Pajuste (2005) note that enforcement lags significantly behind the generally good laws on the books in Poland.

Many of the recent changes in Polish hard law, including revisions to the CCC and The Law on the Public Trading of Securities, has been instigated by the need to harmonize national legislation with the recommendations of the European Commission, which Poland is obligated to do as a member of the EU. This occurred most recently with the adoption of the “EC Directive on the exercise of certain rights of shareholders in listed companies,” which was notified to the EC in January of 2009. The transposition of EU law into Polish law has been prompt and relatively uncontroversial.

### 5.2. Pension fund influence on hard law

Most of the key political debates surrounding Polish hard law in corporate governance predates pension reform, and so it is unsurprising that the OFE pension system has not had a particularly large impact in this area. No pension fund professional, policymaker nor outside observer of Polish corporate governance that we spoke to noted any such political lobbying vis-a-vis hard laws on corporate governance. In terms of lobbying government on hard law matters more generally, the OFE pension system does have an industry wide lobbying organization, the Polish Chamber of Pensions (Izba Gospodarcza Towarzystw Emerytalnych, or IGTE), which acts on behalf of 12 of the 15 active pension funds. IGTE does not engage corporate governance matters as a lobbying issue. This may be because current hard law on the subject reflects decision making in Brussels rather than Warsaw, because the pension funds don’t care very much about corporate governance policy regardless of where it is made, or both. In either case, IGTE lobbies government and the regulatory bodies primarily for changes in policies that affect pension fund management, such as the administrative fee schedule and portfolio composition rules. As we will discuss later, these issues have implications for corporate governance, but lobbying on corporate governance issues per se does not exist through the IGTE.

### 5.3. Corporate governance soft law in Poland

Soft law in Polish corporate governance has evolved considerably since the OFE pension system became an established part of the Polish political economy. “The Best Practices of WSE Listed Companies,” which was adopted in 2007 and came into enforcement on January 1, 2008, is the most important part of this soft law regime. The Best Practices of WSE
Listed Companies is the most recent iteration of a set of corporate governance standards enforced through a “comply or explain” mechanism that was initially introduced in 2002 with the publication of “Best Practices in Public Companies in 2002”.

The 2002 code was drafted by the Best Practices Committee of the Corporate Governance Forum, a group coordinated by the Warsaw Stock Exchange and comprised of lawyers, academics, representatives of Polish business groups, the Warsaw Stock Exchange and PSEC. Further iterations of the code published in 2005, and most recently in 2007 have been the product of a consultation process between the Corporate Governance Forum and various interested parties, organized by the listings department at the Warsaw Stock Exchange.

All three of the codes’ iterations address four areas of corporate governance: general meetings, the supervisory board, the management board, and third party auditors. Because of the centralized ownership structure of the Polish firm, the most important corporate governance issue for minority shareholders is keeping the majority shareholders accountable to the financial best interest of the firm (Bebchuk and Hamdani 2009). The key mechanism for doing so is through the supervisory board and through the auditing process. Rules that provide for effective auditing, more independent supervisory board members with responsibility for more important tasks, and with definitions of independence that include relationships with the majority shareholder (as opposed to a focus on management) promotes the rights of shareholders in a closely held firm. Accordingly, the composition and tasks of these bodies – supervisory boards and auditors – are among the most detailed parts of the best practices code. The relevant rules across all three iterations are reported in table 2.

In some respects, the degree of shareholder protection embodied in these rules has increased over the three iterations, particularly as regards the audit committee and the definition of supervisory board independence, which currently mandates EC guidelines that preclude an independent supervisory board member from having a material relationship with a shareholder holding over 5% of company stock.

In other respects, standards have gone down, particular as regards the minimum number of independent supervisory board members, though it has been argued that the 2002 formulation calling for a majority of independent members was unrealistically ambitious and ill-suited to the reality of the Polish corporate landscape (Dzierżanowski and Tamowicz 2004).

OFE pension funds have not played an active role in shaping soft law. At each point in which the code of best practices for WSE listed
companies was revised, the listing department at the WSE engaged in a wide effort to solicit the opinions of market actors including major institutional investors. Members of the Best Practices Committee of the Corporate Governance Forum report no involvement on the part of the pension funds in the original drafting, despite having already been established as one of the major institutional investors on the Polish market. In the consultation process leading up to the drafting of the 2007 code, only one pension fund participated, though this participation appears to be a point of some pride on the part of that fund. IGTE does not appear to be active in soft-law corporate governance matters in any capacity. Reports of non-participation by pension funds was echoed by those involved in the drafting of the Gdansk code.

The Warsaw Stock Exchange keeps close statistics of the comply or explain reports issued by Polish firms. These data are listed in table 3. We note compliance with the most important provisions separately. For the purposes of comparison, we also report the level of compliance for all other aspects of the code. The number in each cell is the percentage of firms reporting compliance with the provision. As can be seen, the high level of compliance overall stands in stark contrast to compliance with the most important, and most concretely defined provisions. From 2005 – 2007, compliance with the relevant portions of the best practices code increases for the number of independent members of the supervisory board, but remains relatively flat for the other provisions. Compliance with the noted provisions ticks up considerably for 2008, though this is likely more of a function of altered rules rather than improved corporate governance, given that compliance on other rules actually goes down from 2007 to 2008. One complication of interpreting comply or explain data is that, by definition, simply explaining a firm’s non-compliance is, in effect, a form of compliance, though not one that is recognized in table 3. The generally low compliance rates for the most important provisions suggests reasons beyond the apparent non-participation of OFE pension funds in the standard setting process, to be skeptical that the increasing stock holdings of OFE pensions or the widening portion of the Polish population that is invested in these funds have had a large impact on Polish corporate governance.
### Table 2. Important feature of the best practices code for the Warsaw Stock Exchange

<table>
<thead>
<tr>
<th>Rule</th>
<th>2002</th>
<th>2005</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Supervisory board</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td># of independent supervisory board members</td>
<td>Majority of the board</td>
<td>Majority of the board; 2 if there is a majority shareholder</td>
<td>2</td>
</tr>
<tr>
<td>Definition of independence</td>
<td>Not stipulated, but should be laid down in the statutes of the company</td>
<td>Should be laid down in the statutes of the company, recommendation to use EC standard</td>
<td>EC standard, plus disqualification of company employee or related party employee</td>
</tr>
<tr>
<td>Establish Audit Committee with independent board members</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Establish Remuneration Committee with independent board members</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Notification of Conflict of Interest</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Third party auditors</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Approval by Supervisory Board</td>
<td>Yes</td>
<td>Yes</td>
<td>Niedookrślone, domniemane przez radę nadzorczą</td>
</tr>
<tr>
<td>Auditors must be changed every...</td>
<td>5 lat</td>
<td>5 lat</td>
<td>7 lat</td>
</tr>
</tbody>
</table>


### Table 3. Compliance with the best practices code for the Warsaw Stock Exchange

<table>
<thead>
<tr>
<th>Provision</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>independence of supervisory board members</td>
<td>23%</td>
<td>27%</td>
<td>29%</td>
<td>67%*</td>
</tr>
<tr>
<td>audit/remuneration committees established by supervisory board with independent board members</td>
<td>31%</td>
<td>32%</td>
<td>32%</td>
<td>63%**</td>
</tr>
<tr>
<td>auditor approved by supervisory board and audit committee</td>
<td>53%</td>
<td>52%</td>
<td>51%</td>
<td>not required</td>
</tr>
<tr>
<td>all other provisions</td>
<td>94%</td>
<td>94%</td>
<td>95%</td>
<td>91%</td>
</tr>
</tbody>
</table>

* the number of required independent members decreased and the definition of independence increased in the 2007 code

** supervisory boards are no longer required to establish remuneration committees in the 2007 code

Source: Own compilation based on data from WSE
5.4. Pension funds’ relationship with firms

The OFE pension fund executives we spoke with expressed their commitment to playing an engaged role as voters in the firms they invested in, and their belief that such a role was important to their own bottom line. ING is often held as an exemplar in this regard and has recently published a corporate governance code that presents guidelines for voting and making their votes public. Other pensions report reliance on ISS voting recommendations, and such recommendations suggest a strongly pro-shareholder voting stance.

Beyond voting, every pension fund manager we spoke to underlined the importance of having independent members of the supervisory board and their commitment to using their position within the firm to place such members on the board. The funds were also clear that they did not feel it was appropriate (or wise) to attempt to appoint supervisory board members to serve as de facto representative of the pensions. Rather, as with their American counterparts, they prefer to choose supervisory board members that are seen as being truly independent, and they are often picked in consultation with management and majority shareholders. Pension fund executives often spoke of working with a relatively small group of professional board members whose independence and competence are generally accepted by the market.

Pension fund executives we spoke to disavowed the notion that they should be involved in any way in the management of the firm. They see their role as purely to ensure the appointment of independent supervisory board members and then disengage with the firm on a day-to-day basis. We found no evidence of any “name and shame” activities, wherein pension funds use negative publicity to pressure management. Of course, our questions had a clear “right” answer, and we wouldn’t expect pension fund executives to claim indifference to the management of the firms they invest in. Non-pension-affiliated observers of Polish corporate governance were decidedly more mixed in their assessment of pension fund influence at the firm level.

Given their emphasis on appointing independent supervisory board members, the best way establish the impact of pension funds on firm level corporate governance would be to note the statistical relationship between independent supervisory board members and the extent of OFE ownership. However, we presently lack comprehensive data on the number of independent supervisory board members on Polish corporations that would be useful to this end. Even if such data were available there would be no objective way to code the “true” independence of the nominally independent members. We can, however, evaluate the impact a bit more circuitously. The Polish Forum for Corporate Governance (PFCG), a think tank associated with the
The Gdansk Institute for Market Economics produced a series of corporate governance ratings for Polish corporations for several years in the mid 2000s. The PFCG ratings run from 0 to 5, with 5 indicating the highest level of corporate governance. By comparing the corporate governance ratings of these corporations with the extent of OFE ownership we can get a rough sense of how much of an impact pension fund ownership has had. In Figures 4 and 5 we present data on corporate governance ratings and OFE ownership levels. The Y axis notes the percentage of shares held by OFE pensions (ie. .1 indicates that OFE pensions own 10% of a firm's outstanding equity) and the X axis notes a firm's corporate rating from PFCG. We include all firms listed in the 2005 year end WIG 20 for which data was available. These data are shown in 2005 levels as well as in differences from 2003 to 2005, the first and last years these surveys were conducted. No strong pattern immediately emerges from the data. If pension fund ownership leads to stronger corporate governance standards, we would expect to see a positive correlation between corporate governance levels and pension fund ownership. Contemporaneous pairwise correlations, as well as a pairwise correlations of first differences reveal a positive, but statistically insignificant correlation between the corporate governance ratings and OFE ownership levels. Spearman rank correlations yield similarly insignificant results. Moreover, the positive relationships that appear to exist weakly are being driven by outliers (Grupa Kęty and Computerland in Figure 4 and Netia in Figure 5).

Figure 4. 2005 OFE ownership and PFCG score

Source: Dzierżanowski et al. (2005), KNF annual report (2005)
Several interview subjects noted, with some frustration, that the OFE pension funds fail to do the most potentially powerful thing, which is simply to not invest in firms that exhibit poor corporate governance. This sentiment is echoed in the data. In Figure 6 we compare the composition of the WIG 20 with the allocation of pension fund assets across those firms. If OFE holdings are influenced by the corporate governance of the firms they invest in, we would expect to see companies with poor ratings receiving less investment from the OFE funds than would be predicted by a company’s stature in the WIG 20. We use the most recent, 2005 PFCG ratings along with the 2005 year-end composition of the WIG 20 and year end OFE pension holdings.

The Y axis of Figure 6 records the PFCG corporate governance score. The X axis records the difference between a firm’s prominence in the WIG20 and the extent to which OFE pension funds own a firm’s shares (for example, if a firm’s shares accounted for 10% of the WIG20, but only 5% of OFE aggregate share holdings, we would record a score of -5 along the X axis). As can be seen, there is no clear relationship between a firm’s corporate governance ranking and the extent to which pension funds own that share more or less than a firm’s prominence in the WIG 20 would predict. The three firms that score best on the PFCG rankings are all under-held by the OFE pensions. Three of the worst scoring firms in the PFCG ranking are over-held. Pairwise correlations and Spearman’s rank tests bear this out: there is no correlation between
pension fund's enthusiasm for a stock relative to its prominence on the WIG 20 and its corporate governance ranking.

Figure 6. Corporate governance and OFE holdings

![Graph showing corporate governance and OFE holdings.](source: KNF annual report (2007))

5.5. Pension funds impact of political priorities

On top of the lack of explicit pension fund input on corporate governance policy in Poland, there does not appear to an implicit impact through political re-prioritization towards more pro-shareholder corporate governance rules over this time period. The Polish government has not taken the sort of vigorous steps towards higher corporate governance standards that the academic literature would predict. Many of our interview subjects cited ongoing problems in the corporate governance of state-controlled firms. The most closely attuned ministry to these issues, the Ministry of the Treasury, by virtue of its wide ownership in Polish firms and its almost complete ownership of the WSE, has not been an energetic force in favor of pro-shareholder corporate governance. Several pension fund professionals we spoke to expressed significant skepticism concerning Treasury's role or the WSE's role in corporate governance promotion, though the WSE has taken steps towards increasing awareness of corporate governance issues beyond its role in organizing the codes of best practice.
6. Why isn't there a larger pension fund impact on Polish corporate governance?

Why don't OFE pension funds have a larger impact on firm-level corporate governance or corporate governance policy? The theoretical model above suggest three possibilities: 1) OFE pension funds cannot overcome free riding problems, 2) OFE pension funds do not place much weight on corporate governance to begin with, and 3) OFE pension funds are unable to leverage their exit option to affect changes in corporate governance policies. As for the first possibility, this seems unlikely. While we lack even a rough quantification of the financial gains from pension fund activism on the Polish market, several of the OFE pension funds have a considerably larger presence on the Polish stock market that the biggest, most activist funds in the United States have on the American market. Individual OFE pension funds appear to have a sufficient financial stake to motivate policy action on their own. Moreover, through the IGTE Polish pension funds have been far more able to overcome collective action problems than their American counterparts. Collective action problems - in the Olson sense of the word - do not appear to be prohibitive in this case.

It is the second and third possibilities that seems more apt. We focus first on the second possibility. OFE pension funds bound by a warren of regulations and market pressures, which, we argue, ultimately disincentivize the funds from placing weight on the potential gains from corporate governance improvements. It is to these impacts that we now turn.

6.1. Performance incentives, herd behavior and free riding

The sorts of performance incentives faced by funds managers are extremely important to understanding their incentives to become active in corporate governance issues. Are OFEs rewarded for high returns, penalized for low returns or both? The basic structure of the fees collected by fund administrators has been relatively constant since the original pension reform of 1999, and borrows heavily from the Chilean model. Each pension fund is mandated to earn returns that are at least 50% of a weighted average return of all of the funds (weighted by their size), or 4% below the weighted average, whichever is lower. If a pension fund fails to achieve these returns the administrator must pay the
difference out of its reserve funds (1.5% of fees that are mandated to be set aside) or out of its own assets if the reserves are insufficient.

Table 4. 2002 portfolio allocation across asset classes

<table>
<thead>
<tr>
<th>Fund</th>
<th>NF I Shares</th>
<th>Equities</th>
<th>Treasury bills</th>
<th>Bank deposits and bank securities</th>
<th>Bonds</th>
<th>Other investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>AIG OFE</td>
<td></td>
<td>0.27</td>
<td></td>
<td>0.02</td>
<td>0.71</td>
<td>-</td>
</tr>
<tr>
<td>OFE Allianz Polska</td>
<td></td>
<td>0.28</td>
<td></td>
<td>0.03</td>
<td>0.70</td>
<td>-</td>
</tr>
<tr>
<td>Bankowy OFE</td>
<td>0.01</td>
<td>0.30</td>
<td>0.06</td>
<td>0.05</td>
<td>0.58</td>
<td>0.00</td>
</tr>
<tr>
<td>Commercial Union OFE</td>
<td></td>
<td>0.31</td>
<td>0.03</td>
<td>0.03</td>
<td>0.64</td>
<td>0.00</td>
</tr>
<tr>
<td>Credit Suisse Life &amp; Pensions OFE</td>
<td>0.00</td>
<td>0.28</td>
<td>0.01</td>
<td>0.09</td>
<td>0.62</td>
<td>0.00</td>
</tr>
<tr>
<td>OFE „DOM”</td>
<td>0.05</td>
<td>0.34</td>
<td>0.01</td>
<td>0.02</td>
<td>0.58</td>
<td>-</td>
</tr>
<tr>
<td>OFE (ego) (w likwidacji)</td>
<td></td>
<td>0.13</td>
<td>0.09</td>
<td>0.01</td>
<td>0.70</td>
<td>-</td>
</tr>
<tr>
<td>OFE Ergo Hestia</td>
<td></td>
<td>0.25</td>
<td>0.01</td>
<td>0.02</td>
<td>0.72</td>
<td>-</td>
</tr>
<tr>
<td>ING Nationale-Nederlanden Polska OFE</td>
<td>0.00</td>
<td>0.29</td>
<td></td>
<td>0.01</td>
<td>0.70</td>
<td>-</td>
</tr>
<tr>
<td>OFE Kredyt Banku</td>
<td></td>
<td>0.29</td>
<td>0.05</td>
<td>0.00</td>
<td>0.66</td>
<td>-</td>
</tr>
<tr>
<td>Pekao OFE</td>
<td>0.03</td>
<td>0.20</td>
<td>0.06</td>
<td>0.05</td>
<td>0.66</td>
<td>-</td>
</tr>
<tr>
<td>OFE Pocztylion</td>
<td>0.01</td>
<td>0.27</td>
<td>0.04</td>
<td>0.18</td>
<td>0.50</td>
<td>-</td>
</tr>
<tr>
<td>OFE Polsat</td>
<td></td>
<td>0.26</td>
<td></td>
<td>0.01</td>
<td>0.72</td>
<td>-</td>
</tr>
<tr>
<td>OFE PZU „Zlota Jesien”</td>
<td></td>
<td>0.26</td>
<td></td>
<td>0.01</td>
<td>0.72</td>
<td>-</td>
</tr>
<tr>
<td>SAMPO OFE</td>
<td></td>
<td>0.23</td>
<td></td>
<td>0.04</td>
<td>0.73</td>
<td>-</td>
</tr>
<tr>
<td>OFE Skarbic-Emerytura</td>
<td>0.01</td>
<td>0.12</td>
<td>0.23</td>
<td>0.03</td>
<td>0.61</td>
<td>-</td>
</tr>
<tr>
<td>Zurich OFE</td>
<td></td>
<td>0.30</td>
<td></td>
<td>0.04</td>
<td>0.66</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: 2002 KNF annual report

Initially, the weighted average was calculated quarterly for a moving average of returns over the previous 2 years. The quarterly “beauty contest” forced pensions to carry relatively liquid equity portfolios allowing them to “lock in” returns by shifting assets to less risky securities (Stańko 2002, 2003). Reforms in 2004 changed this law so that calculations of the average return are made every 6 months for a moving average of returns over a three-year span, which theoretically allows funds to avoid pressure to dump their equity holdings as frequently. Moreover, the new regulations limit any one OFE’s share in the weighted average to 15%. Thus far, only Bankowy has ever had to contribute funds to make up for a shortfall in returns.
The use of an internal benchmark encourages herd behavior among asset managers whose primary concern is to avoid losses relative to the weighted average return that could incur a penalty. To get a sense of how this herding behavior has presented itself over time, tables 4 and 5 show the allocation of OFE portfolios by asset class for the entire OFE system in 2002 and 2007.

Table 5. 2007 portfolio allocation across asset classes

<table>
<thead>
<tr>
<th>Fund</th>
<th>NIS Shares</th>
<th>Equities</th>
<th>Treasury bills</th>
<th>Bank deposits and bank securities</th>
<th>Bonds</th>
<th>Other investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>AEGON OFE*)</td>
<td>0.00</td>
<td>0.32</td>
<td>0.01</td>
<td>0.03</td>
<td>0.63</td>
<td>0.01</td>
</tr>
<tr>
<td>AIG OFE</td>
<td>0.00</td>
<td>0.34</td>
<td>0.00</td>
<td>0.02</td>
<td>0.63</td>
<td>0.01</td>
</tr>
<tr>
<td>Allianz Polska OFE</td>
<td>0.00</td>
<td>0.34</td>
<td>0.02</td>
<td>0.03</td>
<td>0.60</td>
<td>0.00</td>
</tr>
<tr>
<td>AXA OFE*)</td>
<td>0.00</td>
<td>0.34</td>
<td>0.00</td>
<td>0.01</td>
<td>0.64</td>
<td>0.01</td>
</tr>
<tr>
<td>Bankowy OFE</td>
<td>0.00</td>
<td>0.32</td>
<td>0.00</td>
<td>0.02</td>
<td>0.64</td>
<td>0.01</td>
</tr>
<tr>
<td>Commercial Union OFE BPH CU WBK</td>
<td>0.00</td>
<td>0.35</td>
<td>0.02</td>
<td>0.03</td>
<td>0.59</td>
<td>0.00</td>
</tr>
<tr>
<td>OFE „DOM“</td>
<td>0.00</td>
<td>0.35</td>
<td>0.00</td>
<td>0.02</td>
<td>0.63</td>
<td>0.00</td>
</tr>
<tr>
<td>Generali OFE</td>
<td>0.00</td>
<td>0.31</td>
<td>0.00</td>
<td>0.07</td>
<td>0.62</td>
<td>0.01</td>
</tr>
<tr>
<td>ING Nationale-Nederlanden Polska OFE</td>
<td>0.00</td>
<td>0.35</td>
<td>0.05</td>
<td>0.00</td>
<td>0.59</td>
<td>0.00</td>
</tr>
<tr>
<td>Nordea OFE</td>
<td>0.00</td>
<td>0.35</td>
<td>0.00</td>
<td>0.02</td>
<td>0.63</td>
<td>0.00</td>
</tr>
<tr>
<td>Pekao OFE</td>
<td>0.00</td>
<td>0.36</td>
<td>0.00</td>
<td>0.04</td>
<td>0.56</td>
<td>0.01</td>
</tr>
<tr>
<td>OFE Pocztylion</td>
<td>0.00</td>
<td>0.33</td>
<td>0.00</td>
<td>0.02</td>
<td>0.62</td>
<td>0.02</td>
</tr>
<tr>
<td>OFE Polsat</td>
<td>0.00</td>
<td>0.37</td>
<td>0.06</td>
<td>0.01</td>
<td>0.55</td>
<td>0.00</td>
</tr>
<tr>
<td>OFE PZU „Zlota Jesien“</td>
<td>0.00</td>
<td>0.33</td>
<td>0.01</td>
<td>0.03</td>
<td>0.62</td>
<td>0.01</td>
</tr>
<tr>
<td>OFE Skarbiec-Emerytura</td>
<td>0.00</td>
<td>0.33</td>
<td>0.00</td>
<td>0.02</td>
<td>0.65</td>
<td>0.00</td>
</tr>
</tbody>
</table>

Source: 2007 KNF annual report

Herd behavior across asset classes appears to have magnified from 2002 to 2007, despite changes to the calculation of the internal benchmark. This trend corroborates findings noted by Kominek (2006). Zalewska (2006) also notes a strong clustering in the annual returns of OFE pensions. As Table 5 shows, in 2007 there was scarcely any difference in the proportion of equity held by the various funds. This is particularly true of the large funds: Commercial Union, PZU and ING, which collectively control 64% of OFE pension assets, allocated 35%, 33% and 35% of their portfolios to equities in 2007, respectively. Some smaller funds do have slightly different stakes in domestic equity:OFE Polsat’s 37% position in equities is a considerably bigger bet
on stocks than Generali’s 31%, but these are minor players in the OFE market, as noted in Figure 2.

For savers, the implication of this herding behavior is a clustering of returns such that pensioners are not given an opportunity to choose better performing funds over worse.¹⁶ For corporate governance, the implication is that no individual pension funds, and certainly none of the largest funds, have a financial incentive to invest in the corporate governance of the market as a whole by lobbying for more investor friendly regulation or better enforcement of the legislation that already exists. The fruits of any such investment would only serve to move the weighted average return, but because the equity positions of all of the funds are so similar, the effect would be felt almost uniformly across the pension fund market. Similarly, if the incentive is to increase returns in order to help marketing efforts, any move that also helped the competition would fail to do so. Moreover, as Kominek (2006) shows, OFEs ability to attract new members and new capital is only weakly correlated with returns, if at all, perhaps because the highly correlated returns make such distinctions difficult to make. Because the OFE system is mandatory, it is unlikely that increased performance for the market as whole could attract more new savers into the system.

The herding across assets classes is mirrored by herding across individual stocks. Voronkova (2004) and Voronkova and Bohl (2005) both find a considerable degree of “feedback trading” wherein the trading strategies of one fund are mimicked by other funds. Even were it not for feedback trading, the large share of free float taken up by the OFE pensions, along with their preferences for large WIG 20 firms (in 2007, the 5, 10 and 20 most commonly held stocks accounted for 33%, 49% and 67% of total OFE equity holdings, respectively) all but ensure roughly comparable equity portfolios. To get a graphical sense of this behavior, Figure 7 shows the percentage of the four largest OFE equity portfolios – Commercial Union, ING, PZU and AIG – taken up by each of the 10 most commonly held shares in the year 2007. As can be seen, the larger funds, i.e. those funds with large enough equity portfolios to potentially justify corporate governance activism in financial terms, typically hold the same shares in roughly the same proportion. While there are some exceptions – AIG holds surprisingly little stock in LPP SA, for example – there are no firms in which only a single large OFE fund has a large investment relative to its total equity portfolio. This clustering implies that incentive problems also exist at the firm level. The payoff on a significant investment in the corporate governance of any single firm, even if it yielded higher long-run returns that justified the investment in corporate governance activism, would be mirrored more or less equally in the returns of all of the largest funds. There
would be no way to use this strategy as a means of making a fund more attractive to potential enrollees, even if there were a significant relationship between fund performance and attracting new clients.

**Figure 7. Herding behavior among commonly held shares**

<table>
<thead>
<tr>
<th>Company Name</th>
<th>% of Total Equity Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>BANK POLSKA KASA OPIEKI S.A.</td>
<td>0.08</td>
</tr>
<tr>
<td>PKO</td>
<td>0.04</td>
</tr>
<tr>
<td>BANK POLSKI S.A.</td>
<td>0.06</td>
</tr>
<tr>
<td>POLSKI KONCERN NAFTOWY ORLEN S.A.</td>
<td>0.02</td>
</tr>
<tr>
<td>KGHM</td>
<td>0.02</td>
</tr>
<tr>
<td>POLSKA MIEDŻ S.A.</td>
<td>0.04</td>
</tr>
<tr>
<td>GLOBE</td>
<td>0.02</td>
</tr>
<tr>
<td>TRADE CENTRE S.A.</td>
<td>0.02</td>
</tr>
<tr>
<td>TELEKOMUNIKACJA</td>
<td>0.02</td>
</tr>
<tr>
<td>POLSKA S.A.</td>
<td>0.02</td>
</tr>
<tr>
<td>GETIN HOLDING S.A.</td>
<td>0.02</td>
</tr>
<tr>
<td>POLIMEX-MOSTOSTAL S.A.</td>
<td>0.02</td>
</tr>
<tr>
<td>LPP S.A.</td>
<td>0.02</td>
</tr>
<tr>
<td>CERSANIT S.A.</td>
<td>0.02</td>
</tr>
</tbody>
</table>

Source: KNF 2007

An empirically rigorous evaluation of whether these incentive structures are in fact driving the curiously non-existent corporate governance activism in the Polish case is difficult, not least of which because the internal benchmark used to evaluate minimum returns and the herding behavior that follows have not changed sufficiently over time to expect concurrent changes in behavior. Moreover, the use of such a benchmark is a common feature of most pension reforms based on the Chilean model. The only partial exceptions that we are aware of are Hungary and Colombia. Beginning in 2003, Colombia changed its minimum return guarantee to be based half on a weighted average of pensions operating in Colombia and half on an external benchmark of returns on a synthetic portfolio of long-term assets designed by the Colombian regulators. This policy shift reduced herding somewhat among Colombia’s pensions, though a high degree of herding remained...
The Hungarian minimum return guarantee is set to a benchmark of government bonds, requiring pension to earn 90% of that benchmark or make up the difference out of their own funds. This system was also designed to reduce herding behavior among pension funds.

By moving towards an external benchmark, we might expect that there should be more corporate governance activism by pension funds at the policy level, as all funds have an incentive for domestic equity returns to increase. Indeed, Jordan and Lubrano (2008) note that Colombian pension funds played a role in shaping Colombia’s comply or explain code. However, due to the heavy reliance on fixed income assets in the calculations of these external benchmarks, and the underdeveloped (relative to Poland) stock markets in both countries, neither pension system invests heavily in domestic stocks (roughly 10% in both countries, despite a statutory limit of 50% in Hungary and 30% in Colombia), and neither appears to be playing the sort of role in the corporate governance regimes of these countries that more activist funds play elsewhere.

Several alternative explanation for OFE pension fund passivity can be attributed to the management of the funds by PTEs. Among those explanation we find most compelling are: 1) management of OFE funds by large financial institutions creates conflicts of interest that disincentivizes corporate governance activism, 2) The large non-Polish entities that manage may OFE funds are simply unfamiliar with issues pertaining to Polish corporate governance, and 3) private investors are intrinsically less sensitive to corporate governance issues than public institutions would be. We will briefly address these in turn.

One possible reason why the OFE-PTE relationship may induce less corporate governance activism is through the creation of commercial conflicts of interest. A fund administered by ING, for example, may be less willing to push for concessions from management if the firm in question is itself a division of ING, or if another division of ING manages their corporate pension plan, or sells them an insurance product. This potential conflict of interest can easily percolate up to the policy arena. To alleviate that potential for conflicts of interest, the OFE fund administrators are banned from many kinds of communication with the other divisions of the sponsoring firm. Moreover, no OFE is allowed to purchase shares in firms that are other divisions of the same parent firm, or if the sponsoring firm does substantial business with the firm to be invested in. So, for example, the pension operated by Bank PEKAO owns no shares in Bank PEKAO, despite this firm being one of the largest components of the WIG 20 and the most commonly held...
Why isn’t there a larger pension fund impact on Polish corporate governance?

stock in the OFE system (KNF 2007). The efficacy of these measures in alleviating the potential for conflicts of interest was reinforced throughout our interviews. While certainly possible, no interview subject suggested that corporate conflicts of interest are a meaningful factor in pension fund behavior.

It may also be the case that the relatively remote management of the OFEs by the PTEs leads to less appreciation of the Polish corporate governance landscape and less political action generally than would be expected if the OFEs were all managed by local institutions. While possible, this possibility strikes us an improbable. First, were this to be the case, it should be true that OFE managed by Polish financial firms or consortiums of Polish financial firms are more active in corporate governance matters than their foreign owned counterparts. Based on our interviews, this does not appear to be the case. Moreover, many of the most activist pension funds on corporate governance issues in emerging markets are managed by entities outside of those markets (ex. CalPERS, Hermes). As it pertains to the PTEs and OFE’s willingness and abilities to invest in political action generally, the formation and operation of the IGTE suggests that no significant barriers to political action exist. Our question is not “Why are the OFE pension funds politically inert?” - they are not - but rather, “Why do they choose not to focus on corporate governance matters?”.

Finally, it may be the case that the fact of the pension funds being managed by private entities impedes their willingness to be active on corporate governance issues. While it is certainly the case that in some countries the close relationship between pension fund managers and government has created a political environment favorable to pension fund activism on corporate governance issues (ex. Malaysia, see Gourevitch and Shinn 2005) there are other cases in which this closeness has impeded corporate governance activism (ex. Philippines, see Asher 2000). In the United States, political considerations have often led public employee pension funds to stand down in corporate governance issues so as not to upset firm-government relationships (ex. Romano 1992, Stevenson 1991). In short, we find no convincing reason to suggest that the identity of the PTEs as private actors remote from the OFE and from the Polish government has any significant impact on the political activities of the OFE or their investment strategy.
6.2. Limits of foreign investment and government incentives to retain pension fund capital

A remaining question is: Why hasn’t the Polish government or the Warsaw Stock Exchange done more to promote corporate governance? Hypothesis 3 can give some insight into this question. Poland’s current regulations stipulate that pension can manage a portfolio with prescribed limits on investment in any particular asset class, which is shown in Table 6. Table 6 also shows the aggregate portfolio of OFE pension funds from the year 2007.

As can be seen, Polish OFE’s have a strong appetite for shares, but as a whole tend to be considerably more cautious in their portfolio than statutes require, particularly with respect to foreign investment. Part of the reason is that the restrictions on foreign investment are more stringent than they appear, for at least three reasons. First, OFE pension funds are severely limited in the derivatives that they can hold, and are presently unable to hedge foreign equity purchases with currency based derivatives. In the absence of this ability, foreign investment requires making a directional bet on currency movements as well as stocks and this is simply too risky of a bet for pension funds to take on. Second, PTEs currently must pay transaction fees on foreign markets out of their own funds when such fees are higher than those on Polish markets. Because foreign transactions are often more expensive than trading on the domestic market, pensions are discouraged from making these investments. Finally, in 2003 Ministry of Finance issued a rule mandating that foreign investments be limited to instruments with an investment grade rating. This effectively limits pensions to foreign investments in bonds, which are routinely rated, but not equity.

Table 6. OFE’s aggregated assets

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Percentage in 2007 OFE portfolio</th>
<th>Statutory Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Deposits and Securities</td>
<td>2.52</td>
<td>20</td>
</tr>
<tr>
<td>Domestic Equity</td>
<td>34.01</td>
<td>40</td>
</tr>
<tr>
<td>NFI</td>
<td>0.27</td>
<td>10</td>
</tr>
<tr>
<td>Mutual Fund Shares</td>
<td>0.23</td>
<td>10</td>
</tr>
<tr>
<td>Corporate Bonds</td>
<td>1.28</td>
<td>5</td>
</tr>
<tr>
<td>Other Fixed Incomes</td>
<td>0.37</td>
<td>15</td>
</tr>
<tr>
<td>Foreign Investment (Debt, Equity, Bank Deposits)</td>
<td>1.04</td>
<td>5</td>
</tr>
<tr>
<td>Public Debt (Polish Treasuries, Municipal Bonds)</td>
<td>59.98</td>
<td>no limit</td>
</tr>
<tr>
<td>Other</td>
<td>0.3</td>
<td></td>
</tr>
</tbody>
</table>

Source: KNF (2007)
By restricting the amount of foreign investment so severely these regulations effectively create a captive investor. Claessens, Klingebiel and Luhrano (2002) suggest that such a captive investor is less likely to engage in corporate governance activism. This strikes us as a misguided concern. By ensuring that the OFE pensions have a stake on the domestic market, the limitations on international investment ensures that they can't take the “wall street walk” with respect to the entire market in order to avoid Polish corporate governance altogether. Certainly in the American experience, pension funds became active in corporate governance affairs partially because they became captive investors through self-imposed indexing strategies and when their equity positions became too large to sell without depressing share price in the process. We see little evidence that the ability of limitations on foreign investment to create “captive” pension funds should have a deleterious effect on pension fund activism, and, if anything, may induce the opposite behavior.

The primary concern of creating captive pension fund assets is that it undermines government or stock exchanges' incentives to use corporate governance policy as a way of retaining investments. In the Polish case, the government's need to keep pension fund money at home in order to finance long-term growth and capital accumulation is a long standing priority, even if achieving it comes at the likely expense of savers' long-term returns. If achieving this end were at least partially tied to implicit or explicit demands for better corporate governance policies or, as is more likely, more active enforcement of laws already on the books, it seems reasonable to us that a more active government or stock exchange role would follow. Indeed, this is precisely the mechanism through which CalPERS was able to have a considerable impact on emerging market corporate governance policies (Hebb and Wójcik 2005). Instead, the retention of OFE funds in Poland is effectively guaranteed through regulations.
7. Conclusion and recommendations

There is a widely held expectation among political economists that increasing the size of pension fund assets will lead to more shareholder-friendly corporate governance regimes, as those pension funds 1) lobby firms and governments to install policies in shareholders’ interests and 2) force firms and governments to compete with each other on corporate governance policies in order to attract and retain pension fund managed capital. The rise of pension privatization around the world suggested to many that a new wave of shareholder friendly policies was imminent. In examining the Polish experience, we conclude that such expectations are misguided, or, at the very least, overly simplistic. OFE pensions do not play a significant role in shaping policy, either directly by participating in the rule making process or indirectly by shifting rule-makers’ political priorities. OFE pensions do not engage in name and shame efforts, or attempt to insert themselves in the business affairs of the firms they invest in. OFE pension funds play a modest role in Polish corporate governance, primarily through their insistence on promoting independent supervisory board members in the firms they invest in, though there appears to be a paucity of evidence that these efforts have been fruitful in the aggregate.

Why hasn’t pension reform had a more meaningful impact on Polish corporate governance? We have argued that the regulatory structure faced by OFE pension funds is likely culprit, by decreasing OFE pensions’ incentives to expend resources on corporate governance issues and by insulating government and the stock exchange from the possibility of capital flight. To that end, we think the conclusions drawn in this report strongly suggest that future research on the nexus of pension fund reform and corporate governance policies go beyond simply noting the size and organization of the resulting pension system, but also to the incentives provided by the regulatory regime it operates in.

Several regulatory changes that are being currently debated by the Polish government, or have been proposed by IGTE, could alter this dynamic. One of the more important of these reforms is the expansion of overseas equity investment through 1) lifting the current 5% ceiling, 2) allowing OFE pension funds to hedge overseas investment with currency derivatives, 3) lifting the ban on unrated overseas securities, and 4) reforming the rules concerning transaction fee payments. This reform, if it is pursued to the extent suggested by IGTE, would culminate in a 30% cap on overseas investment by 2015 and would have far reaching effects on the sorts of portfolios held by the pensions.
Under these proposed rules pension fund managers would almost certainly diversify their portfolios internationally, regardless of the corporate governance standards in place in Poland. However, improving corporate governance rules could help keep some of that capital in Poland and, consequently, it could change rule-makers’ attitudes towards corporate governance if the retention of pension fund assets continues to be a major priority. Perhaps more importantly, without an opportunity to shift assets overseas, the continued accumulation of pension fund capital on the Polish capital markets will only strengthen the correlation between the equity portfolios of the different funds. Accordingly, we suspect that the persistence of such severe limitations on foreign investments will exacerbate herding behavior and further disincentivize OFE pensions from acting as corporate governance watchdogs of the firms they invest in.

A pending law suit by the European Commission to liberalize these rules to conform to the 30% standard set for European private pensions would, if successful, force this policy change. However, the reactions by the Polish government to this suit have only underlined the government’s commitment to keeping these limitations in place for the foreseeable future. Of course, the corporate governance implications of potential capital flight have to be weighed against the other, more immediate implications for the domestic economy and we are in no position to evaluate those economic needs. Nonetheless, we do recommend that a long-term, holistic view of the matter including consideration of its corporate governance implications should be taken.

A more likely reform would be to move away from an internal benchmark and replace it, over time, with an external one. There are a variety of ways to construct a system of external benchmarks, and suggesting one mechanism over another is outside of our expertise and outside of the scope of this report. However, constructing an external benchmark of some sort could provide a motivation, currently lacking, for pension funds to take engage in corporate governance issues that impact the market as a whole through lobbying for better enforcement of corporate governance rules, or by taking a more active stance in ongoing soft law efforts to strengthen Poland’s corporate governance regime. Taking steps to strengthen the relationship between fund performance and attracting new enrollees might also serve, in conjunction with the above reforms, to strengthen this motivation. Moreover, if establishing an external benchmark leads to less herd-behavior among OFE pension funds, it could encourage them to take more responsibility for the corporate governance of the firms they invest in.
Appendix

There are three actors in this model: government, who sets policy, corporate insiders, that are assumed to lobby against shareholder friendly corporate governance, and pension funds, who lobby for shareholder-friendly corporate governance policies. Lobbying activities in this model are simplified to consist of financial contributions to politicians. We denote the level of corporate governance as $X \in [0,1]$, with higher values indicating more shareholder friendly corporate governance. In the first stage insiders and pension fund lobbyists declare a contribution schedule – the size of the gift they are willing to give in exchange for any given policy choice made by the government. 17 We denote the gift associated with policy $X$ in insider’s and shareholder’s contribution schedule as $C_I(X)$ and $C_S(X)$, respectively. In the second move of the game the government chooses a policy $X$ and then collects the associated contributions. In the third move markets react to the choice of $X$. In the final move of the game, voters cast their ballots in accordance with perceived changes in their individual welfares. Thus, governments that oversee poorly performing stock markets are more likely to face public sanction. The core tension faced by politicians is therefore how to balance the the contributions of interest groups against their own electoral interest in the general public.

To structure the utility functions we assume that all actors have an ideal level of investor protection – $X_G$ for government, $X_I$ for insiders, and $X_S$ for shareholders – that is the product of their own local knowledge of investor protection’s likely impact. We assume that $X_G$ is the policy that maximizes economic performance, which is a function of, among other things, the extent to which the policy promotes capital inflows or capital outflows, which in turn effects the availability and price of capital, share-price movements of currently listed firms and the extent to which markets host IPOs and attract cross-listing from abroad.

$X_G$ may or may not be equal to 1, which is to say that we allow for the possibility of overly investor friendly corporate governance regimes that place an onerous financial burden on firms, as well as existing complementarities in industry that limit the extent to which greater shareholder influence has a beneficial impact on firm performance, and thus, economic outcomes. We assume that $X_I$ is less than or equal to $X_G$, as insiders have no incentive to lobby for a policy that is gives minority shareholders an inefficiently large amount of power. By the same logic, we assume that $X_S$ is greater than or equal to $X_G$, as shareholders have no incentive to prefer policies that give insiders an inefficient amount of power. The utility functions for politicians, insiders and shareholders are stated as quadratic loss functions and are given below.
Governments utility function \[ W_G \times (X - X^G)^2 + C_1(X) + C_3(X) \]

(1)

Insider's utility function \[ W_I \times (X - X^I)^2 - C_1(X) \]

(2)

Shareholder's utility function \[ W_S \times (X - X^S)^2 - C_3(X) \]

(3)

I define \( W_G \) as the weight governments place on economic outcomes relative to the weight governments place on gifts from lobbyists, which is normalized to 1. \( W_I \) and \( W_S \) as the weight that insiders and shareholders, respectively, assign to policy, relative to the weight that they assign to the costs of gift giving, which is normalized to one. The \( P \in [0,1] \) term in the contribution schedules capture the idea that weight that interest groups are willing to attach to policy \( X \) is proportional to the extent to which that interest group is able to capture the rents associated with that policy, i.e. the extent to which non-contributing actors benefit from the lobbying efforts of others. When there is no free-riding - as would be the case if the organized shareholder lobby were the only minority shareholder in an economy, or if organized insiders were the only managers or majority shareholders in an economy - the shareholder lobby is able to capture the entirety of the policy rents accruing to their position within the firm. In this case, the lobby groups could justify spending as much money on lobbying as the the expected utility of the policy is worth. As free riding increases, the lobby is less able to capture the fruits of their lobbying efforts and the value of policy in their utility function is accordingly lower. A pension that controls 10% of the market, can only justify spending 10% of the value of the policy in their lobbying efforts. In practice, this is more of a concern for shareholders, where the costs of lobbying are overwhelming taken on by a relatively small set of institutional investors, while individual investors and passive institutional investors are able to collect the rents. Among insiders, free riding is less of a concern.

As noted above, this game is substantially identical to “common agency” games noted in Bernheim and Whinston (1986), Grossman and Helpman (1994, 1996, 2001), Dixit, Grossman and Helpman (1997) and others. As Bernheim and Whinston note, the Nash solution to this type of game allows for infinite equilibria, and therefore requires a more refined solution concept. The solution concept Bernheim and Whinston develop, which has been adopted in the subsequent literature, calls for focusing on “Truthful Nash Equilibria.” A Truthful Nash Equilibrium obtains when it satisfies the definition of a Nash equilibrium (no player has an incentive to deviate from their prescribed
action, given the actions of others) and when principles (in this case: lobbyists) structure their contribution schedule truthfully, so that any positive change in X will be exactly compensated by a change in \(C_j(X)\) for \(J \in \{I,S\}\). As a result, for any given contribution schedule the principle is indifferent between all policy choices. We do not reproduce Bernheim and Whinston’s proofs, but suffice it to note that Truthful Nash Equilibria exist in the set of best responses for all possible strategies chosen by other interest groups and may, in practice, serve as focal points (Bernstein and Whinston 1986; Grossman and Helpman 1994).

The solution to this game requires both insiders and shareholders to offer contribution schedules that leave the government at least indifferent between accepting their offer and ignoring it altogether. More formally, lobbyist \(j\) solves the following maximization problem.

\[
\max (X, C) - W_j(P_j) \cdot \frac{(X - X^j)^2}{2} - C_j(X)
\]

\[
(4)
\]

\[
\text{s.t.} - W_g \cdot \frac{(X - X^g)^2}{2} + \sum C_j(X) \geq \frac{W_g \cdot (X - X^g)^2}{2} + C_{t \neq j}(X)
\]

\[
(5)
\]

\(X\) refers to the policy that would obtain if interest group \(J\) contributed nothing. In practice, because lobbyists have no incentives to overpay, equation (5) holds in equality. The politician, in turn solves the maximization problem

\[
\max (X, C) - W_g \cdot \frac{(X - X^g)^2}{2} + \sum C_j(X)
\]

\[
(6)
\]

which yields the first order condition

\[
-W_g \cdot (X^g - \dot{X}) + \sum \frac{\partial C_j(X)}{\partial X} = 0
\]

\[
(7)
\]

where \(\dot{X}\) is the policy chosen in equilibrium. The definition of a Truthful Nash Equilibrium states that \(\partial C_j(X)/\partial X\) is equal to the marginal rate of substitution between policy and money. Thus, we can rewrite equation (7) as

\[
W_g \cdot (X^g - \dot{X}) + W_I(P_I) \cdot (X^I - \dot{X}) + W_S(P_S) \cdot (X^S - \dot{X}) = 0
\]

\[
(8)
\]
Solving for $\delta$ yields the equilibrium policy choice

$$\dot{X} = \frac{X^G W_G + X^J W_J (P_J) + X^I W_I (P_I)}{W_G + W_I (P_I) + W_J (P_J)}$$

(9)

This result makes intuitive sense. As Dixit, Grossman and Helpman (1996) note, equation (9) is effectively weighted averages of each actor's policy preferences. To find the full equilibrium solution we refer back to (5) and solve for $C_j(X)$, which yields

$$C_j (\dot{X}) = \frac{-W_G (X^* - X^G)^2 + W_J (\dot{X} - X^G)^2}{2} + C_{L \neq j} (\dot{X}) - C_{L \neq j} (\dot{X})$$

(10)

The definition of a Truthful Nash Equilibrium implies that

$$C_{L \neq j} (X^*) - C_{L \neq j} (\dot{X}) = \frac{-W_{L \neq j} (P_{L \neq j}) (X^* - X^{L \neq j})^2}{2} - \frac{W_{L \neq j} (P_{L \neq j}) (\dot{X} - X^{L \neq j})^2}{2}$$

(11)

Substituting (11) back into (10) yields

$$C_j = \frac{W_G (\dot{X} - X^G)^2}{2} - \frac{W_J (X^* - X^G)^2}{2} + \frac{W_{L \neq j} (P_{L \neq j}) (\dot{X} - X^{L \neq j})^2}{2} - \frac{W_{L \neq j} (P_{L \neq j}) (X^* - X^{L \neq j})^2}{2}$$

(12)

gdzie $X^* = \frac{X^G W_G + X^{L \neq j} W_{L \neq j} (P_{L \neq j})}{W_G + W_{L \neq j} (P_{L \neq j})}$

(13)

Thus the full, Truthful Nash Equilibrium for this model is given by the policy noted by (9), shareholder contributions equal to

$$C_s (\dot{X}) = \frac{W_G (\dot{X} - X^G)^2}{2} - \frac{W_J (X^* - X^G)^2}{2} + \frac{W_{L \neq j} (P_{L \neq j}) (\dot{X} - X^l)^2}{2} - \frac{W_{L \neq j} (P_{L \neq j}) (X^* - X^l)^2}{2}$$

(14)
and insider contributions equal to

\[ C_i(\dot{\bar{X}}) = \frac{W_e(\dot{\bar{X}} - X^e)^2}{2} - \frac{W_e(X^i - X^e)^2}{2} + \frac{W_i(P_i)(\dot{\bar{X}} - X^i)^2}{2} - \frac{W_i(P_i)(X^i - X^i)^2}{2} \]

(15)
Endnotes

1 The WIG20 (short for Warszawski Indeks Giełdowy, or Warsaw Stock Exchange Index) is an index of the twenty largest firms traded on Warsaw Stock Exchange.

2 Becker and Greenberg (2003), Svaleryd and Vlachos (2005) and others have argued that financial development is also a source of national comparative advantage in trade, as firms listed in countries with better performing capital markets can avail themselves of cheaper access to capital.

3 CalPERS stands for the California Public Employee Retirement System, the largest pension fund operating in the United States, and historically one of the most active in corporate governance issues.

4 See Bernheim and Whinston (1988) and Grossman and Helpman (1994, 1996, 2001) for a more in-depth discussion of contribution schedules and their role in common-agency games.

5 Of course, just because countries have good reasons to privatize their pension systems doesn’t mean that they will. As Brooks (2007) notes, a variety of pressures including a country’s exposure to the world economy, domestic political structures and the extent to which their regional peers have reformed their pension systems all condition the salience of these pressures and the extent to which domestic politicians are pressured to reform their own pension systems.

6 Bergloff and Pajuste find that Polish listed companies are significantly less likely than listed companies in other countries in Central and Eastern Europe to report ownership by management and boards of directors, total levels of executive compensation, and transactions with related parties.

7 Comply of explain refers to a process in which firms must submit annual reports noting whether or not they complied with a certain rule, and, if not, why. This format is quite common, having been pioneered by the Cadbury code in the UK.

8 2002 was something of a boom year for Polish corporate governance codes, as the similarly named Polish Forum For Corporate Governance, an academic institute affiliated with the Gdansk Institute for Market Economics also published “The Corporate Governance Code for Polish Listed Companies”, which is commonly referred to as the “Gdansk Code”. The Warsaw Stock Exchange and Polish Securities and Exchange Commission (now part of the KNF) both adopted the “Best Practices in Public Companies in 2002” as their own internal standard, so we focus our attention on this code.

9 The EC standard for independence of supervisory board members that is now required is defined in Annex II of the Commission Recommendation of 15 February 2005.

10 The actual comply and explain reports for many firms are available on their websites and there appears to be a significant amount of variation in the quality of the responses. For example, some WIG 20 companies cite precise, firm-specific complexities as reasons to choose different arrangements on, for example, the composition of supervisory board. In other cases, the comply and explain reports submitted by WIG 20 companies suggest a more dismissive stance towards the standards suggested by the exchange.

11 The Polish Forum for Corporate Governance is a different organization from the similarly named Corporate Governance Forum that drafted the best practice code.
12 We refrain from a more sophisticated regression analysis for several reasons. First, the decision to invest in a firm is likely endogenous to the extent of preexisting shareholder-friendly corporate governance policies. Estimating a model in first differences, or using firm-fixed effects can adjust for initial conditions, but does not make the direction of causality any clearer. Absent an instrument that is correlated with pension fund ownership but not firm level corporate governance, which has been elusive in quantitative work on the impact of ownership structure on firm characteristics, there is no obvious way to generate more conclusive quantitative evidence.

13 We also analyzed data for a broader set of firms including non WIG-20 firms, and the same overall pattern, or lack thereof, emerged.

14 This is not to say that the establishment of the pension funds has not had an impact on political decision making with respect to capital market operations. The supervision of the pension funds, first under the UNFE, then in a merged insurance-pension fund regulator, the KNUiFE, and now under the KNF, has been a considerable political issue, with the security of retirees’ income being the most prominent factor. These issues, however, are at best tangential to corporate governance policy.

15 Most recently, these efforts have included launching a corporate governance focused website http://corp-gov.gpw.pl/, through which investors and managers can learn more about the code of best practice, and learn about upcoming seminars and conferences on the topic, many of which are coordinated by outside groups such as the Polish Directors Institute (Polski Instytut Directow, or PiD).

16 This effectively constitutes a waste of human capital. While one might expect some funds to have better managers than others, Kominek (2006) finds that there is no persistence in pension fund performance over time.


18 In keeping with Rogowski and Kayser (2002), Bebchuk and Neeman (forthcoming) and Perotti and Volpin (2004, 2007) we assume that the utility from gifts from lobbyists are unconnected to an incumbent’ government’s ability to hold office. This assumption has support in the empirical literature. Extant empirical literature consistently finds that campaign spending by the incumbent lacks a meaningful impact on votes (ex. Glantz, Abramowitz and Burkhart 1976; Jacobson 1978, 1980, 1985, 1990; Abramowitz 1991; Levitt 1994; Gerber 2004; and see Green and Krasno 1988 for an alternative finding). Moreover, many political contributions, particularly from business interests, take the form of promises of attractive work on Wall Street or K Street following a retirement from politics, or other in-kind contributions that are not obviously redeemable for votes. Additionally, in practice, one could easily allow reelection odds to be increasing in campaign contributions. As long as contributions have some positive utility outside of reelection, and as long as incumbent governments’ reelection prospects are more closely tied to economic outcomes during their tenure than to campaign spending, the results of this model would remain unchanged. However, the cost to parsimony for allowing reelection
Endnotes

odds to increase in campaign contributions is significant. Doing so introduces at least two new choice variables. The first of these variables concerns lobbyists' choices over contributing gifts that are useful only to gain votes (buying advertisements, for example), gifts that are not useful at getting votes (such as a promise of a good job post-retirement) or gifts that can be used at a politicians' discretion (cash). Second, one would have to include a choice variable over how an incumbent allocates cash gifts. Analysis of such dynamics, while interesting in their own right, falls outside the purview of this paper.
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