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Transactional Structures of Bank Privatizations in Central Europe and Russia

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Transactional Structures of Bank Privatizations

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Meyendorff, Anna and Edward A. Snyder — Transactional Structures of Bank Privatizations in Central Europe and Russia

In pursuing bank privatization, governments in Central Europe and Russia faced a common set of policy issues including how to break up the monobank system, deal with troubled loans, transfer equity to the private sector, and attract capital to the banks. For each bank undergoing privatization, the government's approach to such issues determines its transactional structure. We develop this conceptual framework and assess the findings from three studies of major commercial banks undergoing privatization. The varied transactional structures used in these privatizations appear to have had significant effects on each bank's microstructure, and to influence bank strategy and post-privatization performance. *J. Comp. Econom.*, August 1997. The William Davidson Institute at the University of Michigan Business School, Ann Arbor, Michigan 48109.

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I. INTRODUCTION

In pursuing bank privatizations, governments in Central Europe and Russia faced a common set of policy issues including how to break up the monobank system, deal with troubled loan portfolios, transfer equity to the private sector, and attract financial and human capital to the banks. For each bank undergoing privatization, the government's approach to such issues determined a unique transactional structure. In this article we develop the transactional structure framework and assess the findings from three studies of major commercial banks undergoing privatization.

The case studies analyze the privatization of three major commercial banks: Zhilsotsbank in Russia, Komer©ní Banka in the Czech Republic, and Bank ©l(ski in Poland. The varied transactional structures used in these privatizations appear to have had significant effects on each bank's microstructure. Antecedent actions, for example, influenced the character of the banks' balance sheets, identified their various clientele, and determined the banks' initial market positions. In addition, these case studies, along with work in progress on Hungarian banks, indicate that the transactional structures have influenced the financial health of the banks, their business strategies, and their post-privatization performance.

Three factors underscore the importance of the insights derived from this approach. First, privatization of the banks derived from the socialist banking structures has been a centerpiece of strategies for financial sector reform in these countries since the late 1980s. Although academic debate continues on the proper role of former state-owned banks, as a practical matter the question has been largely answered by policy makers, who decided early in the reform process that the commercial banks derived from the monobank systems and other specialty banks that

had operated under communism would play an important role in the developing financial systems.

Second, nearly a decade after the countries' reform processes began, these same banks remain quite dominant in their respective banking sectors. In the Czech Republic, the banks hived off from the monobank and the former specialty banks control over 80% of the country's banking assets. In Hungary and Poland the asset shares are 60% or more. Only in Russia have *de novo* entrants established a significant presence, and yet even there state and former state banks have more than 30% of banking assets.

Third, the privatizations of these banks have not transferred effective control to the private sector. Data from the European Bank for Reconstruction and Development (EBRD), in combination with the case studies, indicate that most of the banks hived off from the monobank and the former specialty banks are still under state control.[2] In the Czech Republic, none of the top four banks is in private hands. While Hungary and Poland have made recent progress, most of the assets associated with the original state banks remain under government control. In Russia the government continues to hold majority shares in the two largest banks in the country.

In light of these factors, an analysis of transactional structures can enhance the understanding of how privatization policies actually worked at the level of the individual commercial banks and provides a basis for judgments about why the commercial banks derived from the monobanks remain dominant. Current industry structures are shown to be the result of the transactional structures used, the nature of government-bank relationships, and related government policies such as licensing. Our evaluation of the transactional structures also yields insights about the barriers that have impeded privatization, thus connecting individual bank

privatization efforts to the lack of overall progress in restructuring and reforming the region's financial sectors.

Given the prospect of increasing domestic and foreign competition when European Union rules are extended to countries in the region, an overriding issue is whether the banks in question have progressed in developing sustainable franchise value.[3] While many of the privatized banks appear profitable, their financial health is attributable to their market power and various forms of government support. To contribute to both financial and real sector reform, these institutions will ultimately have to become efficient modern banks, capable of operating in a competitive banking environment. The individual case studies on which we base our analysis provide evidence on the performance of major commercial banks in the region in a variety of dimensions including management of their loan portfolios.

While making the case for a deeper understanding of the transactional structures, the studies and our analysis also demonstrate that factors external to the transaction structure have had a significant influence on bank behavior in transitional economies. These include the quality of bank regulation, the condition of real sector enterprises, and the quality of accounting and reporting by bank clients. Such factors, and especially the role of government in bank operations and corporate governance, may exert strong influence on bank performance. Thus, we recognize that assessments of the transactional structures for bank privatizations must be put in the broader context of complementary policies as well as economic and political conditions.

II. THE PRIVATIZATION PROCESS AND TRANSACTIONAL STRUCTURE ELEMENTS

In this section we describe the bank privatization process in terms of the transactional structure framework and its fundamental elements. We group these elements in three broad categories: (i)

antecedent actions that determine the characteristics of the unit to be privatized, (ii) ownership transfer and governance, and (iii) follow-on actions and ongoing government interventions.

Antecedent actions, including the carving up of the monobank structures, determined the assets and liabilities as well as the clients and branches assigned to various commercial banks and established their competitive positions within the overall industry structure. Additional antecedent actions, especially attempts to deal with the legacy of bad loans, were taken to prepare the banks for privatization.[4] Once the banks to be privatized were initially constituted, the actual ownership transfer and the development of corporate governance could proceed. As a part of this process, the feasible set of future owners was defined and a method of transferring ownership was chosen. In some cases, the privatization plans also specified how much equity was to be initially transferred. During and subsequent to this transfer, the government and future owners determined the new corporate governance structure of the bank, including the roles of the government, outside investors, and incumbent managers in future operations. Follow-on actions include regulation and supervision specific to former state-owned banks, additional portfolio restructuring, and continued use of the banks as instruments of government policy.

A. Antecedent Actions

The monobank structures that channeled funds according to government policy were typically split into a central bank and several commercial banks. In contrast to the foreign trade banks and other specialty banks that existed before reforms began, the new commercial banks reflected a broader cross-section of the economy and were intended to serve as the backbone of the reformed banking sector.

Breaking up the monobank system: The number and type of units into which the commercial operations of the monobanks were divided vary across the region. At one extreme,

Czechoslovakia did very little organizational restructuring of its commercial banking function when it separated central and commercial banking functions. Komer©ní Banka, the subject of Snyder and Kormendi (1997), inherited a loan portfolio consisting of almost all of the Czech Republic's commercial loans as well as the Czech component of the monobank's payments system. Parallel actions were taken in the Slovak Republic.

The Soviet approach was to create specialized banks for foreign trade, agriculture and savings, and to derive two commercial banks from its monobank, one for heavy industry and one for light industry and services. When the Soviet Union was dismantled, Russia inherited the same structure, retaining those branches within its territory. Abarbanell and Meyendorff (1997) analyze the privatization of the commercial bank for light industry, and the subsequent creation of Mosbusinessbank, the privatized bank that inherited most of Zhilsotsbank's assets. Hungary's restructuring of the monobank was similar to the Soviet approach in that it created three country-wide commercial banks, Budapest Bank, Magyar Hitel Bank, and Kereskedelmi Bank, whose loan portfolios and client relationships were specialized by sector, i.e., industry, agriculture, and small business and utilities.

Poland's model was the most complex, dividing the commercial banking function among nine new commercial banks defined primarily by region. Each bank's loan portfolio was, as a result, determined by the regional economy, and each effectively had control of the region's financial services in the short run. Bank ©l‹ski, the subject of Abarbanell and Bonin (1997), is one of two commercial banks that are dominant in the highly industrial region of Silesia.

One can argue that the different approaches to carving up the state bank structure would not be of critical importance if governments were to foster a high level of competition by privatizing state banks rapidly and by licensing *de novo* entrants. On the other hand, if such

policies are not pursued and especially if recombining assets after privatization is difficult, the initial restructuring is likely to have long-term effects on bank performance and overall financial sector efficiency. The case studies support the latter view. Given the general weakness in product market competition, the character of the breakups and the related allocations of assets and client relationships determined the structure of the banking industry and influenced the extent to which banks could exercise market power in their core businesses.

The studies further point to the existence of a trade-off between short-run franchise value derived from monopoly power and long-run franchise value derived from efficiency in the banks that were hived off from the monobank. The minimal restructuring in the Czech Republic and Hungary endowed the commercial banks with strong market positions, thus enhancing their financial stability in the early reform period. However, due to the absence of real competition, these banks have had weaker incentives to increase efficiency. The more extensive restructuring in Poland and Russia generated banks with less market power and with portfolios vulnerable to economic conditions in certain sectors and regions. Many of these banks became insolvent, requiring government intervention, but others developed stronger portfolios, leading to a more rapid transformation and faster improvements in the provision of banking services.[5]

Troubled loan portfolios and recapitalization: Due to deteriorating macroeconomic conditions, the poor condition of real-sector enterprises, and the legacy of non-market-based allocations of credit, the commercial banks derived from state banking operations had a high percentage of non-performing assets in their inherited loan portfolios. According to Thorne (1993), the ratio of non-performing to total loans in 1991 was approximately 50% in the Czech Republic, Hungary and Poland. While none of the governments fully implemented a good bank–bad bank approach to the bad-asset problem, i.e., the transfer of all bad loans to a

specialized hospital bank, governments in the region did take a variety of actions to clean up the portfolios and recapitalize the banks before proceeding with bank privatizations.[6] The extent of cleansing also varied as the result of inflation and the speed of privatization efforts.

In the case of Komer©ní Banka, whose original portfolio consisted of virtually all loans to Czech state-owned enterprises, the government's approach combined asset- and liability-side measures, the end result of which was the transfer of about one-third of the K© 325 billion portfolio back to the state. In early 1991, Komer©ní transferred so-called revolving credit loans with a gross book value of K© 79 billion to the newly created Consolidation Bank; an equal amount of liabilities due to the State Bank also was transferred. In addition, the government made K© 15 billion available to Komer©ní's clients to reduce their debt burden. Komer©ní was able to write off these loans and was allocated K© 7.8 billion in capital, substantially improving its overall financial status.

Hungary has taken several actions to deal with troubled loans. In 1991, the government formally guaranteed about half of the stock of recognized non-performing loans in the three major state-owned commercial banks. No important regulation or supervision was in place at this time, however, and the true extent of the bad loan problem was not known. In 1992, the government became aware of significant growth in new bad loans. In anticipation of privatization, the government initiated a loan consolidation program whereby commercial banks transferred substantial portions of their non-performing loans to the Hungarian Development and Investment Company in exchange for government bonds. For example, the Ft 5 billion allocated to Budapest Bank brought the bank up from a negative to a 0% capital adequacy ratio.[7]

In the following year, Hungary's loan consolidation program was expanded to both encourage enterprise restructuring and promote the sale by banks of their bad debts to companies that specialized in collections and workouts. As part of the program, the banks received nearly Ft 80 billion in state funds for recapitalization of the banks. Budapest Bank received Ft 5 billion of new capital in this phase, raising its capital asset ratio to 4%, still below the standard sought by the government.

In Poland, the problem of troubled loans was also severe but had a regional character. The partitioning of the National Bank's commercial loan portfolio among nine commercial banks left the banks dependent on the financial situation of local enterprises in their regions. Bank ©l⟨ski's loan portfolio was of mixed quality, reflecting the fact that Silesia contained the struggling coal, steel, and automotive industries as well as profitable, export-oriented enterprises. Poland, in contrast to the Czech Republic, was quite deliberate in bank privatization and slow to deal with the stock of troubled loans in the newly-created commercial bank portfolios. From 1989, when the banks were created, to 1992, when plans for bank privatization were formalized, only minor remedial actions were taken.

During this time, a significant part of the original bad loan problem was eliminated by Poland's high inflation, which, for example, was 600% in 1990. Nevertheless, the commercial banks continued to accumulate new bad loans and, as of 1992, the non-performing loans recognized by the banks averaged 26% of the combined portfolios of state-owned banks.[8] After formal plans for restructuring enterprises and privatizing banks were adopted, a one-time recapitalization for state-owned banks was developed using the Polish Bank Privatization Fund. Loans extended subsequent to the creation of the bank were included in the recapitalization program. Because the program was intended for banks that were 50% or more state-owned, and

the privatization of Bank ©l(ski was already in progress, it was excluded from participation. While ©l(ski nevertheless achieved minimum required equity levels after privatization, not participating in the recapitalization program left ©l(ski with a lower-than-average equity position among its peers.[9]

The Russian experience in dealing with troubled loans and bank recapitalization is distinct in several ways from that of the Central European countries. There was a long delay in official recognition of the poor quality of loans extended by newly-created banks. Because enterprises faced soft budget constraints at the time the transfer of bank ownership occurred, enterprise loans were effectively guaranteed by the government and were not treated as a balance sheet problem. For example, Mosbusinessbank, the largest of the banks to be created out of Zhilsotsbank assets, began operations in 1991 with reserves of only 2% against its loan portfolio. Hyperinflation brought on by price reforms in 1992 reduced the importance of these loans even before enterprises were subject to hard budget constraints.[10] When enterprise budget constraints finally hardened in 1993 and 1994, the Russian government lacked resources to fill the equity holes, and little was done to address loan portfolio problems. Only the most politically sensitive banks such as Agroprombank (the agriculture bank) and Sberbank (the savings bank) have openly received government funds.

Conditional on the region-wide policy decision that the banks derived from the monobank structures would play a major role in their economies, recapitalization and restructuring were necessary to establish positive equity positions from which to begin sound banking operations. However, the case studies indicate that the programs designed to address these problems in the economies and banks studied have been only partially successful. The extent to which bad loans were reduced appears to be a function of the nature of the recapitalization programs themselves,

the expectations of future government assistance, and the extent to which the banks remained connected to their original client base.

Hungary and, to a lesser extent, the Czech Republic addressed bad loans in the banks repeatedly, leading to the perception that further bailouts were possible. Komer©ní's management claims to operate with no expectation of government assistance. However, the government's decision not to restructure the banking sector extensively has led to the belief that Komer©ní is too big to fail, potentially aggravating moral hazard problems. On the other hand, Poland has pursued a more credible no–bail out policy towards privatized banks such as Bank ©l⟨ski. In general, the lack of transparency regarding the scope and duration of government programs exacerbates the credibility problem. Russia's policy of selective bailouts in response to crises is a case in point. Again, Poland has been more successful in this respect. Its program for dealing with non-performing assets makes clear which banks and loans are covered and what is required of those who participate.

Many programs for the removal or recapitalization of bad loans in banks have required bank participation in enterprise restructuring. While there is considerable debate about the optimal level of bank-initiated restructuring and the related issue of continued lending to original clienteles, the case studies indicate that government programs and influence are oriented toward having the banks engage in more restructuring while, left to their own, banks tend to eschew this role.[11] Consistent with government preferences, Komer©ní Banka has devoted significant resources to its workout department and has remained focused on its original clientele, exhibiting the least change in lending patterns. On the other hand, not having participated in Poland's official recapitalization program, Bank ©l⟨ski did not develop the extensive workout and

restructuring capabilities required of participants. It has opted for a lower involvement in restructuring activities and is currently pursuing aggressive credit expansion in Silesia and other regions of the country.[12] Mosbusinessbank, its ties to former clients ended because of inflation and largely shielded from government influence, also changed its lending patterns substantially and has not focused many resources on enterprise restructuring activities.[13]

B. Ownership Transfer and Governance

The case studies provide a representative sample of methods of ownership transfer, including voucher privatization, initial public offerings (IPOs), placement of shares with a strategic foreign investor and management-led privatization. Komer©ní Banka's shares were transferred through voucher privatization, with the government specifying that up to 53% of the bank's shares could be purchased while the rest remained in government hands. In actuality, less than 50% of the shares were transferred, as government adjustments of the share price in the final phase of the voucher privatization were conservatively high. Since only Czechoslovak citizens owned vouchers, foreign participation was automatically prohibited. The government has remained the majority shareholder in control of Komer©ní Banka.

Bank ©l⟨ski was privatized through a combination of IPO and equity sale to a foreign investor. As was true of the Czechoslovak government, the Polish government managed the entire privatization process and specified the overall ownership structure of the bank: 30% of shares would by retained by the Ministry of Finance, up to 10% were reserved for employees of the bank, and the remaining 60% would be split between small investors, through an IPO, and a large foreign investor. The transaction was complicated by miscalculations concerning the IPO, but ultimately Internationale Nederlanden Group (ING) purchased a 25.9% stake in the bank while the Ministry of Finance retained a 33.2% stake. This ownership structure remained for two

years during which both the government and ING were viewed as sharing outside control of the bank. The recent sale of most government shares to ING gave it majority ownership.

After significant delays in bank privatization resulting from political infighting and insufficient recapitalization, both Magyar Kulkereskedelmi Bank (MKB) and Budapest Bank in Hungary were privatized through sale of shares to strategic foreign investors, each with the participation of the EBRD. While the government did not retain a majority share in either case, it continued to be a large shareholder: the government share in MKB was 25%. In January, 1996, the government sold this stake to Bayerische Landesbank, which now holds 48.6% of the bank's total equity and 52.9% of the voting equity. The government's stake in Budapest Bank is 22%, with GE Capital owning 27.5% and the EBRD owning 32.5%. However, according to the contractual structure of the equity sale, GE Capital was granted full management control of the bank, with the government committed to a passive ownership role. After significant delays, both of these privatization transactions have recently progressed through the use of innovative incentive measures for the strategic foreign investors regarding pricing and corporate governance.

In contrast to privatization in the Czech Republic, Hungary and Poland, the transfer of bank ownership in Russia occurred through informal management-led processes that affected the fundamental organizational structures of the privatized banks.[14] The only step taken by the Russian government in the privatization of Zhilsotsbank was turning control rights over to bank managers and to the Central Bank's regional offices. Managers and local officials themselves determined both the configuration of the banks to be privatized and their future ownership structure.[15] Large state-owned enterprises and organizations were the initial shareholders in Mosbusinessbank. While in theory these enterprises were providing capital in exchange for

shares, in fact the share price was determined arbitrarily, and many enterprises paid for shares with highly illiquid forms of capital.

Table 1 summarizes methods of ownership transfer used for the case study banks. Each has significant implications for the microstructure and performance of the banks post-privatization. The case studies indicate the importance of several characteristics of the method of transfer, including speed, the level of new capital infusion, the acquisition of new banking expertise and the introduction of independent corporate governance in the bank.

Table 1

Speed of privatization: Speed, other things being equal, increases the likelihood of effective bank privatization and, as such, is a desirable characteristic of the transfer method. Rapid privatization minimizes the likelihood of political interference and, to the extent that privatization is complete, decreases the expectation of future bailouts and encourages earlier realization of operational efficiencies. [16]

Voucher privatization in the Czech Republic was both politically popular and rapid. As explained by Bonin, Mizsei and Wachtel (1996), transfer of ownership through vouchers can occur without resolving the issue of pricing assets and irrespective of level of development of the stock market. Thus, in the Czech Republic, only six months passed between the issuance of the government's privatization plan and determination of the new ownership structure of Komer©ní Banka. However, conflicting government objectives have diminished the benefits of speed. Voucher privatization was rapid, but, given the Czech government's decision to retain majority ownership in Komer©ní Banka, it was also incomplete.

Management-led privatization in Russia shares important characteristics with voucher privatization. First, it was driven by political considerations. As pointed out by Boycko, Shleifer

and Vishny (1995) in their discussion of enterprise privatization, transfer of control rights to managers and local government officials may have been the only way to ensure that this coalition did not block privatization efforts. Second, management-led privatization was rapid. Less than a year passed between the commercialization of Zhilsotsbank and the founding of Mosbusinessbank. In contrast to Komer©ní Banka, however, the central government withdrew completely from ownership of the bank. Hence, the Russian method led to real privatization in the sense of the government giving up control rights.

Bank privatization in Poland and Hungary has been delayed by difficult negotiations with foreign investors and problems in implementing IPOs.[17] Pricing a bank too high leads to delays in identifying a buyer, while pricing too low leads to charges of giving away the bank. As indicated by Abarbanell and Bonin (1997), Poland's search for the "right price" delayed privatization of both WBK and Bank ©l〈ski, and, in the latter case, the government was ultimately accused of underpricing shares sold to ING. Hesitation on the part of governments exacerbates concerns on the part of strategic foreign investors, who face economic and political uncertainty and lack reliable financial information.[18]

After several years of setbacks in privatization negotiations, recent developments in Hungary indicate that there need not be a trade-off between speed and sale to a strategic foreign investor. Despite the absence of fully-developed capital markets, pricing issues have been addressed through innovations in the privatization transactions of both MKB and Budapest Bank, Kormendi and Schnatterly (1996). MKB's transaction included a performance-based price adjustment, which reduced uncertainty for the investor and the risk of undervaluation for the government. The Budapest Bank terms protect GE Capital from downside risk by giving it the option to put its shares back to the government if bank performance is disappointing. It further

gives GE Capital substantial upside benefit, by giving it a call right for both the government's and the EBRD's shares.[19] Though these options are controversial, their value to the strategic foreign investor may be reflected in a relatively high share price.

Infusion of new capital: The level of capitalization of a bank subsequent to privatization influences its ongoing franchise value, decreasing the need for transfer of funds from the government budget while addressing the issue of moral hazard caused by undercapitalization. The voucher method is essentially a giveaway of shares and raises no new capital. Management-led privatization in principle could lead to increases in new capital for the bank, but as demonstrated in Abarbanell and Meyendorff's (1997) study of Zhilsotsbank, once control rights are given to managers, they are reluctant to cede these control rights by selling large blocks of shares.

By contrast, IPOs and the sales of shares to a strategic foreign investor can add significant new capital to the bank. For example, funds raised in the sale of shares of Wielkopolski Bank Kredytowy (WBK) in Poland went directly to the capital of the bank. Likewise, MKB raised capital by selling shares to the EBRD and Bayerische Landesbank. In other cases, however, government revenue objectives have taken priority when bank equity was sold. For example, the Polish government retained all the capital raised in the privatization of Bank ©l⟨ski, even though this left the bank with low capitalization relative to other commercial banks.

Introduction of new banking expertise: The acquisition of specialized banking expertise is vital to the development of banking in transition economies. While twinning arrangements and other forms of technical assistance are means of acquiring knowledge about banking in a market economy, the case studies as a group indicate that the most direct and performance-enhancing source of such expertise is an equity holder with direct interest in improving bank

performance. Of the methods of ownership transfer discussed, only the sale of equity to a strategic foreign investor appears to prompt the transfer of significant banking expertise. The benefits are evident in ING's impact on the operations of Bank ©l(ski, which has begun to realize the full value of its universal license by improving lending procedures, internal accounting and information technology, and by providing new products and services.

Corporate governance structures: The method of privatization establishes important aspects of the corporate governance of each bank by determining the ownership structure and the initial distribution of control rights among stakeholders in the bank. Table 2 summarizes the ownership structures of Komer©ní Banka, Bank ©l(ski, and Mosbusinessbank immediately after privatization and currently.

Tabl

The Czech government, which executed the transfer of Komer©ní Banka's shares, chose to retain majority control of the bank. Diffuse ownership of the remaining stake, with 700,000 citizens trading their vouchers for Komer©ní equity positions, offered no counterbalance to the large government stake. This was true despite the significant role played by investment funds, which ended up holding 42% of the shares.[20] Harvard Capital, one of the Czech Republic's most prominent funds, held the largest stake after the government, with 17.5% of equity. The ownership structure that emerged from voucher privatization solidified both the position of the government-appointed management team headed by Dr. Richard Salzmann, a former executive in the State Bank, and the Board of Directors consisting of government representatives and the bank's senior executives.

Bank ©l(ski's initial privatization also left the government as dominant shareholder, with a 33.2% stake in the bank for the first two years after the initial transfer of ownership. In contrast

to the case of Komer©ní Banka, however, the government was not a majority shareholder, and ING, with 25.1% ownership, became a significant core investor. Remaining ownership, determined through the IPO, was diffuse. The composition of ©l(ski's new management board was largely determined by the Polish Ministry of Finance, with input from ING. The resulting corporate governance structure was tripartite, with the government, the strategic foreign investor, and the management team all seeking to influence bank policy. During this time period, the large government share increased the influence of the management team relative to that of ING, which remained relatively passive.

Of the banks studied, Mosbusinessbank became the most independent of government control despite the fact that its shares were sold to state-owned entities. Management-led privatization resulted in a very diffuse ownership structure, in which the largest shareholder owned a 9.4% stake in the bank. The top management of the bank was self-selected, and it in turn selected the new owners of the bank. This process ensured that the managers had little accountability to shareholders. Further share issues of Mosbusinessbank stock, leading to an even more diffuse ownership structure, solidified this lack of accountability. The combination of incumbent management and client ownership is also likely to have led to significant connected lending, although the effects are difficult to measure.

In sum, none of the bank privatization mechanisms used in Central Europe and Russia led to effective corporate governance by outsiders in the short run, confirming an insight by Brada (1996) that effective governance by outsiders is often more difficult to achieve than is privatization. In the Czech Republic, and initially in Poland, this was largely the result of the government's desire to retain control rights in the bank. In both countries, however, institutions have developed that could increase managerial accountability in the absence of significant

government ownership. Czech investment funds are one such institution, currently prevented both by government regulation and by the government's majority share from playing a significant role in corporate governance.[21] Even given such restrictions, it seems likely that Komer©ní Banka's management prefers continued government ownership to the accountability that could result from true privatization.

The strategic foreign investors in Polish banks represent another example of the potential for effective independent governance. While the Polish authorities were slow to relinquish control of banks, the need to attract new strategic foreign investors has led the government to sell its dominant share in three of the partially-privatized banks. ING's recent buyout of the government share of Bank ©l(ski represents one of the first opportunities to realize truly independent governance.

Russian privatization resulted in a similar lack of effective internal corporate governance, but for different reasons. First, foreign participation in bank ownership was limited. Second, while the government has never had an ownership role in Mosbusinessbank, Russia is only now developing the institutional structures that could exert independent governance. Thus, the Russian method of privatization did not result in a dominant government share, nor did it provide for a mechanism of independent governance by private investors. It can be expected, therefore, that insider control of the banks will be an ongoing problem, increasing the importance of external product market discipline discussed below. In Russia, as opposed to Central Europe, product market competition has acted as an alternative mechanism of internal discipline in Russian banks, providing a source of managerial accountability. The effect of competition on corporate governance is growing in both Hungary and Poland, but it remains insignificant in the Czech Republic.

C. Ongoing Government Intervention

The extent of ongoing government intervention in the operations of privatized or partially-privatized banks is difficult to document because such intervention is often unofficial. However, the case studies provide evidence that government intervention continues, both in the form of direct or indirect financial support and in the use of banks to further policy goals.

Protection of the banks' market positions has effectively ensured their short-term financial success, particularly in Poland and the Czech Republic. Restrictive government licensing policies, discussed below, as well as the provision of implicit or explicit deposit insurance for these banks, have guaranteed high interest rate spreads. Thorne (1993) finds evidence that the state-owned banks' ability to charge high spreads to new private enterprises allows them to subsidize loans to former state-owned enterprises. In the case of Komer©ní Banka, this indirect subsidization appears linked to the expectation that the bank will be involved in enterprise restructuring through loan workouts and will allocate credit to supporting former state-owned enterprises in concert with government objectives. The Polish government has also implemented programs to involve the commercial banks in restructuring enterprise debt.

There are many examples of ongoing financial intervention in former state-owned banks. In Russia, these banks faced less restrictive regulatory standards than did *de novo* banks until 1995. In addition, former state-owned banks in Russia have had easier access to central bank lines of credit than have the *de novo* banks. Finally, until 1995, the Russian government continued to channel directed credits to enterprises through the banking system, disproportionately, though not exclusively, relying on former state-owned banks. While banks initially expected benefits from the opportunity to channel government funds, many enterprises ultimately defaulted, significantly aggravating the problem of new non-performing loans.[22]

Hungary and the Czech Republic provide further examples of differential treatment. In Hungary, state commercial banks were allowed to operate with levels of capital adequacy below the legal limit. In the case of the major Czech banks, their clients' deposits initially were covered by deposit insurance without payment of premia to the government.

Ongoing government intervention has had a detrimental effect on the performance of privatized and partially privatized banks. Government policy intended to provide financial support to poorly performing banks has created moral hazard problems. Government policy that involves banks in channeling credits based on non-market criteria delays the transformation of the banks into effective financial intermediaries. While certain types of intervention seem likely to continue indefinitely, there is evidence that the governments themselves are reassessing the effect of government involvement in bank operations. For example, both differential regulation and the channeling of directed credits have been suspended in Russia.

III. COMPLEMENTARY REFORMS AND THE EXTERNAL ENVIRONMENT

The case studies indicate that numerous factors external to the privatization transaction have had a significant impact on the performance of privatized banks and on the contribution of bank privatization to financial sector reform. These factors include government policies that affect the banking sector and elements of the economic and institutional setting in which bank privatization is taking place. Some factors external to the transactional structure contribute to the creation of efficient private banks, while others impede the progress of bank privatization. Three prominent aspects of the external environment are briefly discussed below.

A. Promoting Competition

Governments can regulate the level of competition in the banking sector in several ways, including licensing policies, limits on foreign ownership, and differential regulation of *de novo*

versus privatized banks. Differences in these policies across countries have created significant variation in the competitive environment in which the case study banks function.

Licensing policies in the Czech Republic and Poland have restricted the level of domestic competition in the banking sector. In both countries, relatively liberal licensing and low capital requirements early in the reform process led to rapid entry, which, in combination with insufficient regulation and supervision, subsequently resulted in numerous bank failures. In response, capital requirements were increased and moratoria were placed on the issuing of new licenses. For example, the Czech National Bank issued no bank licenses in 1994 or 1995. In 1996, the government issued two licenses only to begin a major consolidation program involving three bank conservatorships, revocation of two licenses, and an orchestration of several bank mergers.[23] In 1995, the National Bank of Poland issued only five licenses after a two-year period during which none were granted.[24] Such restrictions have reduced the threats to the market positions Bank ©l⟨ski and Komer©ní Banka inherited. In contrast, Russia has had an extremely liberal domestic licensing policy, leading to a proliferation of new private banks. While minimum capital requirements have been raised several times and numerous banking licenses withdrawn, more than two thousand licensed banks currently operate.

Entry of foreign banks, in particular, and their ability to compete with domestic banks has been severely restricted in the Czech Republic, Poland, and Russia. A foreign bank wishing to operate in Poland, for example, faces a two-year wait for a license. Foreign banks also face severe restrictions on repatriation of profits in both Poland and the Czech Republic. In Russia, a system-wide restriction imposes a 12% cap on foreign ownership of banking sector assets. Another deterrent to foreign ownership has been the adoption of implicit government policies to require or encourage foreign investors to take stakes in troubled banks or banks undergoing

privatization as a precondition for licensing. Both Poland and the Czech Republic are examples. Often, foreign banks with narrow strategic interests are unwilling to take such steps to gain entry. The net result of the assortment of obstacles faced by foreign investors in these two countries is a relatively small penetration of foreign banking expertise and capital. Even considering the recent sale of majority interests in Wielkopolski Bank Kredytowy and Bank ©l(ski, foreign ownership only accounts for 16% of Polish bank assets. The number is even smaller in the Czech Republic and Russia. In contrast, Hungary has encouraged foreign bank entry, and the asset share of foreign banks doubled between 1990 and 1994, reaching 35% of total bank assets by the end of 1995.[25]

As a result of these differences, there is significant variation in the competitive environments of the case study banks. Limits on competition in the Czech Republic have sustained Komer©ní Banka's market position. The bank's strong financial performance is ensured by relatively high interest rate spreads rather than by operating efficiency, bringing into question its ability to survive the competition from Western European banks that will accompany membership in the European Union. Apart from some notable exceptions, Poland's banks have operated in similarly protected local markets for lending, payments clearing, and retail services. The consequences are evident in the slow pace of restructuring of the commercial banks in such areas as product innovation and downsizing. However, recent liberalization of the licensing of new banks as well as the growing impact of strategic foreign investors on the banking sector indicate that competitive pressures are on the rise in Poland.

In contrast to banks in the Czech Republic and Poland, Hungarian banks have faced substantial competition, in particular from foreign banks. The result has been aggressive expansion in the number and quality of services offered, sharply declining interest rate spreads

and internal reorganization involving dramatic cuts in redundant staff. Russian banks have also had to survive in a highly competitive environment, albeit from domestic sources, with comparable benefits in terms of bank performance and efficiency. The top Russian banks have rapidly introduced new services, and have developed organizations capable of responding rapidly to changing profit opportunities. The highly efficient functioning of Mosbusinessbank's foreign exchange operations stands as a case in point.

The benefits of promoting competition, however, can come at a severe cost. The case of Russia highlights the problems associated with rapid entry in the absence of sufficient regulation and supervision. Bank failure and fraud are rampant, giving rise to a legitimate source of government reluctance to allow competition in banking. Nevertheless, Gorton and Winton (1996) argue that the socially optimal level of instability in the banking sector resulting from privatization and rapid entry is non-zero and may need to be quite high in transition economies to ensure adequate capital flows and efficiency.

In sum, promoting competition has been shown to enhance the benefits of privatization by allowing market forces to drive the transformation of the banking sector. Benefits to the economy include the provision of a broader array of banking services and a lower cost of funds. As demonstrated by Mosbusinessbank and Budapest Bank, competition can also mitigate the effects of problems created through the privatization process itself. External product markets can provide discipline where internal corporate governance mechanisms fail to do so. Such external discipline is beneficial both when majority ownership remains with the state, as with Sberbank in Russia, and when control rights are too diffuse for shareholders to exert influence on bank managers.

B. Regulation and Supervision

Regulation and supervision of the banking sector has been a primary concern for transition economies in the process of privatizing banks. Overall, substantial progress has been made in this area. The greatest difficulty lies in finding a balance that enforces prudent behavior and ensures stability without stifling the effects of competition and stemming the flow of new credit to the enterprise sector.

The Czech Republic was slow to introduce and enforce effective prudential regulation following voucher privatization. This fact, combined with the ongoing role of the government in Czech banks, contributed to the flow of new bad loans. Ironically, subsequent tightening of regulation and supervision appears to have swung the balance to the opposite extreme, as new credit is issued infrequently, for short maturities, and at high rates. From the financial perspective of Komer©ní Banka, this situation has led to higher profits and lower risks, but it clearly has had a detrimental effect on the banks' financial intermediation role.

As in other transition economies, the pace of development of prudential regulation and supervision in Russia has been slow. Given the scope of the Russian banking sector, it is unlikely that significant progress in enforcement and monitoring can be made in the near future. This suggests the likelihood that a vast number of marginal banks faced with an increasingly competitive banking environment will engage in excessively risky or fraudulent lending. Inevitably, this will prompt banks to exit, but it will also severely complicate the cleanup task faced by Russian banking authorities and spawn crises in public confidence. The Central Bank of Russia has attempted to reduce these problems with regulations specifically designed to reduce moral hazard problems created by old client-owner relationships and with differential regulation, such as limiting the size of individual loans to a small fraction of capital unless otherwise approved by the Central Bank.

Like the Czech Republic, Poland experienced a fast start toward reform in the banking sector but was slow to develop and enforce strong regulation and supervision. Inadequate regulation combined with liberal bank licensing policies at the beginning of the reform process led to a swift expansion in the number of new banks and an inevitable increase in bank failures. The National Bank of Poland ultimately reacted by reducing the number of new licenses issued and restricting domestic and foreign bank entry by means of more stringent capital and reserve requirements. These measures, along with restrictions on new lending to enterprises that were restructured under the recapitalization program described above, have substantially reduced the flow of new credits from former state-owned banks.

C. Constraints on Lending

Numerous characteristics of transition economies influence new commercial lending practices and, therefore, the extent to which banks, regardless of their ownership, will engage in financial intermediation. First, financial sector reform and the markets for foreign exchange in particular have created attractive financial instruments. In addition, with the execution of monetary policy and budget financing, government debt is an alternative to commercial lending. Both Poland and Russia have financed portions of their large budget deficits by attracting bank funds. In the case of Komer©ní Banka, the only component of its assets that exhibited real growth over the period 1992-96 was various forms of government debt.

Second, several characteristics of the enterprise sector tend to discourage bank lending. Inadequate accounting standards and disclosure, along with the short credit histories of new private companies, create information asymmetry, making it difficult for banks to evaluate risk.[26] This is exacerbated in most banks by a lack of lending expertise. In addition, institutions to address the repayment of delinquent loans have generally been ineffective. For example,

Mosbusinessbank had a relatively aggressive private sector lending strategy at the beginning of its operations. As a result of substantial losses, it has assumed a conservative policy, and lending has been cut back. A similar phenomenon occurred in the Czech Republic and Poland following a surge in bad loans to new private sector companies.

Available data on the extent of financial intermediation and the extent of commercial debt indicate significant differences across the countries studied. In 1994, the Czech Republic attained a 95% ratio of bank credits to GDP, which is close to the 120% to 130% levels that are typical of developed market economies. In 1994, Hungary stood at 63%, Poland at 33%, and Russia at 13%.[27] These figures reflect variation in the obstacles to lending described above, and they are closely aligned with the extent and length of the inflationary period that accompanied early reforms.

By 1996, the figures for the Czech Republic, Hungary, Poland, and Russia were 75%, 27%, 20% and 13%. However, some care must be taken in interpreting these figures. In fact, the ability to divert funds from lending activities into more profitable markets should not be interpreted as a failure of bank reform policies. For example, it can be argued that the high level of bank credit in the Czech Republic has been significantly influenced both by bank ownership of enterprises and by the continuation of government-influenced lending to former state-owned enterprises. Effective privatization would, in this context, have led to a decrease in aggregate lending.

IV. CONCLUSION

As the transition economies of Central Europe and Russia move into a new stage of economic development, consolidating reforms and devising strategies for growth, the efficiency and health of the banking sector is crucial. In the absence of effective financial intermediation, restructuring

and growth in the real sector will be severely restricted. We have focused on the privatization of state-owned banks, only one of many elements in the development of a well-functioning financial system. The three case studies in this volume provide evidence about the effects of the transactional structures of bank privatizations on bank microstructure and performance. Several insights and policy-oriented implications can be drawn from our analysis.

First, evidence from the cases shows that creating only one large commercial bank out of the monobank system is likely to impede privatization. In the absence of active licensing, creating an initially-dominant commercial bank like Komer©ní Banka gives it substantial market power for the longer run. In addition, depending on the size of the bank, it may be difficult to find investors who are able to buy a large equity share. Finally, although Komer©ní Banka has fared well in a protected market, if it were to experience financial difficulties the government would be unlikely to allow it to fail. This implicit understanding exacerbates moral hazard problems. In contrast, creating several commercial banks allows for competition to develop once the banks are effectively privatized, as is starting to happen in Poland, and decreases the likelihood of a government bailout.

Second, recapitalization and privatization of the banks should be closely linked, allowing each bank to be privatized at the time that its value is maximized and decreasing the expectation of future bailouts. This point is made by Bonin, Mizsei and Wachtel (1996), and the case study evidence supports this view. In both Hungary and the Czech Republic, recapitalization of banks without subsequent rapid privatization led to a continuing flow of bad loans and further recapitalizations. In contrast, Bank ©l(ski was privatized almost immediately after a significant recapitalization, and it began to diversify and improve its loan portfolio very quickly.

Third, the cases provide some support for the proposition that there are benefits to rapid privatization. [28] The cost of delays in the privatization process are obvious in the cases of Poland and Hungary; they include ongoing political interference in the process and repeated recapitalizations. In contrast, rapid privatization of Zhilsotsbank in Russia, while creating instability, also allowed for market forces to influence the structure of the privatized banks.

Fourth, bank privatization is more likely to result in good banking if effective mechanisms for corporate governance are in place. The majority of privatization transactions in Central Europe and Russia have left incumbent managers running the banks. In the absence of large independent shareholders, there is little internal control over these managers. Where the government is a large shareholder, the alignment of government and manager interests can lead to the continued allocation of credit based on considerations other than profit-maximization.

Fifth, strategic foreign investors can contribute to the efficiency and health of privatized banks, bringing both expertise and capital into the bank. Transfer of expertise has proven to be much more effective when it comes from an equity holder with a large financial stake in the bank than when provided through twinning arrangements and other forms of technical assistance used, for example, in Russia and Poland. In addition, and in the absence of large domestic institutional investors, strategic foreign investors have, up to now, been the only effective agents of corporate governance in privatized banks.

Sixth, product market competition is an important complement to the privatization of state-owned banks. In the absence of internal corporate governance, competition enforces a degree of discipline on managerial behavior, as is evident in the Hungarian commercial banks and in the remaining state-owned banks in Russia. Perhaps even more important, when combined with effective privatization and internal governance, competition gives new equity

holders the incentive to restructure the bank, focusing on the efficient provision of new services and eventually providing credit at competitive rates. The increasingly active involvement of strategic foreign investors in Polish banks over the past year, at a time when competition is growing, is a case in point. Hungary's experience further supports the idea that competition encourages strategic foreign investors to aggressively transform banks. Hungary is ahead of Poland both in terms of competition and in terms of attracting foreign capital to the banking sector, with the Budapest Bank-GE Capital transaction and the sale of remaining state shares of MKB as recent examples.

In addition to contributing to growth in the enterprise sector, effective bank privatization policies are increasingly necessary in light of the move toward membership in the European Union. While all of the case study banks, which are fairly representative of their banking sectors in this respect, have made significant improvements in their operations and their provision of services, they are not yet ready to compete in all markets with their larger and more efficient counterparts in Western Europe. These banks, however, can have an important role as providers of credit to small and medium-sized domestic enterprises that foreign banks may not service. To be efficient providers of credit, progress to date in transforming the banks must be continued. In some cases, this will happen through the completion of the privatization process and, in others, through complementary policies such as more liberal licensing of new banks. It is to be hoped that impending membership in the European Union will accelerate banking sector reforms. The less desirable outcome is that insufficient reform and fear of competition will delay the integration of transition economies into larger European and world markets.

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TABLE 1

OWNERSHIP STRUCTURES OF BANKS SINCE PRIVATIZATION

	Komer©n Banka (Cz. Rep.)		Budapest Bank (Hungary)	Bank ©l(ski (Poland)		Mosbusinessbank (Russia)	
	May 1992	April 1996	December 1995	January 1994	August 1996	December 1991	October 1994
Government	51.3%	53.1%	22.0%	33.0%	6.0%	0.0%	0.0%
Managers/Employees	0.0	0.0	0.0	8.0	8.0	10.0	30.0
Strategic Foreign Investors	0.0	0.0	27.5	26.0	54.0	0.0	0.0
European Bank for Reconstruction and Development	0.0	0.0	32.5	0.0	0.0	0.0	0.0
Institutions/ Enterprises	42.1	24.8	0.0			90.0	45.0
Individuals/Other Investors	6.7	22.1	18.0	33.0	32.0	0.0	25.0
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Sources: Kormendi and Snyder (1997), Kormendi and Schnatterly (1996), Abarbanell and Bonin (1997), Abarbanell and Meyendorff (1997). Banks are considered privatized if the government is a minority shareholder.

TABLE 2
METHODS USED TO TRANSFER
OWNERSHIP OF SELECTED BANKS

Ownership transfer method	Representative countries	Potential economic advantages	Potential economic disadvantages
Voucher scheme	Czech Republic	fast politically expedient	no new capital raised no new expertise diffuse ownership
management-led	Russia	fast politically expedient	no new expertise diffuse ownership
IPO	Hungary and Poland	new capital raised	no new expertise diffuse ownership slow
Strategic foreign investor	Hungary and Poland	new capital raised new expertise new corporate governance	slow

Source: Abarbanell (1996).

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[2] The *EBRD Transition Report 1995* indicates the status of the top five banks and their asset share. Of note, while the EBRD lists all of the top four banks as privatized and in fact each has undergone a privatization process, Snyder and Kormendi (1997) indicate that the government remains in control of each of these banks.

[3] Franchise value, in the context of financial institutions, is the value of the right to provide banking services. It can be derived from monopoly positions and government support, or it can be derived from the efficient and profitable provision of banking services in the context of a competitive banking sector. While monopoly rents can be a source of franchise value for bank owners and managers, they are not sustainable without a significant loss in consumer surplus. Franchise value from good banking benefits both owners of the bank and consumers of banking services.

[4] There is an extensive literature on the restructuring of the Central European banking sector and methods of dealing with bad loans. For example, Thorne (1993) gives a clear summary of the sequencing of reforms in Central Europe and the structure of the banking sectors in the early reform period, and Pohl (1995) discusses Russian banking reforms in contrast to those of other transition economies.

[5] Since the Czech Republic and Hungary had more sophisticated banking sectors at the start of reforms, we refer here to the speed of adjustment rather than the absolute level of services provided.

[6] See Saunders and Sommariva (1993) for a detailed discussion of this issue.

[7] Figures pertaining to Hungarian loan consolidation programs are from Buch (1994) and Nyers and Lutz (1995).

[8] Poland Infrastructure Report, Bankwatch, April 1996.

[9] Bank ©l(ski's ability to support the restructuring of a troubled loan to FSM S.A., a Polish automaker about to be acquired by Fiat, just prior to the bank's privatization in 1993, is evidence of its relative strength.

[10] See Pohl (1995) for details.

[11] Begg and Portes (1993) argue that banks in Central and Eastern Europe cannot be expected to enforce hard budget constraints and that the only way to stem the flow of new bad loans is to remove preexisting loans entirely from the portfolios of privatized banks and sever old relationships. On the other hand, van Wijnbergen (1996) argues that banks, in part because of preexisting relationships with enterprises and associated informational advantages, are the most likely agents of enterprise restructuring in transition economies. Thus, the best way to prevent an ongoing bad loan problem is to give banks the proper incentives to restructure their own portfolios, rather than having the government take responsibility for bad loans.

[12] Some programs have required bank participation in enterprise restructuring. While Lissowska (1996) provides evidence that well organized programs such as the one implemented in Poland yield positive payoffs to banks, it is not yet clear whether the benefits outweigh the explicit and implicit costs of these activities.

[13] Our assessment of the relative importance of bank- and government-initiated enterprise restructuring across the region is consistent with Borish et al. (1995)

[14] By the time Russian enterprises were privatized, this same method was used in a deliberate fashion. See Boycko, Shleifer and Vishny (1995) for a discussion of management-led privatization in Russia.

[15] We view the initial transfer of control rights to managers as being the most important aspect of the privatization transaction in Russia. Although technically privatization of Russian banks did not occur until the state-owned enterprises that owned them were privatized, there was little centralized control of enterprises at this time, ensuring a clear transfer of control rights away from the central government.

[16] See Abarbanell (1996) for a discussion of these points.

[17] As pointed out by Stiglitz (1992) and others, selling banks raises the issue of asset valuation, which in turn depends on the valuation of enterprises.

[18] See Abel and Bonin (1994) for a discussion of similar phenomena in Hungary.

[19] While the put option would appear to subject G.E. Capital to moral hazard, the combination of downside protection and upside risk is consistent with a solution to a double-sided moral hazard problem. According to this view, the government is also in a position to influence the bank's success and G.E. Capital is likely to make specific investments in the bank.

[20] The Czech case discusses the limited role of investment funds in the ownership and governance of Komer©ní Banka. According to the 1992 Law on Investment Companies and Investment Funds, Czech investment funds cannot (a) hold more than 20% of the

equity of any company, and (b) allow an investment in a single company to account for more than 10% of the fund's portfolio.

[21] The fact that most of the top funds are owned by state banks calls into question the effectiveness of such governance.

[22] In the summer of 1995, the Central Bank of Russia announced a program for assisting banks holding delinquent loans of enterprises that had lost access to government funds and inter-enterprise credit. The program called for government bonds with eight-year maturities to be issued to banks to cover loans for which the government was primarily responsible. Data concerning which banks will receive these bonds and what percentage of their portfolios will be covered is unavailable. Recently, large and unexplained increases in government liabilities have appeared on Mosbusinessbank balance sheets. These deposits have been conjectured to be evidence of informal government support in return for the bank's cooperation with directed credits.

[23] Czech National Bank's *Report on Monetary Development in the Czech Republic* (1996).

[24] Poland's current bank consolidation program would actually reduce the number of licensed banks and indicates an unwillingness on the part of the Polish government to accept the consequences of competition in the banking sector. See Bonin and Leven (1996) for further analysis.

[25] *The Banker*, July 1996.

[26] See Perotti (1993) for an analysis.

[27] *EBRD Transition Report, 1995.*

[28] Contrasting views include McKinnon (1991) and Caprio and Levine (1994), who argue that privatization should proceed slowly.