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AT THE UNIVERSITY OF MICHIGAN BUSINESS SCHOOL

## ***Banks in Transition—***

***Investment Opportunities in Central Europe and Russia***

*Transcript of a Davidson Institute Conference*

*With Editing and Commentary*

*by Anna Meyendorff with Amy Moored*

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This transcript is based on the Davidson Institute conference *Banks in Transition—Investment Opportunities in Central Europe and Russia* held in New York City on May 31, 1996. The transcript was edited, and commentary added, by Anna Meyendorff, Faculty Associate of the William Davidson Institute, with Amy Moored, Research Assistant. Special thanks to Kathryn Clark for assistance with editing. Published in 1997 by the William Davidson Institute with permission of the conference speakers.



# BANKS IN TRANSITION

## INVESTMENT OPPORTUNITIES IN CENTRAL EUROPE AND RUSSIA

Edited by Anna Meyendorff with Amy Moored  
January 1997

This working paper consists of the edited proceedings of a conference entitled *Banks in Transition: Investment Opportunities in Central Europe and Russia*, organized by the William Davidson Institute at the University of Michigan Business School with sponsorship by Citibank and Chase Manhattan Bank.<sup>1</sup> The conference was held on May 31, 1996 in New York City. It consisted of two panel sessions, the first featuring Western European and North American banks and investors discussing their experience entering the financial sectors of transitional economies, and the second featuring Central European bankers and government officials discussing investment opportunities and strategies in their countries.

The first panel highlights the feasibility of various investment strategies in the transitional economy setting. Each of the institutions represented has had different objectives and strategies for entry into the financial markets of Central Europe and Russia. Despite these differences, Western European and North American investors agree on criteria used to evaluate the desirability of investing in any particular region, include prospects for long-term economic growth, the existence of a credible legal and regulatory framework, transparency in administrative rules, and political stability. While these criteria have not always been met, the speakers all reflect a commitment to continued investment and the conviction that there is a growing number of profitable opportunities.

Members of the second panel discuss the current state of the financial sector and bank privatization in their own countries, linking these conditions to opportunities for foreign investment. Several interesting themes stand out. First, ongoing bank privatization in Central Europe will continue to provide opportunities for foreign investment. In addition, in both Central Europe and Russia, consolidation in the banking sector seems inevitable and will provide further investment opportunities. Second, all the speakers emphasize that increasing competition is driving changes in the banking sector, lending urgency to both privatization and financial sector restructuring.

Competition seems to be making the benefits of participation by strategic foreign investors clearer. At the same time, it creates a bias against the type of greenfield investments that several investors on the first panel prefer. Strategic foreign investors are seen by the panelists as

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<sup>1</sup> These proceedings were edited to focus attention on several of the dominant themes which emerged from the presentations and discussion at the conference. This text should thus be viewed as excerpts from a broader discussion. Editing for grammar and style was kept to the minimum necessary for ease of reading. In all cases, the opinions voiced by the speakers should be taken to reflect their own personal views rather than the official views of the organizations they represent.

contributing value to domestic banks, hence making them more competitive, while greenfield operations are seen as increasing the level of competition to the detriment of domestic banks.

Themes from both panels are echoed in the keynote speech given by Dr. David Lipton, assistant secretary of the U.S. Treasury. Dr. Lipton emphasizes the connection between financial sector and overall reform. To further both, public policy in transitional economies should encourage rapid privatization, enforceable property rights and effective corporate governance, financial sectors open to foreign competition, sound regulatory systems, and the creation of a variety of financial intermediaries to channel savings to productive uses.

This conference was intended to break down barriers to foreign investment in the banking sectors of Central Europe and Russia, by generating discussion of existing and future opportunities and strategies for investment. The text which follows illustrates both diversity in approaches to such investment, and consensus about the potential for transactions which are advantageous to both foreign investors and the banking sectors they seek to enter.

## **PANEL 1: STRATEGIC INVESTOR AND FOREIGN BANK EXPERIENCE IN THE BANKING SECTORS OF CENTRAL EUROPE AND RUSSIA**

**GEORGE BLAUVELT - Citibank, Vice-President**

*OBJECTIVES FOR INVESTING IN THE BANKING SECTORS OF CENTRAL EUROPE AND  
RUSSIA - Citibank*

Citicorp's long-term, as well as operational, perspective is not to be a foreign bank. We want to be a bank in every country that permits us to have a banking license and we want to be a full bank in that economy. In the emerging markets, we have identified our basic strategy that we hope will frame our activities and interactions with our host country supervisors for the next twenty to fifty years. The goal is to become an embedded bank, which means becoming one of the largest local banks in the economy. Obviously we don't start as one of the largest and most important foreign banks from day one because we would like to be a large, domestic bank that has access to international funds flows or a large international bank that has access and participates with domestic economies.

*INVESTMENT CRITERIA - Citibank*

What are the requirements or what are our expectations? I will briefly go over the selection criteria we try to use, the business development model that we look for, and the franchise building model that we attempt to have. We look at five basic trends. First, what is the economic model of the country? Is it moving towards freer markets, is it moving towards a price allocation construct as opposed to directed resource allocation? Second, what is the growth potential for the economy, in terms of its industrial base, the general level of wages, disposal income, and savings from the private sector?

Next, and more important, is the legal and regulatory framework. We don't mean that we expect that the countries will say that we (Citibank) are the nicest guys in the world or the best thing that has happened to their country. We mean clarity in the rules, because we want to be good corporate citizens. We do not want to get in trouble with countries that hold our banking franchises, so we need to have some level of comfort in understanding what the rules are and how to apply our business activities so that we comply with those regulations. It is also helpful if they don't change too frequently, but that is not a real issue for us. We have been doing business in Venezuela for almost eighty years and they change the rules almost every week.

Fourth is political transparency or simply how we get things done. Who do we talk to if we need a banking license? How do we process that? How do we get on the regulators' and central banks' radar screens so we know what steps are necessary for us to initiate or expand our business? Finally, macro-economic management informs us of many of the other trends that we need think about. Can they get the numbers right? What are the general fiscal and monetary policies? You people know much, much better than I know the numbers and math, in terms of is this a growing or just a sustainable opportunity.

## *ENTRY MODEL - Citibank*

Usually, we start out by following our customers. We have identified through what we call our mobile relationship bank, approximately 3,000 to 3,500 of the largest global, transnational companies with whom we either currently or would like to do business. We can go where those companies have had opportunities in business, if we want to serve them. In the 1800s, I think in the United States, they used to say that the plant follows trade. Well, Citibank pretty much says the franchise follows the customer base. So, it's multinationals—either as investors in the country under a joint venture kind of construct or if they are not going to reside physically within the host economy, we want to look at multinationals who are going to drive import/export trade policy from outside the country which is the domestic economy. That is typically how it starts.

Once we're in a country, then there is a natural kind of willingness to expand the franchise to include large domestic entities—public, private, recently privatized or still controlled by the state. Essentially, we look at those customers in terms of their strategic importance to the economy.

So, once we have found the customer and gotten the license and selected the country, how do we go about building a Citibank presence? We think it is probably easier for us to build our own. So we have a build not buy bias. We also have a need to be in the economy as early as we possibly can. We want the time to grow our franchise along with the economy, which is why one of our requirements for opening branches is growth potential.

After we are there and have the infrastructure, it always takes us longer and costs more than we planned. From then on, once we achieve a certain minimum critical mass, we do what we refer to as a test transfer. We have a collective experience inside the company in terms of how to service our core customer base in other emerging economies. So for foreign exchange, safe keeping, funds transfer, advisory work, etc., we tend to be able to import those into the new branch fairly quickly.

We have a corporate client base plus we have access to the international market and international task force. This is one of the things, when we talk to customers, that we say is very important in terms of hoping that they will give us business. We have had a cautious and balanced appetite for risk.

Our cross-border exclusion, which is always the biggest constraint on building a business quickly in these countries, is recognized by that. We have a significant amount of cross-border exposure in these countries. It is key, but not exclusive, and over time, we expect cross-border exposure to decline. We expect it to decline over time because we expect the treasury guys in the country to build a local funding base. This is essential to having a large domestic bank. You need a local funding base, but it is very hard to get that right. A local funding base means liquidity and liability management is going to be directly connected to the fiscal and monetary policies of the central bank in the country in which you have a license. It's hard for us to get that right on a

regular basis in the early days in a country because we don't always know how the economy will react. One of the quickest ways to lose a job at Citibank is to be overseas and say, "gee, I need to call New York and ask them to send me money." You don't really get to make that phone call twice in our company.

No place in those franchises that we opened are we yet at the stage where the consumer bank has arrived. However, we did announce yesterday that we will be opening a consumer bank in 1997 in Poland. That's our first one in Central Europe.

### **THOMAS BUTLER - Chase Manhattan Bank, Vice-President**

#### *CURRENT PRESENCE IN THE BANKING SECTOR - Chase and Chemical*

Chase and Chemical have banking investments in a number of the Central and Eastern European countries. In Romania, we have had a wholesale banking branch since 1974. It is now fully licensed as an onshore banking branch. In Prague and Warsaw, we have corporate finance offices that are attempting to originate both corporate finance and capital markets transactions under a representative office license. In Poland, we have a fund management company, Chase Gemini, which is one of the privatization fund management companies. In Russia, Chemical Bank has a 10% shareholding in a joint venture bank, The Russian American Investment Bank. Chase Manhattan Bank has a wholly-owned subsidiary bank in Moscow. The experiences are very different in each country and reflect some of the different regulatory environments and institutional evolution in the different countries.

#### *ENTRY STRATEGY - Chemical Bank*

With the break up of the Soviet Union, Chemical Bank recognized a great opportunity and realized that with the enormous natural base, population size, as well as the interest of our multinational corporate clients in Russia, there was a lot that could be done. We did not have any physical presence in the country and I think, therefore, we were not as comfortable going into the country as other institutions might have been. So, our entry approach at Chemical Bank was somewhat tentative. We took advantage of an opportunity to join with other U.S. investors to share the risk in a new joint venture bank.

As you may recall, in 1992 and certainly through early 1993, Russia was making an effort to attract foreign investment. It was seeking to show an image to the world of cooperation with the U.S., so we and other U.S. investors got a lot of encouragement to make an investment into a bank in Russia. In late 1992, President Yeltsin issued a decree that created our bank and I think this is the only instance where a bank in Russia was created by presidential decree.

On the American side, our partners were American International Group (AIG), Smith Barney, and James Wolfson & Son—"real blue chip partners" that were sophisticated and experienced investors around the world. Hank Greenberg, the CEO at AIG, was instrumental in negotiating the original terms of the investment with Yeltsin and Skokov, his security advisor. On

the Russian side, we had major banks like Vneshtorgbank, the foreign trade bank; Sberbank, the National Savings Bank; corporate giants like Gasprom; a natural resource company, Diamonds of Russia; and an interesting entity, the military pension fund. This seemed like a sure thing, because we had blue chip investors on both sides, high level involvement, and support from the American perspective.

#### *OBJECTIVES - Chemical Bank*

We saw the joint venture bank as an opportunity to create a platform that would allow corporate finance and advisory opportunities, principally in the country; and entree to major Russia corporates, including the oil and gas sector that was of paramount interest to many of our multinational clients.

#### *OBSTACLES TO SUCCESSFUL INVESTMENT - Chemical Bank*

I certainly wouldn't characterize the venture as a failure, but it has been less than satisfactory for all of the investors involved. The reason (which we can talk about more in our breakout) is that in a joint venture investment it is extremely important to get the understanding correct from both sides as to what their objectives are. From our perspective, it was to be a vehicle for developing corporate finance and advisory activities. Understandably, from the Russian's side, it was seen as a vehicle that would attract foreign capital into the country. We were major U.S. corporates that had entree to a lot of investment funds and capital of our own to invest. The Russian investors, looking around at their own environment as to what was working well, saw the success of investment in local capital market instruments, inter-bank lending, ruble dollar speculation, and real estate development. From their view, these were ideal investments that we ought to have been looking at.

As you can imagine, from our point of view, these were perceived to be very risky types of investments that we didn't want to put our capital into. I think there was goodwill and good intention on both sides. But clearly, as a result of a different historical and cultural business, both sides had different expectations and consequently most decision making had to get passed up to the supervisory board level. I think in terms of developing business, we often experienced paralysis rather than the dynamism desired from a joint venture investment. As I mentioned, I don't want to characterize the investment as a failure. The ingredients are there for a successful bank and we continue to nurture it. I expect this year that there will be some changes in the shareholding composition and structure, and hopefully the bank will be much more successful in the future than it has been in the past, as it adopts a somewhat changed business plan.

#### *ENTRY STRATEGY - Chase Manhattan*

Returning for a moment to the Chase Manhattan experience, Chase had a representative office in Moscow, Russia since 1973; therefore, it was a lot more familiar and comfortable with the environment. I think it saw the same kinds of opportunity as other Western banks in the country but, based on its experience there, I think it was much more able to make a decision to



get into the country and to commit capital. It took advantage of that window of opportunity in 1992 and 1993 when the Russian authorities were encouraging foreign investment and Western banks to come into the market place. Like Citibank, Chase tries to adhere meticulously to the regulations and by following all the regulations, received a very welcome response from the Central Bank and the Ministry of Finance, and obtained a license—as did Citibank—in the fall of 1993.

#### *OBSTACLES TO SUCCESSFUL INVESTMENT - Chase Manhattan*

By the fall of 1993, the local and political environment had changed a little bit. The government was concerned that Western influence was too great in the country. There was some reaction by local banks that they would be at too great a competitive disadvantage with Western banks and the technology they would bring. Ironically, as Chemical had been established by a presidential decree, in the fall of 1993 there was a new presidential decree that effectively made it impossible for Chase Manhattan Bank to conduct business with locally registered companies. We were really limited to being an offshore bank at least through the end of 1995. That was a very painful experience because we had committed to hiring people and had rented space. It was costly to be in a situation where we had a license but, effectively, we had no bank.

#### *RESPONSES TO THESE PROBLEMS - Chase Manhattan*

This leads me to some of the responses we made to that situation. Like Citibank, we tried to be a good corporate citizen. We were members of the Russian Banking Association and we lobbied through that group to try to change that presidential decree and allow us to be onshore. That was probably rather fruitful. Art Ryan, President and Chief Operating Officer of Chase Manhattan Bank, made a number of trips to Russia to meet with senior people. We took advantage of the embassy in Moscow and Ambassador Pickering was extremely helpful in lobbying on our behalf.

The political circumstances just weren't right at that time and it wasn't until 1994 that a situation developed that allowed us some leverage. Tobias and Dimitri, the head of the SEC, were very interested in having Chase Manhattan Bank present in Moscow as a custodian. As you may know, none of the foreign investment funds had been able to obtain SEC registration because of concerns about custodial services in Russia. Tobias and others were interested in attracting more foreign investment, particularly on the institutional side. They wanted to have funds able to be registered in the U.S. and so there was a desire on the part of Russian authorities to have Chase as a custodian in the marketplace. That gave us a little bit of leverage and we made it clear that we would not be willing to provide that service unless our onshore banking activities were restored. Later in 1994, there was another presidential decree that did restore that capability to the Chase Manhattan Bank and we were able to effectively open for business in September of 1994.

#### *OBJECTIVES - Chase Manhattan*

Chase Manhattan's objectives are to develop the corporate finance business, like Chemical Bank had been doing, to deepen its bank-to-bank business, to provide custodial services, and to develop capital markets expertise and capability in the local market, as well as cross-border. Unlike Citibank, Chase Manhattan Bank really sees itself as a global bank whose expertise is in the cross-border area. We try not to be a direct head to head competitor with the local banks. We try to work with them generally as partners because they have an expertise we would never be able to develop, probably no matter how many years we were in the marketplace.

#### *INVESTMENT CRITERIA - Chase Manhattan*

One of the most critical investment criteria is the predictability of the environment in terms of regulations, legal standards, reliability of the numbers, and the kind of regulatory oversight there. Our experience, thus far, in the Russia marketplace, but also in some of the other countries, is that these are politically volatile environments. In Russia there probably still is a potential for systemic risk which I don't think exists in Poland. That makes Russia much riskier. The sooner we have an evolution on the institutions that are being set up in the banking environment, the regulatory environment, and some of the capital markets institutions, the sooner we will have a more predictable, reliable environment, and the sooner we will see forward investment into these countries.

#### **DAVID McCROSSAN - AIB European Investments Ltd., Managing Director**

#### *CRITERIA FOR INVESTMENT - AIB*

Poland certainly has the criteria we have set for ourselves; good fundamentals, and a credible legal and regulatory environment, which we regard as absolutely essential where we might invest. In fact, the only other in countries which we would consider investing in Central Europe, at the moment apart from Poland, are Hungary, the Czech Republic, and Slovakia. In relation to the investment itself, I think we were decided that we would stick to the knitting. We only were interested in investment in our own businesses. We want a competent management team in place and any serious bad loan problems to have been addressed before we move forward.

We are not interested in any sort of hostile situation; we want a very positive reaction, not only from the target but also from the regulators in the country. The difficult decision, I think, was that whereas I was asked to make sure that any investment would have the potential to grow into something reasonably significant, the Polish authorities wanted to do it on a stage by stage and low key basis initially.

#### *ENTRY STRATEGY - AIB*

We are not following our customers into these markets as some of the other speakers are. My first visit to Poland was only a year and a half ago, but AIB, as a group, had actually been in Poland with the WBK, specifically, for a number of years. Peter Sutherland was the chairman then. AIB was the first Western bank to agree to go into a training arrangement with a Polish

bank (WBK). This relationship was with our consulting unit and was very important in building up a trust between WBK and ourselves. It really paved the way for our eventual investment.

WBK is headquartered in western Poland, one of the most attractive regions in Poland, with 63 branches and a staff of over 4,000. Pre-tax profit for 1995 was the equivalent of \$74 million U.S. dollars. It's the third largest company quoted on the Warsaw Stock Exchange, by profit, and the fifth largest in terms of market capitalization and shareholdings. I'll explain this a little bit later, but originally we started with 16%, and the state just agreed that they would sell us another 20% so when that deal is completed, which is currently in progress, we will own 36%, and the European Bank for Reconstruction and Development (EBRD) will have 24%. We have an option over that 24%, so between us we have 60%. The state will retain 5% and the shareholders on the market will have 35%.

Again, the places are not important, but you will see that the branch network is spread over the western part of the country. In the context of the Polish banking system that is not a complete list but, I think it is a list of the larger of the Polish banks which are listed on the Warsaw Stock Exchange. WBK is third in terms of profit and fourth in terms of market capitalization of about \$326 million dollars. WBK was the first of the nine commercial banks spun off from the National Bank of Poland. They had to go to the stock market in 1993. Later in 1994, it decided to embark on another share issue and, as happens in these circumstances, subsequently, the Polish Stock Market has suffered considerable reverses and WBK decided it would be sensible to seek underwriting for that issue. Towards the end of 1994, they asked us (AIB) whether we would be interested in that underwriting. We decided we would be happy to agree to that. Having done our proprietary work over the new year period, we signed our own agreement early in January, 1995. I am saying that because many people believe we actually succeeded in signing a deal in a very short space of time. That is true but it was only possible to do it in that space of time because of the warm and efficient welcome we had not only from WBK itself, but from the National Bank of Poland, the Ministry of Finance, the stock exchange, and the EBRD.

Clearly, our objective in the underwriting was to end up with a shareholding. We wouldn't have underwritten just for the sake of underwriting. We had agreements in place with the European Bank so that we would end up with a shareholding even if all of the shares in the issue were taken up, but as events unfolded, we were actually called on to take up most of the shares that we underwrote, becoming a 16.3% shareholder. At that stage, we were established as a shareholder in WBK, had two seats on the bank council, and had an option on the 24% held by the EBRD. One year later, early in 1996, the state treasury advertised that they would like to hear from people that would be interested in buying another 20% of WBK. Based on our experience over the year that we had been in place, we decided we should try to acquire that holding.

There was some reasonably stiff competition from another Polish bank for that 20% but we were eventually chosen as the purchaser. We paid more for the 20% stake than we had paid for the original. The price agreed for the new holding was 11.5 Polish, which is a *p*-ratio of 6.85

times the bank's EPS under Polish accounting standards, 6.4 times INS earnings—total cost about \$50.5 million dollars—bringing our total investment in the bank to almost \$80 million U.S. dollars.

Thus, I think the commitment we had shown in relation to our original shareholding, together with a good reputation that we had established with the National Bank of Poland, the Ministry of Finance, and other regulators dictated the logic of having one strong strategic investor in WBK. In another words, AIB was what eventually won the day. This is also happening in relation to consolidation of the Polish banking industry. Indeed, there is a considerable amount of political will to seek consolidation and to see the Polish banking system strengthened in advance of the opening up of the industry to farmers, which is, people I am talking about, first generation 1997.

We were aware that because WBK was the first of the commercial banks to go to the market, it was likely to be involved in any consolidation that might happen in the future. That was a very positive thing as far as we were concerned. Here too, we believe AIB's own experience of mergers in our industry will be of particular value.

#### *OBSTACLES TO INVESTMENT - AIB*

I was trying to think of some obstacles and the basic one was language. Our problem is that the Irish does not translate particularly well into Polish. We've just appointed a new CEO, who is starting his position tomorrow. He's fluent in both English and Irish, which will be a great help to us. I think on the slide I mentioned that, in spite of the fact we managed to do a deal very quickly the first time around, we found that the Polish system is somewhat more legalistic and bureaucratic than we are used to at home and that it can be a little bit irksome at times. Obviously there are business challenges within the company in terms of the pressure that's going to come on interest margins, the pressure from foreign competition, and the legal difficulties that are there in terms of enforcing security and everything. But, we believe that the base in WBK is strong enough to actually adapt to those changing business conditions. We also have the exchange exposure and that is something that we just decided we would take on the chin. We thought that the possibility of making reasonably substantial returns on our investment would more than compensate for any exchange exposure that was there. As it happened, in the first twelve months that we held the investment the Polish increased the zloty by only 5% against the Irish pound, which was way beyond our best expectations when we went into the investment originally. And over the last year few months, I think it depreciated at a little bit of a faster rate. But, nevertheless, we haven't lost on that.

#### *OBJECTIVES - AIB*

We believe that as a strategic investor we can be very useful to WBK in growing its own businesses and in the important restructuring of the Polish banking industry. We believe that our range of experience in substantial branch networks, consumer products, large commercial and government lending treasury operations really makes us an ideal partner for WBK. I think that by

working with its management and staff, and by sharing our considerable experience in all the businesses that it is in at the moment or that it wants to be in, we can really help WBK to develop its potential and, in the process, provide AIB with a good source of profit into the future.

**ARTURO PORZECANSKI - ING Barings, Managing Director and Chief Economist**

*ENTRY STRATEGY - ING*

In Eastern Europe, the expansion started even before the Berlin Wall came down. Already in 1988 and 1989, ING sent all the top managers out to each country and region and had them personally get acquainted with the situation and scout opportunities. This wasn't the first time that ING literally took management and put it in the field in an unexplored region and it was not the last time. This gave everybody a sense for what potentially could happen.

When the Berlin Wall came down, there was an institutional consensus that this was an excellent year and we should go running into it. The strategy is very pragmatic; first you plant a flag and then you get whatever license you can get—as a representative office, a commercial bank, an insurance agency or investment bank, or whatever. Then you use that to build on.

ING created a presence in the largest number of places, I think—Poland, Hungary, Slovakia, the Czech Republic, Romania, Bulgaria, Russia, and the Ukraine. It is unique in that we are a financial supermarket which has allowed us to develop whatever activity the market is ready for and the regulators will allow us to exploit. So, if you have one place where you can only provide essential banking services, like trade finance, that's what we provide. If there's another place where they are selling treasury bills and there is demand for treasury bills on the part of international investors, we get into the underwriting, trading, and distribution of treasury bills. If there is room for the development of the insurance business, we go into the insurance business as we have done in a major way in Hungary, the Czech Republic, and Poland. If there is money to be managed, we go into asset management as well.

This institutional flexibility is helpful—you are not just one type of financial institution. Having a variety of business components that you can emphasize or de-emphasize or you can introduce or withdraw as circumstances warrant and allow has been a big plus. So, often times you see ING being the first in introducing a new financial product in many of these countries.

The key is to be pragmatic; to get along, to provide training to local staff, to assist in the development of the local capital markets, and to involve local banks in transactions. Many times we could do something alone, but we decide to bring a partner, a co-manager, or someone local along into the transaction, exposing them to how it is done and then we probably, we hope, have a friend for life, locally.

Another factor is serving the subsidiaries of multinationals in the region. I think we have gone a long way to be the bank of choice for a lot of the European and non-European

multinationals operating in the Eastern European theater. I think that you've got to do that, although you cannot just do that.

### *OBJECTIVES - ING*

There is potential, which we are beginning to exploit for all kinds of imaginative solutions. I'll give you an interesting parallel. In Latin America during the 80s, the business that we made the most money in was the trading of bad debt, in this case, mostly sovereign bad debt, but also corporate bad debt. These were defaulted loans that had been restructured, needed to be restructured, that were highly illiquid. NMB Bank was the forerunner of the whole LDC debt trading community and was one of the founding members of the emerging markets trading association and is still one of the leaders in this field. I think there is tremendous potential for that in Eastern Europe. Not just because there is defaulted sovereign debt, but also because you have a tremendous amount of bad domestic debts in many countries. These debts are mostly sitting in a lot of state owned banks or even in some private sector banks and are a major problem in a number of cases—Bulgaria to mention one. I think there is a lot of imaginative work that could be done there using the experience of defaulted debt from Latin America and elsewhere, if the authorities were to allow. So, we look forward to the opportunity to help transform the local banking system by mediating some of these assets that are sitting there and choking the banking systems.

### *ENTRY STRATEGY - ING*

In terms of the future, I think the experience is that, as financial markets mature, the profit margins become thinner and that's where flexibility comes in. You may trade finance for a couple of years and enjoy a very high margin because not everybody else is providing trade finance but then after a while if everybody does it, you've got to move on. So it helps to have an institution that is very flexible and can provide a comprehensive gamut of services. Also in the ways they are being done, we are not tied to any particular model. If there is an opportunity to try retail banking, we try that. If direct marketing can be tried, we try that. If it's wholesale banking, insurance, asset management, or buying a stake in a bank like the opportunity we had with Bank Slaski—my colleague here will elaborate on that, we will try that. So, the key is flexibility and pragmatism. Our view is that Eastern Europe is becoming inextricably linked to Western Europe. These countries are in a very interesting transition that is ultimately of great significance for Western Europe and the rest of the world. We feel we have to be there.

## **Discussion**

### *CRITERIA FOR MAKING INVESTMENTS*

### BUTLER

The principle concerns of our venture capital fund, which is the largest commercial bank-linked commercial venture capital fund in the U.S., relate to the volatility and liquidity of the market, the predictability of the regulatory environment, the tax regime, the fullness of the legal regimes, and other issues of that sort. That's only one type of investment.

I think if one looks at the investment flows that are associated with manufacturing, then clearly they are looking at the potential for large markets. Why then is GM investing in Thailand today as much as it is versus an investment in Russia? There has been an understandable hesitancy because of the regulatory environment in the kinds of factories one might invest in and the difficulty in structuring investments. A lot hinges on the broad investment environment as well as those returns on investment that you are likely to get.

### PORZECANSKI

Number one, I don't believe there ever was, is, or will be a capital shortage. Therefore, we do not have to pit one region against the other. I think there is so much money in the world going around looking for a home that one need not worry about the shortage of capital. Tens, hundreds of billions of dollars flow and are ready to flow and the amounts, the sums are so vast that the shortage of capital is not the problem.

I think the problem is rather the shortage of opportunities. We have institutional investors in the U.S. who would love to buy more shares of Eastern European countries or more bonds of Eastern European companies or sovereigns or municipalities or whatever. It's really the supply side constraint. You really don't have enough private sector companies, companies of size to issue debt or equity or companies with liquidity and reasonable size. Of course, in the case of some countries, their regulatory framework and traditions do not foster the rapid development or the rapid issuance of stocks and bonds, and the deepening of capital markets. I think this will come and the potential is tremendous.

## BLAUVELT

Capital can be led, it can be attracted, but it can't be driven. One of the problems I see in the opportunity set in Central Europe is that the investment infrastructure, if you will, needs to be re-examined, and perhaps re-imagined by the regulatory authorities there. This is true, certainly most importantly for FDI and perhaps most obviously for portfolio investors. For investment to be attractive, especially to portfolio investors of significant mass and sufficient seriousness, there are a couple of requirements. One, portfolio investors will want some pricing transparency. The regulations in which they conduct their business requires almost inevitably all of their assets to market on some calendar frequency basis. They need then to see a multiple of price points in the market available for them which means there have to be a lot of people permitted to play in the capital market in the country where the investment has been issued.

The second thing is that they also require at least the ability to be able to hedge their exposure either in terms of its interest rate basis, its farm currency basis or its maturity basis. Most serious investors will operate against an investment horizon which is different from the average weighted tenor of the liabilities or equities that they invest in. And finally they need a sense of clarity in terms of the regulatory environment because that impacts very directly what they view as the liquidity of the investments. Some of the countries in Central Europe have done a much better job in engendering that kind of a basic infrastructure than others.

## *OBSTACLES TO INVESTMENT*

### BLAUVELT

In terms of regulatory impact on the economic development, I think there are two general problems. The regulatory sophistication of the government is not as robust and as well advanced as we would like to see it. That creates two kinds of concerns for us.

In the absence of a more advanced regulatory construct, it is difficult for many outsiders to be comfortable with the payments system inside the economy because the payments system is run by the banks. To the extent that there is a question about who a bank is, you can't look to the U.S. Fed, the Bank of England, etc., for assurance that a bank is okay. It adds cost to acquiring a new counter-party and being able to flow funds through the economy.

The second issue, as long as you have that question, is that you are going to have a natural limitation on which external investor's pockets you can solicit capital from. Many of the large serious players are going to have legitimate concerns about going to their board, their investment management board, and suggesting that they should take a significant asset allocation in a country if they can't also say, we'll be able to track it and we kind of know who it is and debts equal credits on a pretty regular basis. That is a structural impediment, not just to the capital markets but to the joint venture structure for banks.



## PORZECANSKI

The lack of transparency in capital markets is very serious. The lack of a structured judiciary and court process and so on is also very evident. If it's any consolation, it's common to all emerging markets. I think, in general, in emerging markets what you see is not what you get. And that's true of a Hong Kong based conglomerate, a Mexican conglomerate, or definitely a Russian company. Obviously one of the factors that is creating the supply side constraint is the fact that you don't have that many companies with Western accounting, and that have rating or that you can rely on or have the very basic things that an investor, whether a brick and mortar investor, an equity investor, or a fixed income investor would normally have.

## BUTLER

Particularly if you look in Russia, you see an evolution of some institutions in terms of the SEC or equivalent SEC institution, or the efforts to establish registration institutions and custodial institutions. There is clearly a tiering in terms of banks and those that can be relied upon, or allegedly relied upon at this stage, for transfer of funds. All of those banks are undergoing and have undergone international standard audits.

If you look at the Polish Stock Exchange, the level of disclosure that is required for listed companies is pretty severe and that is a positive thing. So, the question is to what extent that can be speeded up and/or sustained in terms of the pace because it is critical. In addition, the difficulty of doing audits is extraordinary. If we look at some of those important companies like a Gasprom, Price Waterhouse has been laboring for more than a year to make sense of the numbers. Coopers & Lybrand is looking at Norilsk Nickel, a company in Siberia, and it's going to take months, if not years, before those numbers will make sense.

## BILLINGS

The baby boom generation is now just moving into an asset accumulation period. As this cohort moves through this peak earnings and asset accumulation period, an additional \$10 trillion dollars of investment power will be generated. So the numbers are very huge when you put them in the context of a Polish stock market, with a market capital of \$6.5 billion. They are very important flows. The point I want to reinforce is that the real challenge here is not finding the money, but breaking down the barriers and making sure the flow is in the right place.

## *ROLE OF INTERNATIONAL FINANCIAL INSTITUTIONS*

### McCROSSAN

Well, again, as I said during the course of the earlier ten minutes, EBRD was absolutely essential from our point of view. We are a conservative organization. I was asked to develop a significant position, a potentially significant position on the step by step. If the EBRD hadn't already been an investor and WBK hadn't been prepared to support our arrival as a strategic

investor—they were prepared to give us an agreement that they would sell us some shares even if we didn't get any under the underwriting agreement and give us the option on the balance of their shareholding—we wouldn't be in WBK at the moment. So, as a case study of what the EBRD says they want to do and should be doing, I think that WBK experience is absolutely tremendous.

They were there when the bank went to the market initially. They took the stake when nobody else wanted to take the stake. When they saw an opportunity of a strategic investor with a reasonably commercial approach, they made it as easy as possible for us to be there. Our experience with them has been absolutely excellent and I think they did a great job.

### BLAUVELT

When you see the EBRD as an investor in a company, there is clearly a sense that, “hey this is a serious company, we ought to take a look at it.” Often their equity investment and management advice is very persuasive in terms of us saying we would like to be part of that company's financing picture. We'd like to pitch for the business and perhaps put a road show together and see if we can do some fund raising.

### SVEJNAR

My impression was that sometimes it is precisely the problems that we are encountering in these countries that bring about the partnership of say, EBRD and a private bank. For instance, lack of protection of minority shareholders may force EBRD, which would be a very strong minority shareholder, to make special agreements with other potential minority shareholders in order to insure that they do get the access to information, control, and so on.

## **PANEL 2: THE CENTRAL EUROPEAN / RUSSIAN PERSPECTIVE**

**RAFEK SALEKHOV - Mosbusinessbank, Executive Vice-President**

### *INVESTMENT OPPORTUNITIES IN THE RUSSIAN BANKING SECTOR*

Right now, the banking system in Russia consists of the Central Bank of Russia and 2,600 independent commercial banks. These are mostly small and moderate sized banks. However, according to the data available to date, 27% of banks have fund capital of over five billion rubles. Additionally, 794 banks have a simple currency license, 280 banks have general currency licenses, and 105 banks have a license to conduct transactions in gold and precious metals.

However, the general situation with the banking system in Russia overall is very complex. Until recently, most of the banks conducted a very risky investment strategy. You must remember the bank crisis—the liquidity crisis in August of last year—and the significant impact it had on the liquidity and profitability of banks. Over 30% of the banks in Russia lost money last year. In the previous ten years, the Central Bank has canceled banking licenses to 167 banks, while in the last year, a license was taken away from over 260 banks. Another significant development in the banking system in Russia is the differentiation of the banks, not only by the size of operations, but also by the volume and quality of the services provided, of technical assistance and personnel. This is particularly applicable to the regional banks.

Naturally, the problems of the Russian economy and Russian banks are intertwined. The future development of the economy will have a significant impact on the effectiveness of the workings of the Russian banking system. The influence of the banks on the processes in the economy will increase. We are trying to improve banking standards in Russia up to international standards. We are looking for Western assistance in this process because regardless of whether we want to or not, Russia is going to become a part of the international development.

Consolidation in the banking industry will continue in Russia. This concentration and consolidation will involve large, small, and moderate-sized banks. It is going to become the function of the economic structure and processes in the Russian economy. We need a more flexible regulation mechanism from the Central Bank of Russia, and it has taken a number of steps in this direction. It has increased the requirements for the banks and increased the number of criteria to twelve for any bank to be established. I'd like to stress again that we need further assistance from foreign banks and investors. We are looking for investors, not only in the banking industry, but also in the general economy of Russia.

Foreign and strategic investors have started their involvement in the banking business in Russia. The charter funds of the banks with foreign participation are two trillion rubles. There are 161 Russian banks that have foreign shareholders. Eleven are 100% foreign owned, and five have foreign holdings exceeding 50%. Based on some of the previous speeches, all kinds of strategies are good for our country.

## **ISTVÁN ÁBEL - Privatization State Holding Company of Hungary, Managing Director**

### *INVESTMENT OPPORTUNITIES IN THE HUNGARIAN BANKING SECTOR*

In Hungary, we can distinguish between at least four stages in approaches to privatization. During the first stage of bank privatization, between 1987 and 1991, starting new commercial banks seemed to be attractive for investors. Foreign investors came and wanted to buy, but the state said no. The state was not willing to give those foreign banks any access to the large state-owned banks, although the state gave and was ready to issue new licenses to foreign investors so they could start their business there, even in that period. There was a change in that respect after 1992; the period between 1992 and 1994 can be characterized by its emphasis on strategic investors. The state said that if there were so many interested parties to buy banks, it should be trivial to just sell those banks to strategic investors and, of course, there are many reasons why we would prefer strategic investors in this sector.

Unfortunately, we had to realize that no one was ready to buy. Even the most serious investors got really cautious when the negotiations started to deepen. The reason, I would like to emphasize, was not linked to the banks themselves but perhaps it was linked to the client. A major problem in that period was that the reputation risk was too high. If there was any chance that their investment may go bad in the future, then basically they were risking their own managerial positions.

Meanwhile, the market still developed so that large state owned banks started to lose market share. At the same time, smaller banks, especially those that were private, were increasing their market share significantly. So there was a shift in the market that made bank privatization even more important or urgent for economic policy. Policy makers basically accepted a mixed approach, giving up the emphasis on strategic investors and letting other investors join in.

The major change was characterized by the OTP privatization. OTP, the state-owned savings bank in Hungary, was sold to fourteen financial investors in 1995. Twenty percent of the shares were sold to financial investors with an additional 14% sold to domestic investors in the first round. This was the first major transaction in 1995 and by the end of the year Hungary would achieve a quite unique reputation in privatization. The receipts from total privatization in 1995 were 10% of GDP and the change basically started with the OTP.

Let me enter into bank privatization decisions. First, let me address one issue, whether pricing is important or not. When the press asks about bank privatization deals, they usually tend to over emphasize the importance of pricing and, of course, politicians react to this fact and they always say that the price is the most important characteristic of the deal. Unfortunately when a bank is privatized by a state agency, this is the only parameter of the transaction which can be handled. We can compare the bids on the base of price, but unfortunately in such a complicated transaction like a bank privatization, there are many other more important aspects of the deal. I'll mention just a few—guarantees, options, whether there is a portfolio cleaning—which influence the net impact of the deal very dramatically.

Anyway, for the state, the proceeds from privatization or settling are always important. We have to confront the distortion because it makes a difference whether the privatization is a capital increase or transfer of shares. When the state is selling, then share transfer is preferred just because the revenue considerations for the market would be better.

What are the difficulties? We may assume that finding a buyer would be difficult. I have to tell you that this is the most trivial thing. There are always buyers out there. I may risk to say that 1996 might be the year of bank privatization in Hungary just because the interest is increasing. Microstabilization is in place or improving. Profitability is great and improving. Investors are starting to realize that if they don't act fast, they may lose the opportunity because others will take it. The only serious impediment is the slow pace of the bureaucracy to react to this demand.

**RICHARD SALZMANN - Komerční Banka, Chief Executive**

### *INVESTMENT OPPORTUNITIES IN THE CZECH BANKING SECTOR*

From the beginning of the reform, the Czech banking sector was considered key to the future transition to the market economy. Now we have fifty-six banks; fifty are real commercial banks and six are construction savings banks. Between those fifty commercial banks, there are four, we say "big banks". In comparison with those we heard from in the first part of today's discussion, we are dwarfs, of course, but relatively in the country, they have a big importance. These four banks have together something like 85% of the relevant markets—the loan and the deposit market. The rest of the banks are sharing the remaining 15%. There are ten branches of foreign banks in our country and ten companies which are fully-owned subsidiaries of foreign banks.

How is the privatization of the big four banks? These banks still belong to the state. By state, I mean a special agency called the Fund of National Property, which reports to the Parliament, not to the government. The amount of state ownership differs in these banks. The lowest share is 30% in the Investment and Postal Bank, 46% in the saving bank, 48% in the commercial bank, and 80% in the Czechoslovak Trade Bank.

Now, what is the most important problem of privatization or completion of privatization in our country? There are several obstacles. One obstacle is that the state bank, or the Central Bank, is leading a very tight license policy. For the last two years, no new licenses were issued by the Central Bank. Another is that every purchase of bank shares must be permitted, conceded, or licensed by the Central Bank. There is an unwritten rule that the Central Bank will not issue this permission for one single shareholder with a foreign origin of more than 10%, and no more than 25% total for all foreign investors in the bank.

Secondly, the privatization of these four big banks should now be completed from the 48%, 46%, and so on until there is a certain amount or level of state ownership, probably

something like 10%, which should then remain for an uncertain period into the future. This is very broadly discussed. The government states that this privatization should be performed during the next two or three years.

The possibilities are first, to advise the government about these projects and second to find the buyers. This is something which may be performed with the assistance of foreign investors or foreign consultants because the amount of capital necessary is not within the possibilities of the domestic capital market. If the whole state's share in Komerční Banka is to be sold, something like fifty billion crowns will be needed to buy it, according to the existing market valuation.

Another direction of privatization will probably be connected with some simplification of the structure of the small banks. It seems there are too many of them and many are very unstable. Six of them were already canceled or provided with forced administration. I could say that the Central Bank will agree very much if there would be investors who would buy those banks and on the condition that they will settle their problems.

The last question, which is the most important, uncertain and unclear, is whether even the largest Czech banks will be not dwarfed in the future by other banks in Europe, especially when the country enters the European Union. This is a big question which is now over the banking system in our country. It is something which should be advised to the government and the banks themselves, and will be very important in the near future.

**SLAWOMIR SIKORA - Powszechny Bank Kredytowy (PBK), Vice-President of the Management Board**

#### *INVESTMENT OPPORTUNITIES IN THE POLISH BANKING SECTOR*

My experience in bank privatization is on both sides. A couple of years ago I worked for the government and was responsible for bank privatization. Now I work in a commercial bank which is scheduled for privatization this year.

In terms of investment opportunities for foreign investors, privatization is one of the ways a foreign institution can enter the market. Another possibility is just investing in the banking institutions listed on the stock exchange. In Poland, there are twelve banks listed in the stock exchange. Sometimes our stock exchange is called over-banked, since 35% of the total capitalization is represented by banks.

There are two other ways of entering the market. One, which was very strongly supported by the Central Bank some time ago, is reflected in the licensing policy. Some of the banks represented here have experienced that, in their own efforts. The Central Bank's reported solutions involved foreign bank involvement in an existing bank in the country which was in trouble. In other words, the licensing policy was tied to the restructuring of existing institutions in Poland. Of course, the last and quite often favored way of entering the market is a greenfield investment, as the former speakers mentioned. For some of the banks, especially U.S. banks, it

seems to be the most favorable way of entering the market. Of course because of the licensing policy, it is not always possible to start banking operations just as a greenfield. There was a time, especially in 1990 and 1991, when the government supported and was very open to foreign bank investment—100% on subsidiaries or branches. Some of the banks represented here have chosen this way. Citibank opened in 1991 and ING opened a branch, I think, two years later.

What strategies are welcomed by local banks? I think what is the most important on our side is that the foreign investor, either a bank or financial institution, brings not only capital but is also willing to transfer the know how and technology, as well as being an intermediary to international markets. That's probably what the domestic banks expect and is the added value from our perspective.

**ANDRZEJ WALKIEWICZ - Bank Slaski, Executive Vice-President**

*INVESTMENT OPPORTUNITIES IN THE POLISH BANKING SECTOR*

In terms of consolidation in the Polish banking sector, my opinion is that nothing will happen. Most of the large banks will be privatized as individual banks and if there are any consolidation processes, it's going to be a very loose association of banks because I think most of the chairmen of these banks are afraid to lose their positions due to consolidation.

Let me mention a few things about ING. Our staff at Bank Slaski is currently about 6,600. This number always scares me because we should have around 2,400 people to run this bank efficiently. Our staff distrusted ING's intentions from the start, but ING has turned this whole affair into a friendly and positive cooperation.

I do not represent here the ING side of Bank Slaski, I am very neutral in this regard. ING does not have a member on the management board, but has three of them on the supervisory board and the day-to-day management operations. Basically there is no involvement from the ING side at all. We are working very close together because under the management support agreement between the Ministry of Finance and ING, there are several functions which are performed by ING. We are not limited to the consulting services of ING exclusively and we are using various consultants for various projects and various auditors for various businesses that we run. So, we are not limited to ING support at all. We welcome the support and together we are working on a model branch project which hopefully will introduce the modern distribution of retail services throughout Poland and allow us to limit our employment to at least half of the currently high level.

We also are working together on the insurance side. National Netherlands had entered recently—a year and a half ago—into Poland and is distributing insurance products through our branch network and through the network of its own agents. We are presently involved in a huge re-engineering project which has to do with the integrated on-line Information Technology (IT) system. We hope to complete this project by the year end and then introduce a whole network of ATMs, cash management systems, and other services to our customers.

ING assists in preparing policies and procedures and gives us additional tools for risk management purposes. We are in the process of introducing an account management system throughout our network. The management system, which Bank Slaski will introduce, is going to differ a little bit from other account management systems. It's going to be based on the ING Holland system of distribution.

## **Discussion**

### *MARKET PERFORMANCE OF STOCKS AND RETURNS TO FOREIGN STOCKHOLDERS*

#### SALZMANN

Komercni shares doubled their price since the middle of last year. The price is now approximately 2,200, a very good achievement. I've not had the opportunity to explain GDR's action, but last year we sold at the first branch of the GDR, the global depository receipt on a price which nearly doubled. This year, we repeated that on the second try. We have 17%, nearly 18% return on liquidity for the last year and this is the return also to the foreign investors. Because the inflation is relatively low, 8%, the return is not damaged so much by the inflation.

#### WALKIEWICZ

You probably know the answer to your question about Bank Slaski because you follow it very closely. If I remember the figures correctly for the last year, the performance was around 38% or 39%. So taking inflation into consideration, the net was 7%.

#### SIKORA

In terms of this talk, all of it is still in the state hands so what we are providing to our one shareholder is just a nice return on equity. Last year, it was close to 20% in dollar terms. .



## BILLINGS

I'm sure that the audience is aware that this is in the context of markets in dollar terms. Poland is up 50% this year, the Czech Republic is up by about 25%, and Hungary is up about 80%.

## *FUTURE OF THE FINANCIAL SERVICES SECTOR*

### SIKORA

First, we have to take into account growing competition both from domestic as well as foreign banks to perhaps give you a better perspective. Within the past eighteen months, the top seven banks in Poland have been licensed and become operational. Second, I would expect important upgrades in the banking technology, especially IT. All of the Polish banks put a lot of money into technology and I think it will be fruitful within the next two, three, or up to five years, since the banks are in different stages of implementation.

The third element is competition from loan banking institutions. Poland is still dominated by commercial banks, but I think within the next five years competition from investment funds will be especially important. What I would like to emphasize, and we took it in our strategy as important factor, are the changes in our funding base as a result of social security reform in Poland. I think this will move deposits, especially individual deposits, from the banks to different types of pension funds in the future.

So, it takes into account that there are also financial conglomerates, like GE, coming in so we will probably face a measured complaint of the American banks that we are regulated and we bear the high costs of regulation in Poland. For example, the reserve requirements are 19%—which are zero interest bearing—from side accounts. So, if you take 20% inflation, then you know the cost. So, the competition from the non-banking institution is an element in the strategy.

### ÁBEL

In Hungary, we can probably expect very similar things to happen, but there are also differences. The main struggle will be the international players that continue to enter the market. In fact, this probably will not only increase competition. The major impact I expect is that current players will enter new sectors that they haven't entered yet. There are three sectors which are especially important in the future of banking in Hungary. One is retail, another is trade related finances with the recovery, and the last is finances for small and medium size businesses. These three aspects are not equally important for international banks and that's why I think there is still hope for domestic banks in Hungary. It will definitely be a more concentrated banking system, so we can expect some mergers to happen.

### SALEKHOV

Speaking of the situation in Russia and Russian banks, the increased competition from the foreign banks, decreased margin requirements and some of the debt are characteristics of the banking industry in Russia. Our bank is currently working on clarifying its strategy. We are moving from providing single products to our clients to providing a range of services. Relating to this, an important aspect of our future is the assessment of risk— risk relating to assessment of different enterprises, different products, the overall bank, and in comparison to other countries, to other sectors of the economy, and so on.

## KEYNOTE SPEECH

**DAVID LIPTON**

**U.S. Treasury, Assistant Secretary**

It is really a pleasure to be here with so many friends from the Eastern European region, with people who have been working on and thinking about the transition process and also to meet so many new people. I would like to begin by thanking the Davidson Institute for putting this together and for inviting me here today. I think that the study that has been done, which I understand is being distributed today, is an excellent project, a top class piece of work. Perhaps I always feel a little more favorable about a study that says many things that I think are correct. I think that the results of this study are probing and that the Treasury Department is very proud to be associated with it.

Today, I am here in the somewhat unenviable position as an economist speaking to a bunch of bankers about the challenges of banking and investment—a subject that I think you know a lot more about than I do. Someone once said that an economist is someone who has the math training to be an accountant, but doesn't have the personality. Today I will try to provide the economists' and policy makers' perspectives on some of the issues you are discussing.

I recall a story I heard when I first went to Poland, a story that I think was motivated by the fact that there were many economists running around trying to tell the Polish people and government how they might improve their economy. The story is about two fellows who go up in a hot air balloon, and are blowing across the Polish countryside in a storm. When the clouds part, they see a fellow in the field down below and they come down and one guy in the balloon yells, "Where are we?" The guy on the ground yells back, "You're in a balloon." The one fellow turns to the other in the balloon and says, "That's an economist." His companion asked, "How did you know that was an economist?" He replied, "Well there are three reasons. First, he answered without hesitation. Second, what he said was, technically, exactly correct. And third, what he said was useless."

So, I think and hope that not everything economists say is useless. I think the Davidson study is a very good example of how one can blend theory and practice to examine the record of reform in financial sectors, in banking, in this region and to point the way for what needs to be done. When you get right down to it, the challenge of bank privatization in Central Europe is fundamentally a part of a broader challenge, that of creating sustained and steady economic growth in the region.

I want to start by talking a little bit about that, because I think that is the proper setting or context. We all have to understand the stake that countries in the region have in financial sector reform. Many countries, now six years into reform for Central Europe, and three or four years into reform if you go a little further east, are experiencing the beginnings of economic growth. But for the process of transition to ever really be complete, this growth has to lead to a

meaningful integration of the region into the broader European and the world economy. For that to happen, growth will have to be much faster than it is now and it will have to be sustained.

The EBRD's Transition Report from last year estimates that for Central European countries to reach income convergence, or to reach the same level as Western Europe, would require growth of 7% per year for thirty years, with investment ratios exceeding one-third of GNP. Now this is a very rough calculation, and whether you believe that that goal itself is attainable or not, it is clear that conversions and faster growth ought to be a goal and that the countries in this region, in my view, have a lot to learn from the lessons of the fast growing economies in the world, particularly those in Asia.

I think one lesson is that there will have to be a second round of reform in these regions. The reforms that have taken place, of course, have dismantled the old system and put in place many features of a market economy. There is now a modicum of stability. There are vibrant private sectors in a number of countries in the region, but I think that there will have to be a second round of reform for there to be sustained, rapid growth and income convergence and that that ought to be the goal of the policy makers of the countries in the region.

That second round of reform will require a number of things—smaller governments and much more significant domestic savings. While we can all be very pleased about the foreign directed investment that is taking place in the region, there are no countries in the world that have sustained rapid growth just on the basis of foreign investment. There needs to be a much higher levels of savings. Of course, there has to be a financial system that can channel this savings to good purpose and make sure that savings are not used inefficiently and wastefully. That's where today's subject comes into the picture.

When we look around the region, it is clear that some of the financial sectors are still not transformed. There will be no place for antiquated financial systems if the countries in the region are to attain rapid and sustained growth. I think that this is an area where reform has lagged behind and there is a need for an acceleration. Over the past few years, a great deal of effort and energy has gone into developing schemes to privatize banks, orchestrating individual transactions to transfer ownership of key banks to private hands, and to seeing those banks' operations improve. The focus on privatizing a selective set of commercial banks might have been appropriate at the outset of the reform process, but I think the focus should now be changed somewhat.

The main point I want to make is that we should be working to develop modern, private financial sectors that provide a full range of services, and thinking more broadly than just the question of privatizing the small commercial banks. I think that by focusing on a kind of case by case approach for a subset of banks, countries have fallen into a few pitfalls which I'd like to mention. My remarks will echo a lot of the findings that are in the Davidson Institute study.

First, governments get bogged down in trying to determine exactly how and to whom shares should be transferred. Precious time is wasted and the black hole just gets deeper as

governments try to strike the perfect balance between making a fair share of assets available to the general population and to the bank's employees, attracting a strategic foreign investor and getting the maximum price. Second, banks are privatized but often governments refuse to give up control of the banks. In some cases, governments leverage the veto power of a relatively small share into effective managerial control or the potential threat of intervention and managerial control and that is a very damaging process. And with the continuing stake that some governments hold in privatized banks comes the temptation to protect these banks. New competitors from home and abroad are prevented from entering the market and governments may try to dictate plans for the privatized banks to acquire other banks to prevent them from entering certain sectors of activities.

All of this lessens competition and I think impedes the development, diversification, and efficiency of the banks. In addition, governments end up holding the weakest institutions, without a workable plan for how to address those banks' problems. They may be tempted to try to attract investors to weaker banks by injecting successive rounds of fresh capital into those banks when their problems need to be addressed more forcefully. I think that the ad hoc approach to bank bailouts only increases the moral hazard of such operations.

Finally, the case by case approach may leave whole tracks of some economies almost entirely in state hands. This happened in Bulgaria, where state-owned commercial banks still funnel credit to state-owned firms and the government makes these banks whole when the resulting bad loans come home to roost. I think that some of these pitfalls could be avoided if governments focused more on creating efficient private financial sectors and tried to be broader in the scope of the transition that they are trying to affect in the financial sector.

I'd like to make five points that I think should be borne in mind in the second phase of reform. The first principle that I want to talk about is a need for speed, which was stressed in the Davidson study. Moving a bank privatization forward quickly has proven more important to its success than the actual method which was used to transfer ownership. I think that's a fair statement. My own view is that an eclectic approach is better and that countries mustn't let the perfect be the enemy of the good. Governments and investors should not shy away from novel methods of privatization or from using a number of different methods in one privatization operation. The goal should be to find an approach that combines the best of what each method has to offer.

Let me go through a few of the methods, which will be familiar to most of you. Selling shares to strategic foreign partners offers an alluring approach to achieve privatization and insure restructuring but the process of finding a partner can take a long time and governments often are reluctant to cede control to foreigners. Still, Hungary successfully used this approach in the case of the Budapest Bank and Poland has done so in several cases. In this context, I think the EBRD can play an important role as a kind of a pioneer shareholder providing that imprimatur that was mentioned in one of the sessions.

Voucher give aways used in the Czech Republic are fast, but shares are dispersed very widely, as Mr. Salzmann mentioned this morning. To promote restructuring of the bank, governments must then follow up by making it possible for investors to buy up a significant block

of shares by developing the equity market sufficiently. Initial public offerings (IPOs) create new owners, spur financial market development, put a market value on assets, and strengthen investor oversight, but all too often policy makers lament that equity markets aren't deep enough or diversified enough to absorb a major IPO without depressing share prices. While there may be some truth to these arguments, I am inclined to believe the markets may be more resilient and somewhat deeper than governments think, but in sum I think that speed shouldn't be compromised.

The second principle is the importance of fostering good corporate governance. This means effective control by private interests. Governments that wish to maintain a stake in a privatized bank for a period should find legal devices to assure private shareholders that they will be passive players. Such advice could include taking preferred non-voting stock or letting a respected private financial firm manage the government's share for a fee. To get the government out of the business of running a privatized bank, governments should sell out their holdings according to a preannounced plan, providing some discipline and some sense among the new private owners that the government holding period will be limited.

The principle of good corporate governance also means that governments must be willing to let a bank take that next step beyond privatization to restructure the enterprise and increase efficiency. While it is important for a government to develop a view about whether a country is overbanked or underserved, consolidation should be market driven and not government mandated. Governments that abuse their position as minority shareholders and meddle in the plans of privatized banks risk getting a bad reputation and a bad reputation risks setting back the entire financial reform process considerably. There just aren't that many potential strategic investors, who want to come in and take important stakes when there are plenty of other places in the world where they can go. Nor should government succumb to the fallacy that bigger is better or assume that banks will fit together easily. Banks have their own niches and cultures and these may not lend themselves easily to consolidation. The sub-principle that I want to stress is that I don't believe consolidation should be allowed to delay privatization.

The third principle is the need to allow competitors to enter the market. Domestic groups and foreign interest groups should have the right to establish *de novo* operations. Economies need the know how and the infusion of capital that new competitors can bring to financial markets. World Bank studies of financial systems in Latin America and Asia have shown that countries that are open to foreign competitors have stronger financial systems, domestic and foreign. Without competition, banks stay uncompetitive. With competition, even local banks that have not been privatized as well as those that are private, will strive to become more efficient and banking systems will improve.

In some cases, foreign banks are already on the scene. As I look around this room, there are many who are operating in the region in competition with indigenous banks. Governments and indigenous banks, including state-owned banks, are still too resistant to letting in new competitors. In my view, this is shortsighted and, as you know, countries that wish to join the OECD, *join* the EU and integrate themselves into the world economies must let foreign banks in.

I also would say, I was surprised at the comment this morning about Czech Bank licensing. As I understood that one of the obligations that the Czech Republic has undertaken in *exceeding* to the EU was free licensing of banks in the Czech Republic.

The fourth principle that I want to mention is the need to quickly put sound regulatory systems in place and to develop a comprehensive plan to deal with the problem of bad loans, when necessary. This is an area where governments need to do the most and perhaps where they have fallen the farthest behind. Governments need to redouble their efforts to set up appropriate regulatory and supervisory systems based on transparent laws and regulations. The state also will need to help with the sorting out of the inherited problem of bad loans and this is something that has been—the two problems, regulation and working out bad loans—an issue in quite a number of countries. There is progress in this front in several places. I would say that in Lithuania, supervision was invaluable in exposing the true extent of the crisis, and in Russia, the Central Bank's move to close hundreds of banks—taking away their licenses—have both been very positive steps and there are other examples. But in general, this is an area where there is more to be done. The representative of Citibank, I think, said it very well this morning. There have to be clear rules, even if they change from time to time, and there has to be reliable supervision.

Finally, the last principle I wanted to mention is the need to consider the broader spectrum of financial institutions rather than just banks. There has already been some talk about this. Even now in many places in Central and Eastern Europe, the banking system remains largely in state hands, largely focused on providing loans of a very limited sort, to a limited set of enterprises. Governments need to extend their privatization programs, as is being done in some countries, to include specialized banks, savings banks, and other financial intermediaries.

Beyond banks, the countries of the region need other kinds of financial institutions; securities firms, mutual funds, private pension plans, “non-bank banks”, like leasing companies, that are all part of modern financial systems. If the pool of savings is to be increased and used effectively, this will be important. I was interested to hear Mr. Sikora talk about the growing role of insurance as a way of channeling small savers' savings into the financial system. I think this is promising.

Well, let me stop here and say these are five very broad principles that I think are important to creating an efficient, safe and well regulated financial system in the countries of the region. I think governments should think a bit more about creating a framework to encourage dynamic, integrated financial sectors and try to move a bit beyond the focus of individual bank privatization. As I have said before, we are six years into economic reform, and banking systems are still predominantly in the hands of the state. It is easy to see the political temptation to keep it this way but I think to do so would keep in place a major roadblock to economic growth and economic convergence. The region is growing now and that is a tremendous accomplishment that I think has been a surprise to many. But I fear that this growth will not be sustained, unless vibrant, healthy, financial sectors can be developed. Now, I know that this room is filled with people who agree with that proposition and who are working very hard in very practical ways to bring that about.

## **BREAKOUT SESSIONS: OPPORTUNITIES, INVESTMENT BARRIERS, AND ENTRY STRATEGIES**

### ISTVÁN ÁBEL: REPORT FROM THE BREAKOUT SESSION ON HUNGARY

Our group began by identifying some attractive features of the Hungarian environment. There are a few positive factors; a credible commitment to the EU and European unification lead this list because it has implications not only for macro-policies but also for foreign direct investment. We think that the concentrated effort on the government's side to attract foreign capital to Hungary could lead to indirect access to the EU through Hungary.

Second, the country is embracing foreign investment. This is reflected in the last year of privatization success, but it may also be a consequence of the negative impact of privatization with domestic investors.

People still prefer foreign investors to Hungarians in the privatization process. We hope that this will encourage strategic investors, not just in the financial sector but in other sectors as well. Foreign direct investment brings about a very significant improvement both in business culture and human capital.

There are two other issues which might be related, but should first be mentioned separately. One is the relatively developed level of legal and regulatory institutions, which have an impact on macro adjustment and micro-economic restructuring. Let me mention that bankruptcy regulation and other elements of doing business in Hungary are relatively closer to Western standards than in other transforming economies. Finally, although the Hungarian economy's macro performance is not yet great, we believe that we have achieved something positive in micro-economic performance.

Before turning to barriers to investment, we want to mention bureaucratic impediments. We believe that the divided nature of the government bureaucracy and the slow process in making decisions is a serious impediment to modernization. This problem also invites other factors which may work against new entrants, for example, companies who have already established some presence in the country may try to block out others by using political lobbies or playing games that keep out new entrants.

Second, because of problems related to the recession and the financial sector, interest rates are still too high and the resulting high real cost of capital is an adverse selection in the lending policy. The high reserve requirement, which adds to the cost of mediation in the financial system, is part of this problem.

Next is cross-border lending, which represents a kind of dis-intermediation in the banking system and is a consequence of general problems in the financial system. It means that if a foreign



entity comes to invest in Hungary, it is usually undercapitalized. General financing funds go through cross-border landing and collect high interest on that landing. This is basically risk free because it is done inside the ownership structure. We also want to mention the tax structure because it not only distorts economic decisions, but also contributes to the informal increase in the informal sector which again drives activity away from the banking system.

A long lasting barrier we can't hope to get rid of, language complexity, may be a barrier against the West. So the challenges are the macro-policies, with emphasis on the importance of fiscal reforms which are related to the tax structure, but also contain elements of the fiscal policy as well as the monetary issues. We believe the changes, that we all can observe from 1995 until now, are promising. Commitment to the EU will enforce further changes, and may improve our macro-policies. At the same time, we believe that there should be more attention paid to state intervention but not in the traditional form. If there is any state intervention, it should focus on the modernization of the infrastructure, which indirectly could attract more foreign investments.

Our suggestion for strategies for foreign investors can be summarized in one warning, namely we would like it if the investor would pay more attention to the political complexities of the decisions and include political experts with all of the elements in the transactions with these countries. We believe that the level of sophistication of the system has already developed enough, so that the importance of political lobbying is increasing and this should be kept in mind.

#### DON BILLINGS: REPORT FROM THE BREAKOUT SESSION ON RUSSIA

Our group discussed Russia, but in a slightly broader fashion. The obstacles are not only to foreign investment, but in the banking sector, either entering through privatization or de novo. There are also obstacles to banks being effective intermediaries in the economy. The barriers are all rather fundamental problems. Lying behind all of this, of course, is the issue of macro-stability which leads to some of the other problems. The first and most common problem we discussed was a lack of available information that makes sense to investors, which can also be tied with disclosure of that information. While it was understood and, of course, accepted that Russian accounting standards reflect a well-developed logic and system, it is just not a system of presentation that is understandable to investors. One solution is to try to encourage the Central Bank of Russia to promote reform more quickly. We also spoke about a bank itself taking the lead in disclosing information by developing and publishing information as a competitive tool to get its name in the marketplace and to attract funds.

Another impediment to investment is in the form of CBR limits on foreign investment, both on an aggregate market share basis, which is about 12%, and on a bank by bank basis, which limits foreign investors to taking no more than a 30% stake in voting shares. Obviously, to the extent that foreign investors are limited to taking only minority interests, the fair treatment of minority investors becomes much more critical.

The third item, trust, for lack of a better term, refers to the problem of mobilizing domestic savings. The view of the group was that since depositor trust has been so abused, there

may be no quick fix to this problem and it may be deeply cultural at this point. It's a significant problem, but unfortunately, we don't have a solution for it.

The last major barrier is systemic risk, which is a reflection of weak supervision. Competitors who price in the deposit or the lending side in a rational way, or who take excessive positions relative to capital and the ability to absorb losses, affect the market and make it impossible for banks that want to behave prudently to compete.

In terms of solutions, we looked at ways that external actors could participate. First, we talked about convertible loans. Convertible loans could be a sort of a "half way house" to getting a position of influence in the bank's management without taking equity risks, building a relationship of trust and gaining greater access to the information about the bank, and provided that comfort and trust is built, converting that loan to equity later on.

We also talked about the role of rating agencies. The economic logic of rating agencies is particularly powerful here. Because the cost of information is so high I would say it's not just the economics and it isn't just driven by the fact that it's inefficient for all economic actors to interpret the data. It's that the information is not even there. So, this may be a substitute and a particularly powerful and efficient way to get information out on the banks.

We also spoke about on-lending facilities provided by the World Bank or the EBRD who, of course, are actively qualifying banks in Russia through the FIDP program and so on. Finally, we spoke about something that probably can't be fixed except through macro-economic stability. That is just the inability to bridge the gap between a foreign currency based equity investor's needs to get returns denominated in his currency and the inability of a Russian bank, operating in the ruble to hedge that risk for them in a sensible way.

#### JERRY THIEME: REPORT FROM THE BREAKOUT SESSION ON POLAND

First, our breakout group decided to classify or identify the barriers to direct investment or to privatization from the government's point of view. Second, we identified the perceived barriers from the point of view of the investors. Then we tried to list the strategies which could overcome those barriers on the investor's side and on the government or seller's side.

First, but not necessarily most important, is a pricing issue. There is some perception that there is a market price, immediately setting up a confrontation with the offer price. Then the government decision-makers are in the situation where they are politically very insecure in making a decision, they don't have any way to speed the transaction. This is a real barrier.

There is a lot of media discussion about consolidation in Poland. The group's conclusion was that consolidation is not necessarily bad. Instead, it's perceived as bad, or it is bad if it is government driven—a so-called administration consolidation, which could harm rather than help. The government's presentation skills are another issue, especially when the different agencies of the government are making frequent reversals of their positions. We believe that if the

government had some more stable way of presenting these things, it would be much better than frequent changes of government position.

Another barrier is a cumbersome licensing process, meaning changes in the licensing policies. There are some periods when licenses are given, especially during the first phases of the transformation when licensing was easy to obtain. At other times there has been pressure not to start a greenfield operation, but to acquire help to restructure a bank.

There is also fear—by the politicians, the economists, and the regulators of the greenfield operations—that the greenfield will take over the entire banking system and become the only way to invest. On the other hand, many or most of the investors, as we heard this morning, prefer greenfields. They are afraid of entering into the existing culture. There are very different points of view, especially here.

The second thing, which makes it difficult to get a license, or to be welcomed by the local banking communities, is that foreign investors tend to operate only in certain sectors, for example, only corporate banking initially, with no retail. This situation, or only operating in government securities exposes foreign banks to the critique that they are skimming the system by operating in the highest margin areas and leaving lower margin or loss making areas to local banking.

Our first recommendation is: build relationships and create a trust between the two parties; and spend a lot of time, effort, and money to build this trust.

Our second recommendation is about how the strategies and issues should be presented. They should be presented using clear, straightforward language. If the strategies and issues are not presented clearly or in a straightforward manner, the seller may be suspicious that there is some hidden agenda, that not everything is said, or that there is something more than presented. There is a danger that the negotiations will take a long time because the partner may try to uncover a hidden agenda which might exist, but probably doesn't.

The third recommendation, which is closely related, is the correct use and spending of money on PR firms. It is typical for Western companies to spend a lot of money on PR doing business in the U.S, in Western Europe or somewhere else and a minuscule amount of money doing business in Eastern/Central Europe. It's not only important to pay a lot of attention to, but to choose somebody, a PR advisor, who understands local culture and knows the techniques of PR.

The next recommendation, which is quite important, is very clear recognition of who the seller is and what is to be sold. For example, the bank is to be sold, but the seller is the government. In other words, the government is the owner. Next, there is a sequence of discussions with the owner and then with the bank.

Fifth, the bank management, especially shareholders if there are any, need to be educated. One example is a bank which is to be sold and the shareholders had an impression that there was

some worth in that bank, when in reality, there was a negative worth. They needed to be educated about the banking business. Because they put some money in the bank some time ago, they believed that there was some worth or, some value in this bank when actually there wasn't any; it was lost.

The last point is about the use of legal advisors. There are many fears which come with legal counsels. It's not enough to have lawyers from the quarter, it's very highly recommended to have local lawyers. By local lawyers, I mean lawyers operating locally in Warsaw, with experience speaking the language and speaking with people that understand the culture.

#### JAN SVEJNAR: REPORT FROM THE BREAKOUT ON THE CZECH REPUBLIC

I should point out that our group thought only about the problems, so we don't have the positive things here. The positive things, if we look at Hungary, are the commitment to EU, business culture and human capital and, I think, the modest answer would be that the Czech Republic is second to none in those areas.

We talked quite a lot about the problem with disclosure of what's really going on in the Czech Republic. This is not only for foreign investors, but for local investors as well. There is a lack of knowing who owns the firm, the banks, or other firms. This has been a particular problem in the last several months, during the so-called third wave of privatization, when there is consolidation of ownership. Suddenly groups are acquiring shares and very few people really know who owns what and to what extent. This is creating problems for outside investors who would like to move in and know what is going on. There is a new law coming into effect on July 1, 1996 which should improve things in this area. It wasn't clear to us, as a group, whether that's going to be completely adequate, but our impression was that it will improve things a great deal.

The second and related point is that there is a need for an institutional backing of this issue, something like a Securities and Exchange Commission in the U.S, a body which would be equipped to both have a legal structure and be able to enforce it to be sure that the rules and regulations are followed. Currently, this is a major problem. The Ministry of Finance has a unit working in this area, but it is understaffed. It's difficult to obtain or attract people with the correct or adequate human capital characteristics for it, so the agreement is that this is really an area where something needs to be done in order to create investor confidence.

The third area we discussed deals with whether the government is using its muscle to influence investment decisions. The group agreed that this is an incorrect perception and the government does not try to influence decisions of the banks except in its role as a shareholder at the meetings. It votes, and sometimes it does vote a particular way that may go against the wishes of the other shareholders. But, there is no kind of administrative intervention as far as we could determine in this area.

There was also a question as to whether the banks are making bad loans without government intervention and whether this is, in some sense, a problem. And, as far as we could

determine, there really isn't much of a difference. It is possible that the banks, for some reason, again given human capital or whatever the difference, may not behave the same way as banks would somewhere else. This really is not substantiated, so the impression is that there isn't much difference on that front.

Number four is the barrier to privatizing the remainder of the banks. In particular, the division of the government in Czechoslovakia to the Czech and Slovak Republics, has resulted in governments of both countries sharing the government ownership. In the particular instance of Komerčni Banka, one-third of the government stake is really the stake of the Slovak government, two-thirds is the stake of the Czech government. For the corresponding bank in Slovakia two-thirds of the government stake is the stake of the Czech government, one-third is the stake of the Slovak government at the current prices of the respective stock markets. Those do not amount to just a simple swap. It may be quite difficult to find an agreement between the two governments as to how those shares could be swapped and then privatized. So, this could be a major political problem or international/diplomatic issue.

Number five is a policy point. There is no law to this effect but there seems to be a policy agreement on the part of the government officials that foreign investment in the case of individual banks should not exceed 25%. Now, this has not always been enforced. Smaller banks were privatized where this policy was not enforced. Nevertheless, it is an issue which one would have to deal with in the case of privatizing a large bank such as Komerčni Banka. In part, possibly because this bank really is a nationwide bank, unlike Polish banks which may be more regional in nature, if you get a major foreign investor here, strategic control over the entire economy would be obtained. This may, therefore, also be a problem to deal with in the future that may be of larger proportions than we thought.

Finally, over the last two years, the government tried to encourage the take-over of weaker, smaller banks by other owners and was not issuing new licenses. That policy has been changed. Two new licenses were issued this year, but clearly in order to permit entry and privatize the sector, licenses will have to be issued.

## **HIGHLIGHTS FROM CONCLUDING DISCUSSION**

### **LEN LAPIDUS - U.S. Treasury**

One of the points the Davidson study makes is that governments should not be overly concerned about how to sell the banks because the real benefit is a privatized bank or privatized financial sector. The fact is that if a government sells a bank for what is perceived by the public at some time in the future at too low a price, you're going to stand by the politicians who are much more sensitive to it than the economist could be. But it occurs to me that there is a way of cutting a deal on price. Effectively, if the government participates in what happens to the price subsequent to the time the deal is struck, you could sort of take care of that. Has much of that been done and do the people who are involved think that is feasible?

JEFFERY ABARBANELL - Davidson Institute and University of Michigan Business School

Budapest Bank addressed this issue with the put and call options.

ROGER KORMENDI - Davidson Institute and University of Michigan Business School

One of the things that the Davidson/Treasury study showed was that the Budapest Bank transaction and the MKB transaction prior to that, in particular, had ex post performance pricing in that a price on the base of ex post performance ended up being higher.

There is also the possibility of structuring transactions, where the government is a passive participant and so shares in the upside. That puts less pressure on the price, and the government has an exit strategy in a couple of years when the full value of the bank is there.

I'd like to offer one final observation. In a sense, this observation comes from something that was said at the very beginning of the conference and something that was said towards the end. There is a huge, huge pool of capital all over the world looking for opportunities. It's searching in all countries and it's searching in Central Europe. The reason is because there is also a huge pool of potential investment opportunities that everybody sees there.

So you have this huge pool of capital on the one hand and a huge pool of investment opportunities on the other. If relatively few transactions take place relative to what could take place, there is some set of barriers. There are two kinds of barriers. First are issues related to underdeveloped institutions. The human capital in the banks is not as great as it might be; or the modernization is there, but the regulatory environment isn't up to speed or whatever. Those are barriers in a sense but they are also the risks. They are manageable risks and capital with expertise can come in and deal them. What draws capital in is the very high return of dealing with those risks. The real barriers appear to be more the political ones and the best players in this, the ones with the most success, seem to be the ones that can work in that political environment—the Allied Irish, ING, Citibank—those entities. It seems they certainly do bring in capital, but they bring in expertise along with it, and contributions in addition to that. Maybe it's citizenship cooperation.

This is an exact parallel of what happened with the Resolution Trust Corporation (RTC) in the United States. There were capital opportunities, people learned to work with the government in these privatizations and once that expertise was there, there was then an eventual avalanche of success in privatization.

TED SNYDER - Davidson Institute and University of Michigan Business School

There are a lot of investment opportunities in Central and Eastern Europe, including, completing privatization and de novo entry. There are also a lot of barriers and common issues. I think that the Institute's agenda is as follows: to try to encourage the market to develop and find

investment opportunities that are consistent with good banking. These problems that are being faced in Central Europe are, in part, specific to transitional economies. But the long run goal is to create sound banking and that is a difficult problem in any setting. So, I think that we are trying to understand how you get positive franchise value banks that serve the interests of the economy.

I think that is really where we would like to go with our future work. We really appreciate all of the insights that have been shared today because so many of them resonant with that ultimate goal.