Lessons from Bank Privatization in Central Europe

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Non-technical Summary

The experiences of the three fast-track transition economies, Hungary, Poland and the Czech Republic, with bank privatization provide dramatically different policy stories. The foreign-entry deterring protectionist policy favoring domestic banks in both the Czech Republic and Poland has left their banking sectors with weak market discipline and relatively less-developed products and services compared to Hungary. In fact, the early and somewhat deep entry of foreign banks into Hungary left the government with little choice but to rely on foreign capital to privatize the state banks. Two related fundamental properties for evaluating bank privatization, i.e., independence from the state and proper internal governance, were achieved by foreign majority ownership in the Hungarian banking sector. The Czech Republic has a highly concentrated banking sector and a higher degree of financial intermediation measured by loans to GDP than the other two countries. Its experience with using a hospital bank, both for all non-commercial short-term working capital loans and for bad loans, was not wholly successful because it did not address the incentive issue of preventing new bad loans. Moreover, voucher privatization left banks and companies intertwined and the state with a controlling ownership stake in the large Czech banks. Poland's experience with bank-led enterprise restructuring resulted in more debt-equity swaps than working out of bad loans. Its bank privatization program yielded two successes in terms of internal governance out of nine newly created commercial banks. Thus Poland's experience is intermediate between those of Hungary and the Czech Republic in achieving successful bank privatization.

Since the banking market in many transition economies and developing countries is quite small, only a small number of domestic banks will be viable. This is surely the case in Hungary and the Czech Republic although perhaps a little less so in Poland. Hence, the threat of entry and not large numbers is the most likely source of competitive pressure. Three basic lessons for promoting healthy and financially stable banking sectors in any small open economy can be drawn from the experiences of bank privatization in the fast-track transition economies.

First, for incentive reasons, successful policy must pay attention to proper sequencing. Recapitalizing and restructuring of state-owned banks followed rapidly by their privatization to an independent strategic investor aligns incentives properly. The early recapitalizations of the Czech banks were to no avail because soft lending practices continued and future bailouts became necessary. By contrast, the continual recapitalizations of Hungarian banks were ultimately successful because privatization to an independent, usually foreign, owner followed rapidly. Second, the credible transfer of control from the state is the crucial aspect of a successful bank privatization program. Poland lost its credibility with an inconsistent policy that switched from attracting a strategic foreign investor to attempting to arrange two large politically motivated bank mergers. Hungary, on the other hand, gained credibility when it ceded control of its largest banks to strategic foreign investors soon after recapitalization and restructuring. Third, foreign ownership and participation in banking is an essential and inevitable part of bank privatization in small open economies. Hungary has been more accommodating on this issue and now has the strongest banking sector in the region.
Abstract

In the three fast track, Central European transition countries, Hungary, Poland and the Czech Republic, bank restructuring and privatization involved different approaches and met with a variety of outcomes. Hence, these experiences in otherwise similar transition economies provide importance lessons for bank privatization in other transition countries and in developing economies. If an independent market-oriented banking sector is the overriding goal, three fundamental conclusions emerge. First, bank restructuring and privatization must be sequenced carefully to create the appropriate incentives for lending on a commercial basis only in the future. Second, privatization requires a credible transfer of control from the state and often a change in the current management of the bank. Third, the proper corporate culture is most easily established by attracting a strategic investor, preferably a foreign financial institution.

Key Words: bank privatization, bad loans, bank restructuring, financial sector reform, transition economies

JEL Codes: P34, G21 and P52
1. Introduction

There are several stages to the development of banking sectors in transition economies. The first is the establishment of commercial banks as joint stock companies and of a central bank from the Soviet-era mono banks. The second is the restructuring of bank portfolios and the recapitalization of the banks. The third step, privatization, involves a transfer of ownership from the government. The privatization strategies pursued in the formerly planned economies vary from a partial divestiture of shares by the government to a transfer of control to new foreign owners. More often than not, the emphasis on other competing goals leads to a lack of concern with the ultimate goal of transition, i.e., the development of an independent banking sector. Banks should be free of control by the government or by their clients; they should have the ability to apply hard budget constraints in lending activities and develop the capability to manage financial risks. The bank privatization process needs to be judged against these ultimate goals.¹

The three fast-track transition economies of Central Europe, i.e., Poland, Hungary and the Czech Republic, started the financial sector reform process at about the same time but took distinctly different approaches to bank privatization. The two tier banking structure was organized earlier in Hungary (1987) than in Poland and the Czech Republic (1989 and 1990 respectively). Bank recapitalizations began in late 1991 in the Czech Republic and in early 1992 in Poland and Hungary. The privatization process is still underway in all three countries; it began in 1992 in the Czech Republic and Poland and in 1994 in Hungary (Buch, 1998). Poland’s program was eclectic and changed over time with the emphasis shifting from a mix of public offerings (IPOs) and minority stakes to strategic investors in tender offerings to IPOs exclusively and back to tender offers from strategic investors.² The Hungarian bank privatization program progressed erratically in a difficult political environment but now boasts some largely successful bank privatizations to majority foreign investors in tender offers and is virtually completed. In Czechoslovakia, banks were involved on both sides of the first wave of voucher privatization at the end of 1992 with mixed results. The state retained an almost majority stake and voucher funds in the aggregate obtained the only other significant stake. Hence, the existing management was firmly entrenched and banks were not independent of state control. Recently, the Czech government has acknowledged that divestiture of the remaining state owned shares should involve a strategic investor and a transfer of control from the state. In the last few years, privatization strategies in all three countries have changed in pursuit of more effective ways to develop truly independent banking sectors.

These three countries took different approaches to the temporal sequencing of bank restructuring and privatization. Hungary followed most closely the order presented above in that banks were restructured and recapitalized before they were privatized. In Poland, the two occurred contemporaneously and banks also took the lead in enterprise restructuring

² For an earlier summary see Bonin and Wachtel (1999).
based on a program designed in conjunction with the World Bank. Policies in the Czech
Republic are less easy to characterize in this typology. Neither restructuring nor
privatization was completed during the period. The voucher privatization of banks occurred
after an initial restructuring of portfolios but before significant recapitalization. More
importantly, many large enterprises were not restructured and the poor quality of their loans
was recognized slowly. Hence, the large Czech banks remain only partially privatized and
have net worth problems at present.

We examine the interaction between bank restructuring and bank privatization by
applying this typology to these three countries. In the next section, three approaches to
privatization are compared conceptually. The following three sections illustrate the
advantages and disadvantages of each in the three fast-track transition countries, Poland,
Hungary, and the Czech Republic. The paper concludes with lessons for the banking sectors
of slower track transition economies based on our evaluation of the policies pursued by the
fast track countries.

2. Approaches to Bank Privatization

Public offerings of equity in the banks lead to diffuse ownership that favors
entrenched management. IPO privatization usually results in only partial government
divestiture of state ownership and in dispersed ownership. Hence, it fails to create an
environment for the development of a modern, independent banking sector. In addition,
equity offerings can be difficult to implement in countries without experience with stock
market offerings and whose markets have limited depth and liquidity. Bank IPOs are very
large and there may be neither the institutional experience, i.e., investment banks, broker
networks, trading mechanisms, to price these issues nor investor interest to absorb them.
Problems arise because of the underdeveloped infrastructure for handling the processing of
claims from a large number of small owners and due to the lack of absorption capacity of
nascent domestic capital markets in which bank stocks dominate market capitalization.
Thus, bank IPOs in a transition economy may be prone to market manipulation. In such
instances, true reform of the banks may be delayed and the government may not realize as
much revenue from the privatization process as it could.

The attraction of privatization through a tender offer from a strategic investor is that
such a transfer of ownership and control facilitates necessary changes in management, often
transfers knowledge of modern banking techniques, and promises much needed capital
injections. Control is transferred from the government to a new owner with the skills and
financial capability to develop an independent, efficient bank. However, governments find it
difficult to set a price for this control. If the price appears to be too low, the government is
accused of giving away the bank to a powerful group or to a foreigner. If the price is too
high, or if a hesitant government restricts the offer of control of bank assets and activities,
there will be little interest from strategic investors. To further complicate the issue, potential
investors who have the resources and interest to make hefty investments in not so healthy
banking firms are often foreign financial institutions. There may be significant political
resistance to foreign ownership of the domestic banking system. Tenders often involve lengthy negotiations, which delay the privatization of the banking sector.

In theory, voucher privatization provides a speedy transfer of ownership using an egalitarian process that does not favor any particular interest groups. Furthermore, it avoids the need to set a price administratively for the transaction. The clearest disadvantage is that the transaction does not provide any revenue to the government or lead to any capital infusion to the privatized bank. Moreover, this method is likely to result in dispersed ownership and, as with IPOs, it is not conducive to achieving the primary goal of independent governance. As designed in the Czech Republic, voucher privatization of banks resulted in the transfer of less than fifty percent of the bank shares to individual and investment funds with no dominant strategic owner emerging.

If banks are sold, either by tender or IPO, a selling price must be determined. Allowing the price to be determined by the tender offers runs the risk of establishing too low a selling price because prospective buyers may be cautious. A banking investment involves non-diversifiable systemic risk for an investor and, hence, yields an option value to waiting. Thus, the alternative of setting the price administratively in negotiation with a strategic investor is also problematic. The political cost of selling banks to strategic investors, particularly foreigners, in what appears to be a fire sale is severe. However, undue preoccupation with “getting the price right” is likely to retard significantly progress toward achieving the primary goal of independent governance. Negotiated arrangements that include incentive clauses to reduce uncertainty for the buyer may be necessary to attract the desired strategic foreign investor.

Both IPO and voucher privatization provide attractive relatively quick means for the transfer of partial ownership but that is not the sole goal of privatization. These approaches do not facilitate the development of an independent market-oriented banking system. Such development requires a transfer of control of the bank and its assets to a strategic investor with the incentive to modernize the banking business. Although fraught with potential political problems, the role of a strategic investor is crucial and recent developments in all three countries suggest that this has now been accepted.

3. Poland: Government Directed Development and Fear of Foreigners

Even before the political transition began, state-owned commercial banks were created from the commercial portfolios of the national bank in 1989. Nine commercial banks were established along regional lines (Mondschean and Opiela, 1997). Polish authorities, with some inducement from the G7 donor countries and the international financial institutions, set a clear timetable for privatizing these banks. In order to obtain financial support from the Polish Bank Privatization Fund for recapitalizing seven of the nine, they agreed to privatize all nine by the end of 1996. The original blueprint had the Treasury retaining a 30 percent ownership stake, employees purchasing on preferential terms up to 20 percent, and the remaining half divided between a large and small investor tranche. The small investor tranche involved a domestic IPO while the large investor tranche
was intended to attract a strategic investor by tender. Although the details would change over time, Polish bank privatization involved an eclectic mix of IPO and tender offer.

Contemporaneous with the privatization program, a bank-led, enterprise-restructuring plan was designed in consultation with the World Bank. The program was designed to link directly bank recapitalization and bad-debt work outs by a lead bank. In addition to the existing court-based, basically Chapter 7, bankruptcy and the liquidation option under the Polish privatization law, the 1993 Polish legislation offered a new financial instrument for resolving bad debts, namely, the bank conciliatory procedure (BCP). As the agent for all creditors, the lead bank is involved in designing both a financial restructuring plan and a “revitalization” or business plan (operational restructuring). From the bank’s perspective, financial restructuring consists of rescheduling debt (principal plus accrued interest), refinancing obligations with a decrease in the interest rate, writing-down the face value of the loan (partial write-off), engaging in a debt/equity swap, or pursuing some combination of these. Many BCPs were put into place, mainly with the largest borrowers, and almost a third of them involve debt equity swaps (Bonin, Leven and Schaffer, 1998). Encouraging banks to take equity holdings in their clients leads to the well-known conflict of interest between the lending facility and the ownership objective especially in periods of financial distress. Furthermore, it strengthens the ties between banks and their inherited troubled clients when the reverse is the appropriate policy for independent bank governance.

Bank privatization in Poland focused primarily on the nine state-owned commercial banks. The process met with mixed success in creating independent banks. Over time, the government’s privatization policy was inconsistent due partly to multiple objectives with changing priorities. Government-directed bank privatization in Poland was expected to achieve the following objectives:

- maintain Polish ownership of the banking sector in the face of foreign penetration;
- generate revenues for the State Treasury;
- strengthen the domestic banking sector to face foreign competition;
- capitalize the yet-to-be-created pension funds and accomplish other social purposes.

The mix of tender and IPO along with the willingness to tolerate foreign purchase of bank shares changed throughout the period as the weights placed on different goals changed. The result was a process directed by the state with continuing government involvement in the governance of individual banks and the development of the banking sector.

Two banks with high quality management and strong balance sheets were privatized early in the transition (Bonin, 1993 and Bonin and Leven, 1996). Preparations for the privatization of Wielkopolski Bank Kredytowy (WBK) in Poznan and Bank Slaski (BSK) in Katowice began in the summer of 1991. As the smaller of the two, WBK was privatized first on March 15, 1993 to test the absorption capacity of the equity market. To obtain a capital injection, WBK issued new shares that the government intended to sell to a strategic foreign investor in a tender. After an unsuccessful search for a buyer, the EBRD paid $12.6 million for this 28.5% stake and committed to find a strategic owner within five years. The negotiated price of $6.89 per share was applied to an IPO in which a 27.2 percent stake was
sold in a large investor tranche (7.2%) and a small investor tranche (20%). The former was subscribed mainly by Polish investors (80%) and the latter entirely by domestic investors. Employees as a group purchased stake about a 15 percent stake at a discounted price.

WBK opened for trading on the Warsaw Stock Exchange on June 22, 1993 at a price of $19.66. The approximately threefold increase from issue price tracked the increase in the market index, WIG. Slawomir Sikora, the person responsible for bank privatization at the Ministry of Finance, claimed that the stock market run up was due to the privatization of WBK because that act convinced investors that the government was seriously supporting privatization and the market. The privatization of WBK met with mixed success. On the one hand, the domestic market absorbed the IPO easily and the sale of the bank promoted further institutional development; on the other hand, no strategic foreign investor was attracted and the governance of the bank was not independent of the state.

A strategic foreign investor was eventually attracted to WBK and became a majority owner in stages. In March 1995, Allied Irish Banks (AIB) participated in a second new share issue and acquired a 16 percent stake in WBK for $20 million. AIB had been WBK’s twin in a World Bank sponsored program designed to transfer know-how to Polish banks but it had declined to participate in the initial privatization. The new issue reduced EBRD’s stake to 23.9 percent and AIB signed an agreement with EBRD to purchase its stake at a future date. In a subsequent transaction, the state sold an additional stake in WBK to AIB and, by 1997, AIB was a majority owner with a 60% stake. Basically, it took four years before a strategic foreign owner took clear control of WBK illustrating the option value of going slow for the buyer.

Bank Slaski (BSK) was larger with assets valued at twice those of WBK. BSK was privatized in December 1993 following a canceled tender (Abarbanell and Bonin, 1997). The tender had been designed to let the competitive bidding process determine the price of the transaction. When it became clear that the strike price would be at the minimum set by the government and after a change in the ruling coalition following elections, the tender was canceled reportedly due to a lack of sufficient demand. This experience illustrates the pricing problem and its political nature. The original plans were to apply the price determined in the tender to a domestic IPO consisting of a 15% stake in BSK. Following the canceled tender, the IPO was increased to a 30% stake and the price was set administratively at $25 per share. Even with the additional allotment, the IPO was seriously oversubscribed. Reserved for the employees of BSK was a 10 percent stake on preferential terms (half-price). In early December, the Dutch bank, Internationale Nederlanden Group (ING), showed renewed interest in BSK after having participated in the tender bidding earlier. The process resulted in ING taking a 25.9 percent stake in BSK for $60 million on January 13, 1994, employees taking a 10 percent stake and receiving their shares early enough to register them for trading in January, and 817,644 small investors receiving three shares each in the IPO. The terms of the contract with the SFFI require ING to hold the shares for at least three years. The state retained a 33% stake.

When BSK opened for trading on the WSE on January 25, the market-established price was $337.50 or thirteen and a half times the issue price! Trade volume amounted to
32,410 or about 0.35% of the total shares. To be tradable on the exchange, shares must be registered at an approved brokerage house. BSK employees were advantaged both in receiving their shares earlier than the public and in having ready access to BSK's brokerage facilities. The other 800,000 plus shareholders had difficulty registering their shares in a timely fashion. Hence, much of the first-day selling was presumed to be employee shares. Since these were purchased at $12.50 per share, the profit per share for those selling on the first day would have been $325. Public outcry surrounding the BSK affair focused on the special treatment accorded BSK employees and the information about excess demand in the IPO available to ING before it committed to its investment at what was perceived to be a "bargain-basement" price. From an ex post perspective, the obvious problems were the lack of adequate capacity to handle the number of shareholders attempting to register in a short period of time and the below-equilibrium price in the IPO. Neither could have been anticipated in advance and both are clearly interdependent.

In July 1996, ING gained a majority interest (54%) in BSK by purchasing all but 5% of the state's stake. However, in the interim, BSK had two core owners, ING and the state. BSK's management was able to retain significant control by playing off one core owner against the other (see Abarbanell and Bonin, 1997, for details). The privatization of BSK to a majority foreign owner and a clearly independent governance structure took two and a half years from the first tender. It illustrates many relevant issues: the political nature of pricing, the problem with an underdeveloped market infrastructure, the option value of waiting for the purchaser, and the importance of transferring control from the state.

The third bank privatized was Bank Przemyslowo-Handlowy (BPH) in Krakow. In 1993, Credit Suisse First Boston (CSFB) was engaged to supervise the privatization and locate a strategic investor. Both CSFB and ABN-Amro (BPH's twin) found the offer price too high. The CEO of BPH, Janusz Quandt, was arguably not interested in ceding responsibility to a foreign strategic investor. Hence, the BSK affair was sufficient fodder to allow Mr. Quandt to dictate privatization by IPO only with the maximum allowable stake for any single investor at 10%. In January 1995, a 50.2% stake was sold at a strike price determined on a special market day. As a result of lack of demand, the strike price was at the minimum set by the government and the EBRD as underwriter was left with a 15 percent stake. ING and BSK each took a 5 percent stake and increased their combined stake to 15 percent by purchasing the shares remaining with a second underwriter at a later date. The state retained a 43% stake while 27% of the shares were widely held.

In 1995, the government announced plans for bank consolidations prior to further efforts to privatize the banks. Among the proposals was a plan to place the state's shares in BPH with a consolidated group. This would effectively block any attempt by ING/BSK to take an active investor role in BPH. The government seemed determined to retain a core-investor stake in banks so it could pursue banking policy directly through governance in addition to indirectly through regulation. Since BPH was traded on the WSE at the time, the EBRD and others argued that this would be tantamount to renationalizing the bank and the government ultimately abandoned the idea. In 1998, the government announced its intention to sell a 37% stake in BPH and invited bids from strategic foreign investors. Contenders included Sweden's Skandinaviska Enskilda Banken and AIB, which was
interested in merging BPH with its previous acquisition, WBK, in order to form a national bank. Suspicions that the government did not want a foreign bank to achieve too high a market share were confirmed when the Swedish bank was announced as the likely winner and the highest bidder. However, the transaction was not consummated and a German bank, Bayerische Hypo-Vereinsbank, ultimately acquired the stake for $609 million. Although this bank intends to purchase the EBRD’s stake and become a majority owner, the privatization of BPH is still not completed four years after its IPO.

The BPH case illustrates the problem of continuing government meddling in bank affairs when control is not transferred to a core outside owner. The government was able to prevent a foreign bank from acquiring BPH and merging it with another regional commercial bank of which it was the majority owner. The government signaled clearly its unwillingness to allow market-type mergers that increased the market share of foreign dominated banks. Rather the government was promoting its own directed consolidation and supporting Polish ownership of banks over foreign ownership during this period as we document below.

The fourth privatization in Poland was that of Bank Gdanski (BG) in December 1995. BG had been twinned with ING, which was rumored to be interested in purchasing a core stake in the bank. The plan called for a two-pronged IPO with one-third of the shares sold to foreign portfolio investors using global depository receipts and one-third sold to domestic investors. Employees were expected to take a 4% stake and the state retained the remaining 30% of the shares. The design of the privatization indicated the government’s unwillingness to allow a strategic foreign investor to take a core stake in BG. However, an interested core investor emerged from the domestic sale. Bank Inicjatyw Gospodarczych S.A. (BIG), a widely held private Polish bank, took a 24% stake and immediately increased this to 27% with a block purchase on the WSE after BG opened for trading. This transaction provides further evidence that the government preferred Polish financial core investors to foreign investors. BIG moved quickly to consolidate its holdings and created, in 1996, BIG group by merging BG into its own operations. By the end of 1996, BIG group was the fifth largest bank in Poland with a market share larger than that of BSK. The privatizations of BPH and BG in 1995 were clearly designed to prevent ceding control of the banks to a strategic foreign owner.

In the fall of 1995, the government proposed bank consolidations as a method of strengthening the Polish banking sector to face the expected onslaught of foreign competition. The scheme called for the creation of two large banks by merging three of the remaining state-owned regional banks and the already privatized BPH into two large banking groups headed by Bank Handlowy, the foreign trade bank, and Pekao S.A., the foreign currency savings bank. In addition to the protectionist motive, the government wanted to use shares in these two groups to fulfill its financial obligations to the yet-to-be-created public pension funds. Bank Handlowy (BH) is the oldest continuing Polish bank as it was established in 1870 as a privately owned joint stock company but nationalized after the Second World War. The management of BH lobbied successfully for its exclusion from the consolidation scheme. The consolidation plan was revised and, by the end of 1996, it called for merging three state-owned banks, Bank Depozytowo-
Kredytowy (BDK) in Lublin, Powszechny Bank Gospodarczy (PBG) in Lodz, and Pomorski Bank Kredytowy (PBK) in Szczecin with the foreign currency savings bank to form the Pekao group. This financial group is now the largest bank in Poland with a share of over 20% of total banking assets.

In June 1997, BH was privatized in a creative attempt to balance political goals with an independent governance structure. A tender to attract a core group of strategic investors and a domestic IPO were used to sell the shares and a special bond issue was used to satisfy the requirement that the State Treasury reserve sufficient shares for allocation to future pension funds (Kawalec, Nieradko, and Stypulkowski, 1997). Three foreign financial investors, J.P. Morgan, as the lead investor, Sparbanken Sverige AB (Swedbank), and Zurich Insurance Company, were allowed to take a minority core position as a group holding 26% of the voting shares. The price and payment conditions for the foreign owners were a source of controversy and not linked directly to the IPO price. The final contract consisted of a fixed negotiated price and an additional payment related to the bank’s performance. Restrictions were placed on the disposal of shares by the core investors. The government's intent was to create a controlling group of shareholders, similar to the French noyau dur, but incentivized to take an active role in management.

Since the market value of the bank was estimated to be about 25% of the total capitalization of the WSE, the IPO had two tranches, one for individual Polish investors and the second for institutional, foreign and domestic, investors. The State Treasury set a price range for bids in the IPO and the total offering was oversubscribed by a factor of 12.5 with institutional investors accounting for 92% of the value. Due to the oversubscription, the Treasury set the price in the IPO at its maximum and divested itself of 59% of the shares of BH, of which 29% went to Polish individual investors and 30% to institutional investors. As a group, foreign institutional investors acquired 98% of the second tranche. The residual Treasury stake is only 8% although the Treasury holds a 30% stake in the diluted capital of the bank due to the special bonds. By limiting the voting rights of shares targeted for the pension funds, the government was able to attract a core shareholder group that it hopes will take an active role in strengthening the bank in three major areas, investment banking, insurance products and retail banking. By restricting the first tranche of the IPO to Polish individual investors only, the government insured that a significant stake in the bank would be held widely by Polish investors. However, by combining the core investor stake with the aggregate stake held by foreign institutional investors, it becomes clear that a majority of Bank Handlowy’s voting shares are held by foreign investors. The privatization of Bank Handlowy appears to have satisfied the principal multiple objectives sought initially in Poland, although the government’s influence is still apparent. In January 1999, the government decided to use its 25% non-voting stake to capitalize the Polish state insurance company, PZU, but did not inform bank management before the story was reported in the press.

Powszechny Bank Kreytowy (PBK), a Warsaw based commercial bank, was privatized in October 1997. The highest offer from a strategic investor came from the Korean conglomerate, Samsung, but it was rejected in favor of a Polish solution. Two
Polish financial institutions, Warta Insurance and Kredyt Bank, obtained stakes of 13% each as did Creditanstalt of Austria. The State Treasury retains a 15% stake and the remaining shares are publicly traded and widely held. The ninth commercial bank, Bank Zachodni in Wroclaw, is scheduled for privatization this year. An 80% stake of this small, predominantly retail bank is available and BH is reported to be interested. By the end of 1997, state ownership in the banking sector was down to 35% and foreign ownership amounted to 40% of capital. As the two privatizations in 1997 indicate, the government did not seek a strategic foreign investor but rather employed a multiple-objective Polish solution.

The privatization of the Pekao group is a large and significant transaction since the group’s share of the retail market in Poland is almost 50% and the Warsaw stock market values a controlling share in the bank at about $1 billion. A 30% stake is reserved for capitalization of the yet-to-be-created Polish pension funds. In December 1998, 15% of the bank’s shares were sold in a domestic IPO intended for small Polish investors. BH acquired a 4.3% stake with the intention of bidding for a controlling interest in the tender to follow in which a 55% stake of the group is for sale. Despite early interest from BankAmerica, Deutsche Bank, Citibank-Travelers, ABN-Amro and AIG, BH expressed its intent to tap international capital markets for financing a bid or obtain assistance from one of its own investors (J.P. Morgan). BH’s pre-emptive action in the domestic IPO was not viewed favorably by the government. Subsequently, BH has accepted its inability to finance the purchase of a controlling stake and has sold its stake to a subsidiary at a loss. The privatization of Pekao is proceeding currently with negotiations between the government and two foreign investors. If one or two strategic foreign investors purchase a majority stake in the Pekao group, this transaction will mark a significant change in policy in Poland as it will indicate the current government’s willingness to promote independent bank governance by a majority foreign owner.

This change in attitude to foreigner participation in the Polish banking industry may reflect Poland’s joining the OECD and signing an association agreement with the EU. Both of these organizations set open financial markets as an explicit goal. The agreement with the OECD called for opening foreign bank operations at the end of 1998 so that the central bank is no longer allowed to restrict licensing of foreign banks. These issues will loom large in forthcoming negotiations with the EU. The Polish banks themselves have become less resistant as they realize that strategic foreign investors may be preferred to actual foreign competitors.

The Polish experience with bank privatization is rich with lessons.

- Multiple policy objectives coupled with changing political priorities leads to an inconsistent privatization process that delays the transfer of control to an independent core investor. Hence, the development of the banking sector is retarded.
- Pricing is problematic because of uncertainty leading to an option value of waiting and political costs associated with the perception that banks are being sold at bargain prices. Hence, undue preoccupation with getting the price right and extracting maximum revenue up front delays the process significantly.
• The absorption capacity of the domestic market may be underestimated and the demand of foreign investors for minority stakes may be overestimated. Hence, with the state retaining a core-investor stake, the result of dispersed domestic ownership is continued insider/state bargaining over bank policy.

• Because banks have high capitalization values, the transactional infrastructure of the domestic equity market needs to be developed rapidly to avoid political costs like those incurred in the BSK privatization. Hence, the interdependency between the sale of bank shares and the development of the equity market must be taken into account to anticipate institutional problems before they arise.

• Although attracting a foreign strategic investor is the best way to promote independent governance and rapid development of banking efficiency, political resistance to foreign control can be substantial. Hence, protectionism may be a convenient veil for a government that wishes to continue its direct involvement in the banking sector.

4. Hungary: Recapitalize and Sell to Foreigners

Banking reform began in Hungary with the creation of a two-tier system even before the start of the political transition. The commercial portfolio of the National Bank was hived off divided and three state-owned commercial banks were established with clients divided along sectoral lines in 1987. A monopoly state-owned savings bank, established in 1949, and a foreign trade bank operated as separate specialty banks during the communist period. Bank restructuring was drawn out over a three-year period with multiple recapitalizations of the state-owned banks. The final cost of recapitalization was about 10% of the GDP at the time. The first successful bank privatization did not occur until the middle of 1994. However, over the subsequent three-year period, all five state-owned banks were privatized. By the end of 1997, the state owned only 21% of total bank assets in Hungary, down from 68% at the beginning of 1994, and foreigners owned 62%, up from 12% in 1994 (Varhegyi, 1999). Hence, bank privatization in Hungary illustrates the importance of the proper sequencing recapitalization and privatization if a strategic foreign owner is desired.

Hungary used a combination of programs for loan restructuring; its multiple bank recapitalizations beginning in 1992 were criticized by the international financial institutions on incentive grounds. In the first major portfolio cleanup, the Hungarian Investment and Development bank (HID) took over about 40% in face value of the bad loans to work out. HID then repackaged some of these loans and auctioned them off in secondary markets. The other 60% were left with the banks to work out using incentive contracts to encourage recovery. The second major bank recapitalization in Hungary in 1993/94 involved a work out procedure similar to the bank-based one in Poland in that it used a fast-track, Chapter-11-type procedure to facilitate financial restructuring. However, a three-year time limit was placed on any bank’s holding of equity in a restructured company resulting from a debt/equity swap. During this period of restructuring, the large state owned banks, with the exception of the foreign trade bank, were insolvent. The total cost to the state of the entire program of consolidation and recapitalization was about 10 percent of the GDP at that time.
Once the write-offs were completed, the privatization of the banking sector took place rapidly. Five large state-owned banks were privatized over a three-year period from 1994 to 1997 leaving the Hungarian banking sector almost entirely in private hands. These five are Magyar Kukkereskedelmi Bank (MKB), the foreign trade bank, Orszagos Takarekpenztar es Kereskedelmi Bank (OTP), the savings bank, and the three large commercial banks created from the portfolio of the central bank, Budapest Bank (BB), Magyar Hitel Bank (MHB) and Kereskedelmi es Hitel Bank (K&H).

The first bank privatization was that of MKB, Hungarian Foreign Trade Bank and third largest bank in Hungary, in July 1994. Discussions with Bayerische Landesbank Girozentrale Bank (BLB), a German state-owned bank having long-standing business relations with MKB, began in 1991. The privatization of MKB combined a new share offering worth $19 million and a transfer of state-owned shares. BLB and the EBRD paid a total of $54 million for stakes of 25% and 16.7%. The state retained a 27% stake with the other 31.3% of the shares held widely by Hungarian and foreign investors. The sale involved an equity-based, price-adjustment clause for EBRD only (see Kormendi and Schatterly, 1996 for a description of the deal). The conservative nature of the hurdles in the contract suggests that EBRD was concerned about prompting MKB to avoid bad-case outcomes in the period immediately following the privatization. Clearly BLB was able to free ride on this incentive. Nonetheless, by negotiating a performance-based price adjustment with EBRD, the participants on both sides reduced the risks associated with not getting the transaction price "right." Later the EBRD and the state sold shares to BLB so that the German bank now holds a majority stake of MKB.

The privatization of OTP, the national savings bank and the largest bank in Hungary with 430 branches, was the second completed major bank privatization. The expatriate financier, George Soros, had expressed interest in acquiring a large stake in OTP but his offer was successfully rebuffed by a government reluctant to cede control of a large savings bank to a foreign owner. Towards the end of 1994, 2% of OTP’s shares were transferred to municipalities and, in May 1995, 20% of the OTP share capital was transferred to state social health and pension funds. The state retained an ownership stake of 25% and sold 34% of the shares in OTP in a public offering in July 1995. Of these, 20% were sold to foreign institutional investors using GDRs and 14% went to domestic investors. Another 20% of OTP’s shares was widely held by Hungarian investors at the time. The privatization of OTP left its CEO in control with the state as the only significant outside investor. In October 1997, the government sold its remaining 25% interest to foreign and domestic institutional and private investors. Currently, aggregate foreign institutional ownership of OTP is substantial but the shares are all small; the bank has a diverse ownership structure and its shares are quoted on the Budapest Stock Exchange. The privatization of OTP indicates that resistance to foreign core investors in savings institutions is common and persists even in Hungary where foreign control of commercial banks predominates.

The first privatization of one of the three commercial banks was delayed when CSFB pulled out of the final stages of negotiation with Budapest Bank (BB) in March 1995. In December 1995, GE Capital and EBRD paid $87 million to BB which the bank used to pay a short-term capitalization loan coming due on December 15th (see Kormendi and
Schatterly, 1996). GE Capital received a 27.5% ownership stake and a contract giving it full management control. EBRD took a 32.5% stake with the state retaining 22% of the shares. Another 18% was widely held mainly by domestic investors. In addition to the state agreeing contractually to be only a passive investor, GE Capital and EBRD were protected against downside loss with a put option for their entire 60% stake at a pre-determined price. GE Capital, as the bank’s management, was also given the option to turn over to the government certain bad loans during a three to five year period. Finally, GE Capital was given a call option to purchase both the EBRD’s and the state’s stake at a pre-determined price within some time frame. Hence, GE Capital was in a position to reap all the upside gain of its management decisions in BB without incurring the risk of any downside loss. Nonetheless, BB had independent governance and GE Capital had its reputation on the line.

There was substantial opposition to the BB deal that was not made public until well after it was completed. Criticism of the deal mounted when BB exercised some of its rights and sold an unprofitable subsidiary, Polgari Bank, and a package of loans and real assets back to the government. However, the bank is now profitable and is competing vigorously with other foreign banks in the Hungarian retail and commercial markets. Its successful performance has, to some extent, quieted the naysayers who complained about the government having “given the bank away.” The privatizations of both MKB and BB involved incentive contracts to attract strategic foreign investors. In these transactions, the Hungarian government indicated its preference for a well-qualified foreign owner over “getting the price right.”

The fourth large bank to be privatized, MHB, was sold to the Dutch bank, ABN Amro, in December 1996. Prior to the sale but after recapitalization, the loan portfolio was divided into good and bad assets. The bad loans along with the clients’ deposits were separated from the good part of MHB and a department was set up to work out these bad loans. Only the good bank was privatized and the transaction was structured to attract a strategic foreign investor who would increase the bank’s capital. Shortly after purchasing a 90% stake in MHB, ABN Amro increased the capital of the bank and merged it with its own Hungarian branch subsidiary. MHB now bears the name of the Dutch parent and is a financially sound foreign-owned bank. Once again, the goal of independent governance took precedence and a creative deal was structured to sell the bank to a strategic foreign owner.

The privatization of K&H occurred in a two-round tender in July, 1997. K&H was the bank of Hungary’s agrobusiness. The foreign consortium of a Belgian bank, Kredietbank, and an Irish insurance company, Irish Life Assurance, paid $30 million for a 10% stake and the EBRD participated by converting subordinated loan capital of $30 million to registered capital. After a capital increase of $60 million, the foreign investors each hold a 23% stake and the EBRD holds a 18% stake. However, the state still holds a 29% stake so that the privatization of K&H is not yet completed. The state had intended to sell its shares on the BSE in early summer of 1998 but the global financial crisis and a new government put these plans on temporary hold.

3 The specifics of the put and call options are confidential.
By the end of 1997, the Hungarian banking sector was almost entirely privatized. Foreign ownership is mostly by foreign strategic investors but includes some foreign financial investments as well. By registered capital, the ownership structure of the Hungarian banking sector at the end of 1997 and the beginning of 1994 was (Suranyi, 1998, Table A p. 17):

<table>
<thead>
<tr>
<th>Ownership Type</th>
<th>End 1997</th>
<th>Beginning 1994</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic ownership</td>
<td>37.0%</td>
<td>86.7%</td>
</tr>
<tr>
<td>Of which, government and social securities</td>
<td>20.5</td>
<td>67.7</td>
</tr>
<tr>
<td>Foreign ownership</td>
<td>60.8</td>
<td>12.4</td>
</tr>
<tr>
<td>Of which, banks</td>
<td>52.5</td>
<td>9.9</td>
</tr>
<tr>
<td>Other shares</td>
<td>2.2</td>
<td>0.5</td>
</tr>
</tbody>
</table>

The Hungarian bank privatization episode clearly transformed dramatically the ownership structure of the banking sector in a very short period of time. By 1997, the banking sector in Hungary had been fully restructured and recapitalized, substantially privatized and mostly in foreign hands. The percentage of loans classified as "qualified or non-performing" was down to 8% in 1997 from 30% in 1993 and provisioning was full (Suranyi, p.20). The entry of foreign banks, e.g., Inter-Europa Bank, Citibank, and Creditanstalt, early in the process and before the political change facilitated the privatization to foreigners of the large, restructured Hungarian banks. By all accounts, the banking industry in Hungary, which had been the weakest in the region as late as 1995, is now the strongest. The IMF (Country Study 97/103) reported in 1997 that:

"Over the past four year the HU banking sector has undergone a dramatic transformation. The heavy burden of nonperforming loans has largely been eliminated, the majority of the sector has been privatized, largely through strategic foreign investors, and competition in corporate banking activities has strengthened."

Average return on assets for the banking sector increased from (-) 5.8% in 1993 to 0.9% in 1997 (Varhegyi, 1999). Hungary is the only country in transition to receive the highest rating from the EBRD for financial sector reform.

The major lessons from Hungary's experience with bank privatization are:

- Recapitalization is a necessary condition for a successful transfer of governance to an external owner. Weak banks must be restructured and endowed properly before a sale is considered.
- Privatization to an independent owner following on the heals of recapitalization blunts the moral hazard of government bailouts.
- Incentive contracts and creative arrangements that reduce the risk of past legacies are useful if attracting a strategic foreign investor is desirable. Incentive contracts can attract strategic investors who are willing to put up their own reputational capital, which is likely to be of more lasting value to the bank than any upfront financial capital.
As a corollary, the transaction price is not as important as securing the commitment of an independent foreign investor. This is especially true when the financial capital from the privatization transaction goes to the state and not to the bank.

5. The Czech Republic: State and Insider Control Persists

Bank restructuring predated privatization in the Czech Republic but the large banks remain in state hands and are in need of further recapitalization. At the start of the process, optimism abounded about the prospects for successful transition in the Czech Republic. However, neither banks nor enterprises were restructured significantly. Although banks were recapitalized to an extent, they continued to lend to large unrestructured enterprises, sometimes for political reasons and other times because of long-standing relationship that were maintained and strengthened by voucher privatization. The bank shares that were allocated to the voucher scheme constituted a minority of the total. The subsequent allocation did not result in concentrated outside ownership whereas a significant, almost majority, stake remained with the government. Hence, management and the government were entrenched in control of the banks so that there was little incentive for banks to change their behavior. Indeed, evidence can be found of government pressure to make policy loans and insure that Czech companies remained in domestic hands. As a result of continuing government dominance of bank governance, the Czech banking system is now the weakest among the three countries considered here.

Instead of making the state owned banks responsible for loan work outs, the government established a centralized “hospital” bank in 1991, the Konsolidacni Banka (KOB). KOB took over a portfolio of low-fixed-interest, revolving credit loans with no collateral attached (TOZ loans). KOB was given a mandate to restructure these to seven-year maturity loans bearing a market rate of interest. Since TOZ loans (working capital) were held by virtually all enterprises of any significant size in the country, the portfolio of KOB was not all bad debt. In fact, the performance of KOB’s restructured portfolio was better than average for Czech banks.4 After the first transfer, KOB was used as a repository for bad loans by the major Czech commercial bank, Komercni Banka (KB). In 1992, KB was allowed to pass bad loans amounting to about 5.5 percent of its loan portfolio to KOB in return for a capital injection. KB had been partially recapitalized in 1991 with government securities in exchange for bad loans totaling more than 8 percent of its portfolio.

In Czechoslovakia in 1992, three of the largest four Czech banks participated in the first wave of voucher privatization. In addition to KB, which had been created from the Czech part of the commercial portfolio of the National Bank, Ceska Sporitelna (CS), the Czech savings bank created in 1969, and Investicni a Postovni Banka (IPB), formed by a merger of the investment bank and the network of deposit-taking post office branches took part. Investment funds dominated the first wave of voucher privatization collecting about 72 percent of the points allocated. The banks themselves sponsored investment funds and these three Czech banks set up funds that were among the five largest. Hence, banks were on both

4 The portfolio was split into a Czech part and a Slovak part when the two republics separated.
sides of voucher privatization as bank shares were included in the scheme and investment 

funds sponsored by these banks took ownership stakes in Czech companies and in each 

other. This interlocking ownership of banks and clients was coupled with large controlling 

stakes retained by the state in the “privatized” banks. There was little opportunity for non-

bank, non-state owners to exert any control over these privatized banks. Although the Czech 

Republic’s privatization plans were in the forefront among transition economies, the Czech 

banks are still not in independent private hands today.

In the voucher privatization of KB in 1992, the state retained a majority stake in the 

bank (for a thorough discussion of the transaction, see Snyder and Kormendi, 1997). By 

June 1995, the other major shareholders in KB were investment funds, namely, the Harvard 

group with 8%, the IPB funds with 5%, the Vseobecná Uverova Banka (Bratislava) fund 

(VUB) with 3%, KB’s own fund with 3% and the CS fund with 3%.⁵ No other shareholder, 

including other privatization funds, held a stake in excess of 2% at that time. The aggregate 

stake held by privatization funds at the end of 1995 was 33%. Individual shareholders held 

only 8% of the shares while foreign institutions had a 9% stake. By 1997, the government 

stake had actually increased to 53%; the next largest shareholder was the Bank of New York 

with a 10% stake held in depository receipts (ADRs) followed by CS with a 3% stake 

through its investment fund. The remaining shares are held widely by investment funds, 

domestic individuals and by foreign portfolio investors. After voucher privatization, insider 

governance was firmly entrenched at KB under a strong CEO, Richard Salzmann. When 

Mr. Salzmann supported a plan to privatize KB by selling a significant stake of the bank to a 

strategic foreign investor, he was replaced. Hence, the state remains its control over KB as a 

majority owner.

The voucher privatization of CS resulted in more concentrated ownership by 

investment funds as the Harvard Group held 13% of the shares and the major bank funds 

held the following stakes; IPB 9%, KB 4%, and VUB 2%. The retained a voting stake of 

48%. Following voucher privatization, Viktor Koseny, the founder of the Harvard Group, 

attempted to influence governance at CS but failed. By the end of 1995, the total holding of 

privatization funds was 33% of the shares in CS with the remaining non-state shares widely 

held by individual investors. In June 1998, the EBRD took a 14% stake in CS and the 

government increased to 53% its voting shares. Hence, as in KB, the Czech government is 

currently a majority shareholder in CS with the remainder of shares held by investment 

funds, institutional investors, and individuals. Thus, governance of the two largest banks in 

the Czech Republic remains firmly in the hands of the state seven years after the much 

vaunted voucher privatization program.

The voucher privatization of IPB is slightly different as IPB’s own fund 

management company (Prvni Investicni AS or PIAS) obtained 15% of the shares. The 

Czech insurance company (Ceska Pojistovna) held 7% of the shares and 38% were held 

widely by other investment funds and institutional investors. The state’s residual ownership 

stake was dominant at 40%. The insider/state nexus maintained control of IPB with 

management retaining its position. In July 1997, the Japanese investment bank, Nomura,

⁵ Czech regulations prohibit any investment privatization fund from owning more than a 20 percent stake in any company.
agreed to buy the Czech government’s residual stake in IPB. Negotiations about the terms, including a capital infusion, went on over six months and the sale was completed in March 1998. Nomura bought 36% of IPB for $90m, which was towards the lower end of the government’s range of value. The transaction was significant because it represents a change in the Czech approach to bank privatization. Only in 1998, six years after voucher privatization, did the government acknowledge the positive role that strategic investors might play in bank privatization. However, Nomura is still not exercising control over IPB although it added to its stake by purchasing another 10%. Without a majority stake, Nomura has only four people on the twelve-member supervisory board of IPB and no representative on the management board that is in charge of the day to day operations of the bank. More importantly, IPB’s senior management is still running the bank. Either directly through investment funds or indirectly through friendly companies, IPB’s management still retains influence over at least 40% of the bank’s shares. Nomura has yet to take over control of IPB in the way that strategic investors took control of banks in Poland and Hungary. Hence, no large Czech bank has achieved independent governance to date.

Voucher privatization in the Czech Republic resulted in significant cross-ownership patterns and strengthened the non-market relationships between banks and their company clients. Moreover, the bifurcated ownership structure of the banks with the state retaining a controlling stake and the preponderance of the rest of the shares held widely provided ample opportunity for insider/state or solely/state governance. Although voucher privatization is quick and politically expedient, it requires a second round of ownership transfer to bring about independent non-state governance of both banks and companies. In the interim in the Czech Republic, it has entrenched informal non-market relations that will be difficult to break in the future. The non-transparent financial arrangements and conflicts of interest that are present in such arrangements are not market friendly and do not promote the development of the secondary market that is necessary for the consolidation of ownership by outsider. Coupled with controlling stakes held by the government in the banks, voucher privatization retarded progress in enterprise and bank restructuring in the Czech Republic.

The only significant bank privatization in the Czech Republic was the “reprivatization” of a failed bank, Agrobanka. At the time the largest non-state owned bank in the Czech Republic, Agrobanka became insolvent and illiquid. It was taken over from its Czech owners by the Czech National Bank, restructured, and sold to GE Capital. After the transaction, the new investor replaced all the senior managers of the bank. Clearly, GE Capital exercised its control over Agrobanka. In April 1997, a program to accelerate privatization of the three state-controlled large banks was announced but the cabinet took six months to approve plans for their sale. The Krone currency crisis in May 1997 weakened the condition of the banks and it became clear that further restructuring would be necessary before the banks could be sold. Although IPB was subsequently sold to Nomura, the privatization of KB and CS is currently on hold. In 1998, Czech National Bank imposed stiff new rules on the banks for provisioning against non-performing loans. To satisfy these requirements, the banks are reporting large losses and provisioning is not expected to be completed until 2000. In March 1999, new equity in CS was purchased by the state to recapitalize partially the bank. This transaction increased the state’s stake in CS. Further
recapitalization and restructuring on both CS and KB are expected before privatization plans can be resuscitated.

Bank privatization was unsuccessful in the Czech Republic for several reasons:

- Significant political resistance to independent ownership of banks and the imposition of hard budget constraints on large bank customers delayed the necessary change in financial arrangements.
- The banks’ balance sheets weakened over time as a result of continued soft lending and because of external events, such as the May 1997 Krone crisis, the floods, and investments in Russian derivatives.
- Voucher privatization resulted in interlocking ownership arrangements among banks and between banks and their clients of the banks leading to less transparency of financial arrangements. Non-transparency inhibits competition and hinders the transfer of control to an independent owner.
- Foreign banks, first scorned by the Czech government, have been hesitant to consider taking substantial ownership stakes in large Czech banks due to non-transparencies and the continuing relationships between these banks and their largely unrestructured clients.

6. Conclusions

In the three fast track, Central European transition countries examined in this paper, bank restructuring and privatization involved different approaches and met with a variety of outcomes. Hence, these experiences in otherwise similar transition economies provide importance lessons for bank privatization in other transition countries and in developing economies. If an independent market-oriented banking sector is the overriding goal, three fundamental conclusions emerge: sequencing matters, control is crucial, and foreign participation is extremely useful and almost necessary in small open economies.

First, for incentive reasons, successful policy must pay attention to proper sequencing. Recapitalizing and restructuring of state-owned banks followed rapidly by their privatization to an independent strategic investor aligns incentives properly. Restructuring must include both a clean up of the balance sheet and a change in lending practices to avoid moral hazard problems of continuing bailouts. The early recapitalizations of the Czech banks were to no avail because soft lending practices continued and future bailouts became necessary. By contrast, the continual recapitalizations of Hungarian banks were ultimately successful because privatization to an independent, usually foreign, owner followed rapidly leaving Hungary with the strongest banking sector in the region. By restructuring the banks, the Hungarian government was able to attract strategic foreign investors who had an incentive to promote lending on a commercial basis thus precluding the need for future bailouts. In Poland, the bank-led enterprise restructuring program linked temporally bank privatization, recapitalization, and portfolio restructuring, perhaps making it more difficult to attract a strategic foreign investor. Hence, sequencing has a significant impact on the incentives of both banks and their potential owners.
Second, the credible transfer of control from the state is the crucial aspect of a successful bank privatization program. Poland lost its credibility with an inconsistent policy that switched from attracting a strategic foreign investor to attempting to arrange two large politically motivated bank mergers. Hungary, on the other hand, gained credibility when it ceded control of its largest banks to strategic foreign investors soon after recapitalization and restructuring. Incentive contracts that, in some cases, involved a foreign investor obtaining the bank for minimal payment reduced the financial uncertainty for the new owner who was left with its reputational capital on the line. In contrast, the Polish government’s undue preoccupation with the price of the transaction in the tender delayed this crucial transfer of control and finally slowed the momentum of bank privatization due to a fear of foreign dominance of the banking sector. Voucher privatization in the Czech Republic did not promote a transfer of control from the state, left entrenched existing management, and strengthened the relationship between banks and clients both of whom were in need of further restructuring. Hence, the credible transfer of control from the state is a necessary condition for developing an independent, market-oriented banking sector.

Third, foreign ownership and participation in banking is an essential and inevitable part of bank privatization in small open economies. Hungary has been more accommodating on this issue and now has the strongest banking sector in the region. Poland has been slower to recognize the importance of foreign participation in banking to smooth its way into Europe. The Czech Republic is only now beginning to acknowledge fully the necessary role of foreign banking. However, resistance to foreign banks in the region has diminished for practical reasons. The desire to join the European Union is a dominant political force and the EU association agreements call for open financial markets.

Fundamental reasons why foreign strategic investors are important to the banking industry in small open economies include:

- Foreign direct investment in banking is as attractive as any other FDI; it is a fixed asset and represents a long-term commitment.
- Foreign ownership helps clarify private sector control that is independent of the government and creates greater depositor confidence.
- Foreign banks are able to transfer modern banking technology easily.
- Foreign banks and the threat of entry increase competition.
- Foreign ownership reduces the potential for politicization of bank lending and increases the international integration of financial markets.
- Radelet and Sachs (1998) argue that foreign bank ownership may reduce the likelihood of financial crises and would have significantly reduced the seriousness of the recent financial crises in Asia. Making foreign investors responsible for the consequences creates a disincentive for deleterious, speculative short term financial flows. Hence, lending by foreign-owned banks will be more stable than cross-border lending by international banks to local banks. Thus, foreign bank ownership may be in the national interest if it provides some insurance against speculative flows of short term capital and helps the financial system absorb such flows.
• Foreign banking interest is a genuine market test of the value and soundness of domestic banks; hence it is a useful signal when local financial markets are too thin or too small to provide such information.

Beginning in the early 1990's, the experiences in Hungary, Poland and the Czech Republic are good examples of learning by doing in bank privatization. Since the banking market in many transition economies and developing countries is quite small, only a small number of domestic banks will be viable. This is surely the case in Hungary and the Czech Republic although perhaps a little less so in Poland. Hence, the threat of entry and not large numbers is the most likely source of competitive pressure. In summary, three basic lessons for promoting healthy and financially stable banking sectors in any small open economy can be drawn from the experiences of bank privatization in the fast-track transition economies.

• Bank restructuring and privatization must be sequenced carefully to create the appropriate incentives for lending on a commercial basis only.
• Privatization requires a credible transfer of control from the state and often a change in the current management of the bank.
• The proper corporate culture is most easily established by attracting a strategic investor who is more likely than not going to be a foreign financial institution.

These lessons apply equally to developing countries with evolving mixed banking sectors as well as to transition economies looking to create market-oriented banking sectors.
REFERENCES


