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OECD Advisory Group on Privatisation
Eleventh Plenary Session

In co-operation with:
The Italian Treasury

BANKS AND PRIVATISATION

Rome, 18 and 19 September 1997

Synthesis Note

The eleventh meeting of the OECD/CCET Advisory Group on Privatisation (AGP) took place in Rome on 18 - 19 of September 1997, on the subject of "Banks and Privatisation" The meeting brought together high-level privatisation officials and policy makers from Albania, Argentina, Bulgaria, FYROM, Estonia, Georgia, Kyrghyzistan, Latvia, Lithuania, Mongolia, Romania, Russia, Slovenia and Ukraine, experts from international organisations, privatisation officials and other representatives from 21 OECD Member countries (see attached final List of Participants).

Seven papers were presented and discussed at the meeting, which was divided into four substantive sessions and a concluding discussion (see attached agenda). The meeting explored different areas related to banks and privatisation, including the policy aspects of bank privatisation, the design of bank privatisation programmes, the process and methods of privatising banks and the role of banks in privatisation. The presentations covered the experience of transition and OECD economies, whereas the discussions included also problems faced in other emerging economies.

The meeting was successful as it permitted senior experts, officials and policy makers in the areas of privatisation to get a comparative insight of different approaches to bank privatisation in OECD and emerging economies, as well as of the role of banks in privatisation. The papers and shorter panel presentations became the object of lively discussions.

The following conclusions could be drawn from the presentations, panel interventions and discussions of the meeting:

General conclusions

- Despite the different settings in OECD, transition and other emerging economies, similarities are increasing because most countries are reconsidering the role of the state in their economies and are designing and implementing privatisation programmes, which either include the banking sector or consider strategies for its future privatisation. Thus, bank privatisation is seen as a process which can channel new expertise, enhance competition, provide better opportunities to adapt to the rapidly changing world of finance and modernise the financial sector.

- Banks hold a special place in the economy because of the potential systemic consequences of a bank failure. This fundamental characteristic of banks is taken into account in the strategies of OECD and emerging economies, which proceed with bank privatisation as a “second wave privatisation”, i.e. after the institutional and regulatory framework is well established and privatisation strategies are clearly defined.

- Bank privatisation is a politically difficult process. If not properly designed, bank privatisation could involve additional costs by prompting a “renationalisation” in order to avoid major crisis in the financial sector.

- In most OECD countries, privatisation, including bank privatisation, is instrumental in further developing financial markets by boosting total market capitalisation, transaction volumes and liquidity, and by encouraging participation of new shareholders. Thus, bank privatisation in many countries has contributed to a shift from traditional forms of savings to shareholding. This trend has created more demand for privatised assets and has rendered privatisation more popular. Reciprocally, the development of local capital markets can foster the success of privatisation, including for large banks.

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- The excessive use of cross-shareholdings and devices such as stable shareholding ("noyaux durs") to prevent control from outside shareholders may reduce considerably the actual gains from privatisation. They also risk reducing flexibility as a whole and thus delay structural adjustment necessary in the context of increasing globalisation. On the other hand, stable shareholders may prove beneficial in countries with less developed financial institutions/intermediaries. However, they should be used with caution, in order to minimise the risk of rigid governance structures. In this respect, the Italian experience of not allowing co-ordination of policies among stable shareholders was noted as of particular interest.

Approaches to the privatisation of banks

- Different approaches have been adopted with respect to how much should be privatised, how much room for the state should be left as a vehicle of government policy implementation, or whether (and to what extent) to allow participation of foreign investors in the banking sector. In any event, it is important to design an adequate regulatory and supervisory framework for the banking sector.

- Transition economies have applied three types of approaches to bank privatisation: open policies promoting the participation of foreign strategic investors in bank privatisation (e.g. Hungary, Estonia), policies favouring domestic control (e.g. Czech Republic, Russia) or a mix of the two (e.g. Poland).

- The Polish experience is important because it proved that flexibility is essential for a successful privatisation of the sector. After having started bank privatisation by initial public offerings, Poland showed a great capacity to adapt to a new priority of attracting strategic investors which would bring fresh capital and expertise to the local banks. At the same time, Polish policy makers have addressed the need for consolidation in the country's banking sector by merging several smaller banks into a large financial group before privatisation, which has led to significant efficiency gains and better health of the financial system.

- Open policies with respect to bank privatisation in some cases, such as in economies in transition, may be the most practical way to bring new expertise and resources to restructure the sector. The experience of Hungary is unique in this respect: most banks have been privatised with the participation of foreign strategic investors. It also had a strong signalling effect to other banks as regards the rigorous competitiveness requirements of the sector.

- The speed (bank privatisation basically started in 1995 and is nearing its completion in 1997) and the success of the process in Hungary is partly explained by the existence of a single institution responsible for privatisation. Irrespective, however, of the usefulness of a single implementation agent, the Ministry of Finance and/or the Central Bank should have a direct role in the formulation of the bank privatisation programme.

- Certain countries have treated their banking sectors as infant industries and have actively encouraged the emergence of big domestic players by limiting foreign competition. While the political aims of such an approach are understandable, from an economic perspective, protectionism bears the risk of structural weakness in a sector that, more than any other, is exposed to the rigour of globalisation.

Links between the privatisation of banks and the privatisation of the real sector

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- Synergies between bank privatisation and the rest of the privatisation programme are important. Bank privatisation with foreign participation can become a conduit for additional foreign investment in the real sector and provide better infrastructure for domestic clients. On the other hand, successful privatisation in industry would enhance competitiveness, improve productivity of the privatised enterprises and ultimately their ability to service debt payments. This would provide banks with a wider range of reliable clients and have a positive impact on the health of the banking system.

- In transition and developing economies, the banking sector is often hindered by a large volume of non-performing loans to insolvent public enterprises. In such cases the link between banks and the real sector is even stronger. A one-off restructuring/recapitalisation and subsequent privatisation of the banking sector can greatly enhance the competitiveness of the corporate sector by breaking inefficient patterns of credit allocation that create considerable distortions in the economy.

Role of banks in privatisation

- Banks play an active role in the privatisation process as investors, lenders, intermediaries or corporate governance agents.

- The role of banks as lenders in the privatisation process is a controversial one. Experience in developing economies suggests that a high degree of bank exposure to privatisation-related loans can lead to a systemic crisis, as in the case of Chile in the early 1980s. Certain transition economies (e.g. the Czech Republic) are also experiencing high levels of default in privatisation related loans. On the other hand, the absence of corporate finance by banks might render the privatisation process slower and inaccessible to domestic buyers. In order to remedy this, some governments have directly or indirectly subsidised bank loans to domestic investors. The results of such policies remain to be assessed.

- Given the serious problems facing the domestic banking system in transition economies, the role of foreign banks can be very important. Until now, they have played a role mainly in advisory services and trade finance but, in some countries, they have become more active as strategic investors in local banks. This process has been very slow, because of the risk-averse strategies of foreign banks and the sometimes hesitant government policies with respect to opening the sector and implementing a rapid rehabilitation.

- It has been argued that direct ownership of shares in industrial enterprises by banks, under certain circumstances, can improve management and influence investment decisions. In certain transition economies, the links between banks and industrial enterprises are seen as especially important because otherwise many enterprises would not survive the turbulent transition to a market economy. However, evidence suggests that even the largest banks have difficulties monitoring strategic management of the privatised companies. More generally, conflict of interests of banks as lenders and shareholders in a transition setting can run against the efforts of building financial discipline and enforcing hard budget constraints on enterprises. It can result in increased moral hazard in the financial system and facilitate rent-seeking behaviour in the relationship between the state and major corporate players.

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