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Privatisation of individual banks or of the banking system?

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PRIVATISATION OF INDIVIDUAL BANKS OR OF THE BANKING SYSTEM?*

by

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The current project of the OECD Advisory Group on Privatisation has put banks, one of the most important classes of institutional participants of any emerging or underdeveloped market economy, in the focus of its agenda. It has done it in two ways: first it investigates the issue of bank privatisation and ownership structure and then it also looks at the various roles banks can and should play or have played in privatisation, and consequently in governance, of non-financial enterprises. The way governments relate (and have related) to these two major policy issues will shape to a very large extent the future institutional structure and balance in the economy. As other research has convincingly shown (most notably Goldsmith, 1969, King and Levine, 1992), the shape and extent of the financial sector is a very important issue of economic modernisation; the ownership structure of banks and their institutional role in the national economy is a crucial variable in the process of financial deepening.

The first few years of economic transition are the most critical in this respect because the political structures are still in flux and the new structures are not yet consolidated; governments can in this period more easily follow policy considerations since the lobbying force of different classes of vested interests is relatively smaller than either before or after consolidation of the new economic order following the collapse of the socialist system. With every year passing, it will be more and more difficult to implement reform-minded policy projects as

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**. Former Chief Executive Officer, Hungarian EXIM Bank governments will be less and less independent of rapidly consolidating new alliances of vested interests in the national economy. Crisis periods, on the other hand, are also offering an opportunity to think over governments' major policy and institutional objectives. Finally, the need to join the European Union strongly encourages countries to follow EU directives, guidelines and expectations in certain regulatory areas and in the design of their privatisation strategies. This is a powerful anchor in opening banking sectors to international competition, at least in the front-runner countries for EU-membership.

The role of this paper is to open up the discussion over the set of issues the project aims to cover; to raise the relevant questions, outline alternative solutions to them and to some degree evaluate them. It is the governance issue which will be in the centre of this analysis, although it is not the only important one: one can also look at bank and enterprise privatisation from the narrowly or broadly defined budgetary point of view or from some other consideration. However, in the long term it is the set of incentive systems in the economy that strongly influence, besides sound macroeconomic conditions, the growth dynamics of a country. Undoubtedly, the quality of macroeconomic management is a most important ingredient of long term economic success; however, it may be a short-sighted mistake to make short term budgetary considerations the most important goal of bank privatisation. Even the longer term budgetary objectives may be better served by a bank privatisation policy, which optimises banks' performance after privatisation and also optimises privatisation revenue. (This does not mean to say that these two goals will always be in conflict: in some cases they would both lead to the same practical outcome.) Therefore, privatisation is being looked at predominantly from the longer term governance or incentive structure perspective rather than from its short run impact on the budget. Subsequently, although some consideration is given to the fiscal aspects of bank privatisation, the paper is focusing on the resulting governance situation and on what follows from this for bank-enterprise relationship.

This paper, as well as the project, is not going to discuss related problems such as the relative significance of different types of financial institutions, e.g. capital market institutions, alternative savings' vehicles, etc., in different models of market economies. Thus it will also leave aside the issue of banks' different legal mandates in different transition economies.

The discussion of the issues will concentrate on the transition economies where the author's expertise is; applicability of the issues, questions and statements to other reforming underdeveloped settings needs further careful consideration. It seems to me that the main differences between the post-socialist scene and other developing countries' situation are, obviously in a very oversimplified way, twofold. First, banking in East Central Europe is a very new phenomenon after the particular "monobank situation" of the socialist era. Second, domestic investors are largely absent. Here, Russia is an exception as the private sector of banking is dominated by domestic owners; however, this is a result of rather peculiar circumstances such as an extreme level of illegal economy and the fact that the country is very under-banked and yet foreign entry in commercial banking is severely restrained. The third characteristic has already been mentioned: ideologies in Central and Eastern Europe are, for historical reasons, more favourable to private sector dominance in banking than is usually the case in developing countries.

Perhaps the most important methodological trait of this introductory paper is that it is interested in the analysis of the degree of privatisation of the whole banking system, rather than only of privatisation of individual banks. The significance of this approach is that we are not interested only, or mostly, in the quality of the sales process of a single bank but in the "privatisedness" of the banking sector as a whole. Therefore, we are not only looking at the technicalities and policies of selling the government-owned banks but also at the ways governments prefer - or do not prefer - state-owned entities by hidden or explicit subsidies, and exclusive or better access to certain resources and markets; at the way governments bail out troubled banks and handle banking (systemic) crises, and the way they regulate entry of non-governmental banks or bank branches. Only the web of all of these policies will determine the "privatisedness" of a given banking system, which is a much more important policy issue than only one of its components. The analytical literature usually focuses only on "bank privatisation" having in mind the more narrow definition and misses looking at the broader picture. Whereas the broader approach is more complex, thus more difficult to deal with, it is only this approach which can give good enough analytical tools to see the degree of state involvement in the banking sector and the problems this state involvement generates.

1. Is privatisation of the banking system important in the transition economies?

The first question to raise is whether privatisation of the banking sector is necessary/desirable in the transition stage of the emerging market economies. Let us first explore the potential counter-arguments! One argument, probably the most common, holds that in an economy which needs rapid development and modernisation, the government needs to maintain the commanding heights of the financial sector in order to properly allocate resources in the real economy. Interestingly (and logically) enough, this argument is less often heard of from policy makers in transition economies than in other kind of developing countries. This theory assumes that the government has the necessary knowledge and independence from various particular interests to know what parts of the economy to prefer over the others and that it is also able to allocate resources according to its strategic considerations. In the transitional economies past bad experience with governments' planning and developmental skills has generally led to disapproval of this double assumption whereas in many other developing countries it still prevails, often without much convincing factual underpinning. The main reason for this is that East Europeans, in the socialist past, have bad experience with the government wanting to determine which branches of the economy to prefer over the others.

An auxiliary argument is that sometimes there are no good strategic investors in the banking sector during the early period of economic transition (unlike in some other less developed economies with longer tradition of banking); this argument implicitly assumes that the privatisation of particularly the leading banks practically means access of foreign large strategic investors to the core financial institutions of the country, thus giving the opportunity to foreign agents to considerably influence strategic decisions in the national economy. We will return to this argument later with more careful consideration.

The third argument is that in the early period of economic transition the agenda of the government is so full that it has more obvious and less controversial things to do than to privatise banks. Whereas one can agree that governments can not do everything at the same time - economic transition in some of the reforming East Central European economies has been particularly fast, indeed by any historical standard - and also accept that there are things, such as privatising small service units, liberalising foreign trade, introducing current account convertibility, etc., one also needs to put into the equation the price national economies have to pay for a too complacent approach to bank privatisation. In an East European setting it is very likely that credit distribution in a government-owned banking environment will be determined mainly by processes of political lobbying rather than hard economic criteria. It is very likely, with other words, that Kornai's budget constraint will be considerably softened, if not undermined completely, through the credit mechanism in a major way. Also, if government ownership of banks will prevail for a long period of time, the privatisation process of other sectors of the economy will create an enormous temptation to use cheap banking resources to gain access to firms for sale. This situation is, more likely than not, the hotbed of the creation of corrupt business relationships and of corrupt business conduct among bankers and client entrepreneurs. Alternatively, sound non-governmental owners are the best and fastest way towards establishing harder budget constraint, with other words good lending practices in the large financial enterprises.

Some would tempt to say that the experience of Germany - where there are a great many banks in federal, state (*Länder*) or municipal (partial or full) ownership - shows that public banks are a good vehicle of economic development in a certain developmental stage. However, one needs to consider that Germany’s civil service moral in its critical stage of economic development after World War II was much higher than that in any transitional economy today. Whereas there is no hard core evidence that public ownership of banks in Germany contributed to its speedy economic development since World War II, it is very likely that keeping public ownership in today’s setting of the transition economies would put them in a powerful comparative disadvantage to those with properly privatised banking sectors. The recent strong growth acceleration of the Hungarian economy, compared with the ongoing structural problems of the Czech one, seems to be a point in the case that bank privatisation (which contributes to restructuring of the target bank) is a critical growth factor in the period of economic transition. However, at this point we have to turn back to the issue of foreign strategic owners controlling significant banking institutions in the national economy.

2. Do Central and East European governments need to restrict foreign ownership of their banks?

A major concern of policy makers is, as it has already been mentioned, that foreign banks pursue global, rather than local profit maximisation and other strategies as well as that they may easily practice transfer pricing in order to show profits in the countries with relatively lower taxes. Many policy makers are also afraid of foreign control of the economy in case of a large presence of foreign banking organisations; there is a sometimes unspelled assumption that large foreign banks will pursue interests of foreign countries. As these fears may have some real founding, the task of policy makers is to weigh the costs and benefits of an open door policy against each other in the period of economic transition. As Bonin (et al. 1998) points out, in countries where domestic savings are abundant to finance the growth process (as it has been in

Eastern Asia for a prolonged period of time) this question can, for a long period of time, be asked with a certain validity. In Central and Eastern Europe, however, domestic savings may not be sufficient to finance a protectionist development strategy – and participation of foreign banks in the economy may be a particularly good instrument for attracting foreign savings. Bonin (et al. 1998) also makes the point that it is not at all obvious that direct investment into banking offers more influence over economic policy than investment into large industrial sectors. In order to better understand the dilemma one needs to look into the possible alternative methods of privatisation as we will do in the next section.

Another argument in favour of limiting foreign banking is the infant industry argument: in Eastern Europe banking is "infant", therefore it needs protection from foreign competition for some period of time. However, the counter-arguments point out three things. First, East European governments generally struggle under time pressure to introduce an efficient market economy in a very short time period. As experience shows in many countries, a lack of competition in banking takes a heavy toll as inefficient allocation of resources further postpones industrial restructuring. Second, control over banks is a highly political issue and typically it is easy to expose local banks to competition earlier in the transition period rather than later when domestic bank managers' lobbying power will probably be greater. Third, banking is not an infant industry world-wide; indeed many would argue that it is rather a sunset industry. This is an industry which has excess capacity world-wide, specifically in Europe, the nearest developed geographical area; it is legitimate to ask whether from a developmental perspective it is worthwhile to invest heavily into building up an industry which will perhaps be obsolete by the time its market is opened? It may be analogous to protecting shipbuilding or the textile industry on the merits of the same argument.

Bonin (et al., 1998) further emphasises that if the foreign bank develops a domestic deposit base it will very likely behave similar to a domestic bank. A big potential advantage is, as Wachtel underlines, that sizeable foreign banking investment will reinforce other investors to come to the host country and invest. Indeed, the two types of investment reinforce each other as banks attract their home clients whereas investors tend to pull in their home banks. A further advantage of a strong presence of foreign banks and of privatisation which attracts them to the local market is that these international heavyweights will pull in cheap funding which they then can use for lending to the domestic economy. An indirect effect of sizeable foreign banking investment is that it also improves the country's risk profile thus enabling the whole economy to get cheaper finance.

Beside the above considerations, an important element of the policy equation for many countries is that those which wish to join the European Union have to take into account its policies towards regulation of foreign banks' activity in the country. The association agreements provide for a transitional period of maximum 10 years to fully open up to EU banking competition.

A corollary to the question is whether governments should not condition the licensing of foreign banks by an acquisition of a local bank? This practice has been widely used in the Czech Republic and Poland. The idea is that foreign heavyweights create unfair competition by entering the market without the burden of inherited bad loans and, particularly, bad clients. Then using their better names and *carte blanche* portfolio, plus much cheaper funding costs, start "cherry-picking" among the best clients. An indirect consequence of this situation is that the portfolio of the local banks deteriorates further as they loose their best clients. This argument then concludes that letting foreign banks into the country is desirable, however, not with greenfield investment but by taking responsibility for one of the local, usually either government owned or troubled, banks. This argument has its logic but a few questions emerge. The strategy excludes banks which may be very good and do not want to risk taking responsibility for a largely unknown portfolio. Is it an acceptable price to pay that perhaps the stronger and more prudent foreign strategic partners stay away from the country? The second, related, question is whether governments should also ask themselves if their country can afford waiting for bank privatisation to foreign strategic partners. An answer to these questions will decide which sequence of opening up the market to foreign competition will emerge.

3. What consequences should governments draw from world-wide financial sector globalisation?

The nature of banking has changed enormously in the last decades. This paper will only touch upon some aspects of the process which is commonly referred to as globalisation. Technical developments have made the economies of scale as well as the speed of financial transactions so large that there is a pressing need to abandon old geographical limitations (to cross-border banks organisations in Europe and to interstate banking in the US) to the growth of banking organisations. In the last few years truly supranational banking institutions have emerged, developed and rapidly expanded on the two continents. In Central and Eastern Europe, with very nascent commercial banking organisations, competing with them would mean that one has to almost close the borders, so that inefficient local organisations can survive, thus encouraging monopolistic or, at the very least, oligopolistic situations in the banking industry. Otherwise their cost efficiency and better financial know-how will give them a very strong comparative advantage.

Governments which realise that financial sector globalisation affects their country's market have, theoretically, two ways to go about this. One is, among the transition economies most fully applied by Hungary, a strong integration of the sector into the international marketplace by attracting large foreign investors. In case of Hungary the first tier of banks include such strategic investors as ABN AMRO, GE Capital Corporation, ING, Bayerische Landesbank and Kredietbank of Belgium. Each of these investors have controlling influence over their Hungarian banks. The other possible reaction to this challenge is a defensive one: to try and build large "nationally owned" (not necessarily fully government owned) banking organisations which may be able to compete on the local market with foreign competitors. Poland had a large scale consolidation plan for its domestically owned banking sector in 1994-95 which has only partly materialised due to technical difficulties. As a result, Poland has a mixed structure with a limited role of foreign strategic investors (particularly ING and Citibank), some significance of the capital markets and some relatively large consolidated units. The main question in this respect is whether pulling together local banking organisations into bigger ones will mean that bank management improves. Also, organisational consolidation being a complicated business, another legitimate question is what are the chances that a government-consolidated unit will be able to fully utilise the benefits of economies of larger scale. On the negative side, the question looms whether monopoly (or oligopoly) power will emerge in such situations and whether it will lead to less proficient and more expensive services. Also, will not such a larger bank, still with significant government ownership, exert undue government influence and will this not lead to a situation of "too big to fail"?

In some cases, however, consolidation clearly is a necessity: in Bulgaria, the way the two-tier banking structure was created meant that almost 60, mostly small banking organisations were established with a poor capital base and management. In many CIS-countries there are a number of so-called pocket banks as a result of lax regulation and low entry requirements. These kind of situations can be mitigated by fostering consolidation through increasing minimum capital requirement to entry, perhaps gradually over a few years, to levels in conformity with EU-regulation.

On the other hand, a Hungarian-type privatisation flow may raise the following question: how will consolidation take place in a sector which is dominated by foreign participants and which in certain segments (particularly in the blue chip large client segment) has become over-banked as the consequence of the privatisation path pursued? Is this structure not "over-competitive"? Or will Hungarian banks find profitable activities for themselves and thus continue to rapidly improve services for the economy and for the population?

4. What methods offer the best results of bank privatisation?

What should determine the method of privatisation? Governments in different countries and times place different goals into the forefront. Sometimes pressing budgetary needs as well as concern about public opinion puts the sales price ahead; less often the perceived need to increase the capitalisation and transaction flow of the local stock market as well as the desire to avoid large foreign strategic involvement makes governments arrange IPO-sales. This desire sometimes pushes governments towards preferring local contenders. Long-term governance and prudential considerations also appear on the list of preferences of governments, although maybe less often than the importance of the issue for future economic growth would dictate. Finally, banks may be included into popular voucher privatisation schemes. Thus, the four preferred methods are closed or open bidding (with, or without foreign strategic participation), IPO and voucher privatisation. Some CIS-countries have allowed for industrial enterprises to acquire shares in their partner banks perhaps under the doubtful assumption that it beneficially fosters bank-industrial enterprise relations.

Eight years after the beginning of economic transition in Central and Eastern Europe and four years after the first bank privatisations occurred, there is already some empirical evidence to draw upon in guessing the longer term results of these efforts. It is particularly so that different countries have typically preferred different methods of privatisation. Poland opted for IPOs at the beginning, and switched more and more to a mixture of IPO and closed bidding with participation of strategic bidders; the Czech Republic opted for voucher distribution methods first only to shift towards direct sale lately which may result in mixed ownership structures of wide shareholding. Hungary has had probably the most open policy of direct sales each time involving dominant foreign strategic partner(s). This policy has been dictated by budgetary considerations and also by the fact that the government wanted to strengthen its position on the international capital markets; involving large, highly rated institutions in bank privatisation has indeed improved foreign confidence in the country. Increasingly, from 1995 onwards, with the inception of the so-called Bokros-package, governance consideration have become more accentuated among the motives of this policy solution. In the CIS-countries where foreign strategic owners are not part of bank privatisation programmes, less transparent acquisitions often result in industry-bank linkages, sometimes tending towards the emergence of financial-industrial groupings.

We have discussed in greater detail the policy issues related to inviting foreign bidders to the privatisation process. We have also mentioned the governance problems, related to voucher privatisation. One can only add that theoretically voucher privatisation can be orchestrated so that the governance problems solve themselves. First, minority shareholding of the government needs to be minimised or, in fact, completely eliminated. Second, it is crucial with this type of privatisation that the capital market be regulated such that it ensures liquidity of the market and the possibility that some bidders acquire controlling stake in the company. Third, either the local capital market should be large enough to absorb the relatively large capitalisation of banks or a significant share of the banks’ capital should be placed on more liquid stock markets. Sometimes, as in the case of the Czech Republic, these conditions were not guaranteed; in addition, the political process also discouraged concentration into the hands of activist shareholders. As a cumulative consequence of these factors a coalition of insiders (managers) and the government control the largest banks in such a way that it makes shareholder control highly questionable. One can conclude that it is not particularly probable that a transition economy (or any developing economy for that matter) can guarantee the four above listed preconditions for a successful voucher-type privatisation for large banks. As to IPO-privatisation, the main questions are similar to those of voucher privatisation: absorption capacity of the local market as well as the opportunity for any contenders to accumulate large enough shareholding to be able to actively control management.

Government policies usually also include different types of limitations on what percentage any investor or, in some cases, a foreign strategic investor can acquire in the privatising entity. These limitations are rooted in different types of considerations. One consideration, again often unspelled, is the will to maintain some kind of government influence over privatisation. Smaller strategic shareholding may mean more chance for the government to keep its hand on the institution. The second consideration may be political: to award certain classes of “stakeholders” with shares. Most likely it will be managers and employees; in the former case as an incentive vehicle in the latter as a tool to buy positive attitude from the employees. Contributing certain shares of the institution to IPOs means generating additional large capitalisation of the local stock market. We can reiterate the argument which was mentioned in the section on foreign ownership: the price the government may have to pay for politically motivated limitations is that certain serious investors may get discouraged and thus the government may prevent itself the option of optimising on the quality of the sales process.

In addition to the above considerations governments may also try to sell different banking organisations to bidders from different important countries for two purposes. One is to have financial organisations from a variety of countries so that those then attract foreign direct investment (FDI) from their home clientels. The second, again unspelled, reason might be that this way they can mitigate accusations of applicants that the government practices favouritism.

Another kind of "privatisation engineering" is when governments limit one investor's stake to the extent that it invites more than one core investor, each of them owning relatively small portions of the bank. Often governments argue that it is better if a few strategic investors each hold minority shares because then all of them will pull in related businesses, clientele and their own product range. Lately one of the largest Polish banks has been sold to three different strategic investors, the three together holding 24 per cent of the shares. A core argument is that if the different investors are representing different types of financial services (commercial banking, investment banking, brokerage, insurance, etc. as in the Polish case) they will contribute to the development of the privatised bank by increasing its possible product range, hence by developing it into the direction of *allfinanz*. It is an interesting possibility for two reasons: first, because of the opportunity of creating complex financial houses and, second, because this way governments may maintain a certain flavour of national institutions without jeopardising privatisation with the involvement of strategic shareholders. However, allow me draw attention to some of the potential risks with this strategy. Unless the acquirers are strongly tied strategic partners (and usually it is not the case) the risk is there that over time conflicts will emerge between them which does not stem from the operation of the privatised local bank but from conflicting broad, strategic considerations of the two or more international partners. Furthermore, one should also ask whether it is not too ambitious to develop a local institution in the direction of *allfinanz* given that its size by international standards remains too little; and by having different foreign owners none of them will invest into it as heavily as if there was one very strong strategic owner and more concentrated direction for the acquired bank. Also, management controls will probably be weaker if there is not one but more strategic owners.

Finally, allow me also mention that the success of attracting strategic investors into the bank privatisation process depends to a large extent on the perceived country risk. As an example it is worth mentioning that in Hungary it was quite difficult to sell Budapest Bank in the period of macroeconomic difficulties, when Hungary was mentioned next to Mexico as a potential trouble spot. It was quite a different story to sell Hungarian Credit Bank (MHB) a year later, following the very successful macroeconomic stabilisation program of 1995.

Usually governments sell banks by keeping some portions of the stake in their hands. Governments may have several reasons to doing so. First, they may want to maintain some influence over decision-making of the bank so that strategic goals can be better achieved. To the extent governments' will to maintain influence is perceived as a real threat by the potential buyers, this approach may impede the success of privatisation. An informed and serious buyer will see government interference with bank decision-making as a potential threat to business efficiency. Governments may also maintain some stakes in banks in order to free-ride on the strategic owners' and the bank managers' performance by hoping to harvest rich dividends. Here the same objection may apply: in case minority government ownership may deter some of the best potential buyers, the question may emerge whether the government does not loose more in terms of future performance gains of the bank, including higher taxes over profit and employment, than gaining extra dividend incomes. A third, naturally unspelled, reason to keep minority stakes may be political: the government would like to maintain an opportunity to put some of its people on the boards of the directors as well as to influence decision-making in order to access "friendly" businesses to financing. These considerations establish and preserve non-business relationships between the bank and government which again would compromise optimal allocation of the bank's resources from the point of view of the national economy.

Sometimes governments opt for retaining golden share as a way of maintaining control over a limited number of strategic decisions. The additional question, beside the ones raised in the previous paragraph, is whether keeping control over the privatised bank's strategic decisions is really necessary and if so, could it not be better achieved through the privatisation contract between the buyer and the seller, i.e. the government?

After having screened the most important limitations and constraints on bank privatisation, it is worth articulating the question whether it would not be more desirable to actively prefer as full as possible privatisation, perhaps also giving a premium to buyers who help to achieve this goal by their willingness to take full or majority control? The example of ABN AMRO in Hungary seems to indicate that full control by a reputed foreign owner carries the benefit of real, and very robust, commitment to the organization as well as to the country.

Sometimes the split and dispute of authorities over privatisation is a problem hindering the process. This paper does not want to go into the details of whether the national privatisation agency, the Ministry of Finance, Ministry of Economy or perhaps a fourth party should be in charge; it just wants to signalise that one of these agencies should be firmly put in charge and enjoy unequivocal political support so that the unavoidable political difficulties down the road do not stop the privatisation machinery. Sometimes bank managers get strong influence in shaping the privatisation strategy. This may have two reasons: the perception that bank managers know their market and the market for bank ownership better, as well as bank managers strong political influence in a situation of overstretched agendas by policy makers and privatisation officials. However, many analysts have a strong objection to this: bank managers will likely orchestrate privatisation and post-privatisation regulation of bank governance so that they keep excessive strategic influence. Whereas bank managers certainly have strong expertly opinions over their institution's privatisation which are worth listening to, governments need to maintain strong control over the privatisation strategy and implementation if they want to avoid the dominance of particular interests in this important matter of the national economy.

An important dilemma for policy makers is whether they should first restructure poorly performing banks and then privatise them or if they should privatise and allow the new owners take care of the banks' portfolio? On the one hand, governments may argue that banks with risky balance sheets will sell deeply under the price their operational qualities and market potential would warrant. Strategic buyers (mostly foreign financial institutions) will be extremely cautious with banks with bad portfolios. On the other hand, operational restructuring is something that governments with an overcrowded agenda and limited human resources may indeed not be able to do successfully and in a short time frame. It may well be that the interim solution is limited to balance sheet restructuring and/or government guarantees for potentially "poisonous" assets while leaving, in most cases, the operational restructuring to the new owners with greater expertise and know how.

In summing up the mapping of privatisation methods we can reiterate what we said in Bonin (at al., 1998): "at the core of bank privatisation is the issue of ownership versus control". With other words, governments opt, for all kind of reasons, to privatise some of their banks but also try to maintain some degree of control over those same banks. Actually, many times it is not the government but the banks' senior managers, who also try to maximise their post-privatisation control over the institution for obvious reasons. More often than not, this double, clearly conflicting, goal setting determines the final shape of the ownership mix in consequence of (usually) partial privatisation. The method chosen for privatisation will influence bank governance and hence bank performance. If there is no concentration of non-state ownership, the state and/or the insiders have an opportunity to exert significant control over strategic decisions of the bank since it is highly probable that capital markets can play a disciplining role over managers only to a minor extent. Therefore the presence of strategic owners who are ready to exert control seems to be highly desirable.

5. Budgetary impact of bank privatisation

Although we maintain that the most important long term issue of privatisation should be bank governance, it is worthwhile to take a look at the most important linkages between privatisation and budget revenues. The sales price obviously depends on demand which is primarily the function of four things: quality of the bank itself, general attractiveness of the country to strategic investors, method of sale and quality of government marketing of the sale. As to the attractiveness of the country, potential buyers of a bank will closely scrutinise the country risk which has, particularly in case of large banks, strong influence on valuations. The stabilisation of the macroeconomic situation and the general strengthening of law and order in the economies of the Central European countries, particularly Poland, the Czech Republic and Hungary, has contributed to gradual increase in attraction of the banks to bidders. One has to refer again to the privatisation of Budapest Bank, its indirect benefits in spite of low sales' price and also the much better prices the government could achieve on later privatisation tenders.

Usually a hot political issue is government guarantees to doubtful assets of the privatising bank, as part of the contract. Whereas the question of guarantees is a question of registration between the seller and the buyer, one needs to understand the tremendous sensitivity of banking to the goodwill factor; reputed investors can not risk having large bad portfolios in their books. On the other hand, governments should think of incentivising the new owners to improve the recovery of doubtful assets more efficiently and construct the guarantee clauses so as to minimise investors' ability to abuse them.

6. What limitations should governments apply towards market entry to achieve optimal levels of competition and system safety?

Entry regulation can be an important determinant of sector privatisation in many ways. By limiting foreign entry governments are limiting the opportunity of large private sector players to participate in the market; this way they also limit competition in the sector, increasing the likelihood of the emergence of players who can exert strong political influence. If minimum capital requirements are too high, this also limits potential competition in the sector. (This is, of course, not to deny that if entry requirements are too low this, on the other hand, increases systemic risk of damaging failures in the sector, particularly in the infant stage of banking when supervision may not yet be mature enough to apply eloquently other tools of safeguarding the sector.)

There exists a certain trade off between different tools of entry selection: when the supervising authority feels more certain that it can safely examine the criteria of "fit and proper" banking conduct, it may also be inclined to relax the capital requirements not only for commercial (or universal) banking but also for allowing access of non-banking organisations to different parts of the financial market.

Striking a compromise between pro-competition market access and systemic safety is going to be a serious policy issue in the near future, particularly that with improved interest representation of market players the temptation may occur to use the safety argument basically for anti-competitive purposes.

7. How do government policies on bank failures and systemic banking crises affect "privatisedness" of the banking sector?

Privatisation and *privatisedness* of the banking sector also depends in a very crucial way on the attitude and toughness of the economic policy and government approach to bank failures. Financial troubled banks are a very frequent phenomenon in transition economies: macroeconomic conditions are uncertain and often hectically changing, banks often lack know-how and proper attitudes of prudent business conduct. Therefore, it is of paramount importance for the banking sector's future shape (industry structure) and also for the whole development of the national economy how governments relate to bank failures. Government policies may or may not result in a larger government sector or in larger government involvement with banks' businesses which, together with government ownership, also reduces the scope and robustness of entrepreneurial drive in the sector.

In case of solving individual bank failures governments may be driven by the conviction that by allowing for a bank to go under confidence may be shaken in the very new and vulnerable financial sector. Therefore one of the reactions may be unconditional government bailouts. This, on the other hand, may foster irresponsible strategies and business conduct on the side of bank managers, reproducing reasons for repeated financial trouble in the future.

For a long period since the Great Depression, the international consensus was biased "on the safe side", i.e. a strong preference was given to bailing out banks as opposed to government policies which may have carried the risk of a domino effect. It has been perceived that the tough market-conform approach would be more costly than acting in time to solve isolated troubles with government funding. Lately, a few changes have made governments' attitudes somewhat tougher. First, there is an accumulated body of internationally collected evidence that softer policies usually make the whole financial sector less safe on the long run than tougher treatment in the first place, even at the expense of risking some nervous initial reaction on the market, because of the aforementioned bad management attitudes, i.e. increased moral hazard associated with government bailouts of financial companies. Second, the safety of individual banks has become less vital in many mature economies than earlier, as their importance in deposit collection and in providing clearing services has decreased. The fear of a break-down of the system as a result, as well as of depositors' panic and the contagion of a banking crisis has, in some mature economies, significantly decreased. Thirdly, governments' finances are generally more embattled now than used to be the case a couple of decades ago. Therefore they think harder before bailing out any businesses, especially banks.

What should governments do if they decide that their bailout policies should also serve, besides the short-term general security of the system, the purpose of achieving a more competitive and efficient banking industry as well as less government ownership and interference, rather than more, on the long run? Although there is no detailed manual of how to act, in general one can say that the more tough the bank policies are perceived by the financial community the less politicised bank-government relations will be, and banks will concentrate more on improving management and conducting their business in a prudent way. In bailout policies it may mean to be brave in deciding which banks' failure needs and which does not need government interference. Some troubled banks in Central and Eastern Europe do not have a strong deposit base and their going down may simply mean that depositors will look more carefully at the health of the institutions in the future; also, such examples would make banks' managers more careful in order to avoid a similar fate. A hands off approach, by being risky in some cases, can have a tremendous disciplining impact on the banking sector if successful and sustainable. Even if this is not realistic, different government bailout techniques can have different impacts on bank managers' behaviour. Measures against irresponsible managers of banks which rely on government subsidies, including firing poorly performing executives and directors or conditioning state assistance on firing top managers by the shareholders, sends a strong message of the government being serious; furthermore, conditioning the subsidies on future performance also shows the resolve of government with a favourable impact on other banks' managers. Sometimes people defend more malleable government attitudes on bank managers by shortage of competent replacement; it may well be that one should only be braver in reaching out to the younger generation of bankers in such cases. If governments nationalise troubled private sector banks, it helps if they have a clear and transparent programme of restructuring and concluding the action in their privatisation. General bank bailout campaigns, typical of the first half of the 1990s in the rapid reformers among the Central and East European countries, are to be avoided if possible since they again carry perverse incentives and enhance free riding with all the moral hazards associated with it.

Bailouts often take the form of creating government-owned hospital banks and putting bad assets of the weak banks into them. Evidence in Eastern and Central Europe is generally discouraging about such techniques: recovery of the assets are low and analysts usually conclude that keeping the assets at the troubled banks has the advantage that those banks have the best information to handle the non-performing loans. They need, however, to have proper incentives to handle them. Analysts generally prefer recapitalisation of the banks as a way of assisting them in cleaning their balance sheets contrary to taking out the bad assets from the portfolio. Finally, in rare occasions, governments in transition economies resorted to a different approach: a combination of covering losses by lowering the capital base of partly or entirely state-owned banks and then obliging them to reduce their balance sheets so that capital adequacy improves. Governments' dividend policy can also be geared towards covering substandard assets. (A detailed analysis of the issue see in Bonin et al., 1998)

This section has already illustrated the importance of the regulatory and supervisory regime to our subject. It is clearly beyond the scope of this paper to develop on it further. Here we would only like to underline that a general experience with deregulation of the banking sector, highly recommended as a long term goal, always puts a strain on some of the institutions in consequence of increased competitive pressures and a lack of solid know-how, particularly on the side of new market entrants, as regards how to handle institution safety. Therefore, banking reform, including sweeping privatisation, in Eastern and Central Europe, which in a way is a huge deregulation project, badly needs to be associated with efforts to improve banking supervision. Perhaps it is not too much of a generalisation to conclude that the professional preparation of bank supervisors in the region needs urgent improvement.

8. Banks' participation in enterprise privatisation and in corporate governance

Banks as important institutional players in the national economy may have a good financial opportunity to participate in enterprise privatisation. It is a crucial, and rather complex, policy issue of how to shape banks' access to industrial shareholdings and their institutional power in debt collection. As to the first question, the issue is rules which apply in restricting banks' ownership stake in non-financial entities. Customarily these rules limit the total amount of shares a bank can have in non-financial enterprises in proportion to its own capital, the shareholding a bank can have in any particular non-financial firm (as compared to its, as well as to the firm's, capital), and also the maximum time a bank can hold "forced shareholding" (in consequence of a client's bankruptcy or troubled financial position) of a company. Whereas the general mood, concerning banking regulation, is to permit universal banking in the whole region, prudential limits to shareholding of banks in non-financial companies is a separate issue. The Central European fast reformers have generally opted for such limitations, adopting rules similar to the German regulation; in Russia and in many other less structured legal environments in Eastern Europe, it is not the case and as a consequence, powerful financial-industrial conglomerates emerge. There the question is obviously system safety, not only in consequence of direct shareholding but also of lax or non-existent regulation of connected lending.

A specific question is whether government-owned banks should be explicitly excluded from participating in other privatisations (or their participation be limited) as their share acquisition does not result in a "real" privatisation.

Moreover, in case of their industrial stakeholdings the government runs the danger that irregular, less than prudent lending practices will prevail.

Beside general regulation of industrial shareholdings of banks, government programmes may also "pull in" banks into the corporate governance of companies. The best known of these programmes is the well documented so-called banking conciliation programme of the Polish government in 1992. It appears that the discussion of this program is, in a sense, obsolete as it was a typical product of the beginnings of the economic transition. It was necessitated by several factors: initial macroeconomic stabilisation programmes of the government created a liquidity crash in the state enterprise sector in a time when the infrastructure for handling enterprise bankruptcies was not yet operational. Banks were given the role to replace the courts as arbitrators of debt restructuring. Whereas banks were undoubtedly better equipped to handle balance sheet restructuring of enterprises than the courts were, plus recapitalisation of the banks helped to mitigate their financial problems, one needs to underline the importance of the above mentioned special circumstances. It also bears costs if the government somewhat arbitrarily interferes with the institutional structure of the economy as well as with the relative position of the banks against each other.

The other possibility of banks' possible involvement in privatisation is in their capacity as lenders. If no government subsidy is attached to it, this is no particular question of policy concern. In case the government wants to foster demand for privatising assets, it may use banks as distributors of subsidies. As with all such subsidies the next question is whether government can structure the subsidy line in a transparent way or if it will become a source of abuse. Governments have, in the past, used such vehicles to support particular classes of investors such as employees, managers and small investors.

Whereas the strengthening of the banks' institutional position through a relaxed attitude to enterprise shareholdings may run a considerable risk of system instability, their position as senior lenders in bankruptcy or composition procedure needs to be strong in order to strengthen property rights and system stability, thus efficiency in the national economy. As much as different corporate governance patterns are hotly debated, there is a considerable amount of consensus among economists that a basic lender-protective bankruptcy regime is desirable with a particular protection of senior lenders. In case of such a legal framework and satisfactory enforcement practices banks have a strong power over borrowers to enforce financial discipline, thus contributing to efficient corporate governance practices.

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