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Bank Privatization in Transitional Economies

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I. INTRODUCTION

This project, conducted by the Davidson Institute under U.S. Treasury Department sponsorship, studies the process and results of bank privatization in Central and Eastern Europe. It differs from prior research in that the core of the project is comprised of case studies of specific bank privatizations in four different countries. The goal of the project is to build an understanding of the broader process of bank privatization on the specific case studies--a bottom-up rather than a top-down approach. The four case studies follow this initial paper and are complemented by summary paper drawing together the lessons and conclusions from the project. For each case study, the authors were able to gain extraordinary access to senior executives inside the banks and to a rich body of information about the bank's performance.

This initial paper offers a unified framework for assessing bank privatization that is based on the principles of modern economics, finance, accounting and banking, the validity of which is supported by extensive experience. This framework serves as a foundation for analyzing the cases. It accommodates the central reality that "each case is different" and that progress in bank privatization will be on a case-by-case basis, yet also develops common principles that bear on successful bank privatization. Thus, the framework allows analysts and policy makers to decompose any given bank privatization into case-specific factors and the general factors. The case-specific factors are those that are unique to the specific bank in question and that provide the context for applying the unified framework. The general factors are those issues and considerations that can be applied in a unified framework based on modern scientific finance and economics to virtually any case.

II. BACKGROUND

A. The Basics of Banking

Functioning capital markets yield tremendous gains from trade for individuals and enterprises, and hence underlie the value of banking. The high costs associated with executing routine capital market transactions on a routine basis provide an opportunity for banks, which can achieve economies of scope and scale, to earn profits. In its most basic form a bank takes in deposits on which it pays interest and makes loans on which it charges interest. The positive interest rate spread it can charge because of the combination of gains from trade and the costs of alternative mechanisms is a source of economic profit for the bank.

The interest rates on deposits will reflect the time commitment (duration) of the funds, the "repricing" terms of the deposit (e.g., indexing), other financial terms (e.g., options features) and the risk of default of the bank. The interest rates on the loans will similarly generally reflect the time commitment of the funds, the repricing and other financial terms and the risk default of the borrower. Mismatches in the duration and repricing structure of liabilities and assets leads to interest rate risk, which the banks bear. In highly volatile inflation and interest rate environments, such as generally found in transitional economies, such interest rate risk can be significant. Equally important in transitional economies is the credit risk or default risk of both the bank and the borrowers. Higher interest rate spreads, adjusted for risk, implies higher profits for the bank. However, higher interest rate spreads reflect greater credit risk, and will ultimately be offset by default losses on the loans.

If the government guarantees, explicitly or implicitly, the deposits of the bank, then the interest rate cost of such funds will be lower. To the extent that deposit insurance premiums are levied and are fully priced to reflect the default risk of the bank, the premiums will offset the lower deposit interest rate cost. If the premiums do not fully reflect the bank's default risk, an implicit subsidy is involved that will ultimately cause a drain on government revenues, as in the banking crisis that started in the U.S. and spread to Europe and Japan.¹

The client base of a bank may include business--commercial deposits, commercial loans and other commercial banking services -- as well as consumer checking and savings deposits, and consumer loans for consumption, housing, education, etc. Banks can specialize in commercial or consumer business, in certain commercial sectors, in regional areas, in certain lines of business, and so on. Banks can leverage these client and depositor bases to offer related services for fees. Transactional services such as checking accounts, ATMs, money orders, traveler's checks, etc., generate income either explicitly through fees or implicitly through lower deposit rates. Fund management services, trust services, underwriting services, investment banking, insurance selling, loan origination, loan servicing, accounting services, appraisal services, financial advisory services, etc., are all potential sources of fee-based revenues for banks with "universal" licenses. Banks can also engage in trading or market-making in such products as foreign currency, bonds, equities, derivative products, etc., and earn revenues off the bid-ask spread or from trading profits.

In many countries, certain restrictions on the range of financial services are mandated by legislation or regulation. The trade-off between (1) general economies of scale and scope and (2) focusing expertise on specific customer or product niches determines how the banking industry is organized and the geographical distribution of banks.

B. The Fundamental Assets of the Banking System and System Franchise Value

The business of banking as defined above, i.e. the "franchise" to offer a set of banking services to the economy, has a fundamentally positive franchise value, even in transition economies. These services are valued and demanded by a customer base, are deliverable with known technologies and hence can support profitable business activity. While other non-bank institutions can and often do provide such services in competition with banks, banks will generally be able to compete in these markets.

The fundamental assets of the banking system as a whole can be categorized to include (1) the bundle of banking rights existing and latent, (i.e., the rights to conduct banking related business activities such as those described earlier) (2) the brand name capital of existing state-owned banks (3) the existing and potential human capital of the managers and employees (4) the existing operating systems (accounting, marketing, personnel, etc.) (5) the physical owned-assets including the branching system and (6) the existing financial balance sheet of the banking system. It is this set of assets of the banking system that provides the basis of the franchise value of the system and forms the foundation for privatization.

We discuss each of these briefly in the context of privatization.

¹ Cite our prior work; others.

Banking Rights: The rights to provide banking services are perhaps the most important and valuable asset to be privatized. These rights are the fundamental source of franchise value. The other inputs and types of capital can be built up de novo if one has the appropriate rights.

Brand Name Capital: Given their operational history, and despite operational difficulties and inefficiencies, existing state-owned institutions may have accumulated brand name capital that reflects itself in the loyalty of the customer base, and the recognition to function in international capital markets. The brand name capital and the attendant customer base is another potentially important and valuable source of franchise value.

Human Capital: The human capital of state-owned banks are often tied up in inefficient operational systems. This capital is valuable because of the potential to learn and adapt to new operational systems.

Operational Systems: The existing operational systems are generally not efficient or up to speed in terms of modern competitive banking. Depending on their current state, it may be quicker and more efficient to take the existing systems and upgrade these rather than start de novo.

Physical Capital: The physical branches of state banks may be important assets for a privatized bank, but also can be marketed separately, either bundled with or individually.

Existing Asset/Liability Portfolio: Existing client bases represent valuable capital, especially if the relationships can be unburdened by past errors, e.g., stocks of non-performing loans.

C. The Negative Net Worth “Hole”

A critical characteristic of the existing banking systems in transitional economies are balance sheets that have large negative net worths, whose consequences are important bank privatization. The basic structure of this negative net worth hole should be viewed in terms of a unified balance sheet of the country and banking system. The financial assets are the loans from the banking system to state-owned enterprises, governmental units, and other domestic (and potentially foreign owned) enterprises.

But loans under central planning represent governmentally allocated funding, nominally on a future repayment basis, but often at highly subsidized terms, so that there is sometimes more “grant” than “loan” in the loan. The financial liabilities are generally the individual, commercial, and governmental deposits. Because deposits in state banks were often the only savings vehicle, interest rates fell below the relevant shadow market rates, resulting in taxation of individual and commercial deposits and subsidization of the commercial enterprises.

The negative net worth hole is primarily due to the large volume of loan assets of the banking system that are the obligations of troubled SOEs. These borrowers are unable to generate enough income to pay off interest and principle at contractual terms and hence are sub-performing or non-performing. There are also loans to troubled private enterprises that are sub- or non-performing, which tend to be smaller in volume.

D. The Inherent Franchise Value in the Banking System is Fundamentally Positive

One must separate, conceptually at least, the troubled loan assets of the Banking system from the fundamental banking system assets being privatized. The existing troubled loans are the vestiges of the failed economic system and are backward looking in nature. The fundamental assets of the banking system discussed earlier--the potential customer base, the human capital, the physical capital, operating systems and the bundle of banking rights -- represent the franchise value of the system, which is essentially a forward-looking concept and is fundamentally positive.

The franchise value of the banking system can, of course, be turned negative in many ways. One way is to encumber the system with the existing troubled assets of the old economic system. Another would be to encumber the system with liabilities in the form of guaranteed wage and employment contracts for the existing work force. Another still would be to encumber the bundle of banking rights being privatized with excessive regulatory restrictions that effectively eliminate certain profitable services necessary for overall operational profitability. The first two encumbrances with are often involved in bank privatization.

E. The Relation Between the Net Worth Hole and Franchise Value

The relationship between the negative net worth hole and the positive franchise value inherent in the banking system is complex and sometimes confusing. The customer base in a forward looking context will still include those troubled state-owned enterprises that are themselves expected to have long run positive franchise value and hence become good customers in the future. It is critical to understand, however, that the business of turning around troubled enterprises in transition from the old economic system is simply not a banking activity. Thus one must fundamentally separate the business of banking and its franchise value from the business of restructuring troubled transitional enterprises.

It must be noted that the banking sector can, in principle, have a role to play in restructuring troubled transitional enterprises. In principle, cash flows can be carved out or otherwise secured so that a loan can be well-underwritten, in which case good bank lending can be part of an overall enterprise restructuring package. But transitional enterprise restructuring itself is not a banking function. Even in western economies the highly structured financial engineering necessary to achieve this is difficult to put in place. Specialized expertise capable of working out and restructuring troubled enterprises generally resides in venture capital firms, investment banks and merchant banks in western economies. It is this highly specialized expertise that needs to be brought to enterprise restructuring activity in transitional economies.

It is sometimes argued that since banks will inevitably write some bad loans, leaving the troubled assets in the banks will help develop the relevant workout expertise necessary to deal with future bad loans. The problem with this argument is that the focus of developing good banking expertise should be on the effective underwriting of new loans. In principle, troubled enterprise workout expertise could reside in banking, just as investment banking expertise or security underwriting expertise can reside in banks. In practice, however, there generally aren't many examples of banks that have successful workout expertise. This is due in part to the relationship nature of banking, whereas turning around and restructuring troubled enterprises often requires tough adversarial strategies that involve a completely different corporate culture. Workout activity is also a very risky, highly specialized business, and banks generally are not well-suited to either severe risk-taking or developing and keeping highly specialized expertise. In any case, if workout expertise is to be located in a bank, it should not be forced on it, which can only lower the total franchise value.

Existing banking institutions include the existing human capital of management and personnel, the existing operational systems (computer, accounting, etc.), the existing financial assets and liabilities, the existing customer base associated with the existing financial assets and liabilities, and the physical assets including the branches. In principle, some of these components could be separately marketed or bundled in various ways. In practice, however, it will generally be the case that existing franchise value will be preserved by combining existing operating systems, physical assets, human resources (and thus preserving existing brand name capital). Remember, however, that franchise value is a forward looking concept. Thus, it is really the potential for developing from this existing asset base a profitable banking entity that is the key issue. Retaining existing contributions such as discussed above is optimal only if the development of a profitable banking entity can occur from the net base (healthy and troubled assets) faster and more efficiently than starting de novo.

This is not generally going to be the case, however, with an existing balance sheet on which the negative net worth hole resides. A profitable banking entity can be created if the troubled assets can be carved out and dealt with separately in a non-banking workout entity. If this is done, the privatized "good bank" will be more efficient, better able to focus on the difficult enough task of developing a modern efficient bank capable of delivering efficient and competitive banking services. The troubled asset workout entity can then specialize in the very risky, difficult, and sometimes adversarial business of working out and restructuring the underlying troubled enterprises, free from the constraints of a regulated banking system. For both the good bank and the workout entity, therefore, the franchise value of the resulting separate, more efficient operations, may be generally enhanced.

Transitional economies face many adverse contextual factors--such as inflation, budget deficit, political instability -- that make bank privatization a difficult process. However, in the hands of government, the negative net worth hole of the banking system will only grow larger the longer privatization is delayed. Moreover, the rest of the economy, both individuals and businesses, will suffer as well from the resulting delay in the formation of modern efficient banks. Well functioning banks play a critical role in the capital markets transactions necessary to induce economic prosperity and growth. They can also play an important role in achieving the successful privatization of state owned enterprises. Thus, rapid privatization of banks, especially "good banks" capable of delivering efficient and competitive banking services, is a first priority issue.

III. BANK PRIVATIZATION AND SYSTEM RESTRUCTURING

The process of bank privatization is part of the restructuring the banking system, which itself involves the following:

1. Carving out and privatizing the parts of the old system.
2. Determining the method by which to privatize the carved up entities.
3. Establishing the regulatory system.
4. Determining rights to establish and operate de novo banks and foreign-owned banks.
5. Determining the structure and methods of dealing with the troubled banking assets.
6. Structuring the payments system.

The schematic in Figure 1 illustrates the devaluation of the old system into the potential entities of the new system. Many variations of this basic devolution are possible. Troubled asset may be left with privatized banks, separated into specialized private sector entities, or retained by governments in “loan hospitals” or “holding tanks.” Rights to establish and operate de novo and foreign-owned banks may be constrained. The regulatory and supervisory functions may be unified into one entity such as the National Bank. The payments and clearing system may itself be privatized separately, or as part of a bank or be folded into either the National Bank or the regulatory entities.

Decisions on all elements of system restructuring will have ramifications for the value and marketability of privatized banks.

- If de novo and foreign-owned banks are constrained, the franchise value of the privatized banks will be enhanced, but at the cost of less efficient banking services to the economy.
- If the regulatory system is too constraining, both the franchise value of privatized banks (and of novo- and foreign-owned banks) and the efficiency of the banking services will be adversely affected. On the other hand, a totally unconstrained regulatory structure may create a chaotic end product, with resulting uncertainty reducing overall efficiency and franchise value.
- If the troubled assets are bundled with the privatized banks, without adequate capitalization and without the necessary expertise, both the franchise value of the privatized banks and the franchise value of the underlying troubled enterprises may be adversely affected, with large and increasing costs to the economy.
- If the payments systems is inefficiently structured, it can potentially cause havoc, reduce the quality of banking services and increase the risk of banking crises.

A full analysis of all these issues is beyond the scope of this study, but will be addressed in some measure as part of our focus on privatization of existing banks. Part of this focus, however, will include addressing directly the issue of how the existing troubled assets are dealt with in the privatization process.

A. Goals of Privatization and System Restructuring

Implicit in any policy decision as to how to privatize and restructure the banking system are the short run and long run goals. A universally espoused long-run goal is almost always to create an efficient private sector system for delivering banking services to the economy. Related long-run goals would include developing sufficient banking expertise domestically so that domestic banks are competitive and able to provide banking services in the event of national security crises that cause interruption of continued foreign provided services.

Short-run goals are varied. Often there is an implicit desire to achieve a smooth transition that minimizes disruption to the economy and particularly to the current employees. Doing so, of course, comes at a cost, either in terms of government subsidies to the banks, reduced efficiency and higher cost of banking services to consumers and enterprises, reduced viability of banks, less efficient capital markets. In most cases, one should realize that long-run costs accompany the pursuit of such short-run goals as competitive efficiency is lost permanently and as the banking system gets politically “stuck” in an inefficient structure.

Other goals that are sometimes implicitly or explicitly part of the policy process include:

- Joining the European Union--achieving this requires restructuring monetary and fiscal policy in addition to restructuring the Banking system. Reducing inflation, budget deficits, etc., are important for the economy as a whole, and at least as important for the banking sector. Requirements for a regulatory system that adheres to international accounting standards, and is open and competitive, is also important. Thus, the goal of joining the EU is complementary with the primary long-run goal of structuring an efficient banking system.
- Building up domestic banks--In some forms this goal has a protectionist character and would thus impede the structuring of an efficient banking system. However, as a short-run transitional goal it can have some merit, but it can easily have a long-run cost associated with it of getting “stuck” with a less efficient banking system.
- Helping in the Transition Process for State-Owned Enterprises--State-owned enterprises, especially those that are themselves troubled, are part of the negative net worth hole problem. There can be a temptation to help the existing troubled SOEs by essentially tapping into the franchise value of banking to cross-subsidize the troubled SOEs. This is one of the dangers of keeping the existing troubled assets together with privatized banks. The consequence is more likely to be a weak and inefficient banking system and no solution to the troubled SOE problem.

Underlying the above discussions is a central principle. In designing the restructuring of the Banking system, any deviation from the goal of a long-run efficient banking system will involve significant costs, costs that are likely to dominate the intended benefits connected with the alternate goals such as employment in banking, ensuring domestic ownership of banks, and helping transitional enterprises. In fact these alternate goals are all more likely to be achieved through structuring a strong efficient banking system as quickly as feasible, so as to provide the banking base for the capital markets that are necessary to solve the varied economic problems facing transitional economies.

B. The Context of System Restructuring

A large number of factors are important to defining the context of bank privatization and system restructuring. In fact, it is because of the potentially overwhelming number of such factors that people are often lead to conclude that privatization can only be understood on a case-by-case basis. Here we focus on a limited set of core factors that will be important in the context of any privatization/restructuring process.

1. The health of the economy (unemployment and growth)
2. The level and volatility of inflation
3. Exchange rate convertibility and volatility
4. Interest rates (real rates, risk premia, inflation premia and spreads)
5. Fiscal issues (including tax rates and budget deficits)
6. Political risks and conditions

We discuss only a few salient issues here.² With respect to inflation (factor 2), both the level and volatility of inflation is critical. High and variable inflation adversely impacts the health of the economy and capital markets by increasing uncertainty in general and capital market uncertainty specifically. Exchange rates (factor 3) are also adversely affected making any international transaction, including capital flows, much more difficult. This adversely affects both bank franchise value and investor interest.

The effects of inflation on interest rates (factor 4) in these economies is particularly insidious. Nominal rates must reflect an expectant inflation premium, but what inflation will be is highly uncertain so there is a big inflation uncertainty premium as well. Thus, a lending rate which would be 5% to 10% in real terms (an interest rate that an enterprise can afford) turns into a 10% to 20% real rate which is not affordable unless the enterprise itself expects a significant probability of default. The net effect is a banking system that cannot service the needs of private enterprise for capital. Correspondingly, banks are unwilling and unable to pay deposit rates that fully reflect expected inflation, as the uncertainty provision on the funding side works to lower real rates. Thus, spreads appear high, but real risk-adjusted spreads are not at all high. Moreover, the real credit risks are higher as well. The end result of this in many transitional economies is a banking

² Obviously, the stronger an economy (factor 1), the easier it will be to undertake successful privatization. The franchise value of banks will be greater in a healthy economy, making them easier to sell. The troubled asset problems will be declining steadily, reducing the adverse impact on the budget and on franchise value. External capital would be more readily available at better terms. There will be less pressure to protect markets or subsidize employment in the banking system. Unfortunately for most transitional economies at this point in time, the opposite is true. Growth is tepid at best and unemployment is high. There is political pressure to preserve jobs in the banking sector, which threatens privatization, efficiency and competitiveness. The government budgets are under pressure, resulting in difficulty in dealing with the troubled asset portfolios completely and effectively. The franchise values are depressed due to uncertainty about current and future market potential, reducing investor interest and thus making privatization more difficult. Political risks (factor 6) include the risk of renationalization, adverse regulatory change, adverse macro policies, and the like. Such risk and uncertainty affects the ability to undertake stable banking activity effectively and efficiently, diverts bank attention and energy to political factors and away from the business of banking, and is doubly problematic for foreign investment in either banking or enterprise. Fundamental uncertainty and confusion as to the direction of privatization are common and appear due to the competing forces inherent in the political situation. Such uncertainty lowers not only the franchise value of banks, but the willingness of expertise and capital to devote the effort to try to purchase or operate a privatized bank.

system that is making virtually no consumer or commercial loans and using its funding mainly to make government loans or buy government debt. The banking system then becomes a government funding mechanism rather than a private sector capital source.

The effects of very high levels of inflation such as those experienced in Russia are noteworthy. With high inflation, the real value of both assets and liabilities on the balance sheet that are fixed interest instruments will be eroded significantly. Thus, the effect of the inherited balance sheet, particularly the effect of the troubled loans, becomes minimal. In effect, the inflation works to strip out the old troubled loans so that only the new loans have any material consequence for the balance sheet. Of course, these new loans may be troubled as well, but that is the consequence of new loan underwriting not of a large inherited negative net worth hole.

As discussed above, budget deficits (factor 5) make it difficult to adequately deal with the troubled assets of the banking system. The funding of the negative net worth hole is often delayed, and stop-gap measures are attempted. This was the case even in the U.S. at the early stages of the Savings and Loan crisis. The lesson there, however, showed that cost of delay is enormous as balance sheets deteriorated further under ineffective attention, thus increasing the size of the hole even further.

The level of taxation in many transitional economies, once all payroll, income, sales, excise value-added and other taxes are accounted for, is in the range of 70% or more. In this environment, the “supply side” effect of crowding out formal tax paying enterprises in favor of informal tax avoiding enterprises is enormous. The high tax rates make it very difficult to run an ongoing profitable business. If there is anywhere in the world where tax revenues coming into the government would increase as a result of reducing tax rates, it would be in highly taxed transitional economies, and particularly in the capital markets of those economies. Banking is fundamentally a formal activity, and the often thriving “informal” enterprises cannot go to banks for funds, since doing so would subject them to taxation risk. Thus, economic growth, development, employment, etc. are all stymied by the lack of a capital market for the sectors that are the engine of future growth.

Adverse contextual factors, however, do not mean that privatization cannot be accomplished. Privatization will be more difficult. But it does not make sense to delay the process of privatization, because the negative net worth hole will only grow bigger, and process the of undertaking successful bank privatization itself is a critical foundation element to solving the other economic problems.

C. Carving Up the Old System

Among the antecedent actions to privatization is the carving up of the old system into elements that can be privatized. There are potentially many ways to do this, but the major issues boil down to four factors: (1) geographical (2) customer base (3) size and (4) troubled loans. We discuss each in turn.

Geographical: One way to carve up the old system is to structure a system of geographically concentrated banks on the premise that both depositors and borrowers would be better served banking entities that are tied to their local area with resulting better service of local needs by banks that knew the region. The countervailing factor is that regional banks will be

inefficient, unable to take advantage of economies of scale and ultimately non-competitive with larger banks.

Customer Base: Another way to carve up the old system is around the main customer base being served. For example, savings bank structured for individual depositors, a commercial bank with a commercial loan portfolio and commercial deposits, an agro-bank for the agricultural sector, etc. Again the idea is to provide specialized and concentrated expertise to achieve greater efficiency. The countervailing factors are failure to achieve sufficient economies of scale and scope to be competitive in the long run.

Size: Whether a geographical or customer base carve-up is involved, the size of the resulting bank units is an issue. The trade-off is between economies of scale on the one hand and more effective competition on the other. It is argued in this regard that as competition from foreign banks, particularly large Western banks, increases over the next decade or so, own-country banks will have to be larger to compete, and so should be structured to be large at the outset to improve long run competitiveness.

Troubled Assets: Along a completely different dimension, the issue of how to carve out the troubled assets of the banking system is a critical one to be addressed. We defer a discussion of this until Section VI.

The central issue in carving up the old system relates to the goal of establishing healthy banks. In addition, it is widely believed that how the old system is carved up will impact the efficiency of the resultant banking system. This is a natural belief that results from the desire to market products -- bank entities that have positive franchise value -- to maximize societal benefits from privatization: revenues to the treasury, share value to stockholders, and the consumer surplus accruing to the banks' customer base. The franchise value of bank entities to be privatized will depend on what is included in the bundle being privatized. But from a longer run perspective, however, the dynamics of private sector competition may make the particular method of carving less important than establishing regulatory and licensing support for the banking system.

While it is true that how the old system is carved up is important, too much energy and conflict can go into these decisions. In Poland, for example, the original carve up structured nine regional banks with corresponding regional concentrations of loans and deposits. More recently, reflecting dissatisfaction with the initial decision, Poland has been moving to consolidate certain regional banks prior to a privatization action. Often the particular structure of the carve up is the result of political considerations in operation at the time, such as who was in control of privatization decisions at the time of the carve-up.

Notably more important are: (1) how the banking rights are distributed in terms of de novo-and foreign-owned banks ability to enter, (2) how the regulatory and supervisory system is structured, (3) the credibility of the government to non-intervention in private banking (other than through its direct regulatory and supervisory functions) and, (4) the effectiveness within which troubled assets are dealt with.

Once these four critical elements are in place, privatized banks will be able to compete, thrive, fail, merge, restructure, joint venture, etc., motivated by profit to structure or restructure

itself so as to deliver competitively valued banking services. Thus, the first order issues are not so much how to carve up the old system than how to appropriately structure the ground rules of the new system so that effective open competition can take place. As long as the initial carve up makes basic intuitive sense, privatization should take place quickly, since franchise value will only erode while stuck in government hands.

D. Structuring the Regulatory System

The key elements of structuring the regulatory systems are: (1) accounting standards, (2) capital requirements, (3) supervision, (4) deposit insurance, (5) licensing.

While no accounting system is ideal, the International Accounting Standards (IAS) provide a minimum and common standard that is generally superior to the current country standards of transitional economies. Any move toward greater disclosure in conjunction with adoption of IAS will increase the confidence in the system as a whole as well as in individual banks. Such a movement can give a country or a bank a competitive edge in access to the international capital markets.

Building up capital to meet IAS standards requires profits which is part and parcel of the issue of the franchise value of the bank. Current profits, if available, can be retained to build up capital. If current profits are not available but future profits are expected, equity capital may be obtainable from external (including international) sources. Otherwise, it will take government injection of tax payer capital to meet the standards.

To the extent that a supervisory system can be set up that is relatively free of political pressure and that is structured to be aggressive in determining necessary loss provisions, the incentive for operating banks effectively will be greatly enhanced.

A key element of the supervisory function is the determination to close a bank when it breaks the capital requirements. Early intervention has been shown in western countries to reduce the losses from bank failure to the taxpayer and the economy. It also establishes appropriate incentives for efficient management. Governmental credibility in closing down failed banks when they are bankrupt rather than bailing them out repeatedly is a key ingredient.

There is critical interaction between deposit insurance (either implicit or explicit) and capital requirements--a lesson learned with a vengeance in the U.S. banking cities. Deposit insurance involves a put option for the bank--"heads" the bank profits, "tails" the bank is put back to the government to cover the losses. Thus, adequate capital, which causes the owner to lose in the event of a "tails" outcome, is critical to mitigate incentives for excessive risk taking. This is doubly critical when a large troubled asset portfolio (the true value of which is difficult to determine) is involved.

Licensing of de novo banks and foreign-owned banks can improve competitiveness and the overall efficiency of the banking system. In particular, it may be that Novo-banks are the most capable of delivering banking services to the new private secure enterprises. It is critical, however, that the Novo-banks are subject to the same capital requirements and supervisory efforts.

IV. METHODS OF PRIVATIZATION

In this section we analyze alternative methods of privatizing bank entities. The four privatization alternatives attempted thus far include:

1. The voucher mechanism
2. The initial public offering
3. The strategic foreign investor
4. The management-led recapitalization

In the case studies in this project, each of the four methods is represented to a certain degree. Komerčni Bank in the Czech Republic was by and large a voucher privatization. Bank Slanski in Poland involved an IPO, but also a large foreign investor. MKB in Hungary is often pointed to as a strategic foreign investor model. Mosbusinessbank in Russia has the character of a management-led recapitalization.

In reality, almost any case will involve a mixture of some or all of the above methods, and appropriately so. There is no one best way to achieve privatization. Each of the above mechanisms achieves different goals towards the ultimate goal of bringing together the necessary elements for a successful privatization.

In this section, the issues are complex enough without having to bring in the difficult issue of how to handle the troubled assets. We will address this in detail in Section V below. Here we will focus on the case of “good bank” privatization, and thus assume that the troubled bank assets have been stripped out and handled separately. What remains, therefore, is a good bank franchise with positive franchise value. The hole left by the troubled assets has been filled, either by bringing in performing assets from elsewhere in the banking system, or by adding government debt in some form to the asset side of the balance sheet. The issue then is privatizing a good bank with positive franchise value.

A. The Necessary Elements

Any successful bank privatization will require certain elements to be put in place. In a nutshell these elements are

1. financial capital
2. operational expertise
3. leadership capital
4. government-interface expertise
5. transactional expertise

For a successful transaction to take place all these elements will need to be brought together in the private sector team that is on the purchasing end of the privatization transaction.

Generally, all the above elements may not be contained in any single existing bidding entity and will have to be brought together. Markets and networks for bringing these elements into a

transaction exist in Western economies. These markets and networks are less developed in transitional economies. Thus, part of the process of privatization is enabling the necessary markets and networks to form that bring these elements together.

The financial capital consists of all the funding from all sources that totals to the purchase price of the bank being privatized. This includes both debt and equity funding. If the government as seller decides either to retain an equity interest or to undertake seller-financing (a retained debt interest), then the private sector capital needs are correspondingly reduced.

The necessary financial capital can be obtained through a variety of mechanisms that efficiently tap the relevant markets including domestic institutional and individual investors, foreign institutional and individual investors, strategic foreign investors, and multilateral investors.

The operational expertise may in some measure exist in the management and personnel of the existing bank entity being privatized. But in order to make the privatized bank an efficient modern bank capable of delivering competitive effective bank services to the economy in the long run, the purchasing group will have to bring in the necessary expertise to upgrade the operating systems and human capital of the existing bank. While this can be done in some measure through contractual mechanisms with consultants, foreign banking partners, and the like, some of that expertise will need to be in place at the leadership levels of the new bank. In lieu of contractual mechanisms, a strategic foreign investor can provide the necessary expertise as part of their role as owners/operators of the privatized bank, with fully aligned incentives.

Since these are fundamentally transactions with the government, which may have a constrained interface due to financial and/or operational provisions, an expertise at structuring and tending to this interface is critical to successfully implementing a privatization and operating it post-privatization.

The leadership capital required is really at two levels--the operational leadership and the transactional leadership. The transactional expertise involves putting all the parts together in structuring, negotiating, bidding, etc. as necessary to take a transaction to fruition. There may be separate people involved, with the transactional leadership handing over to operational leadership day-to-day control post privatization, but retaining board control. Or it may be that the operational leadership provides the transactional leadership as well.

Obviously, there are several necessary elements that need to be on place in the selling side, i.e., the government side. Transactional expertise, leadership and political will are clearly important to successfully structuring and implementing a privatization transaction, whatever form it takes, constituting the government sector equivalent of a "willing seller." In this regard, however, two factors are critical if a privatization transaction is to be feasible at all. First, the government must be willing to recognize the true size of the negative net worth hole and to fill it sufficiently to restore positive franchise value. Second, the government must be willing to "mark down" the price of the bank sufficiently to reflect all the uncertainties associated with placing capital in a privatized banking entity in a transitional economy.

B. Giving the Franchise Value to the Citizens--Voucher and Direct Share Distributions

To the extent that the bank entity to be privatized has positive franchise value, and thus the expectation of profitability looking forward, the first question that must be addressed is who is to receive the revenues from sale or the rights to the profit stream from ownership. In principle, the government can market the entity and sell it to third party investors using some mechanism and retain the revenues from sale as a means of financing the activities of government. Whether the government uses these revenues to reduce taxes, increase spending, reduce budget deficits (implicitly thereby either reducing future taxes or allowing increased future spending), or increase transfer payments to its citizens is a matter of overall government fiscal policy and involves a certain fungibility. In the subsections that follow, we will discuss various methods of such third party marketing.

Alternatively, the government can give away ownership rights to its citizens, thereby distributing the rights to the future profits stream. This can be accomplished through a voucher mechanism such as in the Czech Republic, but could be accomplished by a direct distribution of ownership shares. Once anything is given away at less than its market value, of course, there will have to be some allocation mechanism. A voucher mechanism has its own allocation mechanism built in as people with vouchers bid for ownership interest. Direct ownership distribution requires an allocation mechanism such as first come first serve or a per person quota. In principle, a buy-in priced at less than market value can be combined with an allocation mechanism, as in the Bank Slanski case. We elaborate on these mechanisms in the rest of the subsection.

One must distinguish between mass voucher privatization, such as in the case of the Czech Republic, and the concept of voucher privatization of a single bank entity. In mass voucher privatization, the vouchers really form an alternative currency for purchasing ownership shares. Thus, what is really at stake is the relative valuation of shares across different enterprises (including banks). To the extent that an efficient market for vouchers forms, voucher prices of shares and currency prices of shares would be arbitrated. However, in transitional economies with newly forming capital markets, that efficient arbitrage will not generally be the case, and the relative pricing through vouchers will deviate from cash share prices.

Once privatization is underway, which is the case in most Eastern and Central European countries by this point in time, what one means by voucher privatization must be made clear. For single bank entities, distributing vouchers for that bank's shares is essentially equivalent to distributing the shares themselves. Thus, voucher privatization of single bank entities boils down simply to share distributions.

As discussed briefly above, if these share rights (or vouchers) are distributed free to citizens, how one allocates them is critical. First-come-first-serve (FCFS), FCFS with a per-person quota, or some sort of mechanism will be necessary. Note here that if the vouchers or shares are not given away, but are priced below the shadow market value, the same problem of allocation of the excess demand will be necessary.

In essence this is what happened in the Bank Slanski case, when the "IPO" share rights were priced well below their shadow market value, creating a large excess demand. There was then a quota, set low enough that tens of thousands of individuals ended up with share rights. A resulting bottle-neck in the conversion of share rights to registered shares created havoc in the markets with disastrous political consequences. The result in Poland was a chilling effect on both

the rate and methods of privatization, whereas the true problem was the rights (or voucher) allocation mechanism.

C. Raising Government Revenues Through Privatization

Given a state-owned bank entity that has positive franchise value, it is possible to capture that franchise value and thus generate revenues for the government through effective marketing of the entity. To the extent raising such revenues is an important goal, the marketing methods chosen may effect the outcome. For example, if the marketing is restricted to domestic interests through a domestic-only IPO, auction or negotiated transaction, the resulting sales price may be significantly lower than if the sale is open to international capital market participation and hence to foreign investors. Therefore, there is an inherent tradeoff between raising revenues and other restrictive goods of privatization.

There are in essence three alternative transactional methods for obtaining government revenues by privatizing banks with positive franchise value--the initial public offering (IPO), an auction and a negotiated transaction. We discuss each in turn.

1. IPOs

The essence of an IPO is the offering of equity shares in the new bank entity to the domestic investor market. Most often this market will be the formal stock market, but in principle an IPO can be done "over the counter." In either case, the key to success is the breadth, depth, and liquidity of the market. Because most transitional economies have only poorly capitalized stock markets that are lacking the depth, breadth, and liquidity of western markets, an IPO can be a risky strategy, both in terms of revenues generated and even ultimate success.

The Bank Slanski case provides an excellent example of the difficulties of undertaking an IPO in the context of a stock market that is itself relatively transitional. One should also note again that if the shares of the initial IPO are distributed at a much lower price than the ultimate market price, the IPO is really a voucher scheme in combination with a follow-on IPO.

2. Auctions

Auctions are an alternative way of marketing a bank. Usually this mechanism would be used to market the controlling interest to a large investor or investor groups. In an auction the market maker, usually an investment bank, supervises the marketing and auction process. The basic stages are

1. defining the bank entity and preparing the information base to be available for investor decision making
2. marketing outreach to attract enough investor interest to form a competitive bidding process
3. supervising the investor "due diligence" process and working with investors to realize the true franchise value

4. setting the ground rules of the auction (e.g., sealed-bids, conforming to certain specifications, by a certain date)
5. conducting the auction
6. working with the winning bidder to close the transactions and follow through on the necessary post-closing adjustments.

In conducting the marketing process for the auction, it is possible to involve foreign investors directly, to encourage foreign/domestic joint venture bidders, and generally to reach the widest possible market. A chilling factor in an auction, however, is that the due diligent process is very expensive for a potential purchaser hence there is less likelihood of participation in the bidding process if investors view the process as “too widely marketed.” In such cases an informed marketing process that identifies only a small number of potential investors and minimizes due diligence costs prior to picking one or two “negotiating” parties may actually enhance the likelihood of a successful privatization.

3. Negotiated Transaction

The disadvantages of some negotiated transactions is that the process of negotiation may be less competitive and the selling party can get caught without the leverage to extract the best financial terms. Often, very sophisticated buyers will request representations, warranties and other options that are very valuable but not easily priced as part of the package, thus reducing the true net price received. “Put options” for assets can be particularly problematic in this regard.

In face-to-face negotiation, it is simply hard to keep fixed the bundle being sold, and a good negotiator will always shift ground looking for value enhancing terms that are not fully priced. This is particularly problematic in privatization transactions when the seller is the government with an investment bank as financial advisor. The success-fee basis of the investment banking business creates an incentive to “do a deal” and do it quickly, without regard to the true net price received, and specifically without regard to non-priced value enhancing terms such as warranties and options.

On the other hand, negotiations with a qualified capitalized buyer can come to a successful conclusion relatively efficiently for all parties as long as too much time is not spent on trying to extract absolutely “top dollar”. Moreover, in the context of transitional economies the priority should probably be to consummate a successful transaction, even if something is left on the table, as long as the privatized entity is truly private and well capitalized and operational incentives are well structured. Then the amount “left on the table” simply enhances the true private equity stake and therefore the economic capitalization.

D. Strategic Foreign Investors

One issue that transcends the particular mechanism chosen for privatization is whether to allow foreign ownership and/or control of the bank. Foreign ownership as such seems to be less of a problem if what is involved is simply diffuse foreign investors owning relatively small equity positions. This is often viewed positively, rather than adversely, as a means of increasing the realizable sale value and the explicit capitalization of the bank. Komerčni Bank, for example,

went to the international market with an equity placement in the form of Global Depository Receipts, even though the Czech Republic has both implicitly and explicitly discouraged foreign ownership that results in control.

Potential resistance is encountered when a strategic foreign investor may take a relatively large and active equity position is taken by an entity with banking, capital market, and related financial expertise. ING in the case of Bank Slanski is a case in point of a large active foreign investor that has strong strategic and operational impact on the bank. BLB, the large foreign investor in MKB, on the other hand, appears more passive and leaves control to management. More recently the GE Capital transaction for Budapest Bank involves GE Capital in the extreme strategic foreign investor role of full owner.

Two very important direct benefits are derived from allowing and even encouraging strategic foreign investors, and two potentially even more important indirect benefits. First, the price received for the bank will generally be greater if one allows the highest valued bidders into the bidding process. These will often be large foreign investors for two reasons. First, that is where the significant risk capital resides. Generally, transitional economies do not have significant volumes of risk capital readily available for such investments. Second, the foreign investors often have the financial and operational expertise to realize greater returns from transitioning to modern efficient banks as well as the capital to support such movement. Thus, they will bid up the price to reflect their higher potential return. The second direct benefit follows from this operational and financial expertise. When the profits of the bank are greater, the other investors including domestic equity holders (and the government if it retains an interest) will be beneficiaries of that profitability. More importantly, however, the consumer surplus of the individuals and businesses that are served by a better bank will increase as well.

The indirect benefits may be equally important. Allowing strategic foreign investors with their operational expertise to take the controlling position in the bank creates a more competitive banking system in two ways. First, it creates a "market for corporate control" that can discipline managers in ways that an ineffective diffuse ownership cannot. This discipline mechanism has proved critical in western economies for unlocking the latent franchise value dissipated by entrenched management. Second, the competition among banks will increase the efficiency of the banking system and more generally capital markets, and the resulting consumer surplus increase can be substantial.

E. Management-led Recapitalization

In Russia, Czech Republic, and Hungary existing management has been a driving force behind the method of privatization and recapitalization. The tools at their disposal are any or all of the above mechanisms. Often management will wish the result to enhance their control position in the bank. This can be done either through diffuse ownership with IPOs or vouchers, as in the case of Komerčni Bank, or through passive friendly investors as in the case of MKB. In significant contrast, Mosbusinessbank in Russia recapitalized by bringing in clients as investors, creating a significant conflict of interest situation as regards credit underwriting.

F. Mixed Strategies

Several different investor “tranches” may be structured as part of the marketing process. In part, this can serve the purpose of reaching out to the widest market. A strategic foreign investor tranche, a multilateral (e.g., EBRD, IFS) tranche, a foreign depository receipts tranche, a domestic IPO tranche, a management owned tranche, etc. are all feasible and may all be incorporated in an effective privatization.. MKB utilized such a mixed strategy with some success. Bank Slanski attempted a similar strategy but got caught up in a volatile stock market and difficult IPO process problems.

The key to all this is that each mechanism is a potentially valid mechanism, either by itself or in conjunction with other mechanisms in a mixed strategy. The primary goals of bank privatization should be simple--achieve a stable privatized bank, free of government control, well capitalized and structured with appropriate incentives for operating as a modern efficient bank. Whether the government gets absolutely top price for the franchise value is less a concern in the long run. The real benefits are not the government revenues from privatization but the consumer surplus of the banks’ customers and the benefits to the whole economy from more efficient banks’ and capital markets.

V. DEALING WITH THE TROUBLED ASSETS

A. The Nature of the Problem

As discussed earlier, a characteristic of banking in transitional economies is a gaping negative net worth hole in the system as a whole. This is primarily due to the large volume of loan assets of the banking system that are the obligations of totally or partially state-owned entities that are themselves troubled. These borrowers are thus unable to generate enough income to pay off interest and/or principle at contractual terms and hence are sub-performing or non-performing. There are also loans to troubled private enterprises that are sub- or non-performing. These later troubled loans tend to be smaller in volume, and the two present very different issues. We will focus on the loans to troubled state-owned entities first.

A troubled state-owned enterprise may or may not have any true franchise value. That is, if all its debts were extinguished, it may or may not be able to operate at a net positive profit over the long term, much less at net profit currently. If it can operate at a positive present value net profit stream, i.e., if it has positive franchise value, then that net profit stream is available to pay off the debt at least in part. For this reason, these loans may have some value (i.e., essentially the equity value) even if they are currently sub- or non-performing. The same is basically true for former state-owned entities that have been partially privatized but that are still troubled and thus have a significant government stake and involvement.

Such loan assets of the banking system are really the vestiges of the old centrally planned economy and are therefore “loans” really only in name. When banks are privatized, these “loans” are generally treated just as if they are true loan assets of the bank and thus are included in the bank’s balance sheet. Instead, these “loans” could be carved out of the banks and treated separately in a specialized entity. We argued earlier that there is likely to be significant benefit to dealing with troubled loans separately, since this is a different business than “good banking,” requiring different expertise and methods from “good banking.” In the U.S., for example, after considerable experimentation with alternative methods of “privatizing” failed banks, it was

determined that selling the good bank separately, and selling the troubled assets separately was the most effective method of solving both the banking crisis and the real estate crisis associated with the trouble loans (which were mainly real estate loans).

When it comes to troubled state-owned enterprises, in particular, it is almost surely better to carve out the troubled loans and consolidate them with the enterprises rather than keep them with the bank being privatized. The logic is as follows. Prior to privatization (or in the case of recent privatization, prior to full resolution of the trouble) both the loan and the borrowing enterprise are owned by the state. The troubled enterprise will be easier to deal with if it is freed from the loan in question. The bank is better off not having to devote its energies to the process of resolving the trouble of the state-owned enterprise.

The bank will need to have the "hole" created by pulling the loan filled either with a performing loan, a government note, or some other asset. The government, however, is not affected at all by this "swap," as a budgetary matter. On the other hand, the government now has a state-owned enterprise that is not encumbered by the former "loan" (that is really an intergovernmental accounting entry). In the government's efforts to resolve the troubled enterprise it will not be encumbered by the bank either acting like a private creditor or, worse, like a quasi-arm of the government.

B. Segregating the Troubled Assets

The discussion above suggest that there are three separate classes of troubled loan assets that may require differing treatment, depending on the type of the borrowing entity. These are

- a. currently state-owned enterprises
- b. partially privatized state-owned enterprises
- c. private sector enterprises.

There seems to be a little rationale for keeping sub- or non-performing loans of current state-owned enterprises in the bank rather than "swapping" these for a government note. For partially privatized and fully private sector enterprises segregation is probably the best resolution strategy. Under certain circumstances, there may be a rationale for keeping such assets in the banks, which we will analyze in the following subsection. In all cases, however, the key issues with respect to such troubled assets are 1) where is the best expertise available to deal with them, and 2) which is the best institutional context in which to deal with them.

The first question to understand, therefore is what needs to be done to troubled loan assets. For currently state-owned enterprises, a whole restructuring and privatization strategy is necessary, perhaps involving issues related to employment security, severance pay and the like. These often involve governmental decisions that a bank has no expertise or capability in addressing. As discussed earlier, there is no rationale for bringing a bank as a creditor into this problem. Private sector expertise may be necessary, but this expertise will be related to operational and financial restructuring in the context of a venture capital "turnaround of the enterprises." A good bank might take a role in providing debt financing to the restructured entity, with plenty of venture equity capital to buffer its risk, but there is no rationale for unnecessarily involving a bank as a creditor in the context of either the governmental effort or the turnaround effort.

For partially privatized enterprises, the same would be true if the government is the true residual stakeholder and also owns the bank that holds the loan. For private sector enterprises, however, or even for partially privatized enterprises for which the private sector has significant residual stakeholder status, one would generally want to avoid a bailout such as a consolidation swap would provide. In this case, it will generally be appropriate to keep private sector type discipline on the turnaround process. The question is whether the bank to be privatized is the best entity to deal with this in the creditor position.

For such partially privatized and for fully privatized enterprises, the restructuring/turnaround effort necessary is likely to be most effective if resources that have the necessary specialized expertise deal with it operate outside the regulated banking environment. Such a turnaround effort is simply a different business than good banking and is a much higher risk, venture than prudent banks should undertake. The question is how best to get such turnaround efforts into the hands of the highest valued user, and in the process both generate maximum revenues for the government and the greatest benefits to the general economy.

For the different types of troubled loans, different methods will be necessary. For troubled state-owned enterprise loans, the loans should be consolidated with the enterprise and replaced on the bank balance sheet with a government note or other performer asset. The troubled enterprise then must be dealt with by the government in some way. Bringing in the private sector, i.e., privatization, is almost by definition the best strategy, but note that once the loan is consolidated that process can be a lot simpler. It then boils down to whether there is sufficient franchise value in the enterprise itself, free of artificial debt encumbrances, to induce the private sector to take an interest.

All the issues related to maximizing revenues, foreign ownership, etc. discussed with respect to bank privatization are also inherent in enterprise privatization, of course. With enterprise privatization, however, pooling troubled enterprise into larger portfolios that the private sector purchaser will then guide through turnaround and end-marketing process may be more effective and efficient than trying to do so in the context of a government "holding tank." These issues are beyond the scope of this study, but are obviously critically important to overall privatization.

For troubled partially privatized and troubled private sector enterprises, there is still virtue in carving the troubled loans out of the bank to make the privatized bank a "good bank," but it will generally not be appropriate to collapse the loan, since such enterprise bailouts are both costly and destructive to operating incentives. Instead, these loans can be pooled together and sold to specified entities that have both the troubled loan workout expertise and the requisite capital to deal effectively with such a portfolio. In general, dealing aggressively with troubled loan workouts to maximize recovery value is best done outside the context of a regulated banking environment, due to both the inherent risk and the different operating culture necessary than in the relationship based banking culture.

C. Keeping Troubled Assets in the Bank

For troubled loans that are the obligation of private sector (or already privatized) enterprises, rather than state-owned enterprises, there may be a rationale for keeping them in the

bank being privatized. If the capital and expertise to deal with troubled loans does not exist in sufficient magnitude inside these transitional economies, it would take foreign capital and expertise to purchase the troubled asset pools and deal with them operationally. If these transitional countries are reluctant to bring foreign ownership into troubled loan workouts and enterprise turnaround/restructuring, then by default, the banks may be the only entities capable of handling the troubled loans.

To the extent that any troubled assets are left in a bank slated for privatization, it is critical that two issues be appropriately handled. First, it is critical that the negative net worth hole created by the troubled loans is aggressively filled. Thus, the loans must be aggressively marked down to reflect all detrimental factors including the expected net cashflows available to partially pay off principal and interest, the high risk of recovery and timing, and the lack of institutions and markets that enable recovery against the loan. Governments and banks have generally been reluctant to take the deep write downs necessary. Until that is done, however, little progress can be made in cleaning up the loan portfolios and thus, the relevant markets will not be able to form as they should.

Second, it is critical that no explicit or implicit capital loss provisions or bailouts are purchased. Similarly, no yield maintenance of any kind can be involved. These methods of insuring bank solvency are generally used to substitute for loss recognition and will create perverse incentives for troubled loan resolution. Such methods were tried in the U.S. Saving and Loan Crises with disastrous consequences.

If the troubled loan assets are to remain with the bank, they should be fully written down, the hole should be fully filled in ways not linked to troubled loan recovery and disposition, and no further guarantees or bailouts should be attempted. In this way the incentives for banks to maximize recovery on the troubled loans, which involves maximizing the franchise value of the underlying enterprises, is fully aligned with the maximization of the welfare of the economy as a whole. In this regard, the likelihood of successful resolution of the troubled loan problem is maximized.

VI. THE ROLE OF THE GOVERNMENT IN A PRIVATIZED BANK.

For a variety of reasons, governments often chose to retain an ownership interest in banks they have "privatized." One reason is a concern for selling assets to private sector interests too cheaply. Retaining an ownership interest affords the government and hence the taxpayer the opportunity to participate in the upside. Another reason is to control the bank directly through the mechanism of corporate governance in addition to its normal regulatory and supervisory role.

Because regulatory restructuring takes time and itself requires a build-up of the appropriate institutions and expertise, regulatory restructuring may lag behind bank privatization. In such cases, retaining an ownership interest for the purposes of monitoring and control through the corporate governance mechanism can be justified. Such a governance role, however, should be as short-lived as possible. No privatization can be said to be truly successful as long as government is in a position to exercise control through the mechanism of internal corporate governance. Thus, adequate supervisory and regulatory restructuring must proceed rapidly and in step with bank privatization.

Independently of any desire to exercise control through governance, there may be valid financial reasons for government retaining an ownership interest. First, if the privatized bank is, in fact, sold with less emphasis on getting the highest price in order to speed up the process, retaining an ownership interest affords the government the opportunity to recoup some of the resulting upside. Second, if the government is more certain or more informed about the course of economic and bank system restructuring than private sector investors, retaining an ownership interest allows the government to participate in the upside that may be too heavily discounted by the less informed risk-averse private sector. Third, by retaining an ownership interest, the government can signal its confidence in the asset it is selling, with a resulting enhancement of bids. Finally, by retaining an ownership interest the government can reduce the capital demands on the private sector capital markets.

It is critical to realize, however, that retaining an ownership interest must be a purely financial issue, and thus explicitly separated from exercising control through corporate governance. The retained interest can be structured to be purely passive, with no control rights. Nonvoting stock is one such mechanism. Contractual provisions eliminating board participation and otherwise limiting internal control by the government can be structural to isolate the government's position to purely a passive financial interest.

Even when fully isolated, however, it is important that the government's passive retained financial interest is short-lived. Any long-term financial stake risks governmental legislative and/or regulatory policies that bias the banking and capital market "playing field" in favor of those institutions in which the government has retained a financial stake. Again, it is possible to contractually ensure a maximum term for the governments retained interest through a purchase option granted to the controlling interests, an explicit expiration provision, or other similar provision.

VII. CONCLUSIONS

Below in outline form are provisional insights for policy from this framework:

A. Transitional Structuring

1. How you carve up the system for privatization is less important than actually privatizing banks.
2. There is no one optimum mechanism for privatization. IPO's auctions, negotiated transactions each have their place and can be used in mixed strategies.
3. Strategic foreign investors bring both capital and operational expertise and can be an important element in structuring a successful privatization.

B. The Troubled Loan Portfolio

1. The troubled loans of state-owned enterprises should not be included in the balance sheet of the privatized bank, but should be consolidated with the enterprise for separate resolution.

2. Dealing with troubled loans is fundamentally a different business from banking and should be dealt with on a segregated basis.
3. If troubled loans are included in the privatized bank, they should be marked down appreciably, with no further capital loss or yield protection (explicit or implicit) so that the bank has full incentives to maximize recoveries on the troubled assets.

C. Regulatory Structuring

1. An effective, non-intrusive regulatory system should be put in place as early as possible.
2. The regulatory system should be structured along the lines of international standards as to maximize the integration with world capital markets.

D. Government Behavior

1. If the government retains an ownership interest in the privatized bank, it should be a completely passive interest. Thus, the government should play no role in corporate governance either directly or indirectly.
2. The government should direct its involvement to the standard supervisory regulatory roles consistent with international standards.