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I. Introduction

Bank privatization in Central Europe has proceeded slowly, at least in comparison to what many have anticipated. This difference between expected and actual rates of privatization is particularly true for Hungary. Because Hungary was more closely linked to Western economies prior to 1989, perhaps there were greater expectations that privatization in general and bank privatization in particular would proceed more quickly in Hungary than elsewhere.

In reality, Hungary's first bank privatization occurred only in mid 1994. This bank, MKB, was the former foreign trade bank. As with similar banks elsewhere in the region it had an asset portfolio that was largely based on foreign trade loans and hence was relatively less problematic and easier to privatize. The privatization transaction involved a so-called strategic foreign investor and a multilateral investor, with the government retaining a 25% ownership stake.

Following MKB in late 1995, the Bank of Budapest, the fifth largest Hungarian bank, was privatized. This bank also had a portfolio that was relatively less troubled than those of other large banks. The privatization transaction again involved a strategic foreign investor, a multilateral investor and a 25% government retained ownership interest. In this case, however, the contractual terms provided the strategic foreign investor with the option to buy out both the government and the multilateral investor.

In addition to MKB and BB, Hungary has sold off part of its interest in OTP, the state savings bank. The transaction, which has been termed a privatization by the National Bank, involved a private placement of Global Depository Receipts representing approximately 20% ownership in OTP on the international capital market and a domestic placement of approximately 15%. The government, however, has itself retained approximately a 50% ownership stake and asserts control through the Board, so that there is an open question as to whether OTP has truly been privatized.

These three privatization transactions are very different in structure and outcomes, and can serve as effective models to assess bank privatization and to understand what constitutes a "successful privatization." This paper is comprised of two parts -- the main paper, which presents an analysis of the MKB privatization in Hungary with contrasting references to the BB and OTP transactions, and an Appendix, which presents an abbreviated case study of the MKB transaction.

In this paper, we summarize the MKB privatization transaction as an extention of the overarching framework developed in Kormendi and Snyder (1996). We also briefly examine the OTP and BB transactions as they contrast to the MKB transaction. Instead of developing a fully integrated case study of these transactions we rather focus on certain key features that serve to illustrate aspects of the framework analysis. In the Appendix, we present an abbreviated case study of the MKB privatization transaction. This case study, which was Hungary's only bank privatization at the time this project was initiated, illustrates in more detail the structure of a comparatively straightforward privatization transaction for a good bank franchise in which significant foreign ownership is involved.

II. MKB

Antecedent Actions

The privatization of Hungary's foreign trade bank, MKB, was in essence a five year process that began around 1989 and ended in 1994. In 1987, MKB obtained a universal banking license. In 1988, Gabor Erdely became chairman of MKB. By 1989 MKB was essentially set on its course to becoming a high quality bank involved in all commercial banking activity and eventually a private bank. It was in 1989 for example that MKB first adopted International Accounting Standards.

The critical "antecedent actions" on the part of the government involved the system-wide recapitalization programs over the course of 1991 through 1994. These programs strengthened MKB's balance sheet. This left MKB relatively free of troubled assets, relatively well provisioned for the troubled assets that remained, and relatively well capitalized versus other Hungarian banks. In part, this result was aided by the fact that MKB's original portfolio was dominated by generally healthy foreign trade based loans.

The recapitalization programs are themselves both interesting and controversial. The Credit Consolidation Scheme, for example, involved a swap of troubled loans for government securities. These swapped loans were for the most part the debt of state-owned enterprises. Thus, by taking these loans out of the banking system, the government

was able to simplify the resolution process of those state owned enterprises by reducing the necessary involvement of banks as creditors in the process.

These recapitalization programs were controversial in part because of the repeated rounds of recapitalizations that were ultimately necessary to restore the banks to solvency (and for some banks it remains uncertain as to whether solvency has been achieved). The repetition of rounds call into question the government's commitment not to bail out failed banks, even when that failure is due to the bank's own action. This, of course, sets up the critical moral hazard problem of incenting managerial investors toward risk-taking and away from efficient bank operations.

Privatization as Process

Even prior to the point in time that the 1994 privatization actually occurred, MKB already had its strategic plans for operating in place. Its client base was generally blue chip companies and high net worth individuals. It had upgraded and modernized its operating systems and moved into activities such as credit cards and ATM's. (It was not, however, running a large branching network, preferring to remain a more limited bank in this regard.) It had also put in place strategies to become a leading regional commercial bank for Central and Eastern Europe, springboarding off its high grade Hungarian corporate asset base and its historical position in foreign trade lending.

In the period since the privatization, one could say that not much has changed either in terms of strategy, operations or governance. The composition of the Board is somewhat different, with both the strategic foreign investor, Bayerische Landesbank (BLB), and the EBRD represented. All indications, however, are that management is currently in full control of the bank, as it has been essentially since 1989. Neither the government nor BLB appear to exercise a strong role in the bank. In fact, BLB might be considered to be a "strategic foreign investor" in name only, as it really does not provide the kind of expertise and "technology transfer" one usually associates with such a role.

Thus, in the case of MKB, tha actual event of the privatization transaction is really more of a non-event, with no real changes triggered in either strategy, operations or governance. In this regard, the MKB de facto "privatization" really took place over time, starting around 1989, but in a sense it is not complete. As we will argue below, the final stage--full divestiture of the remaining government interest--is now all that remains, and there is nothing blocking such a step at this time (except, of course, political will).

The Transactional Structure

The transaction itself has what might be termed a multiple equity tranche structure, with each equity tranche containing a different investor type. Prior to privatization, the government owned over 60%, with 30% ownership in the hands of diffuse private interests including employees, and close to 10% in the hands of diffuse foreign interests.

Immediately following privatization, the government share dropped to around 25%, with BLB and EBRD holding approximately 25% and 17% respectively and with diffuse private and foreign interests dropping to around 30% in total. (In 1995 DEG, another German bank, purchased about an 8% ownership interest, mainly from the diffuse private interests.)

This kind of multiple tranche structure has characterized most privatizations to date, with or without a strategic foreign investor or multilateral participation. The MKB transaction did not involve either a direct distribution of stock to individuals (e.g., a voucher scheme) or an IPO. In fact, MKB stock is currently still not listed on the Hungarian stock exchange, because the retention of the government ownership interest in excess of 25% precludes listing MKB on the stock exchange as a matter of Hungarian law. In eschewing direct stock distribution, the Hungarian government made an implicit policy decision to maximize the revenues it received from the MKB privatization. Of course, the government could sell off its remaining interest in a domestic market IPO and both solve the legal problem and complete the total privatization of MKB.

One particular feature of the transactional structure of the MKB privatization bears emphasis. The transaction price for the purchased interest contained a post-closing performance based price adjustment mechanism. The price adjustment mechanism has two stages and is based on earnings performance for the last six months of 1994 (Stage I) and for the first six months of 1995 (Stage II). The essence of the mechanism is as

follows: if MKB's earnings in 1994 were more than approximately two-thirds (2/3) of its 1993 earnings, EBRD and BLB would pay a 30% price premium for its shares. Between zero and that hurdle, the price premium would be calculated on a pro-rata basis. For the first half of 1995, the (annualized) hurdle was closer to one-half of 1993 earnings and the corresponding premium was also somewhat lower, at close to 25%.

The Performance-Based Price Adjustment Mechanism

This price adjustment mechanism has several interesting characteristics, some of them puzzling in their implementation. First, such a performance-based price adjustment mechanism in principle creates an incentive for MKB to achieve good performance. However, the hurdles appear to be set rather low by historical standards, suggesting that EBRD and BLB were more concerned with incenting MKB to avoid adverse outcomes than to achieve excellent outcomes.

Second, the one year performance term stresses short-term results over long-term results. In particular, the short term provides an incentive for the bank to engage in opportunistic earnings shifting available under standard accounting systems. Deferring recognition of losses and accelerating recognition of income can increase accounting earnings in one period at the expense of those in later periods. It is too early to tell whether this happened but the relatively low hurdles were passed quite handily, suggesting that no such shifting would have been required.

Third, a performance-based price premium has the ability to address issues of uncertainty for investors as to the true value of the underlying portfolio. In general, there can be an asymmetry of information concerning a bank's portfolio between the management or seller on the one hand and the buyer or buyers on the other. This can be a particularly difficult problem for banks in transitional economies with their large troubled asset portfolios. Investor due diligence, the standard method of closing the informational asymmetry gap, is a costly process and is fundamentally limited by both time and the quality of the banks records. Thus, a performance-based price premium is a potentially effective mechanism for mitigating investor uncertainty and would appear to be an innovative solution for such problems, especially in transitional economies.

These caveats notwithstanding, performance-based price adjustment mechanisms may be able to play an important role in structuring privatization more generally in transitional economies. In general, the parameters that define such mechanisms include:

1. The performance indicators (e.g., earnings)
2. The performance term
3. The performance hurdles
4. The premium structure

Tuning these parameters to the particular privatization will depend upon such issues as incentives, information quality, investor uncertainty and the like. It may well be, however,

that certain negotiated privatization transactions that are "stuck" on pricing can effectively navigate that roadblock with the use of such a mechanism.

The Remaining Government Ownership Stake

Returning to the issue of the government retained ownership interest, one should ask what are the reasons for such retention. As discussed in Kormendi and Snyder (1996) retention, in part, allows the government to participate in the potential upside of post-privatization success. In part, however, it gives the government a role in the governance mechanism to exert direct control if circumstances should move it to do so. It is the latter threat that is the real problem of the retention, and the fact that such direct interference has not yet been shown does not mean that it will not happen.

In the case of MKB, moreover, the argument for retaining the upside has probably run its course by now. MKB has proven itself to be a well-managed, successful, competitive bank with a good franchise value and an effective operational strategy. If the government sells off its shares, through an IPO or otherwise, several beneficial consequences can be expected. First, and perhaps foremost, the first total bank privatization in Central Europe would be completed. Second, with the listing of MKB on the stock exchange, the value of all holders' shares would likely increase, if for no other reason than increased liquidity, but probably due to the final extrication from the threat of government interference. Third, the government would generate additional revenues at a

time when it can use them. For all these reasons, and with no strong countervailing reason remaining, a move to total privatization of MKB would be a timely event. As of this draft, the Hungarian government has conditionally approved negotiating with EBRD and BLB to buy out its retained 25% interest.

III. Contrast to OTP and BB

It is useful to contrast the case of MKB to those of Hungary's two most recent privatizations--OTP, the state savings bank, and Bank of Budapest. In this section we briefly discuss OTP and then spend more time on Bank of Budapest.

The OTP Transaction

The OTP transaction can also be considered to be a multi-tranche transaction. In this case, however, the mechanism of Global Depository Receipts (GDR) was utilized to sell approximately 20% ownership stake to a diffuse set of foreign, mostly institutional, investors through a private placement process, with no single stake being in excess of 5%. There was also a 15% domestic investor tranche, which again involves generally diffuse domestic ownership, including management and employees of OTP. In this case, however, the government retains ownership of around 50%, 25% with the state pension fund and 25% with the APUrT.

The OTP GDR transaction, however, must be considered to be a relative success especially in contrast to a similar such placement by Komercni Bank (Czech Republic) which had significant trouble filling a more modest sized tranche. The involvement of significant foreign and domestic investor tranches, however, cannot be considered to be a true privatization, because control did not pass in any true sense to the private sector.

In fact, if anything, the OTP transaction shows that less than fully privatized entities with significant state ownership can attract private investor interest as passive investors under the right circumstances. OTP, the state savings bank, has an enormous deposit base franchise which can be counted on to generate net profits, even under increasing competition. Deposit insurance, implicit or explicit, will almost surely be available for the OTP individual depositor and this creates an important subsidy. The fact that it is controlled by management, with significant retained state ownership does not mean investors cannot foresee a return to the significant franchise value. It also does not mean that OTP has been privatized in any real sense or that OTP would not be more efficient and the Hungarian banking system would not be more competitive if OTP were truly privatized.

The Bank of Budapest Transaction

Examining the recent Bank of Budapest transaction in light of the MKB transacation highlights a set of interesting issues. For all external appearances, the BB transaction shared a similar multitranche character to the MKB transaction. The strategic foreign investor, GE Capital, purchased approximately 27.5%. EBRD, on the other hand, took a higher stake at 32.5%. The government retained a slightly smaller 22% stake. The remaining 18% is controlled by diffuse domestic and foreign interests. This, however, is where the similarities end.

The first and critical difference is that GE Capital was granted full management control of BB as part of the contractual structure. GE consented to provide both its technical expertise and significant staff commitment at both the top and middle management levels. (Provisions are reported to exist for GE Capital, however, to generate fees to offset the commitment of these resources.) This is a radical shift which, in effect, shows that it is possible to structure a transaction where the government retains a residual ownership interest that is purely a passive financial interest, enabling it to share in the expected upside without imposing actual or theoretical control on management.

The second important provision of the transaction involves a call right to GE for both the government's and EBRD's shares. A call right or option must have an exercise price specified and a time frame specified, but these are not known to us at the present time. The exercise price and time frame, however, in effect determines both the value of the option and how the upside that GE Capital can achieve in BB is to be split between GE Capital, EBRD and the government. Our understanding is that this exercise price is set low enough to make GE Capital's option quite valuable, but still give EBRD and the government a reasonable "exit return." Thus, through the call option mechanism, GE Capital has in essence an effective 80% ownership interest at its disposal in the event of positive BB performance, with the remaining 20% under diffuse private ownership.

The third provision is the converse of the second, above. Both EBRD and GE Capital are limited on the downside in the event the value of their BB investment deteriorates. Such provisions amount to a right for GE Capital and EBRD put back their shares to the government in the event performance is poor. Again, this is potentially a very valuable option for both GE Capital and EBRD, and correspondingly lowers the effective price received by the Hungarian government for BB.

Limiting the downside through the put option and enhancing the upside through the call option also can have the effect of creating an incentive for GE Capital to pursue more risky operational strategies. In essence, GE's position is "tails--I am protected, heads--I triple my winnings." Pursuing risky operational strategies is the way to increase the size of the bet and is the value maximizing strategy under these conditions. On the other hand GE's incentive for positive outcomes is very high, and they can be expected to pursue aggressively getting BB established as a successful private bank.

The fourth provision relates to the troubled asset portfolio. GE Capital has purportedly been given limited but significant options to put assets back to the government over a fairly long time frame. In part such a provision can limit the need for extensive due diligence in the event of time pressure. A relatively long time horizon, however, would give GE Capital an option not only on its old inherited bad loans, but potentially on bad loans produced by its own risky loan underwriting. Clearly, again, this is a valuable option and one whose value increases with the term of the option.

Assessment of the Bank of Budapest Transaction

It has been reported that conditions for the Hungarian government to privatize BB was a transaction price that fully covered the outstanding short term "capitalization loan" that was due December 15, 1995. That pricing was achieved in some measure, but it is critical to understand that the prices of valuable but unpriced options granted to GE Capital (and EBRD) may reduce the true net economic price received quite substantially. Does this mean that the Bank of Budapest privatization transaction is not a successful one? Quite the contrary.

While it might be interpreted that the government did not get maximum value for the BB transaction, as we discussed in both Kormendi and Snyder (1996) and Meyendorff and Snyder (1996), leaving something on the table sacrifices some revenues but it succeeds in creating an economic value for the purchaser that increases its stake in the positive operational outcome, and it can succeed in inducing a successful privatization in a short time frame.

The end result of the BB transaction has all the earmarks of a potentially very successful privatization transaction.

- It has brought in a true strategic foreign investor with the unquestioned expertise and capital access required to make BB a successful private bank.

- It has created a structure in which GE Capital is fully incented to provide that expertise and pursue a course that makes BB a successful modern private bank.

- Any success of BB in providing modern and efficient banking services will enhance competitiveness of the banking system as a whole, with correspondingly significant benefits to the Hungarian economy.

- It has provided an automatic mechanism for turning BB into a fully private bank, thereby eliminating (or significantly mitigating) risks of policy reversion on the privatization.

The Hungarian Potential

In summary, the Bank of Budapest transaction may prove to be one of the most successful in the long run, and elements of it might well provide a model for newly privatizing countries to consider seriously as they take their steps toward privatization. If, in the wake of the BB transaction, the Hungarian government would commence the sell-off of its 25% stake in MKB and complete that privatization, Hungary would find itself at the forefront of true bank privatization, finally realizing the expectations, both internal and external, that have heretofore been somewhat unfulfilled. Finally, assuming the lead in

true bank privatization can have a strong salutary effect on overall investor confidence in the direction of Hungarian privatization efforts beyond banking and the Hungarian economy as a whole.

Appendix

The Magyar Kulkereskedelmi Bank Transaction

I. Introduction

A. Background

This Appendix provides a brief case study of the transition of Magyar Kulkereskedelmi Bank (MKB) from a state-owned bank to a private bank. This transaction takes place within the context of privatization in Hungary and within the context of the banking system as a whole in Hungary. The banking system itself in Hungary suffers from the same set of problems as other countries' bank systems in the region: management unfamiliar with operating based on a profit motive, poor technical systems, weak (understaffed and/or inexperienced) government supervision, uncertain macroeconomy, strong foreign competitors, and finally, extensive bad loans both from troubled state owned enterprises and from newer, failed, private enterprises. MKB has in one way or another addressed these problems and managed to maintain a strong reputation internationally.

MKB began the privatization process as a strong bank for the region. This was a precondition for bank privatization as Hungary sees it. The one-at-a-time sales to strategic foreign investors of necessity requires a bank the foreign investors can have a certain degree of confidence in, despite the macroeconomic uncertainties. Additionally, this type of privatization incurs search costs, both in financial expense and in time. Finally, this form of privatization can be stymied when any of the prospective partners gets cold feet. The advantages to this form of privatization are that the foreign investor can bring experience in banking in other countries to the newly privatized bank, the investor can also direct its own clients to the new bank for their own operations in the region. Provided that the new acquisition fits the strategy and direction of the foreign investor and can maintain a good level of performance, the investment can rapidly expand the reach, knowledge and future client base of the investor.

Several elements of MKB's current level of success can be attributed to strong management and a conservative approach to banking. MKB has used international accounting standards for reporting purposes since 1989, and has provisioned for bad loans above and beyond the required amount for some time. This conservatism did not help them when they inherited loans from the National Bank of Hungary, in the creation of the two tier banking system, as some of these were bad loans. MKB participated in the government recapitalization of Hungarian large state banks, and has continued to provision conservatively. Our analysis of the provisioning of the bank system as well as

MKB itself show graphically that MKB has indeed conservatively provisioned, and that the system as a whole is underprovisioned.

We also examine MKB's financial health, not only in terms of traditional financial statement analysis, but also by looking at the changing sectors to which MKB is lending, and the changing concentration and health of their loan portfolio.

MKB's privatization transaction to strategic foreign investors included two possible price adjustments based on earnings performance. The performance-based price premiums can have several effects: by tying the premium on an equity-based result, the investors need be less concerned about the state of the balance sheet itself, the need be less concerned with the due diligence of the bank itself, and as such, can reduce some level of uncertainty in the transaction. The performance-based premium is, however, subject to earnings shifting in the performance period. The performance -based premium is a useful tool for the purchasers in reducing some of the uncertainty involved with the transaction, but it is also a useful tool for the bank, in that based on good performance, the purchase price increases. The price premium approach reduces the problem of undervaluing a bank from the bank point of view.

While MKB is now a majority-foreign-owned bank, the state still owns just over 25%, an maintains a seat on the Supervisory Board. There has been much debate as to whether the government will involve itself in the bank, and if so, how. In fact, the government has several alternatives for involvement, ranging from Supervisory Board and traditional governance mechanisms to acting through the bank supervisory body, the State Banking Supervision (SBS). The SBS is effectively a branch of the Ministry of Finance, and the Ministry of Finance ended up owning most of the state's shares of banks after the second round of recapitalization. To date, the government has not meddled in day to day activities of MKB, and to the extent that the government wants more banks privatized, its energies are better spent elsewhere in the banking system. That being said, if MKB makes a decision contrary to the government interest, or if MKB's performance suffers significantly despite the assistance of the strategic foreign investors, the state may indeed step in.

This study proceeds as follows. Section II examines MKB's operations and financial health prior to the privatization transaction. In Section III, the privatization transaction itself is discussed, with special attention paid to the price adjustment. Section IV reexamines MKB after the transaction, focussing on changes in operating behavior or financial health.

II. MKB Pre-Transaction

A. Overview

Magyar Kulkereskedelmi Bank (MKB, the Hungarian Foreign Trade Bank) was established in 1950 as one of the two principal banks (the other being the National Bank of Hungary) allowed to carry out international banking operations. In 1987, when the Hungarian government liberalized banking regulations, MKB became a fully licensed commercial bank.

The privatization of MKB has been a five year process. Gabor Erdely was appointed chairman of MKB in 1988, and by 1989 MKB was essentially set on its course to becoming a high quality bank involved in all commercial banking activity and eventually a private bank. It was in 1989 for example that MKB first adopted International Accounting Standards, which it has followed since. By the time the 1994 privatization actually took place, MKB already had its strategic plans for operating in place. Its client base was generally blue chip companies and high net worth individuals. MKB developed domestic corporate and private banking. MKB has established branches in seven Hungarian cities since 1987, in addition to the head office and five sub-branches in Budapest, and five foreign representative offices. MKB has credit lines with numerous international banks, and has been active in the Euromarkets since about 1970. MKB's activities include import-export financing, trade financing, merchant banking, domestic corporate banking (as of 1987), and private banking (as of 1989, primarily keeping forex accounts).

It had upgraded and modernized its operating systems and moved into activities such as credit cards and ATM's. It had also put in place strategies to become a leading regional commercial bank for Central and Eastern Europe, springboarding off its high grade Hungarian corporate asset base and its historical position in foreign trade lending.

MKB participated in the loan consolidation program in 1992/3, and improved their balance sheet considerably. Even though MKB did have bad loans, and still has bad loans on its balance sheet, it is in a considerably better financial position than other banks in Hungary. MKB's client relations, its reputation and it's financial strength enabled MKB to 'cherry pick' the domestic corporate and private transaction with which it has become involved. This position has enabled MKB to maintain a strong balance sheet, and a minimum number of bad loans, despite the trouble of other banks.

Privatization of the banking sector has proceeded slowly. MKB was the first bank to undergo a privatization transaction. The initial transaction involved a purchase of a total of almost 42% of MKB by the EBRD and a German bank. Since the initial purchase, an additional 8.33% has been sold to another German bank, making MKB a majority-foreign owned bank, and over 50% private. The state retains a 25.04% interest. This privatization to strategic foreign investors is a pattern the government hopes to repeat. Since the MKB transaction, Budapest Bank sold a majority stake to GE Capital.

B. Organizational

MKB was run by a Board of Directors, whose membership included the CEO, government officials, academics and bank top managers. Members are elected by shareholders at an annual meeting for a term of five years. The Board of Directors is legally responsible for all of MKBs actions, and has an operational role in the bank. This role includes developing strategy, making strategic decisions and approving loans or investments over a certain level.

MKB also had a Supervisory Board that monitors the performance and functioning of the bank and represents the interests of the shareholders. Two-thirds of the members are elected by the shareholders, and 1/3 by the employees of MKB. Membership is for three years, and the Board numbers nine to 15. Members are drawn primarily from MKB, government, and academia. The Supervisory Board may call a shareholder's meeting or a meeting of the Board of Directors if it feels it is necessary, but may only make suggestions as to the agenda.

The CEO is appointed by the Board or Directors, who then appoints a Board of Management to help the CEO in running the bank. Membership generally consists of the heads of groups or departments within the bank (Financial and Operational, Capital Markets and Trade Transactions, Strategy and Consulting, Legal, Personnel, International Banking, Domestic Corporate, Capital Market and Investments, Treasurer: as of end of 1993). This Board is required to meet at least once a week. MKB recently has been perceived as having a strong top management.

C. Financial

MKB has always been in a fortunate position relative to most other Hungarian banks. As the foreign trade bank, MKB holds foreign currency accounts of firms engaged in foreign trade. This has enabled MKB to select those firms most financially stable with which to make commercial loans. This approach, while successful in helping MKB to avoid a significant bad loan problem, has restricted its growth.

1. MKB's Financial Health

MKB's assets have stayed fairly constant since 1992 at about US$2 billion. Most notably, liabilities to the national bank have declined, while deposits and reserves have increased. Net interest income has declined sharply due to narrowing spreads. Commissions and fees from MKB's services and trading branch and extraordinary income in 1993 and 1994 have helped to maintain MKB's profitability.

MKB's assets are primarily from the NBH. Over 1991-1994, MKB has approximately 45% of its assets from the NBH. Commercial assets were as high as 35%

in 1991 and have declined to 24% in 1994, possibly reflecting cleanup of the balance sheet.

MKB's profitability ratios have all been fairly flat from 1993-1994, and decreasing from 1992-1993. Interestingly, MKB's income from assorted state loans has remained at about 58% of total interest income, and private loans (including group companies) represents 42% over both years. On the other hand, the expense structure has dramatically changed from 1993 to 1994. In 1993, the expense relating to state deposits of total interest expense represented 35%, and private deposits 51%. In 1994, the former category was 48% and the latter, 30% (missing fraction is long-term borrowing).

MKB's income sources have remained constant from 1993 to 1994, with approximately 43% of total income coming from private sources, and 57% from state sources.

2. MKB's Provisioning and Provisioning Analysis

MKB has long had a policy of conservatism both in the loans it makes and in the amount set aside for loan loss provision. Table 1 shows the loan situation for the Hungarian Banking System, and Table 2 shows MKB's individual circumstances. MLB has clearly reduced the number of bad loans on its books. Provisions for loan losses follow BIS guidelines, and have recently been amended to allow bank management some flexibility in determining the total amount of provisioning required. The new ranges also follow BIS guidelines, and bracket the earlier absolute numbers. Table 3, columns one and two, show these percentages. Column three is a slightly more conservative loan provisioning scheme that falls within the current ranges. The different assumption is that Performing and Watch loans are not all (or will not all be) perfect loans. We feel that given the Hungarian economy and the still volatile inflation and exchange rates, and the still high interest rates, that this is a reasonable assumption. Column four adopts the approach that, given the ranges allowed, assume the worst. This will provide a worst-case benchmark for provisioning for the bank system.

Chart 1 shows the banking system loan provisions under the assumption in columns 1, 3 and 4. By 1994, the system as a whole was actually provisioned up to 52% of BIS standards, and 28% of our conservative estimates. Alternately, MKB was provisioned to 101% of BIS guidelines, and 56% of our conservative estimate. Chart 2 shows this graphically. It is apparently the case that while MKB has a more conservative approach to provisioning that the banking system as a whole, however, even MKB could afford to provision more.

3. MKB's Ownership

Prior to intent to privatize, and ownership by AV Rt, MKB had 6003 shares of HUF 1 million face value, held primarily by the Ministry of Finance, but also other

Hungarian financial institutions, insurance companies, manufacturing, food processing and foreign trade companies. (See Table 4)

III. The Privatization Transaction

MKB had been slated to be the first Hungarian bank privatized. AvRT had promised to privatize it by the end of 1993, but the state refused to permit the bank to disclose proprietary bank information (eg, client portfolio) because of bank confidentiality laws (WSJ, May 4, 1994).

MKB has had a strong international reputation compared to other Hungarian banks. In fact, in July 1993, MKB issued 100 million DM worth of bonds on the Euromarket, which subsequently performed better than the NBH's international bonds. This issue was led by the EBRD and the BLB. This issue was also the first by a Central or Eastern European bank without a sovereign guarantee.

The introduction of the EBRD and BLB to MKB over 1992 and 1993 prompted discussions concerning the participation of these two foreign entities in a potential privatization of MKB. The Hungarian government hired JP Morgan as a privatization advisor. From the start, BLB had been indicating they were not interested either in being a sole investor, or in purchasing enough shares to dilute the state's holdings to 25.01% (the highest level permitted by the state's new banking law). By the third quarter of 1993, due diligence reviews were under way, and MKB had hired McKinsey & Co to prepare a strategy paper for MKB. MKB's conservative loan policy and ability to 'cherry pick' domestic loans helped convince participants that the bank was well run, as the reviews of the bank's loan portfolio by these potential investors found little to no discrepancy between MKB's valuation of its loan portfolio and their own.

A. The Players and their Goals

The EBRD's goal is to foster the transition to a market economy in central and eastern Europe and the CIS. The EBRD furthers this mission by investing in projects or facilities that promote the development of the private sector. The potential benefits to the EBRD include meeting policy priorities for Hungary by contributing to the privatization and promotion of the private sector and restructuring, and assisting in the development of the financial sector. Further, the privatization of MKB will assist the development of a decentralized, market oriented financial system and represents the restructuring of a majority state owned bank, whose reform should make it more efficient and competitive. Since BLB would not accept sole commitment, the transaction would not be possible without the EBRD. With their large ownership stake, the EBRD can foster East-East trade financing and can reach and finance small and medium private sector enterprises.

Bayerische Landesbank has a AAA rating, and is the fourth largest credit institution in Germany in terms of individual accounts. It is owned 50% by the Free State of Bavaria, and 50% by the Bavarian Savings Bank. BLB provides a broad range of commercial and investment banking activities. It is the house bank for the state of Bavaria, and has a network of 2500 correspondent banks worldwide. The potential benefits to BLB as a result of this relationship include economic growth of the Hungarian

market, possible customer introductions between banks, joint participation in syndicated lending, and an opportunity to introduce Hungarian companies to the German capital market. As of June 1994, BLB was expected to be an active investor in MKB, including at least technical assistance and opportunities for cooperation in trade finance, corporate finance, capital markets and the development of payment systems, provision of credit lines, and dedication of staff to be part of MKB's top and middle management.

B. The Transaction

The transaction itself was a three step process, involving a share repurchase by MKB, a purchase of existing shares by the EBRD and BLB, and a new issue of shares by MKB directly to the EBRD and BLB.

Step One involved MKB's repurchase of their own shares, finally amounting to 12.77% of total shares outstanding of the bank.

Step Two took place on July 12, 1994, three days prior to a Shareholder's Meeting for MKB. At this step, BLB purchased 18,760 existing class A shares with a face value of 10,000 HUF from Treasury for 12,500HUF, a 25% premium. BLB also purchased 82,750 existing class A shares from the AVRt. EBRD purchased 67,670 existing class A shares with a face value of 10,000 HUF from Treasury for 12,500HUF, a 25% premium. The timing of this step allowed the EBRD and BLB to be registered shareholders in time for the shareholder's meeting. This was particularly important as certain amendments to the MKB's charter specifically requested by BLB and the EBRD would be coming up for a vote.

Step Three took place on July 15, immediately following the Shareholder's Meeting. MKB issued new shares approved by the state, and sold them directly to the EBRD and the BLB. The EBRD purchased 77,495 shares of class A, 10,000 HUF par value shares for 12,500HUF. The BLB purchased 116,240 shares of class A, 10,000HUF par value shares for 12,500HUF. The resulting ownership structure includes a 25.01% ownership by the AV Rt, 16.7% by the EBRD and 25% by the BLB.

C. The Purchase Price Adjustment

Additionally, based on MKB's short term performance, the EBRD and BLB guaranteed them a price adjustment as an incentive for good performance. This price adjustment would be payable to MKB by the EBRD and BLB based on pre-tax profits at the end of 1994 and after the first six months of 1995. If the MKB has a pre-tax profit of zero or less (according to IAS), MKB will realize no additional payment from the investors. If MKB has a pre tax profit of 2,300 million HUF or more, MKB shall receive 3,700HUF per EBRD and BLB subscription share. For MKB profit between zero and 2,300 million HUF, the payment shall be calculated on a straight line, pro rata basis. This first payment was made on June 1, 1995.

The second premium payment was to be made based on results for the first six months of 1995. The MKB was to receive no second payment if MKB's profits are zero, 2,915 HUF per subscription share if MKB's pre-tax profit is 1,000 million HUF or more, and for MKB profit between zero and 1,000 million HUF, EBRD's and BLB's payment shall be calculated on a straight line, pro rata basis. This second payment was made on September 29, 1995.

Additional contract terms include the representation of the EBRD on the Board of Directors, pre-emptive rights for BLB should the EBRD or AVRt decide to divest voting shares of MKB, listing of MKB on the Budapest Stock Exchange (or other stock exchange) when conditions are favorable, a commitment by the EBRD and BLB to not sell shares for four years without the approval of the AVRt, unless the Shareholder's agreement is terminated prior to that point, a termination of the Shareholder's Agreement when the bank is listed on a stock exchange, or when AVRt's shares are reduced below 25%, and the development of a management stock option incentive plan, based on international industry standards.

D. Implications of the Price Adjustment Clause

The price adjustment clause of the purchase has several effects. It is certainly an incentive contract for management of the bank to perform well. Additionally, since it is an equity-based adjustment, from the investors' point of view, the investor does not have to be as confident in the bank's balance sheet or due diligence. This has the effect of reducing the level of uncertainty in the bank and its operations that an investor may have.

However, the actual implementation of the price adjustment mechanism has some puzzling characteristics. First, such a performance-based price adjustment mechanism in principle creates an incentive for MKB to achieve good performance. However, the hurdles appear to be set rather low by historical standards, suggesting that the investors were more concerned with incenting MKB to avoid adverse outcomes than to induce excellent outcomes. For example, the first hurdle for the first part of the price premium to be received by MKB (a 30% price premium) is if earnings in 1994 were more than approximately two-third (2/3) of the 1993 earnings. For the first half of 1995, the (annualized) hurdle was closer to one-half of 1993 earnings and the corresponding premium was also somewhat lower, at close to 25%.

Second, the one year performance term stresses short-term results over long-term results. In particular, such a short term provides an incentive for the bank to engage in opportunistic earnings shifting available under standard accounting systems. Deferring recognition of losses and accelerating recognition of income can increase accounting earnings in one period at the expense of those in later periods. It is too early to tell whether this happened but the relatively low hurdles were passed quite handily, suggesting that no such shifting would have been required. Should a manager opportunistically alter the result of the company, and succeed in perpetrating that fraud, that would have a negative effect over time on the value of the firm. Investors will not be eager to invest in a

firm if they get the sense that a manager is that opportunistic. Additionally, investors can write provisions in a contract enabling them to break the contract in some fashion provided proof of opportunistic managers.

Valuation of state owned companies in transitional economies is an extremely difficult prospect. It is easily possible to over or under value a firm. If the management of a firm believes the firm is worth more than a foreign investor does, a transaction may never come to pass. The performance based premium has the effect of addressing these concerns as well. If the management proves the firm is worth more than the investors originally thought, the managers receive more money for the firm, while the investors receive more value from the transaction than they expected.

The performance-based premium is a useful tool for the purchasers in reducing some of the uncertainty involved with the transaction, but it is also a useful tool for the bank, in that based on good performance, the purchase price increases. The price premium approach reduces the problem of undervaluing a bank from the bank point of view and is an innovative solution for information asymmetry problems, especially in transitional economies.

IV. MKB Post-Transaction

MKB was purchased only a year ago, and already had many of the current systems and policies in place. This section will highlight several changes due to the privatization transaction, and discuss other actions and strategies taken by the MKB.

A. Role of the Owners and Organizational Changes

While MKB is now a majority-foreign-owned bank, with the head of the BLB as the Chair of the Supervisory Board, the state still owns just over 25% and maintains two seats on the Supervisory Board. None of the foreign investors have become actively involved in the bank, so there is some question as to what event, if anything, will move them to become actively involved.

The Board of Directors is currently composed of seven people, of which the AVRt and the BLB have the right to nominate two members each, and the EBRD has the right to nominate one, and the AVRt, the BLB and the EBRD collectively have the right to nominate one member, and the other shareholders have the right to nominate one member. The Board of Directors now decides on all internal limits.

The Supervisory Board is currently composed of nine members, of which the AVRt and the BLB have the right to nominate two members each, the EBRD has the right to nominate one member, and other shareholders have the right to nominate one member. The employees have the right to nominate three members, in accordance with the provisions of the Company Act. The Chair of the Supervisory Committee represents BLB.

The state can choose to involve itself in the bank in several ways. The government can exercise traditional ownership rights through traditional governance mechanisms or they can opt to attempt to become involved in the ongoing activities of the bank. The government can interfere through the auspices of the SBS (banking supervisory branch) as well. The Ministry of Finance holds the state's shares of state-owned banks, and is the direct supervisor of the SBS. The conflict of interest inherent in the owner being the supervisor of the system has not been addressed or resolved.

To date, the government has not meddled in day to day activities of MKB, and to the extent that the government wants more banks privatized, its energies are better spent elsewhere in the banking system. That being said, if MKB makes a decision contrary to the government interest, or if MKB's performance suffers significantly despite the assistance of the strategic foreign investors, the state may indeed step in.

B. Financial

In April 1995, Deutsche Investitions und Entwicklungsgesellschaft (DEG) bought 8.8% of MKB, increasing the number and ownership of foreign investors. This new foreign owner brings MKB's foreign ownership to just over 50%, making MKB a majority-foreign owned bank.

MKB has several new methods to resolve a troubled asset problem. In 1991 the most frequently used methods were collateralization and company workout, while occasionally restructuring a loan. In 1995, they still collateralize, they use workouts more often, and foreclose. Additionally, MKB has adopted the practice of forcing an asset sell-off on the part of a borrower.

MKB has concentrated its loan portfolio since 1992. In 1992, MKB's largest loan was HUF2.5 billion. As of September 1995, it was HUF10.4 billion. MKB stays well below the large borrower regulation of less than 15% to one customer. Overall, however, MKB's top ten loans are getting better as well as larger.

MKB has focused on decreasing percent of loan value in trade, manufacturing and food processing industries, instead growing individual and SME loans, usually for high net worth individuals, the public sector, infrastructure and energy (Table 4).

C. MKB's Strategy and Future Business

MKB is currently involved in negotiations for a US$50 million risk sharing agreement with the EBRD that will facilitate MKB's making secured loans to former Comecon countries and will encourage trade between Hungary and central and eastern European countries and the CIS. MKB will operate this agreement. This agreement will further enhance MKB's strong positions as a bank in a strong and central position to facilitate activities in Central and Eastern Europe.

MKB's strong solvency and admirable international reputation, strong top management, improved middle management and computer system place MKB near the top of banks in the region, and prepare it for international competition.

MKB's shareholders channel business of their own headed to the region to MKB.

MKB is refocusing in corporate banking. They are selecting industries to target: energy, telecom, pharmaceuticals sector. New business has been in project finance: lending to utilities, telecom, government guaranteed projects, green field investments.

Decreased reliance on expensive borrowing from the central bank and domestic interbank market have the potential to hurt MKB in the long run. Hopefully, increased business to high net worth individuals and foreign business from shareholders will offset

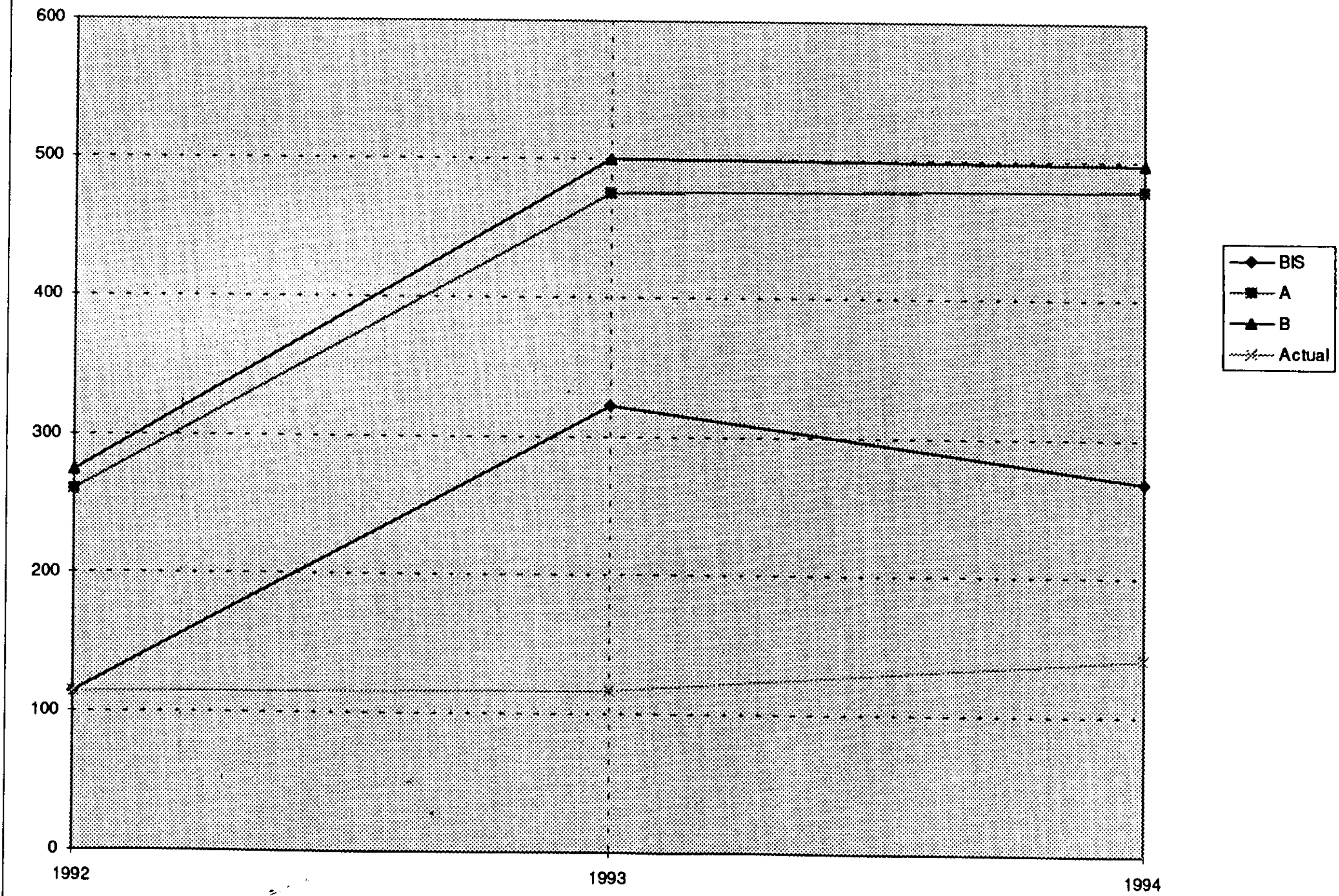
this. MKB offers a wide range of services to these individuals, including forint current accounts, overdraft and lombard credit, telebanking, ATM cards, VISA cards, securities custody, and capital accounts.

Table 1: Loan Ratings and Holdings of Banking System in 1994 HUF

Rating	December 1993		December 1994		Index, %
	in billions of forints	percentage share	in billions of forints	percentage share	Dec 1994/ Dec 1993
problem-free	1665.93	71.5	1776.0	72.8	106.607
needing special attention	152.34	6.6	320.3	13.1	210.253
sub-standard	65.58	2.8	46.2	1.9	70.448
doubtful	138.42	5.9	79.3	3.3	57.289
bad	307.46	13.2	218.5	8.9	71.066
Total	2329.73	100	2440.3	100	104.746

Table 2: MKB's Loan Portfolio

Loan Classification	*1991 HUF billion*	*1991 percent*	*1992 HUF billion*	*1992 percent*	*1993 HUF billion*	*1993 percent*	*1994 HUF billion*	*1994 percent*
Perfrm. and Watch	46.79	65.92%	28.32	55.97%	33.83	73.1%	50.7	85.9%
Sub-standard	0.8	1.13%	0.68	1.34%	1.74	3.8%	1.38	1.9%
Doubtful	18.90	26.63%	16.9	33.40%	1.97	4.3%	1.85	3.3%
Bad	4.49	6.33%	4.70	9.29%	8.71	18.8%	5.68	8.9%
Total	70.98	100%	50.6	100%	46.25	100%	59.61	100%



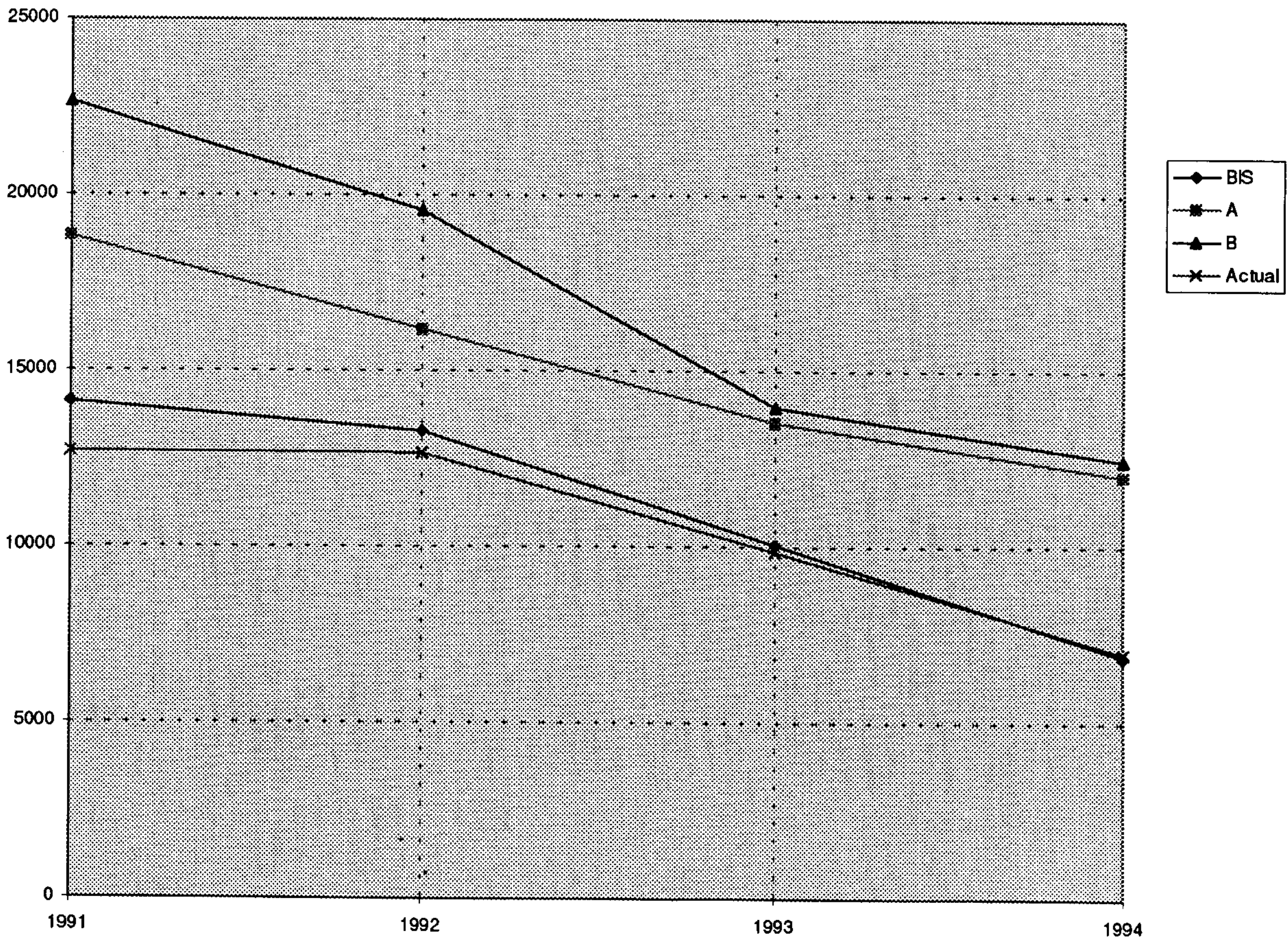
System Loan Provisions
600
500
400
300
200
100
0
1992
1993
1994
BIS
A
B
Actual

Table 3: Loan Provision Estimates

Loan Provision Percentages	*Used by MKB*	*Legal Ranges*	*Alternate #1*	*Alternate #2 (conservative)*
Performing and Watch	0	0	10%	10%
Substandard	20%	11-30%	25%	30%
Doubtful	50%	31-70%	50%	70%
Bad	100%	71-100%	100%	100%

Table 4: Changing Sectoral Nature of MKB's Loans (in %)

Loans by Sector	*1992*	*1993*	*1994*
Trade	43%	30.2%	19.9%
Manufacturing	24.4%	23.5%	16.9%
Indivs/SMEs	2.3%	5.3%	11.2%
Public Sector	0.7%	0.5%	10.0%
Real Est/Infrastruct.	3.2%	3.3%	9.8%
Energy	0%	9.1%	9.6%
Transport/Telecom	2.4%	1.4%	6.8%
Food Processing	15.5%	11.2%	6.3%
Construction	3.9%	4.8%	3.8%
Agriculture	4.4%	4.3%	2.0%
Finance	0%	1.2%	0.7%
Catering	0.1%	1.0%	1.1%
Pharmaceuticals	1.4%	3.4%	na
Other	0.3%	0.2%	1.3%
Total	100%	100%	100%
Actual HUF billion	39.8	37.1	53.8


MKB Loan Provisions
25000
20000
15000
10000
5000
0
1991
1992
1993
1994
BIS
A
B
Actual

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EBRD

OECD