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Privileged Interfirm/Bank Relationships in Central Europe: Trigger or Trap for Corporate Governance?

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Abstract

The paper focuses on the question whether banks and capital markets in Central Europe are capable of exerting a positive influence on enterprise performance at the present stage of the economic transformation. These markets are characterised by privileged, collaborative interfirm/interbank relationships demonstrated through various channels. Among them is the competition for private deposits between commercial and national banks that are simultaneously supervisors of commercial banks, as is the case in Poland. Other channels include: heavily indebted large banks that are owners of industrial companies (as is the case in Slovakia with the steel mill VSZ owning the third largest bank IRB), investment funds that are facilitating industrial restructuring, and foreign banks holding only minority stakes in large domestic financial institutions.

1. Introduction

In a market economy, the financial sector is one of the key channels for economic performance. It is as a vehicle for mobilising private savings and allocating them to investment [Corbett, 1990; Porter 1992]. Therefore, one of the cornerstones in a successful transformation from a centrally planned to a market economy is the development of financial institutions with effective corporate governance [Commission, 1997].

The organisational setting and capacity of financial institutions before the collapse of communism was considerably different from market economies [Zwass, 1979]. Bank services to and households were essentially limited to taking deposits. Transactions of private individuals, namely wages and purchases of consumer goods, were settled predominantly in cash. Commercial banking transactions were essentially facilitated by a monobank or by a few state-owned banks, and money served only the functions of a medium of exchange and a unit of account, not a store of value. Government-dependent national banks controlled all banking activities. Most of the countries had a specialized foreign trade bank established to handle foreign currency transactions and foreign credits. Public savings banks and savings associations did exist, but had limited product range. Stock exchanges were certainly not established. The socialist banks could neither turn away their clients nor declare them bankrupt. Banks served as a venue of "planning control" and "management control" [Zwass, 1979]. In general terms, their functions very distinctively different from those performed by banks in a corporate governance framework.

In the early stage of the economic transformation, commercial banks emerged primarily as spin-offs from the national banks. They have gradually become independent of government influences. The reforming authorities allowed entry of private and foreign banks, and they established formal stock exchanges. While the institutional setting of the financial sector was changed rather quickly, the necessary legal framework lagged behind. Specifically, a system of effective bank monitoring and supervision along with deposit insurance were set up at a slower pace. Privatisation of large state owned banks was hampered by political bickering. It has not been fully implemented in the first decade after the collapse of communism. During those ten years, the financial sector development has been plagued by bankruptcies and obstructed by financial crises. Fraud and imprudent banking have been widespread in the ten Central and Eastern European Countries (CEEC-10) [1] and peculiar bank/interfirm relationships have emerged [2]. This paper examines the extent to which banks and capital markets in Central Europe are capable of exerting a positive influence on enterprise performance.

[1] CEEC-10: Bulgaria, Czech Republik, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia, i.e. the ten EU-associated Central and East European Countries which eventually will become members of the European Union.

[2] For the history of post communist banking 1988–1995, see Fink/Haiss [1997a and b].

2. Corporate Governance

The role of corporate governance is to ensure that market signals and other relevant information are translated into investment decisions [Berglöf, 1997]. Corporate governance deals with imperfect information and different mechanisms that reduce or eliminate moral hazard in the relation between firms and financiers [Hellwig, 1991]. It implies that groups of owners and other stakeholders have mutual, interconnected and hierarchical, but not necessarily uni-directional relationships of influence, ruling, and leading.

Balling (1998) developed a "matrix of governance by sector" as a way of depicting directions of influence capacity, i.e. the power as the ability to get things done the way the respective individuals, organisations or institutions want them to be done [Gibson, Ivancevich and Donnelly, 1985]. Within that two-dimensional framework, it is possible to discuss directions, levels, causes and consequences of various stakeholders positions and their influence in the corporate governance process. The same groups of stakeholders are presented at the top of columns and at the left corner of rows, implying that the stakeholders are able to exercise governance on others at various degrees, while being under the influence of the market participants in other respects. The use of corporate governance instruments by banks depends on the prevailing system of governance and supervision. "If we move into the Matrix from the top and follow a column, we look at the business world from the point of people and institutions who ... have influence... If we go into the Matrix of Governance from the left and follow a row, we look at the world from the point of view of market participants that are under influence of market participants in other respects" [Balling, 1998] (see Table 1).

Balling (1998) assumes that the setting for corporate governance in Central Europe mirrors the situation in market economies and that "if the corporate clients are in financial difficulties, the officials of the bank will normally be in a much better position to evaluate the prospects for recovery than other market participants are" [Balling, 1998] .... and will act accordingly. Therefore, certain cells are treated as "not relevant". They are shown by gray shaded areas indicating no influence of stakeholders on three groups: on "government", "central bank and supervisory authority" and on "personal investors, household and others". Further extensions to this model emphasize changes required for an appropriate theory of corporate governance in transition economies.

The political economy approach applied in this paper assumes that individuals (bankers, depositors, investors, politicians, company managers), organisations

(banks, other financial institutions, non-financial companies) and institutions (governments and their supervisory or privatisation agencies etc.) work, save and consume in order to maximise their own utility [Baldwin, Francois and Portes, 1997]. Stakeholders wish to influence corporate decision-making in accordance with their own interests, particularly when there is a transfer of control. Such transfer takes place through privatisation, takeovers, mergers, restructuring, financial distress or full bankruptcy [Balling, 1998]. It may be also facilitated through layoffs and dismissals of managers or staff members. In essence, corporate governance is driven by the objectives and by the power of stakeholders.

Our analysis takes into consideration possible gains of stakeholders from prudent and non-prudent banking. It further differentiates between the "government" as the principal owner of corporations and banks, the privatisation agency which controls part of state property, and the political parties and lobby groups close to political circles.

The analysis begins from a differentiation between sound and weak investors within the general category of "investors". It does not initially introduce a distinction between institutional investors, non-financial companies and foreign companies.

2.1. Privileged Bank/Interfirm Relationships as a Trigger?

A new set of privileged interfirm/bank relationships has developed in the CEECs since the fall of the iron curtain. These relationships are significantly different from those under the communist heritage, but they are also very different from those prevailing in developed market economies. Forms of ownership and stakeholder influences vary considerably from country to country. There are diversified cases of companies owned or run by governmental entities, by banks and related financial institutions, by institutional investors or their surrogates, by non-financial companies, and by foreign investors in all examined transition economies [Balling, 1998]. By contrast, privileged bank/interfirm relationships are rare in the United States and the United Kingdom. In these highly developed industrial economies and financial markets banks are discouraged from the ownership of non-financial businesses. They can influence companies only in their capacity as lenders. Non-bank institutional investors, mainly pension funds, insurance companies, are all active players in stock markets. For example, pension funds control more than 40 percent of the United States' large and midsize businesses, and they hold about 40% of the medium-term and long-term debt of larger US based companies [Drucker, 1991]. In their dual- role

as large lenders and owners, American pension funds have limited commercial ties with the companies in which they invest or lend. They act essentially as pure asset managers.

The continental Europe is dominated by the universal banking system that is distinctively different from the British and American model. In the European system, banks are permitted to have a wide range of activities within the financial services industry, for instance branching into securities and insurance. They are also allowed to hold majority stakes in businesses linked to banking, including real estate, and in businesses unrelated to banking, such as industrial and trade companies. Banks that are owned or strongly supported by the state or large municipalities have also traditionally played a significant role in these countries. The boards of directors of these banks often represent more diverse groups of stakeholders or constituents than shareholders. In the continental European system of "dedicated" capital [Porter, 1992], the dominant owners are principals rather than agents; they hold sizeable stakes, thereby providing stability. These owners are typically permanent and they seek long-term appreciation of their shares, thus having both the incentives and the ability to engage in extensive and ongoing information gathering about their companies. Unlike the "liquid" capital system, in which the goals are driven solely by the financial transaction, the goals in the "dedicated" system are driven by relationships in order to maximise the wealth-producing capacity of the enterprise [Drucker, 1991]. Suppliers and clients own stakes in each other companies. They do not necessarily seek short-term capital gains from the share ownership. They are more interested in a long-lasting business relationship. Bank ownership helps firms to formulate corporate strategies and it assists them with raising funds to carry out these strategies [Thurow, 1992].

In such privileged interfirm/bank relationship systems, banks often dominate the corporate boards for two reasons: They are either principal holders of equity stakes or they are granted voting rights by the shareholders of these companies when they purchase the shares from the bank (that is, proxy rights). Such practice provides banks with both non-public information and with a considerable influence over management decisions involving corporate restructuring activities. The close co-operation between banks and firms lowers the cost of credit due to lower transaction and information costs by increasing the lender’s stake in keeping the company afloat [OECD, 1995]. Firms that do not meet their banks’ performance benchmarks find themselves under pressure to restructure [Walter, 1994].

The positive continental European experience with the privileged interfirm/bank relationship system suggests that such arrangement can encourage continued and aggressive investment aimed at upgrading capabilities and at increasing productivity

in existing businesses. Such a system has the ability to align interests among stakeholders and to allocate capital efficiently within the economy, particularly in those intangible assets and capabilities required for competitiveness – research and development, employee training and skills development, information systems, organisational development and supplier relations [Porter, 1992]. Stable relationships between shareholders, bankers and firms allow managers and owners to make valuable long-term commitments to each other. In essence, privileged firm/bank relationships by improving corporate governance relations can serve as a trigger of profitability and economic growth, however, only if banks and other stakeholders behave prudently. These advantages seem to outweigh possible weaknesses of privileged firm/bank relationships that may include: slow funding of emerging industries, a high-risk of start-up companies, slow redeployment of capital, and possible conflict of interest. As long as there is enough competition and growth in the market place, market discipline is a powerful instrument for providing incentives for the financial institutions themselves to act prudently [Allen, 1993; Koguchi, 1993].

2.2. Gains from Non-Prudent Banking

The state as an owner is rather weak in pressing companies to be profitable [Fink and Schediwy, 1992] since other interest, e.g. "protecting work places" and avoiding political trouble, override the interest in reasonable profits of banks and state owned companies. Selected features of non-prudence may even be welcome to political rulers since non-prudence gives leeway in exercising power. It helps to get access to capital for political purposes and to serve the politicians' cronies. There may be also a lack of political will to exercise strong bank supervision [Baer and Gray, 1996, 78] because political parties and their allies may gain from non-prudent banking.

In every financial system banks have to be geared towards prudent banking. Positive effects of prudent banking are a public good and they accrue to the general public. Most importantly, the economic stability generated by prudent banking leads to an increasing propensity to save. The accelerated saving is normally channeled by banks into efficient investment, thus it ultimately contributes to growth and to prosperity of nations. The production of public goods justifies public (i.e. governmental) action.

In transition economies most of short-term gains from *prudent banking* are accrued by politically weak stakeholder groups (depositors) or by insider groups.

Individual insiders (managers, employees, individual shareholders of banks) are capable of generating significantly larger direct gains from *non-prudent banking*. In this stakeholder framework, short-term gains from non-prudent banking are primarily accrued by insiders (dominant owners, managers, high rank employees). If bank supervision is inefficient, there is a strong tendency that insiders shift to *non-prudent banking* to internalise quick and large gains from high-risk opportunities, whereas losses from these undertakings are borne by outsiders. In the absence of efficient bank supervision, "new banking licences may initially be nothing more than a licence to steal" [Akerloff and Romer, 1994, quoted by Baer and Gray, 1996].

2.3. Interest and Power

There is a mutual influence among stakeholders in transition economies. This occurs primarily among those in the "shaded" cells referred to as "not relevant" according to Balling (1998). The unwillingness of banks and their Investment Privatisation Funds (IPFs) or self-reliant National Investment Funds (NIFs) can, for example, heavily influence further privatisations via divestments, twilight reporting etc. There is, however a difference in the magnitude and phasing for depositors and the general publics' influence in this scenario compared to the stakeholders framework. In this case, there is an apparent transmission of savings out of vouchers and IPFs and voting in federal elections clearly function with a time lag.

Individual bankers in CEEC-10 take into consideration the interests of major stakeholders to a higher degree than in the majority of financial systems in industrial economies. These major stakeholders include a minister of finance, the national bank, privatisation agencies, own bank staff, depositors, large state-owned corporations, sometimes also shareholders and new private investors. The timing and intensity of bank reforms are determined by the vested interests of the following parties:

– The ministry of finance, often a major debtor representing the state as the owner of large banks.

– Privatisation agencies that influence the timing and select the buyers of privatised banks and their major corporate clients. They ultimately determine the links between the banks and the corporations, as well as the potential level of corporate debt.

– The national bank, often serving as the major supplier of funds. The ministry of finance and the national bank that are responsible for banking supervision, nomination of bank managers, and decisions on bank recapitalisation.

– Bank employees that are interested in keeping their positions and in delaying efforts

toward institutional advancement. They tend to avoid decision making, leaving them for their superiors for the purpose of risk aversion.

– Large state-owned enterprises (SOEs) that are primary corporate debtors and that often exercise influence on bank managers. Their pressures distort effective credit allocation.

– Depositors who serve as providers of retail refinance and who have little influence over bank management. They can exert influence only indirectly as voters in parliamentary elections.

– New private investors having initially a limited influence, but willing to gain access to bank credit. They seek to gain influence on the bankers' decision making. They are often crowded out the debt market by the state and by large (still or formerly state-owned) enterprises.

Bank management flexibility and the presumed strength of relevant stakeholders also show up in various positions of the balance sheet. This analysis reveals the dilemma in bank politics. As long as banks are state owned and repeatedly capitalised or refinanced by the Central Bank, the interest of the ministry of finance and the Central Bank in "as little trouble as possible" prevails. Corporate governance by banks can only assume a modest withdrawal from major debtors. Otherwise, the bank may cease to exist and unemployment may soar as a result of the collapse of large corporations.

Power among corporate governance actors can be derived from a variety of sources: the stakeholders ability to influence because of position (legitimate power) or special expertise (expert power) and the ability to reward followers for compliance (reward power). This is confronted by the power to punish for non-compliance (coercive power) [Gibson, Ivancevich and Donnelly, 1985]. An access to resources (money, information, jobs...) is not the only factor playing a role in exercising power. Stakeholders can further enhance their position through the strength of their involvement in the capital budgeting process – they may have an impact on the scope and the timing of investment decisions, as well as on considerations of decision alternatives and opportunity costs stemming from alternative decisions.

Governmental actors and political circles may rely on a variety of power sources aimed at influencing other stakeholders. For example, federal and municipal governments can influence each other's positions by providing guarantees to the banks that are close to them. Moreover, governmental actors can also influence the central bank and supervisory authorities by changing laws on banks' own funds and on recapitalization. They may further engage in "budget games", i.e. restrictions with regard to staff, information technology etc.

Companies and banks that have been nationalised or that depend on transactions with the government are particularly susceptible to political influences in post-

communist countries. Companies seek the public sector support by engaging in government procurement and banks by holding public accounts. The timing and procedures of privatization and social security reform provide ample opportunities to influence companies that hold portfolios of other companies, e.g. National Investment Funds and insurance companies desperately searching for reasonable investments.

The above-discussed problems also pertain to the enterprises that are still state-owned. Some of their deficiencies in the area of corporate governance are addressed by the expertise on connections and decision-making of banks, Investment Privatization Funds, and political circles. For instance, concerns about debt relief are shared by owner-managers who have acquired considerable stakes through privatization and by workers councils. Depositors and the general public can be influenced, for example, via inflationary threats. In order to control the influence of foreign multinational investors and companies, the government has two choices. It can either restrict their share to a level below 25% or exert pressures on suppliers and bankers to tighten its certain grip – which opens ways towards collaborative actions.

The managers of banks have more room to maneuver when the role of the state in the banking system becomes more limited. However, powerful asset side stakeholders gain a dominant position over banks by increasing their stake in the bank. Since private depositors have little impact on bank management, the pressure to exercise corporate governance on major debtors remains weak if these debtors become owners of a bank. To cushion these influences, managers may form coalitions with preferred borrowers. These coalitions have opened the opportunity of asset stripping in case of financial distress in the CEECs.

Privatization Investment Funds (PIFs) have grown mainly out of the voucher privatization. They have been viewed as a venue of diversification of mutual fund providers varied by their managerial expertise [Balling, 1998; Boeri and Perasso, 1998]. However, since the largest IPFs are controlled by banks, they essentially serve as subordinates of banks. In the United States and the United Kingdom, shareholdings of institutional investors comprise in particular ownership of listed companies, mainly because of legal requirements concerning their portfolio structure [Balling, 1998]. In the near absence of true, independent institutional investors in the CEEC-10, however, we need to refer to typical "National Property Funds" (NPFs) as in Czech Republic or to "National Investment Funds" (NIFs) of the Polish kind.

In Czech Republic, state shareholdings in "privatized" enterprises are practically vested in the National Property Fund (NPF), while in Poland, shares of firms included in the privatization programs are allocated to the National Investment Funds [NIFs; Boeri and Perasso, 1998]. Together with (mostly still state-owned) insurance companies, these

funds hold portfolios of various assets, some with little and some with high value. They also share some functions normally attributed to institutional investors in market-driven economies. Consolidated banks that were handed over the worst of the bad loan portfolios in most CE-countries and that are frequently referred to as "bad loan banks" also share some of these features. They are usually a part of the formal government and directly government-dependent and, to various degrees, locked in the respective national bank for refinance.

Stakeholders in transition economies can hardly be separated from one another in contrast to highly developed market economies. They are more interdependent and evolving. They are bound by renegotiated incomplete contracts between stakeholders since "... ownership and state boundaries remain poorly defined, the state became an active partner with banks and distinct groups of producers to forge new institutions for negotiated solutions" [Hayri and McDermott, 1998; 153]. They share certain aspects of "virtual" organisations, which can be illustrated by the following case studies.

2.4. Case Studies on Privileged Firm-Bank Relationships

Czech Republic: The Ceská Pojistóvna Network

In former Czechoslovakia, two insurance companies existed side by side, but their markets were clearly separated by geography. By the end of 1996, there were 35 insurance institutions registered in Czech Republic, out of which 14 were joint stock companies with exclusively Czech capital, eight had foreign capital, and six had mixed capital participation [Cejková, 1998]. However, Ceská Pojistóvna, the top player in the insurance market with a share of roughly 60 percent of the Czech insurance market and was not nationalized until recently.

Ceská Pojistóvna lost about $9 million through its fraud-ridden Pragobanka/Kreditni banka subsidiary in 1996, resulting in a loss of roughly $7 million in 1996 despite its near-monopoly stake on the domestic insurance market [Harris, 1998]. Ceská Pojistóvna injected 2.5 billion crowns to Pragobanka in 1996 when it was under forced administration to halt its bankruptcy. In 1997, Pragobanka posted a loss of roughly 900 million crowns in 1997, primarily due to the fact that it is constantly having to create reserves.

In early 1998 PPF, an investment fund owning 21 percent of Ceská Pojistóvna took management control by teaming up with at the time state-owned banks – Investicní a Postovní Banka (IPB owns 12%), Ceskoslovenska Obchodni Banka (CSOB, 14%) and

Komercní Banka (10%). The State directly holds 32.2 percent, PPF held options for buying the shares held by IPB and CSOB and exercised the option to buy the 14 percent CSOB-stake together with IPB, thus also gained formal majority. In 1997, IPB took control of Ceska' Pojistóvna´s investment activities, including a 10 percent stake of the state savings bank, Ceská Sporitelná. To combat the outcome of such vested interests (e.g. violations of shareholder rights and allegations of illegal or unethical activity), the Czech National Bank, the Securities Commission and the Finance Ministry signed an agreement on tighter cooperation in banking, capital markets, insurance and pension supervision only in summer 1998.

Czech Republic/Slovakia: The Reappearance of the Tercier Group

At the beginning of 1997, the Tercier financial group disappeared and with it several billion crowns from small depositors. More or less the same former Tercier management forged a new coup in the insurance industry, involving Pojistovna Moravna (PM). The liquidation of that insurance company, which held a market share of about 0.7 percent was the first grave problem in the Czech insurance sector [CTK, 1998a].

In October 1997, the finance ministry imposed forced administration on Bankovni Penzijni Fond (PBF) pension fund, whereby some of PM's assets came under state control since PM is the majority owner of PBF. PM is held by Zdravi Plus, minority shareholders are Banka Hana and the Slovak insurer Slovenska Poistovna. While PM's collapse was officially referred to 1996 flood damage claims, it was mainly caused by dumping prices through which PM wanted to gain market share, general mismanagement and poor know-how taken over from Slovenska postoivna [CTK, 1998b]. On May 6 1998, the Czech finance ministry revoked Pojistovna Morava´s operating license, because its loss in 1997 exceeded its share capital. On May 15 the insurer Pojistovna Universal (formerly Poijstovna Tercier) concluded a contract with PM, under which it took over all PM clients and all rights and duties arising from signed contracts. The contract was concluded without the consent of the Association of Pojistovna Morava Clients (SKPM). The Czech finance ministry considers the contract "legally vague", since it was not the company, but the contracts that were taken over. At the request of Moravas Clients (SKPM), the finance ministry carried out an audit into Pojistovna Universal to check its financial position. The audit resulted in forced administration imposed on Universal. Pojistovna Universal was set up in 1993 by, among others, the Tercier financial group, which thus reappeared in the market. The Krusnohorsky ivesticni fond investment fund holds 20 percent of Pojistovna Universal, another 14 percent are held by the Fond Pro prosperitu pruyslu investment fund

which are – in terms of capital and personnel – interlinked with people close the former Tercier [CTK, 1998b].

In reaction to the failure of Pojistovna Morava, a recent Czech report on economic strategy for entering the European Union noted that "state supervision has no teeth ... and is based on legislation which was drawn up as a quick reaction to the need to create a competitive environment in this sector. In its current form, the legal arrangement is general and incomplete. It does not provide adequate support for practical state intervention even in the case of an insolvent insurance company, which increases the risk of the necessity of a state bailout" [CTK, 1998c]. The report also took notice of the weak growth of life insurance, which is apparently the result of insufficiencies in the capital market and a very limited offer of quality domestic and other stocks.

Miscellaneous Information on Peculiar Networking

Latvia experienced a major banking crisis during 1994–95. After independence in 1991 the number of banks grew quickly to 63 in 1993. Many of these banks had large Russian shareholders and were committed to a large single borrower [FT, 06/06/1995]. In May 1995, four large banks were closed down, among them the largest bank of Latvia, Banka Balttija [NZZ, 05/23/1995]. At first the government indicated a willingness to rescue the bank where one-third of the population held their accounts. The Prime Minister at the time was able to withdraw his personal account before the bank was closed. As a result of delayed action, the government failed to prevent asset stripping by the top management of Banka Baltija [NZZ, 08/03/1995]. In 1998, the overall Russian exposure of the Latvian banking sector was estimated at 8% of total banking assets, with 3.5% of assets held in GKO´s. The 1998 Russian crisis led to difficulties in some Latvian banks, with a small bank closing and one large bank facing a run on deposits.

Latvian privatization suffers from shortcomings similar to Czech Republic. According to the Commission [1998], there has been some reluctance to use privatization methods, which would ensure the establishment of competition in the sector concerned. Substantial stakes of the enterprises already considered to be privatized were allocated for privatization by voucher. Moreover, there are many minority stakes that remain to be privatized. So far, the uptake of shares in enterprises by voucher holders has been limited. Even with a higher rate of uptake of shares by voucher holders, voucher privatization still carries the risk that enterprises will have a diffused and passive share ownership structure, which could mean that enterprise restructuring progresses slowly. Secondary markets enabling the trade of share holdings and allowing a concentration of ownership are important for mitigating any negative impact of voucher privatization.

Estonia has experienced a specific twist of politics and banking. At Hoiupank, a big savings bank, eight of its senior managers took out a $15 million foreign loan, using the banks equity as collateral, in order to buy for themselves part to the bank's new equity offering. The scheme was derailed by the collapse in the stockmarket, which until that incident had been soaring due to a boom in bank shares. According to the Commission (1998), the rapid decline in the Tallin stock market in the second half of 1997 and in the first half of 1998 revealed corporate malpractice, speculative operations on the stock market, and faulty control mechanisms in a number of financial enterprises. Excessive optimism, easy access to funds and sharp competition for market share in the financial sector, in a context of rapidly expanding economy, were among the key factors that led to the emergence of these problems. The Russian crisis exacerbated problems already existing.

The central bank of Estonia has failed to catch on fully to the Hoiupank transaction. Hoiupank´s former chairman, one of the eight managers involved in the scandal, was appointed interior minister in January 1998. The current leader of the main free-market party, who formerly used to be the head of the central bank, has lost his parliamentary immunity over a missing $10 million loan from the central bank in June 1998.

In **Lithuania**, advances in bank restructuring and strategic privatization have often been driven by ad hoc decisions. At the beginning of 1998, foreign investors owned one third of the share capital of Lithuanian banks and had controlling stakes in the two largest private institutions. A law enacted in April 1997 granted a one-year exemption from prudential requirements for the two state-owned banks for privatization. A year later, the authorities decided to liquidate the State Commercial Bank, after repeatedly failing to find a buyer. In September 1998, the privatization tender for the other, Agricultural Bank, failed; a new tender is now pending. Dietuvos Draudimas, the largest Lithuanian insurance company with a market share of 55% and the state-owned Savings Bank still need to be privatized. At the end of August 1998, public-owned banks still accounted for some 40% of all outstanding loans from functioning commercial banks. However, this share has been falling sharply and direct funding of the agricultural sector by public banks has stopped. A fairly active leasing market has facilitated a measure of agricultural restructuring. The persistent lack of interest from investors for some enterprises could change when corporate governance is strengthened and the bankruptcy law is applied more aggressively. Part of the proceeds of future privatization is being channeled to a savings institution restitution fund that will be used to compensate households for the financial losses incurred at the beginning of the reforms.

In the **Czech Republic**, it became known in August 1994 that the fifth largest Czech bank, Agrobanka (founded in 1992) showed negative capital in its 1993 balance sheet. Foreign banks that were major lenders to Agrobanka claimed that the banking

supervision authority had known well before that time about the financial problems of Agrobanka and had failed to warn lenders to Agrobanka. Banking supervision first reacted with a licensing suspension for new banks, which affected a few prominent foreign banks. The Czech National Bank hoped to induce foreign banks to buy already established small but undercapitalized private banks. Since this policy showed little success, the bank license suspension was temporarily lifted in 1995/1996. Agrobanka later was recapitalized by the state bank [HB, 10/19/1994] and needed to be rescued again in 1996. In 1994, the three largest banks were quasi-privatized, with the state holding an important share directly (about 26% in 1994) and indirectly by the National Privatization Fund (NPF, 33–47%). However, managers of some of the former state banks tried to gain control of their banks by increasing the holdings of own shares and setting up a network of weak shareholders consisting of major debtors to the banks [HB 05/31/1996]. Jointly with the top management, major debtors are gaining influence on the business strategies of banks. It is worth mentioning in that context that one of the largest state-owned banks, Investicní a Postovní Banka (IPB) reportedly granted a credit to Mr. Klaus to finance his election campaign in 1992 [WSJ 27/12/1996]. While the Czech National Bank´s supervisory department was reorganized in 1997, the scope of the banks supervisory activities still needs to be strengthened to cover all aspects of the EUs body of law, the acquis communautaire [Commission, 1998]. Similarly, the Securities Commissions independence and regulatory authority and the Insurance and Pension Scheme Department of the Ministry of Finance need to be strengthened.

In **Hungary**, two major Western banks, Swiss First Boston and ING only withdrew from their offers to purchase shares in Budapest Bank, when a silent bailout of that bank was leaked to media [DP, 05/22/1995]. The process of privatization, covering most major banks besides troubled Postabanka and the largest commercial bank (OTP), so far resulted in the 60 percent share of foreign ownership in the total registered bank capital. With regard to OTP, the Hungarian State plans to turn its participation into a single golden share. This entails a rather large range of power that needs to be exercised properly [Commission, 1998]. The market is still highly concentrated, with the largest bank OTP still accounting for roughly 40 percent of aggregate bank assets. This contributes to large spreads between deposit and lending rates and still weak competition within the sector. Average market lending and deposit rates have continued to decline gradually in nominal terms and the spread between the two has fallen. In the past, weaknesses in banks' balance sheets and competition from new non-bank financial operators let too a fall in the stock of domestic credit extended by banks both in real terms and relative to GDP. While net credit to the government and to households and small and medium sized enterprises (SMEs) continued to fall sharply, credit to enterprises rose at an accelerating pace for the second year in a row.

Postabanka, Hungary's second largest retail bank, encountered a run on its deposits in Spring 1997, raising concerns about the stability of the banking system [Kurier, 03/01/1997]. The authorities bailed the bank out initially, various re-capitalizations led to majority re-nationalization, and management was removed. Restructuring of the bank is still an open issue and no strategic (foreign) investor has yet been found. Since regulations were not enforced in a prompt and impartial fashion, the Postabanka affair has revealed worrying failings, suggesting there is still considerable scope for improving both regulatory laws and implementation. The Hungarian Banking and Capital Market Supervisory Authority enjoys a certain level of independence, but is still supervised by the Finance Minister.

In **Slovenia**, Nova Ljubljanska Banka still has a dominant market share of about 30 percent. The interest rate agreement between the banks which sets the maximum rates on deposits is not compatible with a market-oriented financial system [Commission, 1997]. At present foreign owned banks are not allowed to participate in foreign capital transactions and are not allowed to open branches. The links between bigger enterprises and their banks are often strong, so that the latter do not exert sufficient financial discipline on the former [Commission, 1998]. Supervision in the financial sector is not yet sufficiently strong and a cartel still operates in the banking sector. Because of continued high state involvement, the financial sector lacks competitive pressure. The main factor that is preventing rapid consolidation of the banking sector is the pending privatization of state-owned banks.

In **Poland**, the partial privatization of Bank Slaski was a very profitable experience for its employees only. Immediately after privatization, the shares of this bank soared at the Warsaw Stock Exchange, basically due to a delay in handing over the shares to the new owners. Thus, only the employees of Bank Slaski could reap the benefit of a soaring stock exchange [FT, 01/26/1994]. A major setback to the banking system was the bankruptcy of the Polish Agrobank, which seemingly was triggered by Polish government action. After government institutions withdrew about $25 million from Agrobank during 1994, the bank ran into serious liquidity problems and filed for bankruptcy in April 1995 [DP, 04/27/1995]. The largest bank in Poland is still the previous State Savings Bank PKO with assets of $14.2 billion in 1997. PKO and the insurance giant PZU are included in the Polish Government's plan for privatization by 2000. PKO´s clients have a 100 percent deposit protection, while other banks can only guarantee the return up to $5,000 if they collapse. Due to its cheap deposit base, PKO has fuelled a lending frenzy in 1997 that was stopped by the National Bank of Poland (NBP) offering deposit accounts at very preferential rates. Through this unprecedented and highly questionable move, the NBP attempted to tackle the relatively large spread between deposit and credit interest rates by effectively competing with the banks it supervised. In 1997 there was a privatization

sale offer for 34 percent of shares of the market leader PZU SA, but prospective revenues from this operation expressed by two international consortia were not satisfactory from the standpoint of the Polish Treasury [Kornasiewicz, 1998]. In the 1997 sale of Powszechny Bank Kreditowy (PBK), a Warsaw-based commercial bank, South Korea's Samsung initially won the open tender to buy the bank. Rather than let PBK fall into foreign hands, the government, however, cancelled the tender and sold it to a local Polish consortium for a knock-down price. Some markets in Poland are still distorted because particular enterprises are allowed to operate on a loss-making basis [Commission, 1998], with unsolved issues for banks.

In **Romania**, the private bank Dacia Felin was put under central bank supervision in late 1995 due to problems caused by large lending to its major shareholders. Business of foreign banks was repeatedly restricted, for example in early 1996 when the license for foreign exchange trading was withdrawn from 18 of 22 banks. More than half of the commercials banks' assets were non-performing at the end of 1997 and overdue loans increased from 23% in December 1997 to 31% in mid-1998. The increasing weakness of banks has been reflected by a sharp decline in foreign assets during the first half of 1998. The amount of credit to the non-bank sector shrank from 24.5% of GDP at the end of 1996 to 14.4% of GDP at the end of 1997. The share of credits denominated in foreign currencies has increased, thereby raising the risks linked to a devaluation of the currency. Banks have increasingly invested in treasury bills, which carry high returns.

Financial supervision of credit institutions is carried out by the Central Bank of Romania. It has increased powers granted through the 1998 Banking Law, but it has failed to react appropriately in dealing with several troubled banks according to the EU Commission's 1998 progress report.

Serious gaps persist in the legislation of securities markets with regard to: insider regulations, general information to be provided to the public, and as regards authorization and capital adequacy requirements for investment firms. Repeated changes in the legal framework for foreign investment and privatization have made foreign investors cautious to invest in Romania since the autumn of 1997. The over the counter exchange RASDAQ represents mainly minority shareholding in state controlled companies and still performs poorly. Reporting on companies contributes little to the transparency of markets. Both the official Bucharest Stock Exchange (BSE) and RASDAQ have not been used sufficiently in the context of privatization nor as vehicles for raising long term finance. While the National Securities Commission (CNVM) is formally politically independent, commissioners face political influence and pressure from the major market actors. Similarly, the Office for Supervision of Insurance and Reinsurance Activities is not independent and is included in the structure of the Ministry of Finance. It is a weak institution, with almost no political

support and insufficient budgetary endowment to become a strong supervisor of the market.

More fundamentally, the absence of a properly functioning market economy, and the non-respect by a large number of economic agents of their contractual obligations do not ensure a sound basis for economic activity in Romania. Corporate governance in banks has not improved. Given the uncertain prospects for privatizing the largest of the public banks, there is still a strong possibility of moral hazard. This calls for a major strengthening of supervision activities and for addressing the absence of financial discipline in public companies and entities which has been the fundamental problem of the Romanian economy. A respect of contractual obligations, including timely payments of creditors, remains elusive in Romania. Data on arrears to banks show a major increase from 1% to 5.6% of GDP between June and December 1997. The government is accumulating large tax arrears and not viable companies have not been liquidated. The special credits that the National Bank of Romania (NBR) had been forced to extend to agriculture and enterprises were terminated and the new statute of the NBR limits the amount of financing that it can temporarily grant to the government, which are important achievements in the improvement of the framework for monetary policy [Commission, 1998].

In **Slovakia**, Investicná a Rozvojová Banka (IRB) was in deep trouble in late 1997 and is now held by the steel mill VSZ which has covertly grabbed control of the bank it is borrowing from, thus posing systemic risk [Kapoor and Cook, 1997]. VSZ is managed by people close to HSDC, the former Prime Minister Meciars´ party that allegedly put many companies in their network during privatization. The continued lack of transparency in the privatization process and the lack of foreign direct investment have negatively affected enterprise restructuring. Privatization has continued through direct sales, often at preferential terms with the possibility of spreading the payments to the National Property Fund (NPF) over a period of up to ten years. However, an important number of privatizations have lacked transparency and fairness. Additional examples of unannounced sales of shares of listed enterprises at sharply reduced prices, often to unknown buyers, have been recorded. A group of "essential" enterprises, including the financial sector, has been excluded from privatization. Debts to bondholders or banks can be rescheduled or cancelled under the Enterprise Revitalization Act through a secretive and non-transparent procedure with important political involvement. The unequal treatment of minority shareholders in listed companies in the privatization process reduced the attractiveness of the stock exchange. Selling to domestic industrial groups does not fundamentally improve the financial sector's capacity to restructure. Most new owners of privatized enterprises typically lack the financial means that are needed for restructuring, since they already had to invest to acquire the control of the company. As a resultant, investment for restructuring has to be financed exclusively from retained

earnings of the enterprises, which is only possible for firms that are already profitable. Because of the precarious situation of the government budget, the state will also not be able to cure the solvency problems of the state-owned banks. Therefore, there is a need to prepare a rapid sale of the banks to strategic, most probably foreign, investors [Commission, 1998].

In **Bulgaria**, bank privatization was started with the sale of one bank in 1997 and the completion of a second bank privatization in 1998; three more were scheduled for 1998. Sustained pressure from international institutions has been necessary to keep bank privatization moving forward, however [Commission, 1998]. The government has sometimes appeared uncertain about the necessity of far-reaching reforms and the national authorities have intermittently made statements that sent mixed signals about the government's commitment to rapid bank privatization. The State Savings Bank, which still holds most household savings, is being transformed into a commercial bank. In the Bulgarian insurance sector, there is a danger of monopolization of the market by the former state insurance companies since the requirements for licensing are very high. Progress has been made in bringing insurance legislation into line with the acquis, although the insurance market is still underdeveloped.

The Bulgarian Government also attempted to accelerate enterprise privatization and to increase transparency of the process by contracting out the privatization of several large companies. The cumulative share of divested long-term assets of enterprises amounted to 20% at the end of 1997. However, many firms have been bought by their managers and employees. Although this is helping to consolidate support for market reforms, it may slow down the rate of improvements in competitiveness since it may not be conducive to rapid restructuring. Moreover, questions may be raised about the ability of worker-owned firms to undertake restructuring when it requires workers layoffs. The new owners are unlikely to have substantial funds of their own with which to undertake investment in modern plant and equipment. They may face special problems in raising finance because the banks have little experience of lending to such enterprises, and also because banks are currently adopting a very cautious approach to lending.

The authorities have announced their intention to privatize companies by offering shares through the stock market. So far, little has happened in this area. The Bulgarian Stock Exchange became operational in late 1997, but trade is still limited. To date, shares are listed in just one company on the official market, but an active over-the-counter market has appeared. The authorities are also keen to sell some companies by distributing privatization vouchers to the population. The number of investment intermediaries increased as a result to the transformation of the former Privatization Funds into investment funds. The Securities and Stock Exchange Commission also licensed a number of banks and investment funds to serve as investment intermediaries.

Experience in other countries has shown that this sort of privatization can produce a diffused ownership structure that is unable to exercise effective control over the enterprises.

As the recovery strengthens and economic activity picks up, the ability of banks to act as responsible providers of investment finance will come under increasing attention. The current ability of the Bulgarian financial sector to fulfill the role of financial intermediation between savers and investors in the changed circumstances of the currency board arrangement remains largely untested. Banks have to date undertaken very little new lending, so it is impossible to assess whether they are able to act as responsible financial intermediaries. The government's ability to borrow money at low rates suggests that banks are either reluctant or unable to lend for productive investment because of the need to strengthen balance sheets. This is likely to constrain economic growth.

3. Prevailing Inefficiencies in the Banking Sector

3.1. Bank Governance and Financial Crises

Banking reform has been an ongoing issue in all CEEC-10 countries. Perhaps with the exception of deposit insurance [Groszek, 1995], the formal Central European candidates for the European Union accession have *established* almost all the *institutions* needed to perform the financial market *functions*. However, there remains a lot to be done in the *implementation* in order to make the financial system a contributor to the economic growth which, so far, has been generated by factors remaining outside the banking system. Furthermore, the implementation needs to "create an effective and stable framework for monetary policy" [Kozinski, 1995; Groszek, 1995]. The institutional development of the emerging financial systems is only possible when governments maintain fiscal discipline. A failure to keep the state budget deficit low contributed, until 1994, to the crowding-out of private investors from the financial markets in Poland [Groszek, 1995; Kozinski, 1995] and in Hungary [Buch, 1995; Bonin and Shaffer, 1995]. A successful disinflation is a favorable contributing factor to the financial system development since it helps to avoid taxation of "paper profits" [Solarz, 1995]. The financial sector cannot facilitate the growth of financial intermediation if governments and parliamentarians remain reluctant to establish rules of prudent banking. Prudent financial institutions reduce market imperfections and improve allocation of resources by performing the following functions:

(a) Facilitating transactions, thus introducing an effective payments mechanism and securing a transfer of wealth.

(b) Managing investment portfolios.

(c) Transforming illiquid assets into liquid liabilities, providing liquidity insurance and risk sharing opportunities to agents.

(d) Minimizing transaction costs, monitoring of loans and signaling their efficient allocation [Vives, 1991].

One of the major sources of bank failure comes from (c), which is strongly influenced by international capital flows. The overvaluation and real appreciation of most CEEC-10 currencies has contributed to serious distortions of financial markets [Orlowski and Corrigan, 1997]. Banks and firms have been able to generate profits by engaging in speculative transactions and making use of deliberate fixidity of exchange rates and delays in exchange rate and interest rate adjustments by governments and central banks.

There is a considerable degree of financial distress in most of the 10 CEECs. Many of the state-owned and newly founded private banks have been undercapitalized [Baer and Gray, 1996; Commission, 1997; Jones, 1997; Krzak, 1997; Tsantis, 1997]. Out of the total of about 500 banks in the region, at least 200 were either recapitalized (mostly the large banks with a market share of 60–80%) and/or merged with other banks or closed after outright bankruptcy. Bank crises took place in Estonia (1992), Latvia (1995) and Bulgaria (1996/97), causing losses of savings deposits of 25% to 40%, respectively [Dobrynski, 1995; Krzak, 1997]. In the Czech Republic the Czech National Bank (CNB) took control of five large banks in 1996, accounting for less than four percent of banking system assets, under special "conservatorship". It further liquidated six other failed banks in the period 1994–1996 [Folkerts-Landau et. al., 1997]. Most serious asset-quality problems were experienced by the new, private Czech banks that were established in the period 1991–1993 when the country's licensing rules were lax. In 1994 alone, the CNB closed three banks for asset-quality and alleged fraud reasons. It later placed several worst performing banks under special monitoring regime and closed seven more banks since the beginning of 1995. The CNB was forced to take $5 billion of non-performing assets of banks off their balance sheets in the period 1995–1996. At the end of 1996, classified loans constituted 30.1 percent of total bank assets (down from 33.4 percent in 1995) and in the fall of 1998 another banking crisis emerged in the Czech Republic. Poland and Hungary are experiencing similar poor asset quality problems although the situation has considerably improved over the last three years. Classified loans in Hungary were 8 percent at the end of 1998, down considerably from the peak level of 28.5 percent in 1993. In the same year, they reached in Poland 10.5 percent, compared with the top level of 31 percent in 1993.

Bank privatization in the CEEC-10 is hardly progressing with the exception of Poland and Hungary. In Czech Republic, where privatization was pushed forward, a lack of

adequate rules is weakening bank supervision and raising concerns about more widespread moral hazard. Only in Hungary and Estonia there are certain signs that the banking sector could be opened to EU competition after 1999 as envisaged in the association agreements with the EU. The weak financial sector may become a stumbling block for EU-membership for most of the 10 CEECs.

In well-developed financial systems, banks overcome information and incentive problems by monitoring the firms they finance [Hellwig, 1991]. On the contrary, banks in Central Europe's transforming economies having difficulties in managing themselves are not fully prepared to exert a positive influence on the management of corporations and to increase the efficiency of firms. One can rather expect tinkering around with debt. The banks attempt to circumvent apparent management problems by applying slow withdrawals from troubled enterprises and balance sheet cosmetics. Supported by policy makers, banks take advantage of market imperfections and contribute to high spreads of interest rates and to foreign refinancing, while governments keep the domestic currency overvalued.

3.2. The Size of Financial Markets

The smallness of financial markets in the transforming economies can be attributed to four general reasons:

– the neglect of financial intermediation under communism (and to varying degrees also during the first years of transition),

– the low level of GDP per capita,

– the small size of population of most countries concerned,

– the repeated cases of fraud and imprudent banking which lead to significant financial losses by households and businesses.

Further problems of financial markets in these countries are triggered by their classification in the group of emerging market economies. Turbulent speculative attacks on financial markets of Asian and Latin American countries in 1997 and the spillover from the Russian crises in 1998 have slowed down the growth of capitalization of financial markets in CEEC-10s [Orlowski, 1999]. Investors that have held securities of CEEC-10 in their emerging market portfolios express worries about possible contagion risks [Linne, 1999]. They have partly reconsidered allocation levels to emerging and established markets. These effects are posing major problems. Underdeveloped markets are prone to speculative attacks. Foreign investors can easily influence asset prices on the financial markets of the economies in transition and exercise a disturbing influence on the real economy [HB 28/07/1995].

From the relatively small degree of financial and banking intermediation, one may conclude that banks cannot have an overall strong impact on economic efficiency in CEEC-10. Continuous deficiencies in the banking sector imply that banks need to undergo far-reaching institutional improvements. Banks need to improve trustworthiness to their customers thus attract a higher degree of financial intermediation. Even if banks are institutionally prepared for prudent banking and they become more trustworthy, it will take a while until they grow strong enough to have an overall positive impact on the efficiency of the transition economies.

The volume of financial assets in relation to the GDP in CEEC-10 is roughly 85 percent lower than in the USA, EU or Japan where it is higher than 300 percent. The high ratio of Japan 452 percent in 1998 reflects significant inefficiencies that became transparent during the 1997/1998 financial market crisis in Japan.

There are, however significant differences among individual Central European countries in terms of the degree of financial intermediation. The two countries where the financial market reform has significantly evolved show average (Hungary 86%) and below average (Estonia 49%) ratios. There might be a threat of bursting financial bubbles in several countries where financial reforms have been lagging behind but where there is a relatively large size of banking intermediation and stock market capitalization (Czech Republic, Latvia, Lithuania, Slovakia), as shown in Table 5.

4. Synthesis

The financial sector reform in the CEEC-10 is lagging in the process of the economic transformation. Privatisation, legal infrastructure and the establishment of a sound and independent supervision of financial market institutions are advancing slowly.

There have been excessive pressures from political circles, governments, central banks, managers and new owners of state-owned and newly privatised large corporations emerged on operations of financial institutions. Members of these politically powerful networks share interest and gain from imprudent banking. They tend to delay institutional reforms and implementation of efficient banking, stock exchanges, and insurance supervision. They further attempt to prevent effective legal actions against fleecing of private investors and the reestablishment of financial market institutions that have a history of involvement in bankruptcies and firm dissolution where considerable amounts of money have disappeared or have been transferred abroad.

Without an effective supervision and strict legal rules aimed at protecting depositors and small private investors, the prevailing privileged bank/interfirm relationships

significantly contribute to the malfunctioning of financial markets in the Central European applicant countries for the EU-membership. The privileged interfirm/bank relationships have become a trap for corporate governance. A requirement of the reduction in the scope of this problem would be a useful clause in the programs of the accession of the examined countries to the European Union.

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