

Banking Crises Resolution in Central and Eastern Europe: Cross Country Experience

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Abstract

The objective of the study is twofold. First, the paper aims to provide a critical analysis of the various applied methods used in resolving banking crises in Central and Eastern Europe (CEE). Secondly, it offers an estimate of what would have been the optimal way of resolving crises in state-owned commercial banks (SOBs) and small and medium sized commercial banks (SMBs) in the Czech Republic, Hungary and Poland. In addition, the linkage between the economic environment and the banking system is considered as a crucial one in the enlargement process.

The analysis shows that applied measures in dealing with banking crises have varied among transition countries and were dependent on political consensus. Bad loans clean up has turned out to be relatively complicated. A delay in restructuring increased costs and eventually required a stronger response. Examining the experience of three CEE countries, no firm conclusion can be drawn about the optimal crisis resolution in the banking sector in transition. However, looking back we could argue about the essential elements of what could have been an optimal resolution, elements that have, to some extent, characterised a quasi-optimal crisis resolution as in the case of Hungary.

JEL: F36, G21, G34, and P20

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1. Introduction

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This paper does not aim to describe the methods and approaches of how to deal with banking crises in CEE. It attempts to provide evidence and a critical analysis of the best practise of handling banking crises in three transitional countries: the Czech Republic, Hungary and Poland in the last 12 years. Although these countries had, to some extent, comparable starting conditions—a relatively high inflation, a deep recession, monobanking system, etc.—the results of crisis resolution varied substantially between them.

The paper is structured as follows: Section 2 summaries and review the transition conditions in the process of banking development. Section 4 assesses methods of resolving banking crises. The issues linked to an optimal solution are discussed in Section 5. Section 6 concludes.

2. Summary and Review

The economic transition and the new market environment in all transition countries created many difficulties in the banking sector. Banking crises resolutions were necessary at the outset of transition because of the dominance of inherited bad loans on the state-owned banks' balance sheets. These loans would worsen banks' liquidity and solvency once hard budget constraints were imposed.

CEE countries have addressed problem loans and the resulting weak capital bases in various ways. The Czech Republic, Hungary and Poland, like other transition countries, faced the problem of the assumption of bad claims from the portfolio of SOBs. At this stage of transition, authorities had to recognise and estimate the true value of inherited non-performing loans (NPLs) in portfolio of the SOBs that inherited from the previous system. Many of these banks were technically insolvent or, at least, chronically undercapitalised. Cleaning up bank portfolios and their restructuring in conjunction with their preparation for privatisation became an essential step in their resolution.

The fundamental changes of banking sector reform, that involved breaking up the mono-bank system into a two-tier banking system, were performed, however, in an institutional and legislative environment tailored to the command economy. There was not only a underdeveloped institutional framework, but also a legislative framework covering the bankruptcy law, corporate law, laws protecting creditors as well as debtors, accounting standards, reliable auditor firms and so on. Therefore, it was subsequently recognised that the resolution in the first stage of transition was insufficient and repeated rescue operations were needed.

During the last decade there has been a vast literature on banking sector restructuring in general (Caprio, Atiyas and Hanson, 1994, Dziobek, 1998, BIS, 1999) and in transitional countries particularly (Borish, Long and Noël, 1995, Honohan, 1997, Hernes and Lensink, 2000; Green and Petrick, 2002). However, there is still a lack of research explaining the differences in progress among the transitional countries. After more than twelve years of transition there is a need to assess the effect of different restructuring methods and approaches and what follows attempts to provide this.

3 The Economic Environment facing CEE Banking Systems in Transition

3.1. Economic Conditions

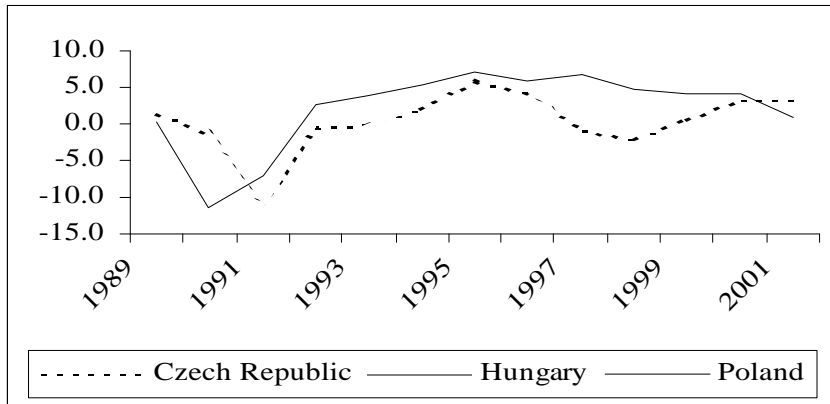
The approach taken towards developing a viable financial sector varies among the three countries and has been dependent on a number of factors. The most important factors

have been the starting conditions, macroeconomic setting and development, the pace of other reforms—including institutional and legal—and, last but not least, the political consensus in support of market-based institutions.

Looking at the development of banking sectors across CEE some differences are observable. Hungary, for example, had already initiated banking reforms in the early 1980s and that had also been accompanied by legal and enterprise reforms. The other aspect that had an impact on the future development of banking systems was whether transition countries followed the so-called “rehabilitation”, or the new entry approach. The rehabilitation approach is based on recapitalisation and consolidation of state banks, including limited privatisation and new entry (Hungary, Poland and, to some extent, the Czech Republic). The second approach—new entry—applied mostly in the countries of former Soviet Union had been based on relatively liberal entry of new banks including rapid privatisation.

Macroeconomic conditions and development and the microeconomic restructuring process have become fundamental factors for the development, stability and soundness of the banking system. All CEE were exposed to both domestic and external shocks that could not be accommodated by the existing economic system. Such shocks including price liberalisation, currency devaluation, privatisation, industrial conversion, foreign trade liberalisation, the collapse of the former trade organisation CMEA, significantly affected the transition economies including their banking sectors. At the beginning of the 1990s, these shocks resulted in a deep decline in output (see Chart 1) and consequently in a further deterioration of the financial position of SOEs.

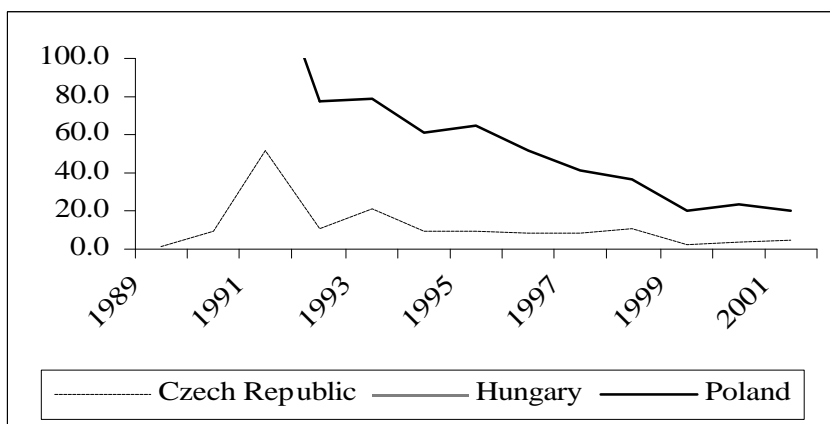
Chart 1 Gross domestic products (y-o-y) %



Source: International Monetary Fund

Macroeconomic destabilisation, above all through high inflation induced by a monetary overhang had a direct impact on the burden of NPLs. An environment of relatively low-inflation such as in the Czech Republic (see Chart 2), helped to avoid a credit crunch, and the erosion of households savings in the first phase of the transformation caused by wiping out most of the value of existing debt and savings in domestic currency. On the other hand, unexpectedly high inflation reduced the burden for debtors by eroding their loans through negative real interest rates. An analysis of comparing the advantages and disadvantages of high inflation for banks solvency is inconclusive (see Claessens, 1996).

Chart 2 Consumer price index (annual average) - %



Source: International Monetary Fund

An integral component for successful banking reforms has been the pace and extent of legal and enterprise reforms such as collateral recovery, bankruptcy law, protection of creditors instead of debtors, regulatory and supervisory policy, etc.. These were essential elements determining banking soundness.

3.2. Initial Conditions in the Banking Sectors

At the outset of banking reforms, CEE had a unique opportunity to build a two-tier banking system almost from scratch. Nevertheless, there are several questions regarding the expansion and openness of the banking system in transition economies. It has been recognised that the way of how banking systems were set up could have direct implications on the extent of rescue operations by governments and central banks.

In the first stage, commercial banks were created out of a monobank. This step was identical for most of the former communist countries undergoing banking sector transformation. But looking at the segmentation of these banks it is possible to see different shortcomings in the adopted measures. In Poland, nine state-owned regional banks were established instead of one or two large banks. The advantage of such a policy is, at least for the first stage of development, to avoid creating “capture banks”. Decentralisation led to covering all major regions in the country and the allocation of credit was better monitored. This might be explained by better knowledge of debtors and regional conditions. However, the experience shows that a regional break-up limits the competitiveness within a given market since one bank plays a dominant position in that market.

In contrast, in the Czech Republic, five state-owned commercial banks were created at the beginning of 1990. All five banks were highly concentrated, centralised and specialised banks. Since these banks had only a few branches across the Czech Republic, except *řeskÆ spořitelna* (Savings Bank), there was a lack of financial services in the regions outside of Prague. A similar strategy adopted in Hungary where four banks had

an oligopolistic position within the Hungarian market as a whole. These banks were created from the commercial banking departments of the monobank.

All three transition countries have been undergoing a complex process of liberalisation similar, but more radical, to those in EU countries in the 1970s and 1980s. The authorities set the basic regulatory and supervisory framework, new operational guidelines and principles for banks' prudential behaviour. However, regulatory and supervisory capacity was severely limited and banks lacked, among other things, the basic credit skills. This was reflected later in a further destabilisation in the banking sector.

4. Banking Crises Resolutions for the CEE

The pace of economic reforms, macroeconomic conditions, changes in the institutional framework and applied methods of further banking reforms determined the degree of the future development (stagnation) within the banking sector.

The two-tier banking system was not established at the same time in all three countries and by no means had the countries completely identical starting conditions. Nevertheless, we can observe that all newly created banking systems faced severe banking crises. A deterioration of the portfolios within the group of banks that inherited loans from the central banks needed to be resolved early on after the system break-up. SOBs were either technically or actually insolvent. The liberalisation of entry for SMBs, in the early stages of transition, created additional problems within the banking sector, testifying further to risks as described by Davis (1999).

4.1. Dealing with Banking Systemic Risk in the First Stage of Transition

If the governments and central banks wanted to set up a competitive, efficient and credible environment in the banking sector, then it was desirable to "clean up" the portfolio of undercapitalised SOBs created out of the monobanks. Since the origin of the banking crises was simply, in the first stage of transition, an inheritance from the planned

economies, government and central bank support was not surprising. Banks were state-owned institutions and the options of banking crisis resolution through private involvement were limited.

Authorities did not have to search for new ‘special’ methods of dealing with NPLs and distressed banks. They only had to decide which strategy should be appropriate for their banking system. Authorities could opt for either a centralised or decentralised solution. In the first stage of the transition the Czech Republic and Hungary applied a centralised approach within a framework of the banking sector consolidation programme. NPLs were transferred to a centralised asset management company (AMC) or so-called “hospital bank” that dealt with NPLs transferred from the portfolio of the financially distressed SOBs. Simultaneously the banks that participated in the consolidation program had discretion to write-off remaining NPLs when the likelihood of recovery was low or the burden of NPLs might cause the bankruptcy of viable firms.

Although the centralised loan consolidation programmes applied in the Czech Republic and Hungary improved commercial banks’ portfolios, these banks remained undercapitalised and additional measures had to be taken later on.¹ In Hungary, it was only recognised later, unlike in the Czech Republic, that the high concentration of assets in one institution would impose a constraint on an efficient recovery of NPLs. Klingebiel (2000) and Hoggarth, Reidhill and Sinclair (2002) argue that the centralised approach has the advantage of economies of scale there was not evidence of this in the Czech and Hungarian cases. On the contrary, an accumulation of a large amount of the heterogeneous NPLs in one institution, as in the Czech case, rendered the asset management a technically impossible task.

In the case of the decentralised approach, applied in Poland and later in Hungary, the government did not carve out NPLs of the portfolio of commercial banks but left them with banks. Banks had to take their own responsibility for restructuring their portfolio.

¹ It was later recognised that this method created a problem of double moral hazard (Begg and Portes, 1993) and required higher financial injection into troubles banks.

Two alternatives were applied. Banks could either sell to an AMC at a discount NPLs or recuperate NPLs by establishing subsidiaries that had the form of the Special Purpose Vehicle (SPV). Although the restructuring process was time consuming and the outcome uncertain this regime provided banks with the possibility to restore their business activities without the imposition of any conditionality. Polish commercial banks set up special departments that were directly accountable for the resolution of NPLs. This method was apparently more efficient since regional banks had a good knowledge of local markets and could target assistance on a selected basis to companies with a restructuring potential.

The Hungarian government recognised the bottlenecks of the centralised method in 1992 and tried to recapitalise banks on an individual basis. The new bankruptcy law, which resulted in companies being declared bankrupt, reinforced the urgency of applying the decentralised approach. The new consolidation programme was set up in December 1993 shortly after the so-called Loan Consolidation Programme. It was phased in in three steps and aimed at increasing capital adequacy ratios to reach the regulatory required level (8 per cent).²

The main shortcomings of these programmes were the lack of transparency and the application of discretionary policies, which left incumbent managers with no incentive to recover NPLs. The fast and significant restructuring of both SOBs and state-owned enterprises (SOEs) was crucial. The flaw of the centralised method, applied in the Czech Republic, lay above all, in the unresolved issue of the initial cause of the NPLs that is, non-restructured or insufficiently restructured SOEs. By creating an AMC or hospital bank the authorities disposed NPLs from banks' balance sheets which enabled them to provide financial services. However, banks in many cases faced a recurring problem of new NPLs. This then required repeated rescue operations by the authorities in the second half of 1990s. Extensive credit expansion by SOBs to SOEs, in the first stage of transition, postponed their restructuring.

² The total cost amounted to HUF 163 bn. The generous financial injection provided by the government led to an increase in the state ownership of banks that participated in this programme.

The Czech and Hungarian case clearly confirmed that the centralised method is an inappropriate solution in the case of transitional economies. It materialised soon that the government did not prevent newly created NPLs. The government overemphasised a resolution of NPLs originated under a command economy and a problem of newly created NPLs by SOBs was overshadowed.

The Polish method, although introduced later than in the Czech case, significantly reduced the flaws of the centralised approach. The Polish authorities focused attention not only on the NPLs from the central planned economy but also took into consideration preventing repeating problems. The Act on the Financial Restructuring of Enterprises and Banks set the legal framework in which SOBs and SOEs could operate.

The lack of transparency and a clear message about no future interventions by the government, coupled with the *too-big-to fail* issue for large banks, gave rise to banks' expectation of a future government bail out. Indeed, the presence of a moral hazard problem became evident in the early stage of banks' consolidation. This had the direct consequences on the business behaviour of the incumbent management. Particularly dangerous was the double moral hazard problem when SOBs and SOEs formed, unfortunately, correct expectations about future bailouts.

An example of this effect was seen in the Czech Republic, where the issue was exacerbated by the applied bank privatisation method (Section 4.3) and cross-ownership by SOBs and SOEs. The Czech government cleaned up the state-owned or partial state commercial banks' portfolios during 1991–1993. However, the ratio of NPLs had increased in SOBs immediately after this consolidation process ended. An essential explanation of this situation was unimproved corporate governance and cross-ownership by SOBs, SOEs and private firms.

In the Czech Republic, cross-ownership by SOBs and SOEs or even private companies had generated a viscous circle of credit flow. SOBs in order not to lose their credits

provided new loans for paying off *old* claims, which led, in essence, to the classical case of *Ponzi finance*.³ The presence of soft budget constraints and the unbusinesslike behaviour of SOBs—*government bankers*—were strengthened by the implicit state guarantee in the form of financial support for covering any financial difficulties that the banks might have. Expectations relied on two doctrines. The bank is *too big to fail* or *too important to fail*, including other factors that provided, if not assurance, then at least hope of financial support, i.e. a bank that is *too loyal to fail* (Hampl and Matousek, 2002). In the second half of the 1990s, the idiosyncratic behaviour of partially state-owned banks started to be labeled as financial socialism.⁴ Certainly not a less important phenomenon was that decisions on credit allocation relied more on political calculations than economic calculations.

The moral hazard issue was present even in Poland. Chudzik (1999) analyses the bad debt restructuring process in Poland. The so-called Bank Conciliation Procedure was considered the most promising approach to loan restructuring in the CEE. Under such a programme banks rescheduled their loans according to certain conditionality—partial debt write-off or even debt-equity swap for borrowers which on the other hand have to outline and implement a rescue program—for firms that have thought to have adaptive potential to the market environment. However, political considerations played an important role in deciding the extent to which banks wrote off companies' debt. Therefore the Polish approach to debt clean up also seems insufficient to have been provide a strong guarantee against expectation for future government bailouts.

4.2 Resolution in the Segment of Small and Medium-Sized Commercial Banks

³ This situation had occurred many times during the Asian crisis, though to a more extreme degree than in the Czech Republic.

⁴ The term used by Suzuki (1986) in the mid-1980s for the troublesome state of the Japanese financial market and the close link between the banking sector and unproductive companies.

Newly established banking systems suffered, among other problems, from relatively high concentration and an insufficient supply of financial services. SOBs had a dominant position in the market and the increase in the demand for financial services could not be satisfied.

One way to overcome this problem was to open the banking sector to domestic and foreign banks. Partial access to the market was applied to domestic banks in some CEE. But this often resulted in the creation of so-called captured banks that served mainly the business activities of their shareholders in the absence of adequate banking regulation. Moreover, these newly operating banks were mostly poorly capitalised and managed.

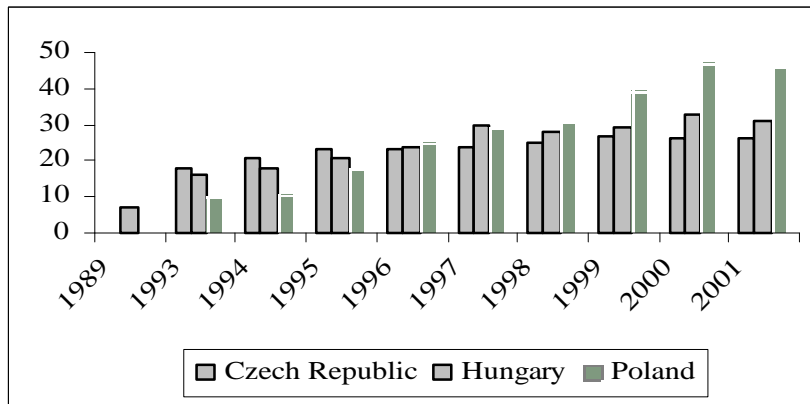
A sharp increase in new entrants—small and medium domestic banks—was the root cause of the banking crises in the private banks sector from 1994 onwards. The empirical evidence shows that the consolidation and stabilisation process in this segment of the banking system was primarily caused by an over expansion of these newly established domestic banks (See Chart 3). The rapid growth of new commercial banks in the period 1989-1991 in Hungary and in the Czech Republic and Poland during 1991-1993 brought a certain degree of competition into the financial market but later the financial position of these banks was considerably impaired. However, this unrestricted entry into the banking sector, which was mainly adopted because of the perceived benefits of competition, has in fact been detrimental. All three countries stopped providing new banking licences after problems were identified. This had to help to consolidate distressed banks.

One argument that has justified ceasing to provide banking licences was grounded in the fact that the banking system proved overbanked and that there were elements of instability at several banks.⁵ Therefore, when establishing a banking environment, stricter selection criteria for granting banking licences should be used. In addition, “first class”

⁵ Hoggarth, Reidhill and Sinclair (2002) provide the theoretical framework of consequences of the overbanked system.

foreign commercial banks should be allowed to set up greenfield sites or merged with domestic banks if they have an interest.⁶

Chart 3 Number of Commercial Banks



Source: Central Banks

The number of SMBs in the Czech Republic expanded rapidly between 1991-1993. It was evident later that the owners and management of most of these banks primarily provided loans to their shareholders' and a likelihood of future repayments was significantly low.

The Hungarian experience was different since some of financially distressed small and medium sized commercial banks were state-owned and these had exited during the previous regime in the 1980s. Their main activities focused on providing liquidity to special development funds like the Industrial Development Fund, the Fund for the Development of Industrial Cooperatives, the Fund for Innovation, etc (Abel, 2002). The basic objective of these banks was similar to the newly established small and medium sized commercial banks in the Czech Republic. These banks also provided financial sources to their owner (shareholders) mostly on the basis of a soft budget constraint.

⁶ Demigüç-Kunt, Levine and Min (1998) showed that presence of foreign banks lowers the likelihood of banking crises.

In Poland, the crisis occurred at the cooperative banking that in some form also existed before transition. In Poland there operated one state-cooperative bank and a network of 1663 small, local cooperative banks, providing financial services for communities in villages and small towns that lacked the local presence of commercial banks (NBP, 2001). The sector of the Polish SMBs also faced difficulties but to less extent.

In the early stages of transition, the main weaknesses of the SMBs in all three countries was insufficient capital especially. A further issue was the lack of primary deposits. Newly established SMBs had a few branches to collect deposits and they had to 'compete' with the large savings banks, which traditionally collected customer deposits. The significant scarcity of primary deposits was also reflected in the inappropriate assets-liabilities mismatch. In addition, the shareholders structure of banks was non-transparent and executive management was only a veil over the structure of corporate governance. Further, during the period of high inflation, in the early 1990s, even banks that wanted to pursue true business activities faced a dilemma of adverse selection and moral hazard. In an environment where thousands of new businesses were created without any credit history the banks faced a difficult decision of how to ration credit. In addition, creditor rights have been limited by non-effective debt workout, laws on collateral and foreclosure were unenforceable without the consent of debtors which increased a moral hazard problem.

The reaction by Central Banks to the fragile segment of SMBs was strict (frozen) licensing policy on new entrants including foreign banks. Foreign investors would be allowed access the market only via acquisitions of financially distressed banks. However, Tables 1-3 in the Appendix shows that only in the Polish case were the authorities able to attract foreign investors to take over these banks. It does not appear to be clear economic rational for these take-overs. Polish authorities may have successfully applied moral persuasion in these cases.⁷ Although Poland proved successful in avoiding a systemic

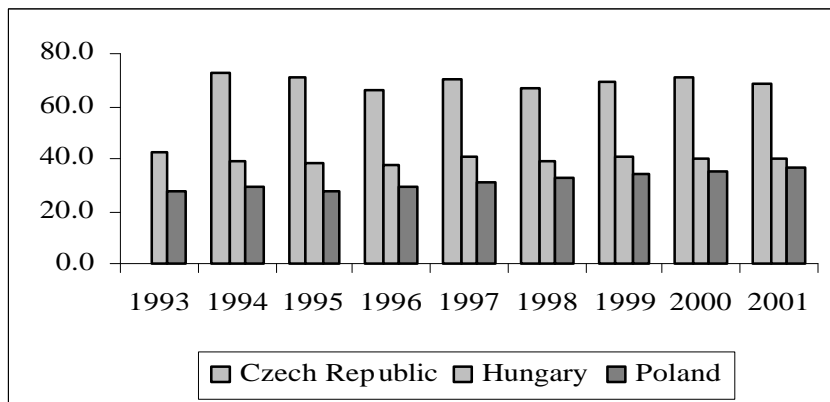
⁷ The fundamental factors for mergers can be as follows: an effort by banks to become a member of a core bank group, to secure unrealised economies of scale, to enable the demands of large customers to be met, to match the size of other banks in international banking, to meet foreign bank competition in their home country, to carry out the rationalisation of branch networks or to grant the banking license.

crisis in this segment of SMBs but real difficulties in the cooperative banks sector were present.⁸

The Czech Republic and Hungary were only partly successful in selling distressed small banks to foreign investors. The small and medium size banks' problem was more pronounced in the Czech Republic where takeovers by foreign banks did not materialise. Therefore the authorities had to find a fast and credible solution to prevent a systemic crisis in this sector. As seen from Table 1 in the Appendix the authorities opted for a merger of these small banks with other domestic banks. However, this solution was harmful for the banking system as a whole.

Although the share of all small sized banks in the Czech banking market was around 5 in terms of total assets in 1993, continuing bankruptcies within this sector undermined gradually public confidence in the banking system as a whole. Rescue operations via mergers and acquisition had to be assisted by government financing in order to avoid a systemic crisis.

Chart 4 Bank Deposit to Annual GDP Ratio- %



Source: International Monetary Fund

⁸ Two hundred cooperative banks were qualified for bankruptcy and sixty were suspended.

The CNB requested financially distressed banks to increase their capital in order to cover their bad loans. If they were not able to do so, the CNB put these banks under forced (special) administration and looked for a strategic partner. During this period the authorities tried to find bridge banks, new banks or other institutions which would maintain the banking activities of the failed banks. Such a method was, for example, applied when Barings failed in 1995 and its activities were transferred to another bank.⁹

These standard instruments for banking crises resolution, however, only postponed the closure of many banks and substantially raised the fiscal cost of transition see Table 5 in the Appendix. The CNB decided to run the so-called (Consolidation Program II) and later the government announced a further programme helping medium and small sized commercial banks - Stabilisation Programme.¹⁰

The last, but not necessarily worst, way of dealing with failed institutions is to revoke the banking licence of the bank in question. Such a step avoids a further deterioration of the situation. On the other hand, liquidations can have negative consequences for the credibility of the banking sector as a whole. In addition this solution can be costly particularly if a deposit insurance scheme is not established.

The choice of supervising instruments to resolve a banking problem is constrained above all by the legislative framework. In the case of the CNB, there was a limited array of instruments to cope with banks that were in financial difficulty.¹¹ At the same time, the new Banking Act also redefined criteria for the suspension of a banking licence.

⁹ The bank was put under the administration and then sold to ING, the Dutch banking and insurance group.

¹⁰ The government through the Czech Financial Corporation Ltd., a special institution set up for this purpose as a subsidiary of the CNB, temporarily purchased the bad assets at the face value, up to 110% of respective bank capital. The bought assets return had to be bought back within a period of 5-7 years. The banks did not have to pay interest. The programme was initially financed through the extension of short-term credit from the CNB to the Czech Financial Corporation Ltd. Further, the CF was refinanced at market cost through the Consolidation Bank that issued bonds for this purpose. The CNB also extended credit to CF together with the transfer of bad assets bought by the central bank during the second stage of the consolidation programme.

¹¹ These legislative limitations were recognised during the turbulence in the Czech-banking sector in 1995-1996. The current Banking Act (No.21/1992) was revised and the legal instruments available to authorities were strengthened and widened.

It should be stressed that the regulatory and supervision activities were limited not only because of an insufficient legislative framework, but also by the lack of experience of regulators and supervisors. Therefore the authorities had to opt for measures that alleviated this obstacle. The implementation of subordinated debt or subordinated deposit might be a powerful regulatory device (see Ramirez, 2002). The another measure that might reduce the likelihood of a crisis would be to increase the minimum capital requirement for banks – a measure that has a relatively fast and positive impact on the banking structure. However, a side effect of rising capital requirements is that a few of the small banks which do not have any difficulties at present would also have to either increase their capital or merge with a larger bank.

4.3. Bank Privatisation as an Alternative Solution in a Banking Crisis

Privatisation is other method to resolve the problems with financially distressed SOBs. It has been recognised, in transition countries that privatisation is an alternative solution to government bail out. However, this method incorporates some difficulties and may fail to achieve the objective of stabilisation. The most important aspect of bank privatisation is to cut the links between the banks and the government owned companies. The co-existence of SOBs and SOEs induces a conflict of interest.¹²

The Czech Republic, Hungary and Poland applied three different privatisation techniques. The first method — the initial public offering (IPO) — was applied in Poland. The privatisation program for the nine commercial banks was based on selling 40-50 per cent of total shares of the state-owned banks to domestic investors by IPO on the Warsaw Stock Exchange, 10-20 per cent of total shares to bank employees and 10-20 per cent of total shares to foreign investors, reserving 30 per cent for the state. Bank privatisation in Poland was intensified from 1998 after rules were relaxed on ownership.

¹² SOBs are often misused for government's objectives to finance SOEs with a low likelihood of possible repayments.

Hungary adopted two different methods of bank privatisation. The first method was the sale of shares by public offering to a dispersed group of foreign and domestic investors similar to the Polish way. The second method was the sale of a large stake to strategic investors. Making portfolios attractive by the loan and bank consolidation programmes, the government intended to search for strategic financial investors for each bank with the exception of OTP – the National Saving institution.¹³ In the case of Postabank, Hungary's third largest bank, a special combination of the two methods was adopted: the public offering followed four years after the initial sale of minority shares to foreign professional investors.¹⁴ Hungary is the best example of bank privatisation in CEE. In all cases foreign strategic owners received the majority of the shares. By the end of the privatisation process in 1997, the market share of state-owned banks had fallen to 20 per cent.

The Czech experience was principally based on voucher privatisation — the third model. The majority of large state-owned banks went through voucher privatisation: the state kept 26 - 67 per cent of the shares of the largest banks and, while the other shares were sold by vouchers. Since the large banks collected the major stake of vouchers through the investment privatisation funds founded by them, significant cross-ownership evolved between the banks and their clients and amongst the banks. In 2000 the Czech government completed the privatisation of four SOBs, following a clean up of these banks' portfolios through government intervention or guarantees.¹⁵

State control over the banking sector exerts long term effects by distortion the economy through non-commercially based lending, frustrating the objectives of privatisation. There are four main shortcomings of the government intervention: delaying restructuring, restricting competition, allowing bad loans to accumulate and postponing bankruptcy particularly of the largest companies. In order to avoid the political consequences of

¹³ Recent developments suggest that rapid privatisation of banks and opening of the market to foreign investors has helped to increase the efficiency and competitiveness of the Hungarian banking sector.

¹⁴ Postbank had been run into the ground by its previous top management and had to be rescued, rehabilitated and recapitalised at the beginning of this year, returning the bank into state ownership.

¹⁵ Investiční a Poštovní Banka (IPB), however, was sold to Nomura without portfolio restructuring which was reflected in the selling price.

widespread bankruptcies and consequently unemployment, government has had an interest in saving failing politically important firms. Therefore, strong political pressure is put over state-owned banks to subsidise loans to such firms. The bank-state relationship is not explicit. Personal relationships and unexpressed understandings between bankers and government agencies are factors that are difficult to evaluate. The bank management and the government are involved in a sort of preliminary game: they interact in a game whose outcome is the set of rules under which they will subsequently play another game whose outcomes are economic payoffs.

The resulting implicit or explicit political decisions about credit allocation by state-banks besides the fact that such banks are barely qualified to assess credit in general, let alone equity and risk, increases the probability of banking system running risk for a prolonged period during the transition.¹⁶ Therefore, government control over banks raises the question of company insolvency banking firm solvency in general and banking insolvency in particular.

The relationship between banks and the government is complicated further persisting expectations about the government bail out if banks get into trouble in the future by making unsound loans. The probability of government bail out is in many cases positively correlated with the banks' lending policy. If banks provide new credits according to what it is perceived by government to be national interest rather than based on a commercial decision, it leads to a situation where no large company (including banks), facing real difficulties, becomes bankrupt. Governments continue to bail out the banks in trouble.¹⁷

¹⁶ In the Czech Republic up to mid-1998 the four main banks remained to a large extent state-owned and were effectively state controlled. Their business activities continued to be geared toward large industrial loans, with credit allocation, dictated by industrial needs. The banks have been used to prop up obsolete industry with some new loans granted to companies in default.

¹⁷ For example in the Czech Republic in December 1998, the government assumed the nonperforming loans of CZK 10 bn (around \$ 300 million) of the big Saving Bank, (Ceska Sporitelna). In August 1999 the Czech government increased the capital of Czech Commercial Bank, (Komerčni Banka), by CZK 9.5 bn from which the state ownership in the bank was increased from 49% to 74%.

In the case of Hungary the situation was similar. In January 1999 the Hungarian government bailed out Postabank, injected Ft 152 billion (some \$706 million), and saved the bank from big losses. Although two Polish banks—the Savings Bank PKO and Agricultural Bank BGZ—were bailed out in 1994, they suffered heavily from the subsidised loans given to housing credit and strong agricultural lobby respectively. The privatization of these banks was accompanied by a further government bail out.

State ownership, control or past government interference in the banking sector increases the moral hazard problem.¹⁸ The expectations of bank manager are critical for the bank lending decision. A sound capital base that countries tried to create to solve the inherited bad loans problem is a necessary but not sufficient condition to ensure that banks have incentives to make good investments. If bank managers believe that poor performance will trigger a government bailout in the future with little or no consequences for themselves, then their incentive to take difficult decisions on existing borrowers and to screen carefully potential borrowers are not strong. Moreover, to the extent that these bailouts are expected, their existence is taken into account when the banks plans are made. Therefore, banks could commit capital to such ‘safer’ firms in the short run other than making loans to new politically unimportant firms, even when these ones are more efficient, resulting in new bad loans. If banks cannot expect such government assistance, then the incentive for good performance is much stronger. To sum up, if governments are showing themselves only too willing to protect banks – as has often occurred in the past in the Czech Republic, Hungary and Poland – then banks are just as willing to protect the industry.

5. Effects of Banking Crisis Resolution in CEE

In transition countries, the resolution of banking crises has three basic objectives. First, to re-introduce the intermediation function of commercial banks. Second, to mitigate the

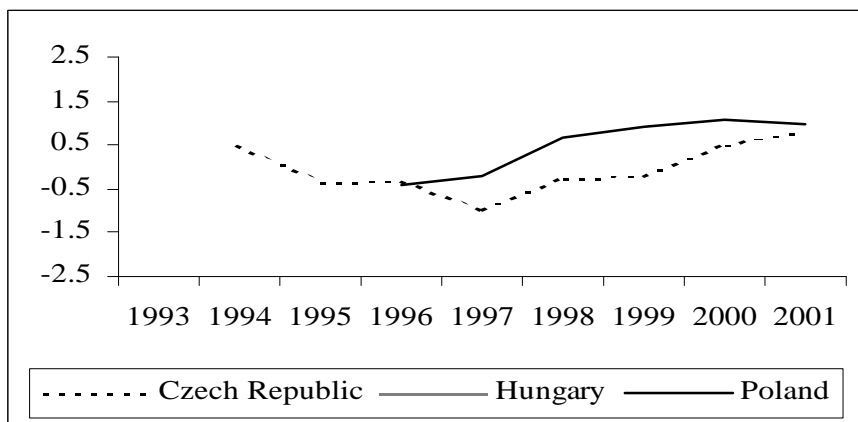
¹⁸ Claessens (1996), using a sample of twenty-five transition countries, finds that preferential treatment by government and excessive concentration in banking in transition economies, restrain the progress of banks.

risk of systemic crises. Third, to speed up the institutional and legislative changes supporting a market oriented economy.

As discussed above the method of achieving these objectives in practise has varied across countries and time. A crucial question is how to measure an optimal solution to banking crises. Dziobek and Pazarabasioglu (1997) make a decision on the basis of improvements in banks' performance, overall economic performance and intermediation capacity.

However, the effect of banking crisis resolution has a significant lag and it is hard to compare banks' performance when the systems face continuing disruptions. Using profitability as a performance criterion suggests all three banking systems have performed poorly (see Chart 5). The sudden fall in profitability in Hungary in 1998 is probably due to the impact of new strategic investors consolidating banks through provisions and reserves. Nevertheless, the ROA is surprisingly low in all three countries, given a relatively high inflation environment. Higher inflation may also explain the better profit performance in Poland than the Czech Republic notwithstanding the more competitive environment in the latter case.

Chart 5 Pre-tax ROA (%)



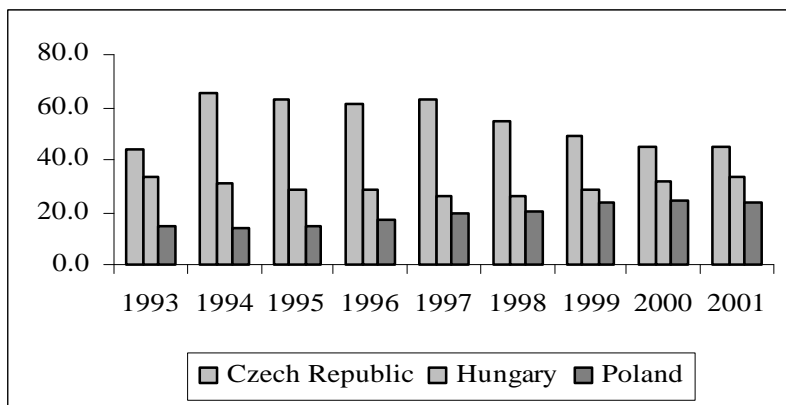
Source: Central Banks

An analysis based on overall country performance for all three countries is also inconclusive. Applying the criterion of overall economic performance in the selected

countries, Chart 1, shows that Hungary and Poland performed on average better than the Czech Republic after the first stage of transition. That said, inflation was lower in the Czech Republic than in Hungary and Poland through the transition period (Chart 2). A good macroeconomic performance, however, does not necessarily imply a functioning banking sector (as seen in other transition countries, e.g. Albania).

Intermediation capacity measured in terms of financial deepening has also limitation as is shown in Chart 6. This indicator shows only the dependence of an economy on credits but cannot tell us anything about the impact of banking crisis resolution on the system as a whole.

Chart 6 Credits to GDP (%)



Source: International Monetary Fund

An extension of these indicators is desirable for transition countries. The cumulative total fiscal costs of banking crises resolution to GDP might explain not only the extension of the crisis resolution (relative to GDP), but also the efficiency of the rescue operations in individual countries.

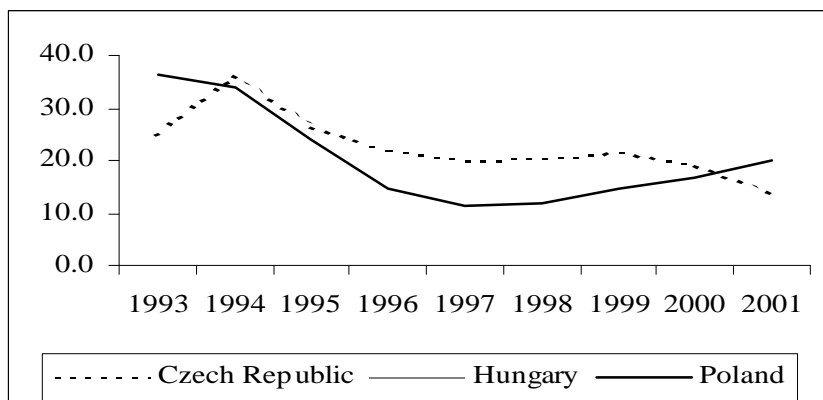
The cumulative costs of banking restructuring for the government and central bank were 25.2 per cent of GDP in 1998 (for more details see Table 5 the Appendix). This is twice as high as in Hungary (12.9 per cent) and two and half times higher than in Poland (8.7 per cent). It has been clearly shown that incomplete and partial resolution in banking and

corporate sectors required additional actions as in Czech Republic and Hungary in the early 1990s. In contrary, it may be argued that this measure is biased since the scale of problems varies across countries depending on the heritage of the past.

Another indicator such as the ratio of NPLs to total loans (assets) might help us with indicating whether or not rescue operations were sufficient. As has been mentioned, the path of NPLs might provide us with a more specific indicator of banking sector performance. Chart 7 suggests that only the Hungarian banking system showed a continuous decline in NPLs. The increase of NPLs in Poland, mainly in the late 1990s, could be explained either that foreign investors overestimated true proportions of NPLs or by disclosing a true value of NPLs after privatisation.

However, when the indicator of NPLs is combined with the applied privatisation methods, discussed in Section 4.3, its explanatory power in analysing an optimal banking crisis resolution increases. Hungary demonstrates the lowest proportion of NPLs. Hungary was also the first country, among CEE countries, that finished the privatisation process of the banking sector. Based on the Hungarian current situation in the banking sector, it may be concluded that the timing and the way of privatisation proved to be essential elements of banking crisis resolution in CEE. On the basis of this analysis it might be argued that the decentralised approach of banking crisis resolution combined with rapid privatisation to strategic foreign banks (investors) seems to be a quasi-optimal solution.

Chart 7 Non-performing loans to total loans (%)



Source: Central Banks

6. Conclusions

Banks' restructuring and consolidation process in CEE seem to have been finished. Most of specific factors of the transformation process have also been dwindled. Economies are stabilised and are not suffering from the external and internal shocks of the beginning of reforms. A legislative and institutional environment has been cultivated, regulator and prudential rules are systematically introduced and applied, privatisation is ending, and corporate governance has been gradually improved. The banking system, however, is neither at the end of transition, nor out of the transition path. The final stage of transformation of the banking system is gradually approaching.

The analysis shows that applied measures in dealing with banking crises have varied among transition countries and were dependent on political consensus. Bad loans clean up has turned out to be relatively complicated. A delay in restructuring increased costs and eventually required a stronger response. Examining the experience of three CEE countries, no firm conclusion can be drawn about the optimal crisis resolution in the banking sector in transition. However, looking back we could argue about the essential elements of what could have been an optimal resolution, elements that have, to some extent, characterised a quasi-optimal crisis resolution as in the case of Hungary.

Rescue operations and consequent consolidation must be simultaneously accompanied by macroeconomic stability, enterprise restructuring and replacement of inept management, and abolishment of forced subsidised credits. If this is not achieved then it will be reflected in the continuous misallocation of credits. The failure to recognise the problem of establishing a firm line between old and new loans (stock vs. flow) called for repeated bailouts in the Czech Republic. Another observed mistake of banking crisis resolution is that government interventions did not guarantee a 'level playing field' for enterprises and banks. In addition, the presence of moral hazard due to budgetary softness was evident in

all three countries. The Czech and partly even Hungarian case shows that without an incentive structure, a re-capitalisation programme would fail.

A crucial aspect for stabilisation of banking sectors, among others, was privatisation. Delays in privatising (state-owned banks) had negative external effects on restructuring process and the economy as a whole. Partial privatisation, e.g. applied in the Czech Republic at the outset of reforms, was undoubtedly positive but a further delay caused additional costs. Bank privatisation, however, should not be perceived as a panacea for all shortcomings within a given economy, but is essential to eliminating distortions caused by mixed ownership structure.

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Appendix

Table 1 Resolution of Small and Medium Sized Bank Failures in the Czech Republic

Banks	Established	Resolution
Agrobanka	1990	Take-over by GE (1996)
AB Banka	1991	Licence revocation (1996)
Banka Bohemia	1991	Licence revocation (1994)
Bankovni dum Skala	1990	Take-over by Union banka, licence revocation (1997)
COOP banka	1992	Take-over by Foresbanka, Licence revocation
Ceska banka	1992	Licence revocation (1995), Bankruptcy (1996)
Ekoagrobanka	1990	Take-over by Union banka, licence revocation (1997)
Evrobanka	1991	Take-over by Union banka, licence revocation (1997)
Kreditni a prumyslova banka	1991	Licence revocation, (1995), Bankruptcy (1995)
Kreditni banka Plzen	1990	Licence revocation (1996),
Podnikatelska banka	1992	n.a.
Prvni slezska banka	1993	Licence revocation (1996), Bankruptcy (1997)
Realitbanka	1991	Licence revocation (1997), Bankruptcy (1997)
Velkomoravska	1992	Licence revocation (1998)Bankruptcy (1996)
Pragobanka	1990	Licence revocation (1998)Bankruptcy (1998)
Universal bank	1993	Licence revocation (1999) Bankruptcy (1999)

Source: CNB

Table 2 Resolution of Banks Failure in Hungary

Banks	Reason fore failure	Resolution
Általános Vallalkozasi Bank	Fraud	Acquired by WestLB (1992)
Ybl Bank	Fraud	Taken over by Budapest Bank (new institution Polgári bank) – 1993
Leumi Bank	Fraud	Liquidation – 1994
Agrobank	Fraud	Merger into Mozöbank –1996
Iparbankház	Manager's myopia	Liquidation – 1995
Konzumbank	Excessive credit growth	Acquired by state Development Bank – 1995 And offered for sale (1999)
Corvinbank	Manager's myopia	Acquired by state Development Bank – 1996 And merged with Konzumbank – 1997
ÁÉB	Privatisation to non strategic partner	Sold to Gazprombank –1995
Dunabank	Uncontrolled costs	Liquidated and part sold to ING – 1995
Polgari bank	Fraud	Acquired by Penzintezeti Kozpont Bank – 1997, Merged with it as Polgari Kereskedelmi Bank – 1999
Realbank	Fraud	Brought under control of Deposit insurance Fund (1998) and liquidated (1999)

Source: Abel 2002

Table 3 Resolution of Failed Banks in Poland

Origin Banks	Investor	Year
INTERBANK SA	ABN AMRO BANK N.V	1994
Solidarność Chase D.T. Bank SA	GE Capital Corporation and the Selective American Financial Enterprises.	1995
PETROBANK SA . today LG Petro Bank SA	LG Investment Holdings BV	1996
Bank Rolno-Przemysłowy SA	Rabobank International Holding Nederland	1996
Bank Ogrodnictwa Hortex. SA later Polbank SA and OPEL BANK SA,	General Motors Acceptance Corporation	1996
Bank Przemysłowy SA	Union Group AS	1997
Bank Podlaski SA	AIG Consumer Finance Group, Inc.	1998
Bank Rozwoju Energetyki i Ochrony Środowiska MEGABANK. SA	Bayerische Vereinsbank AG	1998
BWR Bank Secesyjny SA	DaimlerChrysler Services (debis) AG	1999
Bank Współpracy Pracowniczej SA	Unibank A/S	1999
Bank Komunalny SA	Nordbanken AB	1999
Bank Współpracy Regionalnej SA,	Deutsche Bank AG	1999

Table 4 Banking Crisis Resolution in CZ, H and PL

	Stages		Institutions	Method
Czech Republic	1991-93	Consolidation program I – inherited NPLs	All state-owned commercial banks (KB, CS, CSOB, IPB)	Centralised: KOB
	1995-97	Consolidation program II and Stabilisation program	Small and medium sized commercial banks	Centralised: KOB & Ceska finacni
	1997	Cosolidation and recapitalisation (second stage)	State (partially) state owned banks (KB, CS, IPB, CSOB)	Individual capital injection, transfer NPLs into KOB, state guarantees for NPLs.
Hungary	1991-93	Loan Consolidation Program - inherited NPLs	14 Commercial Banks and 69 savings co-operative banks (capital adequacy lower than 7.25percent)	Centralised
	1993-94	Restructuring & consolidation program	Individual banks with non-adequate capital	Decentralised – capital injections to undercapitalised banks
Poland	1990-91			
	1993-94	Restructuring & consolidation program	State-owned commercial banks	Decentralised
	1994-98	Consolidation program	Agricultural banks	Decentralised

*Hospital Bank

Source: World Bank