

Banks and Governance in Transition Economies *

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1. Introduction

A distinguishing feature of the planned economic system was the absence of the concept of governance. Governance in the sense of control exercised by the owner over an enterprise was irrelevant, not only because of the pervasiveness of the state as the owner, but also because even the most limited forms of economic responsibility – not even extending to personal economic loss – of individuals or boards were avoided since economic agents simply carried out the directives of the plan. Thus, the establishment of governance in transition economies is far more difficult than the transition to the private sector. In planned economic systems, many individuals, notably bank and enterprise managers, were penally or administratively liable for non executing the directives, so that personal risk taking in the economic sphere was strongly discouraged.

The first part of this paper provides an overview on the conditions which will enable transition economies (TEs)¹ to develop bank governance. These conditions essentially consist of a market-based system, of clear rules of the game (legal and supervisory framework), and of the existence of negative pay-off, the possibility of bank failure. The related issues of deposit insurance, and the behaviour of monetary and supervisory authorities are also considered.

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* The paper was partly written when the author was working at the Office of the Chief Economist of the European Bank for Reconstruction and Development in London. The views of the author do not necessarily represent those of either institution.

¹ "Transition economies" refers in this work to the countries of the former Soviet Union and of Central Europe, including Albania, Croatia and FYR Macedonia. China and Vietnam, which are included in the category by the World Bank, are not considered here.

Two important questions will be examined, both relating to the relationships between banks and state-owned enterprises. First, banks and enterprises share participation to the bad debt problem. In the planned economy, the lending function of banks was essentially limited to the provision of working capital, and the quality of loans was not a concern given their purely accounting function. With the start of transition, enterprises suddenly had to face harder budget constraints together with dramatically unstable business conditions and macroeconomic environment. As soon as the falling profitability of enterprises was no longer covered by the directives of the plan, a large proportion of the assets of banks were suddenly worthless.

The bad debt problem is twofold: on the one hand it is necessary to come to terms with the past, that is, with the overhang of non-performing loans which penalise banks, and of which they cannot always be kept responsible. On the other, looking at the future, it is important to eliminate the sources of loans which originate from state-owned enterprises badly in need of restructuring. Under these conditions banks can be held accountable of their behaviour and the concept of governance begins to assume meaning.

The second part of this work, as its title suggests, deals with the possibility of bank-exercised governance on new and formerly state-owned enterprises. Banks have been looked at by many researchers and reformers as the guiding system which, beyond imposing hard budget constraints to enterprises, could provide much-needed governance through credit or direct ownership of shares in enterprises. These hopes have been largely unattended by the actual evolution of the financial sector in TEs, which, far from taking the lead of the process of change, has been lagging behind the developments in the real economy and in economic stabilisation.²

It is possible, though, that actual developments in TEs give banks an important role in an unexpected way. While Western observers insist on a prefixed path for banks and their relationships with enterprises, which generally follows the Anglo-Saxon model, it is already possible to witness to the creation of relatively original institutions mixing banks and enterprises and blurring the distinction between the responsibilities of the two organisations. They are the Russian financial-industrial groups, whose model seems to be spreading beyond the national borders to countries such as Belarus and

² European Bank for Reconstruction and Development (1996).

Kazakhstan. Indeed, in the Commonwealth of Independent States (CIS) they could become an important competitor of the "Western model", widely emulated by Central European countries.

The paper is organised as follows. After a description of the characteristics of banking systems in the classic socialist economy (Sections 2 and 3), the conditions enabling bank governance in TEs are considered, together with possible solutions to the bad debt problem (Sections 4 and 5). Supervision, financial crises, and deposit insurance are then discussed (Sections 6 and 7). Last, the role of banks in governing enterprises is analysed (Section 8). Conclusions (Section 9) sum up the lessons from the overview.

2. Banks in the planned system

Banks in the classical socialist system did not have much in common with their counterparts in capitalist economies.³ Banks were not even individual institutions but, rather, arms of the central bank, and were specialised on a geographical or functional basis. Generally, the central bank would direct the operations of a savings bank (for the public), an investment bank, and a trade bank. With regard to the dependence of the latter from the central bank, many authors speak of a "monobank" system, a concept originally elaborated by Lenin. Furthermore, as single banks were subordinated to the central bank, so the latter was dependent on the political-economic leadership.

Creation of money was the only function of such a banking system which could be considered "normal" in industrialised countries. Its peculiar nature, however, made the planned economies only "semi-monetised", because money was not a universal means of exchange. State enterprises had to keep all their financial resources in central bank accounts, which were divided in functionally specialised subaccounts, destined to wages, inventories, the purchase of intermediate products and so on. Enterprises were not free to dispose of these accounts, the movements of which were largely determined according to central directives. The impossibility of transfers, even between accounts of the same enterprise, inhibited enterprises from

³ Kornai (1992).

using their financial resources for investments, which were, instead, generally carried out by a specialised investment bank.

Banks were therefore accounting bodies holding the financial records of all operations undertaken by enterprises, and accumulated a huge amount of unused information on inter- and intra-enterprise financial flows. Commercial banks, not supposed to invest long term, extended credit only in the form of short-term inventory and working capital financing. This gave them effective control on the operations of enterprises.

Savings of the public were subject to analogous restrictions, and could be kept only with the savings bank, the only alternative being cash. No other legal form of investment was possible. Together with a centralised setting of the wage level and a rationed supply of consumer goods, this allowed the state to heavily influence the saving rate, which was matched at the central level by the aggregate level and the distribution of investments. The financial system, consisting almost exclusively of banks, did not therefore perform the function of intermediating between savers and enterprise investments.⁴

The absence of decentralised intermediation was also reflected in the role played by the interest rate. Following Marxian thought, services of capital were not considered a relevant component of the determinants of marked-up product prices, which, in order to reflect the "social cost of production", consisted mainly of raw material and labour costs. As a consequence, nominal interest rates were normally very low, sometimes implying negative real interest rates. This concept of the interest rate was consistent with the role of the price system. Many prices were administratively set to satisfy a number of social and economic requirements, and caused a distortion of the whole price structure, disconnecting it from the scarcity of resources. The irrationality of the price system was on the other hand matched by a low price responsiveness of enterprises, which, although nominally pursuing an acceptable level of profit, were rather led by quantitative targets, if not by the personal agenda of managers.

Not even the specialised investment bank carried out credit as a strictly commercial business. In fact, credit was often "soft", in the sense that an enterprise unable to honour the loan contract could negotiate a roll-over of the loan with the bank, or obtain an implicit/explicit agreement not to respect some terms of the contract. How-

⁴ Bulter and Bagci (1996).

ever, the concept of bad debt was irrelevant since financial resources could not be priced by their opportunity cost, and loans could not be compared in terms of quality.⁵

3. Bad debts and banks

The collapse of socialist systems affected enterprises in many ways. First, after the liberalisation of prices, inefficient enterprises were no longer allowed to be profitable by artificially compressed costs. Second, collapsing government revenues restricted budgetary outlays to enterprises. Third, in the initial stages of transition, the macroeconomic environment was suddenly very uncertain, with high inflation and sharp fall of real GDP in all TEs, inducing deep changes in demand patterns and levels. Demand patterns were also strongly influenced by the liberalisation of trade, and the contemporaneous collapse of trade relations within the former Council of Mutual Economic Assistance (CMEA), following the break-up of the Soviet Union.⁶

In this difficult environment, many enterprises, in order to survive, to maintain good industrial relations through the payment of high wages,⁷ or to further the personal interests of managers, increasingly resorted to soft credit, in the form of new loans or roll-overs. The low, sometimes negative real interest rates made servicing additional debt very cheap if not outright profitable, with the effect of adversely selecting the worst borrowers and further lowering the quality of loans.

Expansion of soft credit was parallel to the sharp accumulation of inter-enterprise arrears, also with the function of loosening enterprises' budget constraint.⁸ Arrears tend to increase in times of tight monetary policy, and are at the same time a symptom and a cause of non performing loans allowing enterprise to tolerate delays

⁵ Fries and Lane (1994).

⁶ Only in the last couple of years directions of trade have begun to stabilise, pointing to a strong resurgence of intra-CIS transactions.

⁷ Coricelli and Lane (1993).

⁸ Begg and Portes (1992).

in payments.⁹ On the other hand, by raising the liquidation value of ailing enterprises, arrears make it more difficult to evaluate the expected benefits for banks to trigger bankruptcy procedures.¹⁰ In the transition, bank lending and inter-enterprise arrears largely substituted the previous methods of softening the budget constraint of enterprises.¹¹

Banks satisfied – and to some degree still satisfy – the increased demand for credit for many reasons. In the first place, at the outset of transition all commercial banks were state-owned, and therefore were not concerned with making a profit. Second, faced with the danger of their own insolvency caused by initiating bankruptcy procedures, where available and enforceable, banks generally preferred to roll credit over.¹² Third, the lack of credit records of individual enterprises, and the limitation of banks' experience in commercial lending, were reflected in the poor information about the quality of outstanding assets.

Lastly, it was very difficult to break the network of relationships long established in the previous system, and the connected and mutually supporting vested interests of banks and enterprises. Participation to such network was the only non-price rationing mechanism in place to distribute the provision of credit, and its survival is proving to be perhaps the most serious unresolved problem of the banking sector.

The size of the bad debt problem can be measured by the proportion of bad loans in 1996. The fraction of classified loans in total loan portfolio was 30% in Russia, 35% in the Czech Republic, and a staggering 75% in Bulgaria¹³ (Chart 1). Such large overhang of bad debt negatively affects banks in many ways. Lending practices can be made weaker by the knowledge that, at the margin, another loan of doubtful quality has only a limited impact on overall asset quality.

⁹ The dimension of inter-enterprise arrears is measured by their net and gross value. The former indicates the degree of absolute indebtedness, the latter the size of the phenomenon.

¹⁰ These are not the only negative effects of arrears: they also increase the systemic risk of the economy by tightening the interconnection of commitments, and they redistribute much-needed liquidity from sound to unsound enterprises. See Begg and Portes (1992).

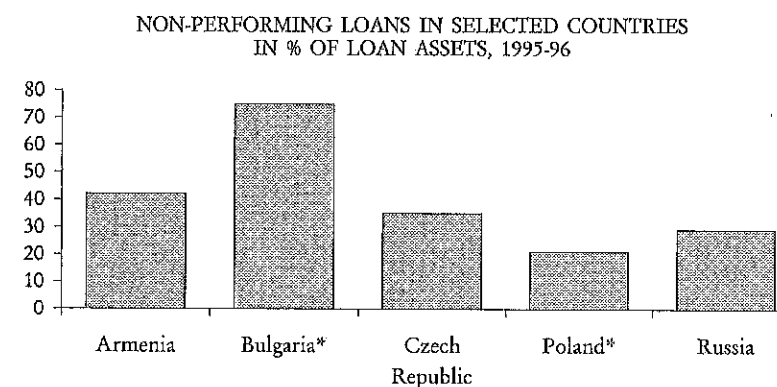
¹¹ Kornai (1992).

¹² Even if bank managers repute the borrowing enterprise to have negative net worth, they can decide to avoid bankruptcy procedures if their cost is higher than the expected benefits, or if the prospects of recovering the principal of the loan seem to improve in the long term.

¹³ European Bank for Reconstruction and Development (1996).

Managers of insolvent banks can also undertake a gambling behaviour, accepting high levels of risk of new loans in the hope of recapitalising the bank, reinforcing adverse borrower selection processes. An alternative, apparently safer lending practice, based on the requisite of large collaterals of the borrowers, paradoxically leads again to the selection of large state-owned enterprises, thus strengthening the established connection network.

CHART 1



* 1995.

Sources: European Bank for Reconstruction and Development (1996), Russian Economic Trends, OECD (1995).

4. Bank governance

Despite all these shortcomings, effective bank governance can be implemented in TEs. However, some conditions must be fulfilled. First, the banking system should be as market-based as possible, with minimum state ownership, since this tends to imply unlimited liability to losses and scarce attention to profit maximisation. Second, there must be well defined rules of the game, both in the form of a sophisticated and enforceable legal system, that clearly allocates economic liability and favours transparency to the public, and in the form of appropriate and effective supervision. Third, besides the rules of the game, negative pay-offs to bad governance must be in place, i.e. there must be a credible threat of bank failure and managers' job loss and the concrete possibility of economic loss to bank shareholders. The advantages of a credible failure threat must be balanced with the

costs originating from possible financial crises and from loss to depositors. The question of depositor protection is especially important, since in TEs there is often a less than perfect information on bank-specific risk.

To achieve those conditions, reformers in TEs must tackle a number of issues. A solution must be found to the inheritance of the past, the large amount of bad debt, and this solution is linked to the overall reform of the banking system. Actual approaches are a combination of the extreme cases of the rehabilitation of existing state-owned commercial banks (Hungary, Poland), which can consist in the work out of bad debt on a case-by-case basis or sweeping across the board, and the free entry of new private banks, both local and foreign (Russia, Estonia), possibly for a limited time period. Even though the explicit recapitalisation required in the rehabilitation approach has a cost to the state, it should be clear that large financial resources are always needed to ensure sufficient capitalisation of the banking sector.

Lastly, legal and supervisory frameworks, designed to be compatible with the existing banking system, must be established, and should include the possibility of bank failures, as well as able to deal with the financial crises, the danger of which is inevitably inherent to the transition.

5. Rehabilitation and free entry

The choice between working on the existing state-owned financial system and allowing free entry has partly depended on macro-economic conditions, mainly inflation, partly on cultural, institutional and legal factors. Periods of hyperinflation have in many countries erased outstanding loans of banks, resolving the problem of bad debt, and, from the point of view of the capital base, have put existing banks on the same level as new entrants (Charts 2a and 2b). The advantages enjoyed by existing state-owned commercial banks, in terms of human capital and fixed assets, have been outweighed in many instances by the constraints imposed by the web of established connections with state-owned enterprises. The relative freedom from the latter gives new private banks the possibility to build lending

business on a sounder basis, even though, until the private sector in TEs is sufficiently developed, it will be difficult to find borrowers outside the state sector.¹⁴

CHART 2A

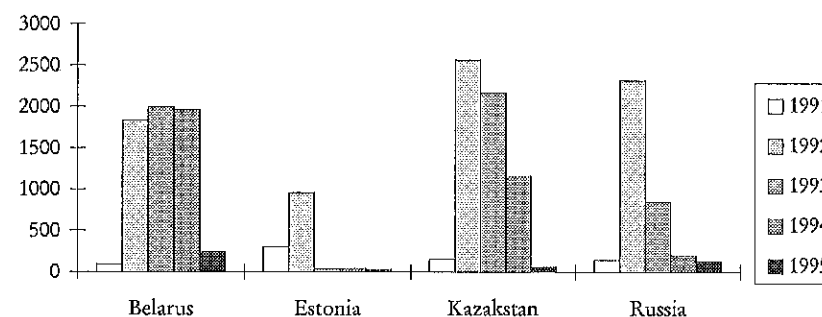
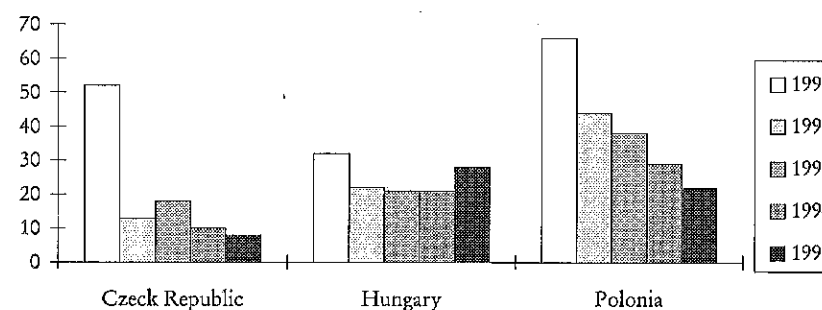
INFLATION IN SELECTED COUNTRIES
IN TRANSITION ADOPTING 'FREE-ENTRY', 1991-95

CHART 2B

INFLATION IN SELECTED COUNTRIES
IN TRANSITION ADOPTING 'REHABILITATION', 1991-95

¹⁴ However, in some countries, notably Russia, the dominating industrial groups have established strong links with new private banks, or have even created their own "proprietary" banks. This phenomenon accompanies the reorganisation of the economy under new financial-industrial groups, which in part follow the pre-transition ripartition of power, in part are based on transversal alliances (see below, Section 8).

Rehabilitation of existing banks also calls for relatively sophisticated legal and institutional environment which is generally more present in Central European countries than in the CIS. The drastic restructuring implied by 'free entry' is probably less acceptable in countries with a history of pre-communist private banking sector, and where relatively more attention to the bank clients is established.

5.1. Rehabilitation

The rehabilitation of the existing state-owned banks allows to exploit existing resources, especially human capital and fixed assets, and should in theory favour the passage to a reformed system without dramatically undermining confidence in the banking system, as is often the case with the 'free entry' approach.¹⁵ Whereas the latter is very simple, if sometimes straining for the economy, rehabilitation approach's major drawback is represented by its complexity, in particular when the position of each bank is examined and resolved case by case, recovering loans from state-owned enterprises in the highest possible degree. That task can be decentralised and left to the individual banks, as, for example, in Poland, or, if the number of state banks is very large, it can be concentrated in special institutions established to deal with bad loans, on the side of banks and of enterprises.

Many authors¹⁶ support the specialised agency solution, quoting the successful example of the Treuhand in Eastern Germany, on the grounds that the symbiotic relationships between banks and state-owned enterprises could be more easily severed, and that it quickly promotes sounder lending.¹⁷ Furthermore, one of the cause of the accumulations of bad debt would be removed, with sufficiently recapitalised banks having no incentive to roll over existing inesigible loans. By giving strong powers to a single agency, it would be easier to deal with the diffused interests represented by the managers of the state-owned enterprises, and by others benefitting from them, such as politicians.¹⁸

¹⁵ World Bank (1996).

¹⁶ See for example Fries and Lane (1994) and Blommerstein and Lange (1993).

¹⁷ In direct opposition to the decentralised solution, which could in fact encourage tighter relationships between the management of the state-owned enterprises and the bankers, and lead to conflict of interests and concentration of economic power.

¹⁸ There are some drawbacks, of which the most serious is that any expertise in clearing bad debt would not stay with the banks, i.e. the agents most likely to be affected again, and would indeed be lost with the elimination of the specialised agency once the main task is completed (see Fries and Lane 1994).

Sweeping solutions aim at obtaining extensive clearing of bad debt with the minimum effort and the maximum speed, possibly with some provisions to distinguish between low quality loans originating from the previous system, and those incurred due to bad administration. Such provisions would restrict the compensations for losses to those incurred after some cut-off date, or in some determined sectors associated with particular distortions. This partial coverage procedure has been followed in Bulgaria and Chechoslovakia.

5.2. The costs of rehabilitation

Rehabilitation has costs for the government budget. Bad debt can be either outright cancelled or socialised. In the first case, the direct cost to the government budget depends on the existing guarantees on unrecoverable deposits of the public following the elimination of bank assets.

Debt socialisation, on the other hand, directly affects the budget, entailing the clear indication of provisions to cover for the exceptional outlays, as opposed to costs being hidden as a contingency. Furthermore, debt socialisation precisely spells out the terms of the government intervention, potentially minimising moral hazard problems associated with loan guarantees. By taking up the bad assets of banks, the government acquire rights which place it in a position to influence banks' restructuring, and, if these bad loans are enforceable in some degree, to deviate resources to the most productive among state-owned enterprises.¹⁹

With sweeping solutions, at least part of the costs of recapitalisation and reform is shifted to the public sector, in the form of guarantees on deposits when outright cancelling the debt, or as budget expenditure items when debt is socialised.

5.3. Recapitalisation

Decentralised methods to deal with bad loans are normally associated with the full recapitalisation of the commercial banks, in the light of subsequent privatisation, sometimes with the involvement of bank managers as future shareholders.

¹⁹ A clarification of fiscal and financial accounts can also lay the basis for more accurate and reliable statistics, with positive effects on the quality of monetary policy (Begg and Portes 1992).

Reformers should take care to clearly distinguish, in the eyes of the public and of bank managers and owners, the once-for-all recapitalisation to put the system back on tracks from a probably recurrent bailing out of failing banks, and mark such recapitalisation as an exceptional event, to reduce as much as possible the insurgence of moral hazard problems.²⁰ These are particularly strong in TEs because the devices usually implemented in Western economies to reduce them, such as the removal of existing management, the (at least partial) attribution of losses to private owners and efficient and complete regulation and supervision, cannot be relied upon. In particular, management substitution is rarely an option given the scarcity of human capital, which also often prevents the authorities from enforcing otherwise well-designed regulations.²¹

The timing of recapitalisation must be carefully chosen to coincide with privatisation, in order to minimise the dispersion of new capital at the hands of old and inefficient managers, if early, or to induce attempts to capture regulators by new owners, if late.²²

Hungary is an example of repeated recapitalisations unsupported by clear commitments to privatisation or structural reform of banks, including management substitution. Banks were recapitalised four times in the period from 1991 to 1994, using different instruments including direct fund injection and government bond swaps on the asset side of banks' balance sheets. In 1996, two of the largest banks were still state-owned. A decided and consistent recapitalisation effort was pursued in Poland in 1993, when banks were issued with government bonds worth around 1.5% of GDP, and the incentive structure of management was radically changed. However, banks' lending procedures were not improved, and turnover of management was clearly insufficient, implying the risk of rebuilding weak portfolios.²³ In fact, two of the state banks had to be further recapitalised in 1996.

²⁰ This includes a sufficiently extensive clearance of bad debt, unless capital markets where bank shares are traded exist which are sufficiently liquid and efficient to discount the low or negative net worth on the value of the shares. Markets with these features are however virtually absent in TEs. For formal modelling of banking bail-out in TEs see Aghion, Bolton and Fries (1996).

²¹ The poverty in banking, and in general in market-oriented skills, contrasts with the often quoted large human capital stock of TEs, often positively compared with its lack in developing countries (World Bank 1996).

²² Caprio (1995).

²³ See Baer and Gray (1995) for both the Hungarian and Polish cases; Bonin and Schaffer (1995) for Hungary.

By the half of the same year, only 4 of the 13 state-owned commercial banks had been privatised, a case of early timing of recapitalisation.²⁴

5.4. Bank privatisation

In practice, the process of bank privatisation has encountered many difficulties and is far from completed in most countries, often after a promising initial impetus. While voucher privatisation, for example in the Czech and Slovak republics, has had some success, the limited liquidity of capital markets and the inefficient features of state banks have represented an obstacle to domestic cash privatisation. Foreign banks normally prefer to set up banks *ex novo*. An additional element to discourage potential investors is the behaviour of the state, sometimes going as far as the renationalisation of privatised or even private banks. This is the case of Lithuania, where following the banking crisis of end 1995 the state has gained control of the largest private bank, holding almost 15% of the country's deposits.

5.5. Free entry

In countries pursuing the 'free entry' approach, such as Russia and Estonia, a policy of relatively relaxed regulations has led to the creation of a large number of private banks in a short time. This choice can be the result of a deliberate refusal of the state to take up the costs of restoring an adequate level of capitalisation of the banking system. It must be stressed, however, that recapitalisation is necessary, and shifting the relative onus to the private sector, while formally discharging responsibility from the state, usually has the effect of favouring a severely undercapitalised banking system. The high number of banks normally hides the reality of limited total assets and the fact that the source of income is foreign exchange speculation, not the extension of credit to enterprises.

The relaxation of regulation and supervision leading to free entry must be considered a temporary phase, and should be followed

²⁴ European Bank for Reconstruction and Development (1996).

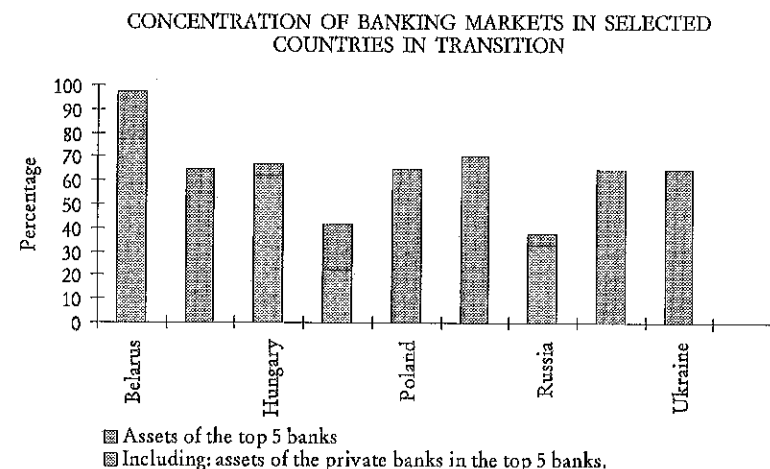
by a gradual tightening of the necessary requirements for banking operations, and the imposition of acceptable levels of transparency.

The gradual tightening of the regulatory environment has indeed been common to many countries which have favoured the free entry approach. For example, in Russia, the August 1995 interbank crisis in Moscow was the occasion to begin an overdue rationalisation of the banking sector, which reduced the number of banks from around 2600 in early 1995 to around 2200 by mid-1996. In Estonia, the number of commercial banks shrunk from 42 to 14 in the period from 1992 to 1996, in a process of liquidation and consolidation. In Kazakstan, the number of banks had risen to 210 by mid-1993 but, by mid-1996, had fallen to little more than 120, mostly due to closures imposed by the central bank.²⁵ In all these cases, the tighter supervisory stance of the central authorities was coupled with the adoption of sophisticated, Western-style regulations which could hardly be complied with by operators (see below, Section 6). In Belarus most of the 47 commercial banks operating in 1996 have been licensed in 1994, but the current process of implementation of more stringent regulations has not yet had the effect of favouring a restructuring of the sector.

The actual experience of many TEs has been a mix of the two instruments of rehabilitation and free entry. In many countries, a core of large banks, of which some still state-owned, coexists with droves of small banks, generally dedicated to foreign exchange speculation, leading to a very high concentration of assets in few large banks (Chart 3). In the long run, the mutated macroeconomic conditions, notably the fall in the inflation rate, and the consequent diminished opportunities in non-core business, will concur with stricter supervision to a drastic reduction of the number of smaller banks.

²⁵ European Bank for Reconstruction and Development (1996).

CHART 3



Source: Bree Ltd, European Bank for Reconstruction and Development, World Bank quoted in European Bank for Reconstruction and Development (1995).

6. Introducing effective supervision

Whether reform in banking system is carried out by working on the existing state banks, or by allowing the entry of new banks, new models of supervision and regulation must be found and implemented, taking into account not only the desired evolution pattern of financial systems, but also the available resources and the initial conditions which can be widely different across countries.

In line of principle, a Western-style supervisory and regulatory system could be thought desirable and attainable. In practice, its implementation is rarely possible because of the limited resources, both in terms of human capital and of financial means, available for supervision.²⁶ Furthermore, they could even be harmful when originally tuned on the much more robust financial systems of industrialised economies. TEs should more appropriately be treated on the same level as developing countries from the point of view of systemic risk and adequate capitalisation.

²⁶ For a technical but useful survey, see Bank for International Settlements (1995).

For example, Basle capital adequacy requirements are, on one side, certainly too low for TEs or, generally, emerging markets, in light of their systemic risk, and the possibility of over-optimistic quality classification of loans. On the other side, they are too high to be satisfied by the overall existing assets in most banking systems in TEs. Only few banks will be in the conditions to satisfy the requirements. This would not constitute a problem, if banking supervision were efficient enough to individuate and expel uncomplying banks. In TEs, where expertise and resources of supervising authorities are limited, it is difficult to enforce such stringent regulations. It could then be necessary to concentrate on few sound banks, and use relatively less resources in the supervision of all the others. Some of supervisory reform proposals go indeed in this direction.²⁷ Various supervisory schemes have been proposed for banking system in TEs.²⁸

6.1. *International standard banks*

Long and Talley (1994) were the forerunners of a system which is being actually implemented in Russia with the support of multilateral financial institutions,²⁹ and relies on the award of an international banking standard license to a core group of banks satisfying strict requirements, mainly on capital adequacy. The license carries deposit insurance, in contrast to uncomplying banks. Depositors would benefit from the clear distinction between 'good' and 'bad' banks. The implications for the spread between loan and deposit rates are not obvious. Depositors would be ready to accept lower interest rates in exchange for deposit insurance. The resulting larger spread would help 'good' banks cover the higher cost of maintaining a relatively high capital ratio. The effectiveness of this system is limited by the

²⁷ It must be noticed that in the long run, 'free entry' systems should therefore – theoretically – be considered on the same level, with regard to regulation, as systems where reformers have attempted a rehabilitation of existing banks.

²⁸ The solution of McKinnon (1991), who rules out banks as sources of enterprises finance on the grounds of their weaknesses, and proposes the exclusive reliance on capital markets, is probably too extreme. The functions of banks are insubstitutable (Calomiris and Kahn 1991, Caprio and Levine 1994).

²⁹ Under the Financial Institutions Development Programme, supported by the European Bank for Reconstruction and Development and the World Bank, 32 banks had been accredited by mid-1996. It would seem that prevalently large banks, hence more solid and probably safer, participate in the program (European Bank for Reconstruction and Development 1996).

overall quality of loans in the economic system. Furthermore, if the costs of satisfying regulations translate into higher interest rates on loans to enterprises, adverse selection effects could decrease the quality of credit.

6.2. *Alternative proposals*

Another proposal, which has a theoretical interest even though it has not yet been put into practice, is based on the franchise value of banking licenses, and aims at limiting the number of banks through the award of underpriced or even free permits in a strictly predetermined number.³⁰ The awarded banks would have strong incentives to respect the criteria required to retain the licence, and in the long run this process would select the most profitable banks. This would be true even in the absence of given costly prudential requirements, because existing and potential banks would compete on 'good' behaviour to stay in or enter the market. The problem with the franchise value theory is the license award/withdrawal mechanism, both at the initial and in later stage of the implementation of the procedure. Classical questions of regulators' capture arise, which are often found in the regulation of infrastructures, also based on the award of a limited number (possibly one) of licenses.

6.3. *Free banking*

Some banking systems in TEs, typically those which favoured free entry of new banks such as Russia and Estonia, are seen by some authors in terms of the historical precedents of 'free banking' in Scotland or the United States in the last century. Poehl and Claessens (1994), for example, propose to complete the free entry model with the restriction to tax collection of the activities of state-owned banks. However, while 'free banking' constitutes an interesting historical precedent, it is not a wholly appropriate example, being based on unlimited liability of private owners.

³⁰ Caprio (1995).

7. Financial crises and deposit insurance

TEs are particularly subject to bank crises. Besides the Russian interbank crisis in August 1995, the recent past has seen banking troubles in Lithuania, Latvia, Bulgaria and the Czech Republic. The failure of a bank is not, *per se*, a desirable event, and certainly it has costs for bank owners, for depositors, if unprotected by an insurance scheme, and for borrowing enterprises, which undergo a sudden credit crunch. However, it is vital for the long-run health of a financial system that the concrete possibility of failure exists for insolvent individual banks. Potential loss to owners and depositors induce them to exercise control on bank operations.³¹

The need of ensuring a potential negative pay-offs must be balanced not only with the costs to owners and depositors, but also to the economic system in case the crisis of one or few banks expand to the whole financial sector. The latter costs must be kept at a minimum, and in this the role of supervision and the behaviour of monetary authorities are crucial.³²

Supervision and monetary policy influence the stability of the system on two levels. First, they can help build a system which is structurally as stable as possible. Second, the quality of their response to a crisis is vital in limiting the diffusion of bank failures, maintaining at the same time the necessary credibility of the effective threat of failure.

A bank can be solvent but subject to a strong even though temporary funds withdrawal. In opposition to such liquidity crises, bank insolvency will in the long run be a cause for failure. A healthy and solvent banking system can be protected from liquidity crises if sufficient liquidity is structurally built in the financial system.

Other structural measures reduce the system's exposure to liquidity crises. Supervisors can promote the diversification of domestic banks' lending across sectors and, as soon as it is feasible, abroad. The entry of branches of foreign banks is also positive in light of the buffering function of the large assets of the mother banks.

³¹ Gorton and Winton (1996).

³² Gavin and Hausmann (1995).

In the evenience of a bank failure, it is important that the supervisory and monetary policy authorities recognise the nature of the trouble and act accordingly. The intervention of the monetary authorities to bail out the affected banks is appropriate in the former case, while it is doubtful in the latter. The pressure to bail out failing banks can be very strong, though, both for political reasons and for more substantial concern for the public interest. An example of appropriate intervention is represented by the liquidity easing behaviour of the Russian central bank in occasion of the August 1995 interbank crisis, which seems to have been a determining factor, together with the mutual support of the bigger banks, in avoiding an all-out financial break down.

8. The role of banks in the corporate governance of enterprises

Economic transition has been as traumatic for state-owned enterprises as for banks. The need of corporate governance has also arisen especially because enterprises in TEs are exposed to the danger of dispersion of financial and physical resources among all various 'stakeholders', consisting, besides the owner, often the state, in the managers, the employees, as well as local politicians and government officers. The absence of effective governance allows attention of managers to wander away from the advantage of creditors or shareholders, towards the benefit of all these various 'stakeholders', to the detriment of performance. State subsidies, arrears, or soft credit, still soften the budget constraint and allow enterprises to survive, though at the cost of high inefficiency.

Many reformers, especially at the outset of transition, have insisted on the creation of mechanisms of corporate governance, through the privatisation process and banking sector reform. Banks should have played a crucial role,³³ but actual developments have not been very reassuring.³⁴ The conditions enabling effective governance

³³ See for example Phelps *et al.* (1993), van Wijnbergen (1993).

³⁴ For accounts of the experience of some countries, see Baer and Gray (1995), Bonin and Szekely (1994), Borish, Long and Noel (1995), that in particular provides a very complete overview from the point of view of the policy-maker and of multilateral financial institutions.

are similar to those described with regard to banks: reduction of the role of the state, creation of clear rules in the form of legal system, which permits the enforcement of property rights and in particular of credit, and the existence of negative pay-offs, i.e. failure and economic loss to owners. The place of supervision in triggering failure is replaced by other controls, originating from inside or outside the enterprise.

Enterprise control of insiders, i.e. management or employees, possible because of vague ownership rights or the outright insufficient attention of owners, is likely to result in further diversion from the interest of the owners, for example through the maximisation of wages or bonuses. A small but significant ownership share in the hands of the management could be a partial corrective.³⁵ The most important outside controls are applied by shareholders, particularly when a significant portion of ownership is held by some core investor.³⁶ Besides banks, the latter can be private individuals or institutional investors, such as pension funds or insurance companies.

In most countries, the first wave of privatisation has been based on the distribution of vouchers to a large proportion of the population. Attribution criteria have varied from the age of participants to the scheme, to preferential treatment to employees and management. The result almost in all cases has been the extreme fragmentation of the ownership of the enterprises. In many instances, the management and employees have retained control, often with a relative majority of small absolute size. The consequence has been a very low weight of shareholders on enterprise management. In addition, transparency and diffusion of information are still very limited, and the scarce liquidity or outright absence of stock exchanges make trading very difficult.

Along these direct controls over management, another check on managers' behaviour is the threat of potential take-overs, allowed by a low share value. This type of control relies crucially on the existence of liquid and relatively large stock exchanges, and on the possible

³⁵ Relevant ownership shares attributed to employees are likely to distract the management from the maximisation of future profitability. This pattern is however common in TEs following voucher privatisations. See Phelps *et al.* (1993).

³⁶ Incentive devices and product market forces can also constitute effective outside controls. See Phelps *et al.* (1993). Foreign equity participation, albeit in principle very effective, can play a limited role due to the still small size of foreign direct investments in TEs.

concentration of ownership in the hands of core investors. Both conditions are hardly fulfilled in TEs.

A partial remedy to the absence of core ownership of individual shareholders has been the concentration of ownership in institutional investors, such as (private or public) investment funds, often set up in the context of mass privatisation,³⁷ pension funds, and insurance companies. In industrialised countries, they are often more effective than individual shareholders in governing enterprises because of their expertise, economies of scale, and sheer size of shareholding. Unfortunately, in TEs institutional investors are still at a nascent stage,³⁸ due to limited liquidity, cultural and institutional factors, which assign pensions and social benefits to the state or to state-owned enterprises, and to the inadequate regulation efforts in most countries. However, even in TEs, given the appropriate conditions, institutional investors could play a significant role. In the Czech Republic, investment funds, which had gathered around 70% of the privatisation vouchers, were highly instrumental in the so-called "third wave" enterprise restructuring.³⁹

Banks represented at the beginning of transition a possible source of core ownership or, at least, of effective debt mechanism controls. In general, long credit relationships between banks and enterprises allow the exchange of better information, and free the enterprise from the need of retaining high self-financing for signalling purposes and from the search of alternative means of funding. Managers can thus concentrate on long-run performance. Furthermore, they have the incentive to behave well to avoid excessive interference of banks in the conduct of business or, in the extreme case of bankruptcy, the loss of job.

Banks could exercise a governing role also by owning significant fractions of equity. The core investor role of banks in TEs has been intensely debated.⁴⁰ A first, often implicit, argument against it is based on the rigid distinction, firmly entrenched especially in Anglo-Saxon banking since the Great Depression, between investment and com-

³⁷ For example, in the recent Romanian privatisation scheme, voucher holders could directly subscribe to enterprises to be privatised, or to one of five investment funds.

³⁸ Lankes and Impavido (1996).

³⁹ See Coffee (1995).

⁴⁰ Dittus and Prowse (1994) extensively examine pros and cons. See also Dittus (1994).

mercial banking, on the grounds of the danger of propagation of financial crises to the real sector.

Mostly, though, equity ownership of banks is considered inappropriate because their weakness would inhibit an efficient ownership role. Banks are still burdened by bad debt and undercapitalisation, are often still state-owned, cannot rely on sufficiently skilled personnel and sound lending practices, and are inadequately supervised. Furthermore, dispersion of energies in non-lending business, particularly when it implies difficult and costly enterprise restructuring, could slow down the learning process in commercial banking core activities and affect the level of services offered to the public. In most countries, lastly, the state has shown a continued intention to meddle in the financial sectors.⁴¹

The main argument – and a decisive one – in favour of large equity holdings of banks in TEs is represented by the lack of other potential core investors, with the exception of the state and, in very few countries, of investment funds and foreign strategic investors. In the long run, banks can make contribution to bank restructuring and governance. It is as unreasonable, though, to expect efficient performance from the start. As this is true also of commercial operations of banks, there is no particular reason to forbid them to own significant enterprise shares.

The answer to the question of bank equity ownership, therefore, lies in the possibility of the establishment of a sufficiently sound banking system, which should indeed be the objective of reformers. Supervisory authorities should concentrate on creating sensible regulations for bank operations, in enforcing them, and in promoting the adoption of sound lending and accounting standards, as well as promoting the training of the staff. As a measure of caution, banks' equity ownership could be delayed until a minimum acceptable level of soundness has been reached, with the provision that, anyway, banks as any other investor, especially in TEs, will need a learning period, and that mistakes will inevitably be made.⁴² Also, given that in some cases bank privatisations beyond a certain threshold are objectively difficult, it could be reasonable to concentrate instead on

⁴¹ The absence of developed capital markets is not necessarily a significant impeding factor, as sometimes stated.

⁴² The fact that banks themselves are not particularly propense to own equity (Dittus and Prowse 1994) may be a comforting sign of wisdom on their part, but does not necessarily imply that they never will, nor that they will never be able to exercise governance.

the implementation of an equal treatment of state-owned and private operators. While state-owned banks certainly constitute a hindrance to competition and efficiency, a sufficiently efficient albeit second best, banking system, could be achieved even with a significant state-owned presence, as has been the case in Italy and France.

Apart from the theoretical debate on bank-led enterprise governance, banks have so far failed to significantly fulfil this task for the following reasons:

- the regeneration of banking systems through the rehabilitation of state-owned commercial banks, and the entry of new private banks, has been slower than hoped. Furthermore old and new banks have rarely broken links with state-owned enterprises;

- state-owned enterprises need not only governance but restructuring, which requires expertise, strength, and determination well beyond the normal skills of commercial banks, let alone banks in TEs which still lack the experience and often the means, if not the incentives, to develop even day-to-day banking skills;

- bankruptcy laws, while in 1996 formally present or under preparation in virtually all countries in transition, are being actually implemented in a systematic way in a very small number of countries, namely Hungary, Estonia, the Czech Republic, and Slovenia, thus making the essential mechanism of bank control over insolvent enterprises unavailable to banks in most TEs. The role of bankruptcy goes beyond its actual implementation against a given enterprise; it rather consists in a potential threat, which allows creditors, including banks, to obtain better management or to negotiate a more favourable ripartition of assets in case of failure. The absence of formal bankruptcy procedures leads banks and enterprises to carry out informal settlements which highly depend on the relative balance of power between parties;

- the sheer size of most banks has remained very low, and most banks, especially in countries where free entry has been favoured, have not developed any significant loan portfolio, concentrating instead on off-balance sheets activities. Often, the largest banks are formerly – if not currently – state-owned.⁴³

⁴³ Russia is an exception, since most of the largest banks were born as private. As a consequence, they are playing an active role in the reorganisation of the industrial sector, albeit not in the direction originally envisaged by Western economists (see below, Section 8).

The conclusion can be drawn that in the financial sector changes from above can be imposed with difficulty. The spontaneous evolution of institutional economic systems, like the delicate complex of check and balances of corporate governance, can take a long time to reach an efficient form. Often, Western observers look at TEs with an optimal design in mind, forgetting that it is based on the end-process of historically determined changes in Western financial institutions; sometimes, that optimal design relies uniquely on Anglo-Saxon experience. It is important to realise that the historical process taking place in TEs could as well take unexpected bends which do not conform to that design. The case of the financial-industrial groups (FIGs) in Russia is a good example of this.

A visit in Korea of the Russian First Deputy Defence Minister, Andrei Kokoshin, in 1992, gave the deciding impulse for the legal recognition of the links between groups of industries and banks in the form of FIGs, on the basis of the Asian model and in particular of the *kaebols*. Against the resistance of many liberal reformers, including Anatoli Chubais, then Minister of Finance, FIGs have become important players on the Russian economic scene: at the end of 1995 there were 24 FIGs, employing more than 2 million people, and accounting for almost 5% of GDP. The features of FIGs, including the growing role of banks, particularly Moscow-based, in the ownership and governance of industrial enterprises, the large dimension of corporate structures, and the weak role of the stock exchange, all strikingly resemble not the Anglo-Saxon model, to which they were indeed consciously opposed, nor the Asian model, but, indeed, a 'Tsarist Russian' model. This impression is reinforced by the closeness of links between some government members to FIGs.

The importance of the role of FIGs for the future of enterprise governance has been underlined by the 'debt-for-shares' swap scheme, under which banks could extend credit to the government with a collateral of shares in the enterprises to be privatised. The eventual outcome of this complicated scheme has not been yet defined, but it is likely to significantly increase the holdings of shares of large corporations in the leading commercial banks. FIGs could indeed represent a possible, although controversial, model of future development of bank-industry development, widespread at least in countries of CIS.

9. Conclusions

In TEs, the path to the establishment of effective governance of banks and enterprises is long and troubled as is the process of economy restructuring. While the easier and sometimes more radical structural reforms, such as trade and price liberalisation and mass privatisation, have been relatively simple and fast to implement, further progress in transition to a market economy is showing signs of slowdown. In the banking sector, delays regard privatisations, which have not followed recapitalisations as closely as it would have been desirable, the resolution of bad debt problem and of the ties to state-owned enterprises, and the development of adequate supervision to the banking sector and the financial system in general. Of course, this has negative implications for the creation of mechanisms of effective governance in banks – the primary focus of the paper – and in enterprises. However, this mixed experience allows to draw some lessons.

First, privatisations of state-owned banks should not distract attention from other, more important priorities, especially when a substantial proportion of private or privatised banks has already been established.

Second, the design and implementation of supervision in the banking system, and of an adequate legal system in the economic system at large, represent the indispensable preconditions not only for establishment of governance mechanisms, but also for an 'automatic' restructuring of the whole economy.

Third, this implies that a strong effort should be undertaken, by national as well as multilateral institutions, to strengthen the resources of the regulatory and monetary authorities, rather than to assist the development of the financial sector by the injection of funds, even *via* relatively sound banks.

Fourth, structural reforms, in particular in the banking sector, would benefit from a credible and determined state, able to define and implement rational and credible rules of the game. Credibility derives from an equal as possible treatment of all players, whether public and private. The example of economic development in continental Europe in the last century supports this view.

Fifth, *ex ante* theorising and recommendations of institutional policy design, in particular by Western observers, can clash with the actual development of financial systems driven by powerful forces which are deeply rooted in the political and economic establishment. This is all the more true, and has more relevant implications, for a large country such as Russia.

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