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State-Owned Banks in the Transition: Origins, Evolution, and Policy Responses

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Acknowledgments

The authors wish to thank Paul Siegelbaum, director of the World Bank's Private and Financial Sector Department for the Europe and Central Asia region, for his support of this study throughout all stages of its development. His important guidance has greatly contributed to the final product and conclusions. Luigi Passamonti and Hormoz Aghdaey served as peer reviewers, contributing greatly as well through their thoughtful feedback. Alexander Fleming, Julian Schweitzer, Andrew Vorkink and Daniela Gressani also offered their support and provided a number of useful comments to the authors. The authors also would like thank Johannes Linn, vice president of the World Bank's Europe and Central Asia Region, for his support in putting the important issue of state banking on the regional agenda.

The authors would like to express their appreciation in particular to Alexander Pankov for leading the major research and data gathering effort on the state banks, and Anna Sukiasyan for working to compile the required data. Alexander Pankov is also the primary author of the most cases on individual state banks in the annexes. The authors would not have been able to produce this report without their thorough research, effective output, and tireless effort.

George Clarke compiled much of the macroeconomic data used and produced the data on arrears that have been incorporated into the text. The many task managers and researchers who assisted with data requests, clarifications, and opinions also helped immensely with the effort.

Executive Summary

Continued state ownership of banking systems in transition economies has undermined economic reform efforts and distorted emerging markets. Where countries have been slow to reform their troubled banking systems, the delay has added greatly to the economic costs. These costs have been evident not only in the Commonwealth of Independent States (CIS), where the transition to a modern banking system has been most difficult, but also in the countries of Central and Eastern Europe and the Baltics, where governments have been more willing to pursue many economic reform measures.

After more than a decade of financial sector reform, however, many countries have failed to solve their problems with lingering state-owned banks. How should such countries deal with their remaining state banks, especially given that most have poor prospects for privatization? What are the lessons from the past decade? And what strategies and approaches have proven most effective?

This study examines the history and evolution of state banks in the transition economies of Europe and Central Asia. Chapters 1–4 review the experience with state banking over the last decade, explore the roles that state banks have played since the early stages of transition, and examine the problems that exist today. Chapter 5 compares various approaches to reform and calls attention to the significant costs associated with continued state ownership. The study concludes with lessons from experience and recommendations for policymakers on approaches to ending state ownership of banks in the region. The findings indicate that restructuring of state banks has proven time consuming and costly, and governments are better off moving swiftly to privatize or liquidate their remaining state banks than to attempt to rehabilitate them.

The study also includes seven case studies of individual state banks that have been reformed or privatized over the past decade. The case studies highlight the challenges of implementing various reform measures and illustrate how such challenges have been addressed in difficult economic and political contexts.

In this study, a "state" bank has been defined as a bank that has a minimum of 25 percent of its shares owned by the government. The definition does not include the many "private" banks that have emerged in the region that also have strong ties to the government. A full analysis of such private banks is beyond the scope of this study, although the governance and non-commercial management decisions of such banks also weaken financial systems in the region.

Main Findings and Lessons

Continued State Ownership of the Banking Sector Has Big Economic Costs

Many of the distortions in poorly performing economies do not originate in the banking sector. But where state banks still control a large share of the resources in the banking system,

they continue to pose a risk to macroeconomic and fiscal stability. State banks are typically vehicles for patronage that worsen the prospects for competitive market development. Alternatively, these state banks can be ineffective shells that fail to perform a useful intermediation role once the government imposes effective hard budget constraints and a modern supervisory system.

The presence of state banks has deterred prime-rated foreign investment from the banking market, and the potential distortions resulting from patronage or preferential treatment of state banks have deterred these and other banks from taking on more risk. Consequently, in countries where state banks continue to play a prominent role, lending has tended to be scarce and costly for many enterprises, putting a brake on economic growth. Where banks are still used for noncommercial purposes—such as directed lending to enterprises—these practices have more often than not led to a severe financial crisis in the banking system, high levels of corruption, and big costs for the government.

The most problematic state banks have been agricultural and industrial banks, whose original role was to finance state farms and industrial enterprises that employed large numbers of people and served as the backbone of the socialist economic model. Because these banks focused on lending to what eventually became loss-making farms and enterprises, they became the most deeply insolvent. In addition, because of their perceived importance, they have often been considered "too big to fail." Efforts to shore them up as going concerns have generally required repeated recapitalizations and involved regulatory forbearance that has distorted markets and prevented the emergence of more efficient banking systems.

Delaying Banking Sector Reform Only Adds to the Costs

In transition economies that have been slow to take corrective action to deal with troubled state banks, the delays have ultimately led to higher recapitalization costs and weakened the financial sector overall. While there have been cases when continued state ownership of the banking sector has helped to maintain stability in a country's financial sector (such as in Latvia), postponing reforms with interim measures or restructurings fails to resolve core issues and should be done only for a limited period. Delayed reforms have also resulted in significant macroeconomic costs—high inflation, high real interest rates, fiscal deficits, exchange rate depreciation, and balance of payments pressures stemming from higher debt service requirements and lower international reserves. The troubled banks have also generated a deep loss of faith in public institutions, which has had ramifications throughout the banking sector and civil society—through lower deposits, lower intermediation rates, and tax evasion. For these reasons, delayed reforms have been correlated with sluggish economic performance.

Many transition economies have adopted laws designed to move toward modern banking systems. But even where laws are adequate, the institutional capacity—judicial, regulatory, and supervisory—needed to effectively carry out the laws has been slow to emerge. And many countries have not yet adequately addressed poor financial discipline, loan defaults, weak legal support for secured transactions, lack of veracity in financial information, and other problems that further undermine market-based banking. As a result many banking systems continue to perform poorly.

Banking Systems Have Shown Diverging Performance Across Regions

While all transition economies have faced common problems in their banking sectors during the transition, in the CIS countries the transition to sound, stable banking systems has been far more difficult. There are several reasons for this difference. While hyperinflation wiped out asset values in the CIS, inflation was less

devastating in Central and Eastern Europe and somewhat less so in the Baltic states. In Central and Eastern Europe governments were more willing to pursue broad restructuring programs before privatization, resulting in healthier banks. CIS countries sometimes set up parallel structures for commodity resources considered strategic and essential for foreign exchange earnings. As monetary systems imploded, CIS countries shifted increasingly to a system of arrears, barter, and netting, often bypassing the banking sector.

Thus by the mid-1990s the CIS countries had much of their economic and asset values in nonbank institutions, while countries in Central and Eastern Europe and the Baltics focused on building a stable banking system. In these countries the practice of directed lending through state banks slowly unraveled as macroeconomic pressures called for hard budget constraints, solvency and liquidity standards were tightened, effective new private and foreign banks emerged, and, for some countries, negotiations began for entry into the European Union.

Banks now show stronger growth in deposits and capital in many countries in Central and Eastern Europe and the Baltics, suggesting that these countries have put into place structures that have helped to restore confidence in banking systems among creditors, investors, and the public. By contrast, deposit mobilization has been more limited in the CIS countries, and banks have undergone significant decapitalization since 1995.

Most Remaining State Banks Should Be Treated as Resolution Cases

With few exceptions, the remaining state banks carry large burdens of nonperforming loans and have a big share of their assets invested in government securities, raising questions about their future earning prospects and solvency. For these troubled banks, liquidation should generally be the solution, not restructuring or recapitalization.

Liquidation is an important means for consolidating banking systems and creating open, competitive markets. Without such market conditions, banks will not assume risk, and intermediation will remain limited and distorted.

Governments Should Include Measures to Mitigate the Social Costs of Privatization

A main deterrent to privatization is the fact that many state banks serve as very large employers. Governments resist privatization and liquidation often because it means that thousands of individuals will lose their jobs. Sberbank, the Russian state savings bank, for example has more than 200,000 employees working throughout the country in 21,000 branches.

As a result of such social pressures, successful financial sector strategies must include specific measures to mitigate social costs of privatizing state banks. In rare cases, it may be necessary to keep certain state owned banks open for a limited period to avoid a crisis. This may require short term technical assistance or strict controls on lending to impose limit on spending and prevent additional losses. Privatizations of state banks—as with privatization of any state-owned enterprise—that will result in large dislocations of labor should also be accompanied by social protection programs to retrain staff and help employees find new jobs.

Recommended Strategies

Governments need to design strategies to reduce state banking in order to help create a stable banking environment. Governments privatizing their banking system have a few broad options:

- ***Restructuring:*** In general restructuring has proven to be a difficult and costly exercise. Experience has shown that governments are often much better off moving swiftly to liquidate their state banks. Where

there is potential for privatizing a bank through sale to strategic investors, however, restructuring is probably warranted. Whether restructuring should precede or follow privatization needs to be decided case by case, taking into account economic and market conditions.

- ***Consolidation:*** Consolidating banks before privatization may help reduce the transaction costs of negotiating privatization transactions, but it has often turned out to be complex and costly, and the results suboptimal. Relying on market mechanisms to consolidate banking systems is usually a better choice. Most of the remaining state banks could probably be consolidated more efficiently by simply offering them for sale to banks—domestic and foreign.
- ***Purchase and Assumption:*** Given poor privatization prospects, a purchase and assumption exercise is probably the fastest way to modernize the banking system. This approach, in which unwanted parts of a bank being privatized are spun off to another bank that might be able to give them some value, allows the market to determine what is salvageable. It thus sends a signal that markets are open and transparent and that the state is getting out of activities better left to the private sector.
- ***Regulatory Approach:*** Where market mechanisms are not sufficient to consolidate the banking system, the regulatory approach is an option. A separate administration could work with specialists to establish a consolidation plan for banks that focuses on a strategic economic or financial objective and includes indicators to measure progress toward that objective.
- ***Liquidation:*** For a bank with no potential for commercial viability, liquidation should occur promptly. Branches can be spun off to other interested parties, including nonbank financial institutions such as credit unions and microfinance groups. Many governments have resisted liquidation, particularly for savings or agricultural banks, because there have been few alternatives for people in rural areas and because these banks have served many older people uncomfortable with the prospect of change. While these are understandable reasons for deferring closure, in reality continued support of these banks distorts the market, reduces competition, and limits development of viable private bank and non-bank financial institutions.
- ***Ensuring Access to Services for Poor or Target Groups:*** Governments often keep state banks alive because of both perceived and real benefits to poor, rural or target populations. In certain countries with poorly developed financial systems, state banks are sole providers of financial services to remote or rural areas or pensioners. In addition, many people in both rural and urban areas rely almost exclusively on state banks for delivery of their welfare benefits, to pay for utility bills, and to make other transfers. They also perceive state-ownership as offering an implicit guarantee of their savings. As a result, many governments bail out failing banks because they fear leaving large or disadvantaged groups without access to services.

  In such cases, where the state bank in fact is the sole provider of financial services to certain groups (such as in Russia, Ukraine, or Albania), governments may decide to keep the bank alive for a given period. During this time, however, they can take measures to limit damages and prevent further losses such as narrowing the licenses of the bank so it cannot continue to lend and does not worsen its loan portfolio. Government policies should also encourage commercial banks and non-bank financial institutions to expand services to rural areas and provide incentives to serve other hard to reach groups. Microfinance institutions and leasing companies may in fact offer services better tailored to the poor, small entrepreneurs, and rural populations in the long run. In

pursuing such a strategy, however, the government should have strict criteria to identify what banks should be kept open, for example, by share of the market, or outreach to certain areas to be sure that it is not subsidizing services that could be alternatively be provided by the private sector at a lower cost to the financial system.

- ***Improving the Business Environment:*** Governments should take measures to improve the business environment as part of a broad overall strategy to strengthen the financial system and end state ownership of banks. Such measures include providing support to improve corporate governance, reform judicial systems, build registries of collateral, reinforce creditors' rights and contract enforcement, modernize accounting and auditing practices, reduce administrative obstacles to business registration, and modernize bankruptcy laws.

Chapter 1

The Early Stages of Transition

At the beginning of the 1990s, the transition economies of the region embarked on a remarkable transformation. The financial systems—which provided the backbone of the socialist economies—required massive structural change to meet the needs of the emerging market economies.

Economic Structure of Transition Economies in the Early 1990s

When the transition began, the formerly socialist economies were generally oriented toward industry (figure 1.1). In 1992 the industrial sector produced 47 percent of total output. Services accounted for about 38 percent, most of it related to government. Agriculture produced only about 15 percent of recorded output, although this figure does not capture subsistence farming. By contrast, in OECD countries in 1992, services accounted for 66 percent of output, industry for 23 percent, and agriculture for only 5 percent.[1]

The structure of transition economies varied little. A few countries, mainly in Central and Eastern Europe, had prominent service sectors. For example, Hungary, FYR Macedonia, and Slovenia all had service sectors that accounted for more than half of GDP, suggesting that beyond direct government administration there were enterprises active in transport, distribution, tourism, and related activities. But in the CIS and Baltic states services (including government) did not exceed 39 percent (the share in Russia), and they averaged about 35 percent. The service sector showed low levels of development in the Baltic states, particularly Latvia and Lithuania.

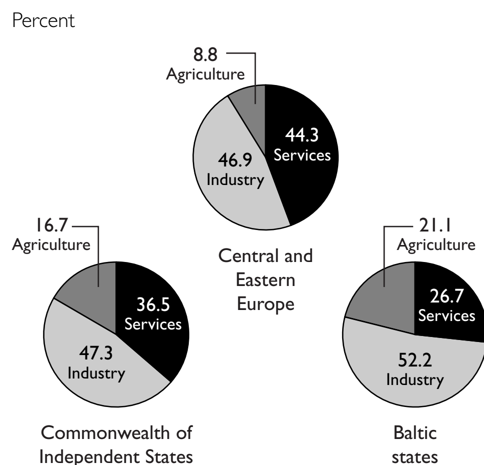
Agriculture played only a limited role. Indeed, Central and Eastern Europe showed extraordinarily low agricultural output, at only 8 percent of GDP. This figure may understate output, however, as many people in the region rely on subsistence farming as part of their safety net. Moreover, because private farming was permitted in several countries of Central and Eastern Europe, much of the output is presumed to have gone unrecorded.[2] Only Albania recorded agricultural output amounting to more than half its GDP. In many CIS countries this share was about a third.

With this kind of economic structure, most banking was geared to financing industry. Foreign trade banks attempted to sustain traditional trade links integral to central planning, but these generally imploded when the Soviet Union collapsed. When trade opened, these banks financed the export of goods for hard currency. This kind of export financing had already been taking place in such countries as Hungary, Romania, and Yugoslavia, which had opened their trade regimes well before the collapse of the Soviet Union. In some cases these functions focused on agriculture, agro-processing, or commodities (for example, oil in Azerbaijan and Kazakhstan, natural gas in Turkmenistan, and cotton in Tajikistan and Uzbekistan).

FIGURE 1.1

Structure of Transition Economies, 1992

Percent



Note: GDP data for FYR Macedonia and Turkmenistan are based on per capita income times population.
Source: World Bank (1994b); EBRD, *Transition Report 2000* and *Transition Report 2001*.

Monetary and Fiscal Trends in 1989–95

During the early period of transition, the monetary and fiscal trends varied widely across the region. Overall, the countries of Central and Eastern Europe did not suffer from the very high inflation experienced in the Baltics or the hyperinflation experienced in the CIS, and as a result, pursued largely different monetary and fiscal policies.

Central and Eastern Europe

Following the initial shocks in the early 1990s most Central and Eastern European (CEE) countries tightened monetary policy if they had not already done so and, by extension, the regulations limiting risk-seeking behavior in the banking system. These countries had shown earlier signs of monetary discipline and central bank independence, resulting in greater stability by the mid-1990s. Inflation rates averaged 15 percent (on an unweighted basis) in 1995, far lower than peak rates just a few years before, in 1990–94 (table 1.1).[3] Six of 10 countries had single-digit inflation, and no country had year-end inflation (as measured by the consumer price index, or CPI) exceeding 33 percent.

The weakness was more on the fiscal side. Loss-making enterprises continued to receive financing—from the banks (usually state owned), the budget, or off-budgetary accounts or through arrears to state companies and energy suppliers. While lower than in earlier years, fiscal deficits averaged about 3.3 percent of GDP (on an unweighted basis) in 1995. Consolidated deficits were respectable by 1995, but they understated the softness of budget constraints on the state sector due to the buildup of arrears. Moreover, lending to the state sector still accounted for stocks and flows of bank lending.[4] Continued state ownership in the banking sector, particularly in "large" banks with large exposures and long-standing ties to state enterprises and farms, made the continued lending to the state sector possible.[5] State banks' asset shares were declining in CEE countries in the early to mid-1990s, yet were still high. In 1995 state banks accounted for more than half of all banking system assets in most of these countries, even where their shares were reported to be less.

The Baltic States

The Baltic states had higher inflation rates than the CEE countries, most of which kept inflation below about 340 percent. Year-end CPI rates in the three Baltic states peaked at about 1,000 percent in the early 1990s, perhaps because they faced greater monetary challenges (table 1.2). The Baltic states showed a high level of discipline, however, bringing their (unweighted) average inflation rate in 1995 to about 29 percent—a small fraction of earlier peak levels.[6] Meanwhile, monetary discipline was reinforced by fiscal discipline as all three countries kept spending within reasonable bounds, even during the period of hyperinflation.

TABLE 1.1

Selected Fiscal and Monetary Indicators in Central and Eastern European Countries, 1990–95

(percent)

Country	Inflation rate		Fiscal deficit as a share of GDP		State bank assets as a share of total	
	1990–94	1995	1990–94	1995	1992	1995
Albania	237.0	6.0	–31.0	–10.3	97.8	94.5
Bulgaria	338.9	32.9	–10.9	–6.4	82.2	82.2
Croatia	1,149.0	3.8	–3.9	–0.9	58.9	51.9
Czech Republic	52.0	7.9	–3.1	–1.8	20.6	17.6
Hungary	32.2	28.3	–8.9	–6.2	81.2	52.0
Macedonia, FYR	1,935.0	9.0	–13.8	–1.2	—	—
Poland	249.3	21.6	–6.7	–2.8	86.2	71.7
Romania	295.5	27.8	–4.6	–2.6	80.4	84.3
Slovak Republic	58.3	7.2	–7.0	0.2	70.7	61.2
Slovenia	247.1	9.0	–0.3	–0.5	47.8	41.7
Unweighted average	**459.4**	**15.4**	**–9.0**	**–3.3**	**62.6**	**58.9**

— Not available.

Note: Data for inflation rates (year-end CPI) and fiscal deficits (general government balance) refer to the peak in 1990–94. State bank shares of assets are the earliest reported if not available for 1992 or 1995. The small state share of bank assets in the Czech Republic reflects the exclusion from the data of two large banks (Ceska Sporitelna and Komercni) with major ownership by the National Property Fund.

Source: EBRD.

TABLE 1.2

Selected Fiscal and Monetary Indicators in the Baltic States, 1990–95

(percent)

Country	Inflation rate		Fiscal deficit as a share of GDP		State bank assets as a share of total	
	1990–94	1995	1990–94	1995	1992	1995
Estonia	953.5	29.0	–0.7	–1.3	28.1	9.7
Latvia	959.0	23.1	–4.0	–3.9	7.2	9.9
Lithuania	1,161.0	35.5	–5.5	–4.5	53.6	61.8
Unweighted average	**1,024.5**	**29.2**	**–3.4**	**–3.2**	**29.6**	**27.1**

Note: Data for inflation rates (year-end CPI) and fiscal deficits (general government balance) refer to the peak in 1990–94. State bank shares of assets are the earliest reported after 1992 or 1995 if not available for those years.

Source: EBRD.

The combination of monetary and fiscal discipline imposed hard budget constraints on the state enterprise sector, and by 1995 Estonia and Latvia showed small state shares of bank assets. Estonia reduced the state asset share fairly systematically, liquidating loss-making banks that had been branches of the Gosbank system. Only Lithuania took several more years to reduce the state share of bank assets. Still, "private" ownership alone was not sufficient for sound performance. In Latvia, where the state share of bank assets was low before 1995, the largest bank collapsed in 1995 while technically a private bank.[7] This prompted a more disciplined approach to financial services and banking supervision, an approach consistently reinforced by the central bank since 1995.

The Commonwealth of Independent States

Meanwhile, the CIS countries faced the enormous challenges of hyperinflation and a weak fiscal base. By all measures the CIS countries had failed to achieve the macroeconomic stability needed to accommodate structural reform. That triggered a downward spiral greater than those in most CEE and Baltic countries, with a larger drop in output.[8] As a result the CIS countries have found it much more difficult to recover from central planning.

TABLE 1.3

Selected Fiscal and Monetary Indicators in the Commonwealth of Independent States, 1990–95

(percent)

	Inflation rate		Fiscal deficit as a share of GDP		State bank assets as a share of total	
Country	**1990–94**	**1995**	**1990–94**	**1995**	**1992**	**1995**
Armenia	10,896.0	32.0	–54.7	–11.0	1.9	2.4
Azerbaijan	1,788.0	84.5	–15.3	–4.9	88.7	80.5
Belarus	1,996.0	244.0	–2.5	–1.9	69.2	62.3
Georgia	7,488.0	57.4	–26.2	–4.5	98.4	45.9
Kazakhstan	2,984.0	60.0	–7.9	–2.7	19.3	24.3
Kyrgyz Republic	1,363.0	31.9	–17.4	–17.3	100.0	69.7
Moldova	2,198.0	23.8	–26.2	–5.7	0.0	0.3
Russian Federation	2,506.0	128.6	–42.6	–5.9	—	37.0
Tajikistan	7,344.0	2,133.0	–30.5	–11.9	—	5.3
Turkmenistan	9,750.0	1,262.0	–1.4	–1.6	26.1	26.1
Ukraine	10,155.0	181.0	–25.4	–4.9	—	13.5
Uzbekistan	1,281.0	117.0	–18.4	–4.1	46.7	38.4
Unweighted average	**4,979.1**	**362.9**	**–22.4**	**–6.4**	**37.5**	**33.8**

— Not available.

Note: Data for inflation rates (year-end CPI) and fiscal deficits (general government balance) refer to the peak in 1990–94. State bank shares of assets are the earliest reported after 1992 or 1995 if not available for those years. Earliest data available for Russia, Tajikistan, and Ukraine are for 1996.

Source: EBRD.

This difficulty was evidenced first by the extraordinarily high inflation, with peak rates averaging nearly 5,000 percent (table 1.3). This high inflation led to the introduction of new currencies in CIS countries, including eventually in Russia, which introduced a new ruble on January 1, 1998. Even by 1995 the CIS countries still faced significantly higher inflation than the CEE and Baltic countries, with several remaining at hyperinflationary levels. Moldova was the only CIS country whose inflation rate was less than the average for the three Baltic states that year. Among CEE countries, only Bulgaria, Hungary, and Romania had higher rates that year than Moldova.

At the same time CIS fiscal deficits were about twice those of the CEE and Baltic states, averaging more than 6 percent of GDP. The large deficits related in part to the collapse of the industrial sector, as enterprise sales had generated much of the earlier fiscal revenue flow in the form of turnover taxes.[9] With sales now plummeting and often unrecorded (to avoid tax payments), government revenues declined. Corruption also played a part, with taxes being paid but not making their way into national treasury accounts. All this made for a very unstable environment for normal banking operations.

Against this backdrop CIS countries often imposed hard budget constraints—in some cases more by circumstance than by choice—on the state sector. But CIS countries were also caught in the difficult situation of seeking to maintain or revive production to preserve jobs and reactivate the fiscal base. In a tight money regime this led to budgetary subsidies and transfers, concessionary rollovers from the banking system, and arrears to enterprises, social funds, workers, and fiscal authorities (see annex 6). Interestingly, the CIS countries showed a state bank share of assets about half that registered in the CEE countries. This indicates that "private" banks in the CIS were largely used as financing vehicles for their enterprise owners and other related parties rather than as channels of financial discipline. These "privatized" practices reflect weaknesses in the banking sector framework and incentive structure in the CIS countries and inherent flaws in ownership transformation.

Notes

1. In OECD countries financial services accounted for 19 percent of GDP. While reliable figures are not available for the 27 transition economies at the time, the share of financial services in GDP was considered to be much lower.

2. Bulgaria, Poland, and the former Yugoslavia permitted small-scale private farming during the socialist era.

3. EBRD data show a mean inflation rate in 1995 of 20.5 percent for Central and Eastern Europe and the Baltics, 39.4 percent for southeastern Europe, and 350 percent for the CIS countries.

4. Quantifying bank lending to the state sector with precision is difficult because of the prominence of large industrial enterprises that were partly privatized or classified as "private" even though the "strategic investor" might have been the National Property Fund. In most CEE and Baltic countries (except Estonia), however, state enterprises often benefited from less than hard budget constraints.

5. The classification "large" is based on nominal balance sheet values, not discounted for risk and quality. In reality, virtually all "large" banks would have been much smaller had they written down their assets and capital to reflect internationally accepted standards for accounting and valuation. These banks eventually faced up to this reality in the second half of the 1990s. But banking systems in the CIS and in several CEE countries are still dealing with these issues.

6. Similarly, in the CEE countries the 1995 unweighted average inflation rate was 3.4 percent of the unweighted peak average rates in 1990–94.

7. See Fleming and Talley (1996).

8. On average, CIS countries now operate at about 60 percent of pretransition levels, compared with the Baltic states at 70 percent and the CEE countries at around 90 percent. See Fischer and Sahay (2000).

9. See Barbone and Marchetti (1994).

Chapter 2

State Banks Early in the Transition

Banking system reform in postsocialist Central and Eastern Europe and the former Soviet Union has shown common patterns yet produced broadly divergent results. Most transition economies introduced two-tier systems around 1989 as communism and its monobank system collapsed. This change placed monetary policy and its implementation in the hands of the central bank and established the basis for normal banking functions by a second tier of commercial and other banks. Before 1989 these functions had all been part of one monobank system in most socialist economies. Thus merely configuring the institutions of financial intermediation represented a challenge to transition economies. It involved defining new roles and responsibilities for the new system and conceptualizing how intermediation could occur at a time that traditional production, trade, and investment were in a state of dislocation and even collapse.

As part of the reconfiguration, central banks were generally entrusted with banking supervision because of their monetary policy role. As laws were introduced for both the new central bank and the second-tier banks, fundamental prudential norms and initial measures to establish supervisory oversight of the banks were also introduced. These initially dealt with ownership, capital, lending exposures, reporting requirements, and other common components of banking legislation and regulation. The prudential requirements proved to be insufficient, however. Moreover, supervisory capacity was undermined by poor accounting and financial information in the banks, weak off-site surveillance capacity, and lack of experience with on-site examinations.

After an initial period of experimentation with low minimum capital requirements and a push to liberalize the licensing process for new banks, most transition economies experienced severe instability in their banking sectors. These problems were part of the larger structural problems in postsocialist economies, reflecting macroeconomic disorder (hyperinflation, exchange rate instability), the breakdown of traditional trade patterns and distribution channels, and the severe decline in the purchasing power of enterprises and individuals. Liquidity shortages triggered a dramatic increase in interenterprise, tax, and other arrears while debt service payments to banks declined. Arrears also became more generalized, particularly in the CIS countries, where power companies, fiscal accounts, wage earners, and pension, health, unemployment compensation, and other social funds effectively became net creditors to the economy.

Despite some preliminary efforts to have banks operate on a commercial basis, government officials in most transition economies could not resist using at least some of the banks as vehicles for directed lending. Banks operating "privately" often did so on behalf of their connected shareholders rather than on the basis of normal commercial banking principles.

Meanwhile, state-owned banks continued to serve as the primary banking vehicle for directed lending and quasi-fiscal financing, usually for loss-making state-owned enterprises and collective farms.

Some countries were seeing the slow emergence of private banks and private sector development, including in Central and Eastern Europe (in the Czech Republic and Hungary in particular), where high levels of direct investment and remittance flows were catalyzing modernization and privatization. Nonetheless, most intermediation occurred through state channels. As a result the loan portfolios of these banks deteriorated rapidly and for the most part irretrievably.

Early Structural Changes in the Banking Sector

Virtually all the centrally planned economies had monobank systems, though a few had commercial banks that functioned more independently. In addition to the central bank, most had a small number of specialized state banks such as savings, foreign trade, industrial investment, and agricultural banks. While this system might seem to resemble the two-tier system established later, these banks functioned more like departments of a single bank than as independent commercial banks.

Late in the socialist period (mid-1980s) some governments began timid attempts to decentralize the banking sector by establishing new, specialized commercial banks. For example, in 1987 the government of Bulgaria moved to establish seven such banks (in addition to the four existing state banks), each serving a particular industrial sector. The new banks provided current account facilities, accepted deposits, made loans in both local and foreign currencies, and provided "venture capital" for firms in their sector. But decentralization went only so far. None of the new banks had branches, and they dealt with their customers through the local offices of the National Bank. More important, the banks had no opportunity to exercise independent judgment. Instead, they merely allocated investment funds to state-owned enterprises in their sector according to central planners' instructions.

These experiments signaled the failure of the traditional system to meet the broad banking needs of the economy. But as a result of the continued state control in most cases, the experiments led to little real change in the way the socialist economies operated. Moreover, Bulgaria was more the exception than the rule. Even as the earlier system failed to meet anything more than rudimentary banking needs, other countries made little effort to push for reforms until after the socialist system collapsed.

Apart from Yugoslavia, which established a two-tier system in 1971, Hungary was the only other real exception to the rigid socialist model. Hungary introduced a market-oriented two-tier banking system in early 1987. The National Bank carried out monetary policy, while independent commercial banks operating in a competitive market undertook credit activities. Poland followed Hungary's lead in January 1989, and Bulgaria, Czechoslovakia, and Romania did so in January 1990.

These exceptions notwithstanding, centrally planned economies generally relied on the Gosbank system, with departments that specialized in meeting the financing needs of different sectors. This functional specialization helps explains why the initial two-tier banking system was still characterized by sector concentration (agriculture, industry, export-import, housing, savings) in state banks in 1992. In some countries, such as Croatia, Estonia, FYR Macedonia, Poland, and what is today the Slovak Republic, some of the state banks were small and commercially diversified yet still geographically concentrated, just as Gosbank branches were.[1] Often these banks were owned by state enterprises. In other countries the banks were specialized by economic subsector.[2] In general, the large state banks created from the monobank system represented the core of the

BOX 2.1

Profile of Selected Commonwealth of Independent States State Banks after the Breakup of the Monobank System

Armenia

Armenia inherited all five state-owned banks that had operated on its territory before the breakup of the former Soviet Union (FSU) in 1991. These were the specialized Bank for Industry and Construction (Ardshinbank), which separated in 1991 from its FSU counterpart Promstroybank; the specialized Agrobank, which also separated from its FSU counterpart in 1991; the Export-Import Bank of Armenia (Armimpex Bank), reorganized on the basis of the former Vnesheconombank, which carried out all foreign exchange transactions in Armenia; Econombank, which did not specialize in any industry; and the State Savings Bank (Sberbank Armenian Savings Bank, or Sberbank ASB), which separated from its FSU counterpart (Sberbank) at the end of 1991, when it accounted for most household deposits in the system. All except Sberbank ASB were incorporated as joint stock companies in 1992, although the majority of shares remained in the hands of the state or were sold to state-owned enterprises. These five banks remained the largest in the country from 1993 through 1996, despite the entry of many commercial banks. In 1993 the state banks accounted for more than 70 percent of the banking system's balance sheet measures. But the banks were weak and unprofitable, a legacy of the directed credit policy. As a result of large loans extended to state-owned enterprises under government pressure, most of their assets were nonperforming. A major restructuring of the former state banks was initiated in 1996.

Latvia

Following the breakup of the Soviet Union Latvia found itself in much the same position as the other FSU countries. It inherited branches of the specialized Soviet banks: the Savings Bank (Latvijas Krajbanka), Agricultural Bank, Industry and Construction Bank, Housing and Social Development Bank, and Foreign Trade Bank. In addition to inheriting large portfolios of nonperforming loans and management unused to lending along commercial lines, these branches were suddenly cut off from their former head offices. Moreover, the authorities in Moscow were unwilling to pass on the assets needed to cover a substantial portion of their liabilities. While most other newly independent countries converted the branches they inherited into nationally owned specialized banks corresponding to the old Soviet banks, the Latvian government placed all the branches of the specialized banks (except those of the Savings Bank) under the direct supervision of the Bank of Latvia (the central bank). These branches dominated the credit business, since the Savings Bank initially did not make loans to private or public enterprises. As a result, at the end of 1991 the 45 branches controlled 83 percent of all credit to business and held three-quarters of enterprises' demand deposits.

Russian Federation

In 1991 the Russian government broke up the two-tier system, consisting of the Gosbank (the central bank) and five specialized banks, that had existed in the Soviet Union since 1987. This reform led to the creation of some 800 new banks, which took the capital of the former state banks. In 1992–95 the number of banks grew enormously, with nearly 2,500 banks operating in Russia by 1994. Still, the system was characterized by significant concentration. The largest 10 banks accounted for 50 percent of assets in 1995. Most of these banks were spin-offs of former Soviet specialized banks, or new commercial banks created with limited capital. Thus the nearly 2,500 commercial banks had only a limited impact on the real economy through lending to enterprises. Many were speculating heavily in hard currency and then diversifying their asset holdings into treasury bills and equity stakes in blue chip enterprises. These practices proved unsustainable, and the number of banks declined sharply. By 2000 Russia had 1,311 banks, about half the peak in 1994.

(Box continues on next page.)

BOX 2.1

Profile of Selected Commonwealth of Independent States State Banks after the Breakup of the Monobank System (continued)

Ukraine

Early in the transition Ukraine's banking system consisted of four state-owned specialized banks that were spun off from the corresponding Soviet banks as Ukraine gained its independence in 1991. The state banks specialized in agriculture (Ukraina), industrial lending (Prominvestbank), social programs (Ukrsotsbank), and household savings (Oschadny Bank). A fifth state bank, Ukreximbank, was formed in 1992 to process Ukraine's foreign trade payments. All the specialized banks except Oschadny and Ukreximbank were corporatized (and thus nominally privatized) in 1992. This occurred primarily through ownership transformation, with a number of large state-owned enterprises taking substantial ownership shares in the banks serving their sector. During the ensuing years the ownership structure of these corporatized banks became more complicated as a result of a 1993 government order requiring the transfer of all state enterprise shares in the banks to the Ministry of Finance. This order prompted the banks to devise a method of transferring ownership through the distribution of shares to the employees of client enterprises and of the banks themselves. Ownership became diluted among tens of thousands of shareholders, most of them individuals. But most major policy and personnel decisions were still made by top managers of the state enterprises that had been majority shareholders before the share redistribution. Thus the state continued to exercise a great deal of influence in the banks' affairs.

Source: See case studies and bibilography for references.

new banking system, which remained state owned and highly concentrated in nearly all transition economies (box 2.1).

With the onset of transition, the number of banks increased quickly. By the early 1990s, shortly after the rapid move to ownership transformation and private entry, the 27 formerly socialist economies of Europe and Central Asia had roughly 2,350 banks. Of these, only 200 were considered to be major state banks.[3] Russia alone had 1,306 banks in 1991, 2,456 banks in 1994, and 2,297 banks in 1995. Early in the transition period the CIS accounted for 1,841 of the 2,350 banks in transition economies, and by 1995, for 3,171 of the 3,783 banks. Thus the CIS countries consistently had about 80 percent of the licensed banks in transition economies through the mid-1990s.

By the mid-1990s, shortly after the monobank system was dismantled, state banks accounted for a nominal $131 billion in assets. The real market value figure is virtually impossible to estimate because of inaccurate accounting methods, overvalued properties and loan portfolios, inadequate provisions and reserves, and the general market risk that ultimately triggered many banking crises and subsequent failures. Nonetheless, estimates based on existing data and converted to U.S. dollar exchange rates put the total asset value of these banks at about 16 percent of GDP by the mid-1990s, most of it in Central and Eastern Europe.[4] This translates into an average asset value for state banks of about $654 million.[5] The real average could be much smaller, however, if the denominator included the many small banks over which state or local governments continued to exercise influence and control. The real average would also have shrunk if international accounting standards had been applied, which would have adjusted balance sheets (and earnings) for nonperforming loans, overvalued fixed assets and secured loans, asset revaluation from hyperinflation, and related practices that made the banks' financial position look better than it actually was.

Most transition economies had at least three specialized state banks, and by 1992 the average for the 27 countries was about seven major state banks.[6] As noted, in some countries state banks did not specialize by sector but instead

TABLE 2.1

Profile of State Banks in Transition Economies, 1992

Country	Industrial	Agricultural	Savings	Foreign trade/ EXIM	Other
Albania	✔	✔	✔		
Armenia	✔	✔	✔	✔	
Azerbaijan	✔	✔	✔	✔	
Belarus	✔	✔	✔	✔	✔
Bosnia and Herzegovina	✔			✔	✔
Bulgaria	✔	✔	✔	✔	✔
Croatia	✔				✔
Czech Republic	✔		✔	✔	✔
Estonia	✔		✔		✔
Georgia	✔	✔	✔		✔
Hungary	✔	✔	✔	✔	
Kazakhstan	✔	✔	✔	✔	✔
Kyrgyz Republic	✔	✔	✔		✔
Latvia	✔	✔		✔	
Lithuania		✔	✔		
Macedonia, FYR	✔				
Moldova	✔	✔	✔	✔	✔
Poland	✔	✔	✔	✔	✔
Romania	✔	✔	✔	✔	✔
Russian Federation			✔	✔	
Slovak Republic	✔		✔	✔	✔
Slovenia					✔
Tajikistan	✔	✔	✔	✔	
Turkmenistan	✔	✔	✔	✔	✔
Ukraine	✔	✔	✔	✔	✔
Uzbekistan	✔	✔	✔	✔	✔
Yugoslavia	✔	✔		✔	

Source: BankScope; EBRD; World Bank; IMF; and a number of other sources as listed in the bibliography.

focused on local markets. But the vast majority of transition economies had state banks that specialized by function, with some crossover in some cases (table 2.1).[7]

The countries with noteworthy state banks were Yugoslavia, Poland, the Czech Republic, Hungary, and Bulgaria. Yugoslavia had 8 of the 24 largest banks[8] in the transition economies, accounting for $50 billion in assets in 1991 (table 2.2). Poland had 7 large banks, although they recorded only about $27 billion in assets, half as much as the major Yugoslav banks. Hungary had 4 banks with $16 billion in assets. Czech Republic and Bulgaria accounted for the balance.

Traditional Roles of State Banks

Government ownership of banks is a pervasive phenomenon not just in transition economies, but around the world. Although state banking played a particularly important role in many economies of Europe and Central Asia, many industrialized economies such as Germany, France and the United States also have supported and continue to support state banks as well.

State Banks in Industrialized Countries

While many proponents of state owned-banks in developing countries point to relatively successful examples of state-owned banks in OECD countries, studies have shown that the economic costs of public ownership of banks have been high and the benefits less than expected. In particular, a recent analysis points to greater negative effects of state banks in low-income countries where there is less financial sector development and weaker property rights

TABLE 2.2

Assets and Global Asset Ranking of Large State Banks Early in the Transition

Bank	Country	Assets (millions of U.S. dollars)	Global ranking
Beogradska Banka	Yugoslavia (Serbia)	15,983	287
Bulgarian Foreign Trade Bank	Bulgaria	14,151	312
Sberbank	Russian Federation	13,000[a]	—
Ljubljanska Banka	Yugoslavia (Slovenia)	9,121	425
Komercni	Czech Republic	9,085	426
OTP	Hungary	8,575	448
Jugobanka DD Beograd	Yugoslavia (Serbia)	7,542	475
PKO BP[b]	Poland	6,923	—
Bank Handlowy & Warszawie	Poland	6,756	497
PKO SA	Poland	5,722	548
Privredna Banka Sarajevo	Yugoslavia (Bosnia and Herzegovina)	5,307	580
Vseobecna Uverova Banka	Czech Republic	4,839	606
Privredna Banka Zagreb	Yugoslavia (Croatia)	4,295	636
Zagrebacka Banka	Yugoslavia (Croatia)	3,852	683
Bank Gospordarki Zywnosciowej (food industry)	Poland	3,150	757
K&H (Commercial & Credit) Bank	Hungary	2,923	786
Stopanska Bank	Yugoslavia (FYR Macedonia)	2,752	804
Magyar Kulkereskedelmi (Foreign Trade) Bank	Hungary	2,675	818
Vojvodjanska Banka	Yugoslavia	2,357	860
Bank Przemyslowo Handlowy (industry and commerce)	Poland	1,826	918
Budapest Bank	Hungary	1,793	925
Bank Slaski	Poland	1,650	942
Mineral Bank	Bulgaria	1,420	968
Wielkopolski Bank Kredytowy	Poland	803	993

— Not available.
a. Data are for 1995.
b. Although PKO BP had sufficient assets, it was not ranked.
Source: For Sberbank, *Moody's Banking Statistical Supplement*, 1998; for all others, *The Banker*, July 1992.

protection.[9] In addition, many state-owned banks also suffer from some of the same management and governance problems as in transition economies and are criticized for often controversial government-direct lending projects and fiscal irresponsibility (box 2.2).

State Banks in Europe and Central Asia

Under the socialist command system state banks played varied roles in the economy, however, did not offer a very extensive range of financial products overall. While their key functions were lending to state farms and enterprises and mobilizing and safeguarding deposits, they served above all as conduits for the financing of line ministries' production plans and targets. Centralized planning routinely set output targets by industry or sector for achieving national and multiyear economic goals. Once these targets were set, budgetary resources were allocated and transmitted through the banks to state farms and enterprises. Thus banks were essentially passive administrative units rather than active processors of credit information and risk-takers operating on commercial principles.

As a result, when the monobanks were split and new second-tier state banks were created, the banks had neither the orientation nor the skills or experience to impose financial discipline on enterprises. Instead, at least in the early years, they retained an administrative orientation, processing loans and payments based on the instructions of line ministries or enterprises. As their enterprise clients became increasingly subject to market forces or unable to rely on

BOX 2.2

State Banks in Selected Countries of the Organisation for Economic Co-operation and Development

State banking became important during the last century in some OECD countries and declined in the 1980s. State banking was demanded by sectors that were pressed to invest but that could not find access to long-term credit because of the marginal importance of small and local banks in countries with centralized market and state institutions.

State banks first appeared in some countries in the form of agrarian mortgage banks and gained momentum before the wars, with the creation of banks for industry, and during the postwar decades, reaching their peak in the 1960s. They have been declining ever since. State banks assumed considerable importance in Belgium, France, the Netherlands, Norway, and New Zealand, but remained of limited importance in Britain, Italy, Japan, Spain, and Sweden. State banks were insignificant in Denmark, Canada, Switzerland, and the United States.

Germany: Westdeutsche Landesbank

In Germany public banks have played a large role in the banking system for decades. While government ownership in banks declined throughout most European countries, the market share has remained comparatively high in Germany. In fact, the state ownership in German banking system's assets declined from 52 percent in 1970 to 36 percent in 1995, whereas the market share of assets in public banks in 1995 was 25 percent for European Union and 28 percent for OECD countries.

State banks have historically been less problematic in Germany than in other countries. This due in part to the fact that the banks operate in a well-developed financial system and the public banking system is decentralized. Local ownership and control make the banks more transparent. Some policymakers argue, however, that the importance of state banks in Germany has hurt competition in the market and as a result, Germany has a lower level of foreign penetration than most European countries. The European Commission, with support of private sector banks, argues that guarantees for state-owned Landesbanken and municipally-owned Sparkassen are incompatible with European Union law.

Together with state-controlled savings banks, the 12 Landesbanken account for more than half of all bank assets in Germany. Westdeutsche Landesbank enjoys government backing from the state of North Rhine-Westphalia and gets government guarantees on the debt it raises from the markets. It is the largest lender to industry in North Rhine-Westphalia and a strong force in the Frankfurt capital markets. Like other Landesbanken, it provides wholesale and investment banking services for local savings banks and acts as house bank to the local government.

Westdeutsche Landesbank is the country's fourth-largest bank with assets of $390 billion. Many critics and policymakers argue that breaking it up would spur a much-needed restructuring of German finance and create a more level playing field between public and private sector banks. Successive German governments, however, have refused to reform the Landesbanken because state governments count on them to finance government-sponsored projects.

France: Credit Lyonnais

In the mid-1980s, Credit Lyonnais, a French state-owned bank, was one of the world's largest banks. But by the early 1990s, it excessive lending, bad management, rapid expansion, caught up with it, resulting in massive losses and scandal. The bank required successive bailouts of nearly $20 billion (FFr120 billion). The near collapse of the bank led to a decision of French government in 1993 to replace the management, clean up the bank's lending practices, and prepare it for privatization.

The privatization of Credit Lyonnais in 1999 has reduced the state ownership in the bank from around 90 percent to 9.7 percent. The bank's main group of shareholders now include several international banks and insurance companies owning 32.3 percent of the capital; the balance of shares is owned by the general public. In view of the reduction of its international activities in recent years, Credit Lyonnais' significance as an international bank has diminished, however, its importance in the domestic market continues today.

(Box continues on next page.)

BOX 2.2

State Banks in Selected Countries of the Organisation for Economic Co-operation and Development (continued)

The bank's profitability has steadily recovered due to rigorous actions taken to cut costs and improve asset quality. Net income has gradually increased with a 9.6 percent net return on equity for 2000. A complete overhaul of Credit Lyonnais' risk management systems, a substantial shrinking of its balance sheet, and more selective lending have contributed to significantly improved asset quality. Loan loss provisions fell to 0.40 percent of average loans for 2000. In addition, Credit Lyonnais has built up a cushion of general loan loss reserves (almost EUR 1 billion) that, when added to specific reserves, cover non-performing loans by over 90 percent. Credit Lyonnais' capital ratios have risen significantly over the past few years and are now in line with those of other major French banks.

United States: Export-Import Bank

The United States Export-Import (Exim) Bank is an official export credit agency of the US government. It was created to provide guarantees of working capital loans for US exporters, guarantee the repayment of loans, and make loans to foreign purchasers of US goods and services. The bank also provides credit insurance that protects US exporters against the risk of non-payment by foreign buyers for political or commercial reasons. The bank aims not compete with commercial lenders, but to assume the risk they cannot accept. In 2000 it supported about $15.5 billion worth of exports by authorizing $12.6 billion in loans, guarantees, and export insurance. Exim Bank is a valued source of export subsidies for major US firms. Exim Bank benefits several strategic industries in particular including aircraft manufacturing, energy-generation equipment, and transportation.

Critics of Exim Bank argue that it is a device for channeling public money into a narrow set of industrial interests. Although created as a lender of last resort and authorized to extend credit only when private credit markets fails to do so, some economists and policymakers argue that in practice the bank's activities are unnecessary. If the private market will not make a loan, it is because the loan is too risky.

Source: La Porta 2000; Helk 2001; Fairlamb 2000; Verdier 2000; Fitch Ratings 2001; and Oxford Analytica 2001.

the state for financial help to keep them going, the state banks inevitably ran into severe loan portfolio problems. While the state and former state banks continued to operate largely under traditional assumptions and processes, governments were introducing new prudential norms as they began to tighten monetary policies and introduce hard budget constraints to rein in hyperinflation and unsustainable fiscal deficits. These conflicting approaches to prudence in monetary and banking matters combined with conditions in the real sector—which was uncompetitive and suffering breakdowns in production, trade, and investment—resulted in massive volumes of unrecoverable loans.

In banks' other key area of responsibility, safeguarding citizens' savings, many of the traditional savings banks and some of the agricultural banks appear to have earned citizens' trust. They had done so by establishing a significant branch presence and maintaining passbook savings, processing pension payments and other compensation awarded to people as part of their benefits package (mainly the responsibility of savings banks), and carrying out subsidy and other programs to support agriculture and agroprocessing. But this trust evaporated in CIS countries with the loss of savings value resulting from hyperinflation and the inability of governments to bail out banks in the face of fiscal pressures. In non-CIS countries confidence levels varied with the degree to which banks could accommodate withdrawals and the level of deposit protection provided in the event of a bank failure or liquidity crisis.

While other transition economies lost savings through hyperinflation, the breakup of socialist Yugoslavia presented a distinct set of circumstances. Banking systems in all the former Yugoslav republics faced a crisis in 1992

with the freezing of foreign currency savings deposits, which could no longer be honored after the central government confiscated and spent the hard currency assets funding those accounts. Slovenia and Croatia issued bonds early in the 1990s to provide some cover for the account holders. FYR Macedonia, with a more fragile economy, issued bonds later in the 1990s. Depositor confidence has been more difficult to restore in Bosnia and Herzegovina, FYR Macedonia, and the Federal Republic of Yugoslavia as a result of the many crises in the Balkans during the 1990s. The relatively new government of Serbia has committed itself to honoring the frozen deposits over a period of years. How that action will affect depositor confidence remains to be seen. Evidence in most of the countries suggests that local citizens have little trust in domestic banks. They are willing to place their funds in foreign banks, however, as has been particularly evident since late 2001 and the conversion of the deutsche mark and other EU currencies to the euro.

During the socialist period and early in the transition, active campaigns to increase retail deposits were rare because private savings were limited in most countries. Exceptions sometimes occurred during national emergencies (such as wars or floods), but these were government directed rather than commercially driven.[10] Moreover, in countries with comparatively high private savings (Slovenia, today's Czech and Slovak Republics, Poland, Hungary),[11] people often kept resources outside the banking system to avoid administrative harassment from the authorities.[12] Thus while state banks fulfilled their fundamental role as safekeepers, they were ill equipped to pursue commercial campaigns to attract private savings. And their inability to protect the value and availability of deposits and pensions was exposed in the CIS by the hyperinflation, nonindexation, and collapse of the ruble (and then other local currencies) in the early 1990s. Most of the non-CIS countries also suffered shocks and losses, although the damage was less.

Governance, Management, and Operating Standards of State Banks

Because the state banks were still social and political units when they were established, governance was generally exercised through board representation from the ministry of finance. Bank managers often had been trained in the public enterprise system and were used to operating in that domain, whether in banking or another field. Many managers were experienced in the sector on which their bank focused (for example, industrial engineers often managed industrial banks). The shortcomings of this approach eventually manifested themselves in poor financial performance.

Most state banks continued to lend as instructed or for patronage purposes (though the tightening of monetary policy and prudential norms reduced their use as vehicles for lending to uncompetitive enterprises). Thus their commercialization as joint stock companies was not accompanied by sufficient commercialization of their credit management, product development, service levels, operational efficiency, or risk management. All this meant poor loan performance and eventually insolvency. Many factors worked against early detection of such problems—poor accounting and auditing standards, inexperienced supervisory personnel, inadequate prudential regulations, decentralized and often incomplete information systems (with branch accounts not consolidated with headquarters accounts), and the traditional reliance on the government for additional funding when liquidity became short.

Since the banks were not run according to market-based norms, governance standards often deviated from best practices. Some banks operated according to reasonably professional standards, with management focusing on increasing profitability, boosting capital, managing liquidity, containing risk, and building franchise value. But others were poorly managed and less concerned with financial sustainability.

Board members often lacked qualifications and adequate information. Internal audit functions were underdeveloped and had little autonomy. Management information systems were weak. All these factors worked against timely and effective scrutiny of management behavior. Annual shareholder meetings were often formal endorsement ceremonies rather than serious evaluations of performance. The absence of market information and involved institutional shareholders further weakened prospects for active, effective governance. Moreover, the weaknesses allowed many managers to take advantage of preferential deals that reinforced traditional networks of patronage but undermined the banks' commercial prospects.

Bank operations were generally manual, which meant high staffing levels and inefficient processes. This inefficiency is still evident in the high employment figures for many state banks compared with those for private banks. A key challenge for state banks has been reducing costs, increasing productivity and efficiency, and balancing the needs of the emerging marketplace with the demands of stakeholders, often transmitted through workers' or employees' councils. When privatization initiatives were announced for state banks, many of the banks included set-aside provisions for employees (for example, 5 percent of shares) as an inducement to cost containment and modernization. But overall state banks continued to be highly inefficient compared with the new banks emerging with better systems and better trained and motivated staff.

Roles of Specialized State Banks

In most transition economies, governments supported a number of specialized state banks, each that supported a particular element of the economy that the government deemed valuable or strategic such as industry, foreign trade, or agriculture. As a result, most of these industries depended on state banks to finance their investment and credit needs. Other banks, such as savings banks were developed to reach target populations with financial services.

Industrial Banks

Early in the transition most transition economies had at least one major state bank that focused on industry, usually with a bias toward heavy industry (table 2.3). These banks functioned largely to sustain production and employment levels and to generate some fiscal revenues. The banks often propped up loss-making enterprises because the enterprises served as a source of tax revenue (turnover taxes from sales proceeds) for the government. While no reliable financial data are available for the early transition years, these banks were generally loss-makers from the outset. Set up to finance troubled companies, they were often doomed from the start—serving administrative, political, or patronage purposes rather than commercial ones. Most have been restructured, recapitalized, or liquidated. Only a few have been successfully privatized.

Several specialized banks also performed other functions, such as providing savings facilities and trade finance. Particularly in the former Yugoslavia, which had a less centrally planned economy than other formerly socialist countries, banks had more diversified activities. As a result the industrial banks in Bosnia and Herzegovina, Croatia, FYR Macedonia, Slovenia, and Yugoslavia were less specialized than the industrial banks in other transition economies, although their ownership structure and lending activities did have an industrial orientation.

Agricultural Banks

Although agriculture played a relatively minor role in the transition economies, the sector employed a large number of people, often through state farms, collectives, and cooperatives. Like most of the world's governments, central planners were concerned with food

TABLE 2.3
Industrial Banks in Transition Economies, 1992

Central and Eastern Europe and the Baltic States

Country	Banks
Albania	National Commercial Bank
Bosnia and Herzegovina	Privredna
Bulgaria	More than 7 specialized banks
Croatia	Privredna; HBRD; several smaller banks focused on shipbuilding finance
Czech Republic	Investicni Banka
Estonia	Bank of Industry and Construction
Macedonia, FYR	Stopanska Banka
Hungary	Magyar Hitel; Hungarian Credit Bank
Latvia	Industry and Construction Bank
Lithuania	No specialized bank
Poland	Bank Handlowy; Polish Investment Bank
Romania	Banca Comerciala Romana
Slovak Republic	Priemyselna Banka; Investicni Banka
Slovenia	No specialized bank, although Nova Ljubljanska played this role
Yugoslavia	Jugobanka-Bor; Jugobanka-Beograd; Beobanka Belgrade; Invest Banka; Beogradska Banka; Vojvodjanska

Commonwealth of Independent States

Country	Banks
Armenia	Ardshinbank (Bank for Industry and Construction)
Azerbaijan	Promstroibank
Belarus	Belpromstroibank
Georgia	Industriyabank
Kazakhstan	Turan Bank
Kyrgyz Republic	Promstroibank
Moldova	Moldindconbank
Russian Federation	Promstroibank
Tajikistan	Tajikbankbusiness; Tajikorientbank (previously Promstroibank)
Turkmenistan	Investbank; Gasbank
Ukraine	Promstroibank
Uzbekistan	Uzpromstroibank

Note: The banks shown were generally the country's major state banks focusing on large-scale industrial enterprises. They include "apex" development banks established to help allocate or direct lending from abroad to selected companies and sectors.
Source: World Bank; IMF; and a number of other sources as listed in the bibliography.

security, stockpiling, warehousing, distribution, postharvest losses, and similar issues. Moreover, trade networks often relied on the shipment of cereals and grains and the export of processed foods in exchange for inputs and other needed goods. For example, small countries like Armenia, Georgia, and Moldova were known to ship wine and brandy to Russia. Such trade arrangements were not limited to CIS countries: Bulgaria, Hungary, Poland, and Romania also shipped processed foods to Russia, in exchange for energy supplies.

Agricultural banks financed the central planners' directives for domestic and export production, serving the needs of the farms, collectives, and cooperatives and often those of food processors and beverage and tobacco producers as well. They also sometimes took deposits, providing basic services for rural communities.

Most transition economies had at least one dedicated agricultural bank by 1992 (table 2.4). These banks have generally been deep loss-makers, and some have since been liquidated. Nonetheless, they have often been protected because of the political patronage resulting from close ties to agricultural or farmers' movements and because of the extensive branch coverage that many offered.

Savings Banks

In most transition economies new savings banks were established when the monobank system was broken up (table 2.5). Some of these (Sberbank in Russia, Uzsberbank in Uzbekistan, Sberbank in the Kyrgyz Republic and Tajikistan, Ceska Sporitelna and Slovenska Sporitelna in the Czech and Slovak Federal Republic) were very narrow institutions that

TABLE 2.4

Agricultural Banks in Transition Economies, 1992

Central and Eastern Europe and the Baltic States		Commonwealth of Independent States	
Country	Banks	Country	Banks
Albania	Rural Commercial Bank	Armenia	Agrobank
Bosnia and Herzegovina	No specialized bank	Azerbaijan	Agroprombank
Bulgaria	Agrarian and Cooperative Bank	Belarus	Belagroprombank
Croatia	No specialized bank, although some regional banks focused on agribusiness	Georgia	Agroprombank
Czech Republic	Agrobank	Kazakhstan	Kazagroprombank
Estonia	No specialized bank	Kyrgyz Republic	Agroprombank
Macedonia, FYR	No specialized bank	Moldova	Agroindbank
Hungary	Agrobank	Russian Federation	Soviet Agroprombank (later renamed Rosselkhozbank)
Latvia	Agricultural Bank	Tajikistan	Agroinvestbank ("Shark Bank")
Lithuania	Agricultural Bank	Turkmenistan	Agroprombank
Poland	Bank Gospodarki Zywnosciowej	Ukraine	Bank Ukraina
Romania	Banca Agricola	Uzbekistan	Uzagroprombank
Slovak Republic	Slovak Agrobank (Slovenska Polnohospodarska)		
Slovenia	No specialized bank		
Yugoslavia	Vojvodjanska Banka (agro-processing)		

Source: World Bank; IMF; and a number of other sources as listed in the bibliography.

essentially placed all their savings in cash deposits with the central bank or other state-owned banks or in government securities to help finance the budget as tax revenues shrank and fiscal deficits grew.[14] However, some of the banks, such as those in the Czech and Slovak Federal Republic and Russia, later took on more diverse activities characteristic of commercial banks. Other savings banks (PKO BP in Poland, OTP in Hungary, CEC in Romania, DSK in Bulgaria) were used as before to finance housing and other fundamental household needs. In fact, savings banks often pursued basic asset-liability matching strategies under central planning, matching long-term savings with long-term housing loans. Thanks to the strict price controls and suppression of inflation in most transition economies, the banks had no need for sophisticated strategies to manage interest rate, market, or foreign exchange risk. Postal savings banks also existed, sometimes as part of the larger savings banks.

Savings banks were often protected because of the important financing role they played for the government.[15] This was the case particularly in Central and Eastern Europe, where the savings banks have been among the last banks privatized in most countries. Indeed, in Poland PKO BP remains state owned. The Czech Republic privatized Ceska Sporitelna only in 2000, about the same time as the Slovak Republic privatized Slovenska Sporitelna. Moreover, even when countries have opted for strategic privatization, the ownership of savings banks' shares after privatization has sometimes been more diluted than that at other banks, impeding effective governance.[16]

In the Baltics the Lithuanian Savings Bank was privatized as late as 2000, while the Latvian Savings Bank was still in state hands in 2001. In the CIS too, savings banks remain among the last to be privatized. However, in most CIS countries the savings banks were hit particularly hard by hyperinflation, and most individual accounts were devastated. This undermined the integrity of implicit deposit guarantees, and public confidence in many of these banks remains low.[17]

TABLE 2.5

Savings and Postal Savings Banks in Transition Economies, 1992

Central and Eastern Europe and the Baltic States

Country	Banks
Albania	Savings Bank
Bosnia and Herzegovina	No specialized bank
Bulgaria	Durzjavna Spestovna Kasa
Croatia	No specialized bank
Czech Republic	Ceska Sporitelna
Estonia	Savings Bank
Macedonia, FYR	No specialized bank
Hungary	Orszagos Takarekpenztar es Kereskedelmi (OTP) and Postbank
Latvia	Savings Bank
Lithuania	Savings Bank
Poland	PKO BP and PKO SA
Romania	CEC
Slovak Republic	Slovenska Sporitelna; Postovna Banka
Slovenia	No specialized bank
Yugoslavia	No specialized bank

Commonwealth of Independent States

Country	Banks
Armenia	Armenia Savings Bank
Azerbaijan	Sberbank
Belarus	Savings Bank
Georgia	Savings Bank
Kazakhstan	Halyk Savings Bank
Kyrgyz Republic	Sberbank
Moldova	Savings Bank (Ekonomii)
Russian Federation	Sberbank
Tajikistan	Sberbank
Turkmenistan	Sberbank
Ukraine	Oschadny Bank
Uzbekistan	Uzsberbank

Source: World Bank; IMF; and a number of other sources as listed in the bibliography.

TABLE 2.6

Foreign Trade and Export-Import Banks in Transition Economies, 1992

Central and Eastern Europe and the Baltic States

Country	Banks
Albania	No specialized bank
Bosnia and Herzegovina	No specialized bank, although Union Bank (formerly Jugobanka) tried to play this role
Bulgaria	Bulgarska Vnushnoturgovska Banka
Croatia	No specialized bank
Czech Republic	Obchodni Banka; Zivnostenska
Estonia	No specialized bank
Macedonia, FYR	No specialized bank
Hungary	Hungarian Foreign Trade Bank
Latvia	Latvian Foreign Trade Bank
Lithuania	No specialized bank
Poland	Bank Handlowy; Bank for Export Development; Bank PeKao (Bank Polska Kasa Opieki)
Romania	Bancorex; EXIM Bank
Slovak Republic	Obchodna Banka; Slovak Zarucna Banka
Slovenia	No specialized bank
Yugoslavia	Eximbank

Commonwealth of Independent States

Country	Banks
Armenia	Armimpex (Export-Import Bank); possibly Econombank
Azerbaijan	International Bank
Belarus	Belvnesheconombank
Georgia	Eximbank (privatized in 1992)
Kazakhstan	Alem Bank
Kyrgyz Republic	No specialized bank
Moldova	Vneshekonombank
Russian Federation	Vneshtorgbank
Tajikistan	Tajikvnesheconombank
Turkmenistan	Vnesheconombank
Ukraine	Ukreximbank
Uzbekistan	National Bank of Foreign Economic Affairs

Source: World Bank; IMF; and a number of other sources as listed in the bibliography.

TABLE 2.7

Social, Housing, and Related Banks in Transition Economies, 1992

Central and Eastern Europe and the Baltic States		Commonwealth of Independent States	
Country	Banks	Country	Banks
Albania	No specialized bank	Armenia	No specialized bank, although ASCB's early role is unclear. The Bank for Industry and Construction and Econombank may have provided some housing loans
Bosnia and Herzegovina	Most banks were regional or local and provided loans for social, housing, and other purposes[a]	Azerbaijan	No specialized bank, although Promstroibank may have provided construction and housing loans
Bulgaria	Stroybank (construction); Mineral Bank (SME financing)	Belarus	About 13 small, geographically focused banks provided loans for housing, construction, and the like
Croatia	No specialized banks, but local banks made housing and construction loans	Georgia	Zhilsotsbank
Czech Republic	No specialized bank	Kazakhstan	Kredsotsbank (housing)
Estonia	Estonian Social Bank	Kyrgyz Republic	Zhilkomhozbank (housing)
Macedonia, FYR	No specialized bank, although the Macedonian Bank for Development Promotion financed social, housing, infrastructure, and other activities	Moldova	Moldsotsbank
Hungary	Konzumbank	Russian Federation	No specialized bank, although Sberbank made housing loans
Latvia	Housing and Social Development Bank	Tajikistan	No specialized bank
Lithuania	No specialized bank	Turkmenistan	Turkmenbank, Gasbank, Senegatbank
Poland	PKO BP (housing)	Ukraine	Sotsbank
Romania	CEC (housing loans); Romania Bank for Development	Uzbekistan	Four sectoral banks provided specialized support (for example, Phat Bank and the cotton bank)
Slovak Republic	Slovenska Zaruchna Bank (guarantees, specialized in support to small enterprises)		
Slovenia	No specialized bank		
Yugoslavia	No specialized bank		

a. Among Bosnia and Herzegovina's 23 banks, 17 accounted for only 21 percent of bank assets. With total assets equal to only $3.1 billion in 1997 (and with these values overstated due to weak classification and provisioning), most banks were very small. These 17 banks had average assets of only $38 million.

Source: World Bank; IMF; and a number of other sources as listed in the bibliography.

Foreign Trade Banks

Foreign trade banks were common and increasingly active in the transition economies of Central and Eastern Europe, in part because trade in these countries shifted more rapidly from the former Soviet Union to the more lucrative markets of Western Europe than it did in other transition economies (table 2.6).[18] Moreover, Western Europe showed early interest in direct investment in such countries as the Czech Republic, Hungary, and, later, Poland. Romania and Yugoslavia, because of their greater policy emphasis on nonalignment, also established early trade links with Western and other markets. As a result foreign trade banks and export-import facilities (and in some cases banks) emerged to encourage these trade and investment links.

In the CIS markets there was clear interest early on in establishing trade and investment ties with Russia and with the other CIS countries with strategic resources, such as Azerbaijan, Kazakhstan, and Turkmenistan, with oil and gas. But neither trade nor investment flourished in the CIS, and only Russia received much direct investment from abroad.[19] In 1993 the CIS countries had only about 36 percent as much trade with the European Union as Central and Eastern Europe did. Thus while banks existed to accommodate trade and investment links, they did not have the product range or volume that those in Central and Eastern Europe did. Moreover, many of the

largest CIS companies, such as Gazprom and Lukoil, were able to obtain financing from Western banks or markets through syndicated loans and issues of depository receipts. By contrast, smaller companies were often unable to penetrate Western markets because of quality or scheduling issues, which only added to their difficulties in arranging financing.

Other State Banks

Several transition economies had other state banks to finance infrastructure and social programs, many of them dedicated to housing and construction (table 2.7). In addition, some banks tried to stimulate small loans to households for development of small enterprises. In Hungary Konzumbank represented consumer cooperatives.

As state budgets tightened, however, support for these banks often diminished. And most of the banks appeared to be relatively ineffective. For example, housing finance remains scarce in most transition economies, with Poland the possible exception. More recently, mortgage lending has increased in such countries as Bulgaria, Croatia, Hungary, and the Czech and Slovak Republics. But lending for housing construction remains limited, and mortgage bonds and securitization even more so. And lending for small enterprise has often depended on donor funding. More recently, commercial banks in the most stable markets have increased their lending to households and small enterprises. But this type of lending has often become sustainable only after serious reforms.

Notes

1. In Poland, for example, nine of the smaller Treasury-owned banks were specialized geographically though diversified in their banking activities. Separate from the initial four large state-owned banks spun off from the central bank, these banks specialized by function (such as agriculture, foreign trade, housing, and foreign currency savings). In Croatia most of the banks had a local orientation.

2. For example, Bulgaria had specialized banks for transportation, chemicals and biotechnology, electronics and defense goods, and building and construction. In Central Asia several banks were specialized by commodity (such as cotton in Uzbekistan and natural gas in Turkmenistan).

3. This figure may underestimate the number of smaller banks that remained publicly owned—by the state, municipalities, local government, and funds (such as the National Property Fund) that were influenced or controlled by the government. For example, Russia had more than 400 state banks in the early 1990s, although the government did not own majority stakes in most of these. Sberbank and Vneshtorgbank were the two large state banks by 1992, while others were relatively small. Similarly, Yugoslavia had the "big six," but more than 20 other smaller banks were state owned, socially owned, or both.

4. Asset and GDP measures need to be used with some caution. However, state banks are estimated to have had $130,758 million in assets, and GDP was roughly aggregated at $804,405 million.

5. $130,758 million/200 state banks = $654 million.

6. This is the average number of major state banks. As noted, many governments had smaller stakes in banks that could be technically classified as state banks, or at least as government-owned banks, including at municipal and local levels.

7. Several specialized banks played multiple roles (for example, many industrial banks also financed foreign operations and construction activities, some savings banks made housing loans, and foreign trade banks financed export manufacturers). Similarly, several nonspecialized banks provided savings facilities, trade finance, loans to industry and agriculture, and financing for housing, construction, and the like. Thus an empty cell in table 2.1 does not mean that the country's banks did not provide that particular type of financing. Instead, the table simply highlights the banks dedicated to particular sectors, largely reflecting their earlier focus as part of the monobank system.

8. These 24 banks were those ranking among the 1,000 largest in the world in 1991.

9. La Porta, et al. (2000)

10. The state's "official obligations" (similar to bonds) were a major instrument for encouraging savings in the Soviet Union. These instruments, of varied kinds, were often issued to support a specific cause, such as development of the air force and navy in the 1930s. The biggest effort was mounted during World War II, much as in the West. All these obligations turned into worthless paper after 1991. Issuing such securities was a common practice in other socialist countries, especially in the first postwar decade. For example, in the early 1950s the government of Hungary issued a bond called "Loan for the Peace." People were forced to spend a certain percentage of their salaries to purchase these securities. There were no maturity dates, nor was interest paid, and the vast majority of the securities were repurchased at face value at the end of the 1960s.

11. The comparatively high savings rates in these countries reflected conditions that differed from those in other formerly socialist countries. Slovenia was a major exporter in the former Yugoslavia and, like Croatia, benefited from relatively open borders to accommodate the tourist trade, part of which was serviced by the private sector (lodging, cafés, restaurants). The Czech and Slovak populations traditionally maintained high savings; numbered accounts appear to have provided most people with a sense of privacy and some measure of confidence. Poland benefited from significant private remittances from abroad and from informal commercial trade. Hungary too benefited from remittances from abroad.

12. This was less the case in the Czech and Slovak Republics, where inflation was kept low, accounts were often numbered to protect privacy, and savings were traditionally high.

13. See Oxford Analytica (2001, 2002).

14. Some of these narrow savings banks may have had small amounts of loans on their books. But by and large they focused on savings and had limited commercial lending.

15. Public sector ownership of savings banks is not restricted to formerly socialist countries. It has also been common in many euro zone countries. Austria, Finland, France, Germany, and Sweden all have savings banks that have been at least partly owned by central or local governments for many years.

16. For example, in Hungary the ownership structure of OTP when "privatized" was as follows: the state owned 25 percent plus one share; two state social security funds owned 20 percent; domestic investors owned 27 percent; 100 foreign investors owned a total of 20 percent (up to 2.5 percent individually); and Creditanstalt and Schroeders each owned 2.9 percent.

17. Sberbank of Russia may be an exception, with substantial deposits and assets (see case study on Sberbank).

18. Central and Eastern Europe had about $120 billion in trade with the European Union in 1993, the first year for which statistics are available for all countries, and about $223 billion in 2000.

19. Foreign direct investment in the CIS in 1992 was only $226 million, of which $200 million went to Ukraine. By 1995 it had risen to $3.7 billion, of which $1.7 billion went to Russia and nearly $1.0 billion to Kazakhstan.

Chapter 3
State Banks in the Mid-1990s

By the mid-1990s, after several years of difficult transition, the number of major state banks in transition economies was roughly the same as in 1992, about 200.[1] Yet there was growing recognition of the need to restructure and privatize these banks to modernize banking sectors. This process began in Central and Eastern Europe and the Baltics, prompted largely by the failure of many state banks, the high cost to the state of keeping banks, and the superior financing capacity and global information that many foreign banks brought to the domestic marketplace. The growth in trade, and its shift away from the CIS and toward the European Union, was linked to expanding foreign direct investment, which sharpened foreign banks' interest in markets in Central and Eastern Europe and the Baltics. All this created more intense competition for the state banks and began to challenge their dominance. By contrast, in CIS banking markets strategic, prime-rated foreign direct investment was still limited in 1995, although some major banks did have operations in some of the CIS countries.[2]

Structural reform and ownership changes sometimes led to disappointing outcomes. Many private banks were undercapitalized, poorly managed, or used for personal gain. Although these problems were particularly prevalent in the CIS and Balkan markets, they also emerged in parts of Central and Eastern Europe and were still evident in some of the Baltic banks. Meanwhile, the larger foreign banks catered mainly to a small segment of the corporate market and took on only limited balance sheet risk. Thus by the mid-1990s private banks still had not triggered the shift in intermediation fundamentals that policymakers had hoped for earlier in the decade. These fundamentals did show improvement in several markets a few years later and lending flows based on commercial criteria had begun to increase by late 1995 in some countries, such as Hungary, Poland, and the Czech and Slovak Republics.[3]

Diverging Patterns of Development

By 1995 banking systems in the different transition regions had already taken different paths. The CIS countries continued to have a far larger number of banks, although these banks were much smaller on average. Most operated as "pocket" banks, subservient to their enterprise shareholders and other related and controlling interests. By contrast, the CEE and Baltic states were already consolidating their systems, actively restructuring and in most cases recapitalizing their domestic banks as foreign investment in the sector began to materialize or was on the verge of doing so.[4] With the exception of Slovenia, however, the former Yugoslav republics had not moved ahead with major bank restructuring, largely because of the war and civil unrest in the

Balkans. But even poor countries such as Albania were beginning to attract foreign branches and investment, and other countries whose economies were performing poorly, such as Bulgaria and Romania, were also able to attract investment in the banking sector.

On average, the CIS countries each had 264 banks by 1995, of which 7 were state banks accounting for about a third of bank assets. The CIS countries had total banking system assets of about $83 billion in 1995, of which $74 billion were in Russia. State banks in the CIS countries had about $30 billion in assets, with Russian state banks accounting for about 90 percent. The Russian state savings bank, Sberbank, alone dominated the market since its establishment as a joint stock company in 1991 (see case study on Sberbank).

While the CEE countries had fewer banks, those banks had greater assets. In 1995 all the CEE countries and the Baltics together had 537 licensed banks, less than 25 percent of the number in Russia alone. On average, the CEE and Baltic countries each had 45 banks, of which 8 were state owned. Bank assets totaled about $192 billion, more than twice the assets of CIS banks, with state banks accounting for about 65 percent on average. Thus the state banks in the CEE and Baltic countries had a more prominent role than their counterparts in the CIS, with more than three times the assets (about $100 billion).

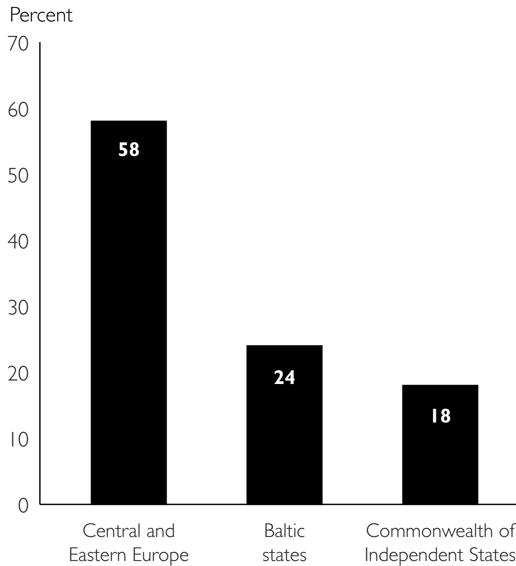
One reason for the differences is that while hyperinflation wiped out asset values in the CIS, inflation was less devastating in Central and Eastern Europe, and somewhat less so in the Baltics. A second reason is that CEE governments were more willing to recapitalize major state banks as part of broad preprivatization restructuring programs that occurred at varying speed and scale through the 1990s. For example, Croatia, the Czech and Slovak Republics, Hungary, Poland, and Slovenia all undertook at least one major recapitalization, and Romania also recapitalized banks.[5] In addition, Croatia and Slovenia floated bonds to compensate depositors who lost foreign currency savings when the National Bank of Yugoslavia froze their accounts in 1992. For these reasons state banks had larger balance sheets in the CEE countries than in the CIS.

There are two other explanations for the differences. One is that CIS countries sometimes set up parallel structures for commodity resources (such as the Oil Fund in Azerbaijan) that they considered strategic and essential for foreign exchange earnings. The second is that the CIS countries shifted increasingly to a system of arrears, barter, and netting as the monetary system imploded, often bypassing the banking system (see annex 6). Thus by the mid-1990s the CIS countries had much of their economic and asset values in nonbank institutions, while the CEE and Baltic countries focused on eventually building a stable banking system. In the CEE and Baltic countries the practice of directed lending through state banks for preferred farms and enterprises slowly unraveled as macroeconomic pressures called for hard budget constraints, new regulations required stricter bank adherence to solvency and liquidity norms, new private and foreign banks demonstrated superior capacity, and, for some countries, negotiations began for entry into the European Union.

On a stock basis, asset measures appeared reasonable in the CEE countries, lower in the Baltics, and microscopic in the CIS countries. Bank assets in the CEE countries totaled about 58 percent of GDP in 1995, compared with 126 percent in OECD countries (figure 3.1). These stock figures should be treated with caution, however, because in many cases assets were overvalued. When loans, securities, real estate, and other assets were more properly valued, balance sheets usually shrank for the largest and most exposed banks—usually state banks that were recapitalized and restructured before privatization, sometimes more than once. In the three Baltic states bank assets were about 24 percent of GDP, while the CIS countries had a ratio of about 18 percent. The ratio for the

FIGURE 3.1

Bank Assets as a Share of GDP in Transition Economies, 1995



Note: Data are for 1995 or earliest year reported after 1995. No reliable data are available for Tajikistan, Turkmenistan, Uzbekistan, or Yugoslavia.
Source: IMF, *International Financial Statistics*; EBRD, *Transition Report 2001*; authors' calculations.

CIS, where GDP was so low, illustrates the severe decline in asset values resulting from the collapse of central planning. It also shows how irrelevant most banks had become in CIS economies.

By the mid-1990s state banks accounted for a smaller share of lending flows, although they continued to hold a disproportionate share of total bank assets in CEE economies. State banks had higher credit figures than private banks, but a large share reflected overvalued claims on government rather than loans to creditworthy enterprises. State banks also often held significant shares of deposits, although their capital positions were not always as strong as those of private banks, even before adjusting for risk and capital adequacy. As countries asserted increasing monetary discipline to control inflation, the role of state banks started to become even less important. And as it became clear that bank assets were overstated, it also became clear that state banks held most of the assets that would later be reclassified and written down.

Broad Trends in Financial Intermediation

Lending and deposit mobilization were sluggish throughout the banking systems of nearly all transition economies in the mid-1990s. Net loans increased by only $36 billion from 1992 to 1995, little more than $1.3 billion in each country on average. With the 3,783 banks operating in transition economies, this amounted to about $10 million per bank,[6] suggesting that most banks were doing little if any new lending. Net deposits increased by $60 billion, about $16 million per bank on average.[7] These trends suggest that most banks continued to suffer from weak funding bases as they mobilized little in the way of additional deposits, lacked access to syndicated debt markets, and had few opportunities to increase capital through earnings or new issues. They also point to risks in the interbank market, where relatively weak banks often borrowed funds.

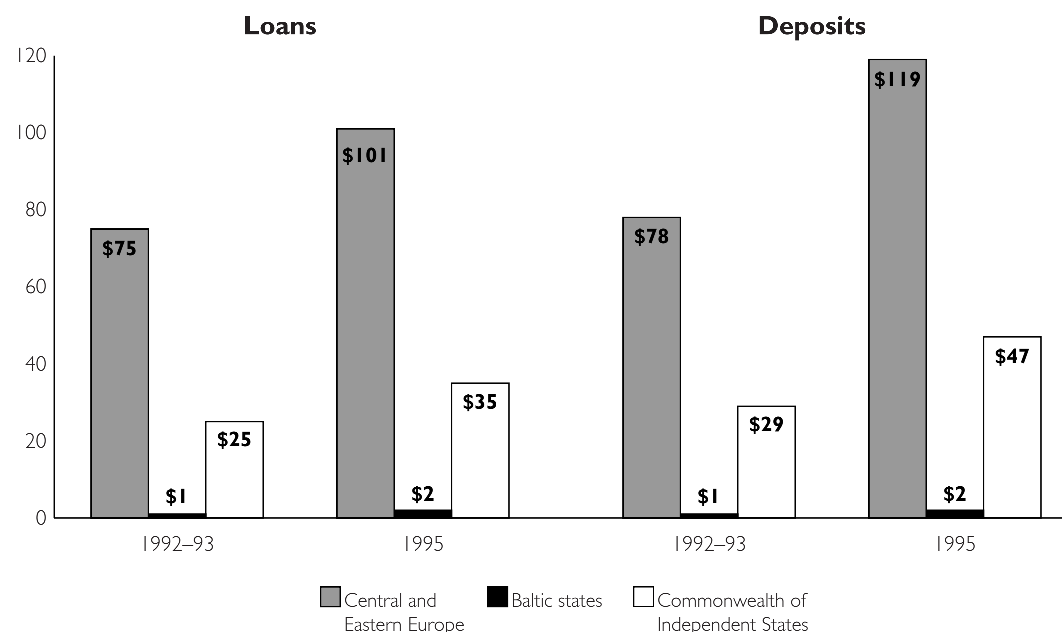
The CEE countries showed the greatest increase in loans and deposits between 1992 and 1995. Loans grew by nearly $26 billion, with the biggest increase in the Czech Republic (figure 3.2).[8] That country and Poland accounted for about 80 percent of the region's net increase, while Bulgaria, Hungary, and the Slovak Republic showed net declines. The CIS countries had a net increase in loans of about $10 billion, with Russia accounting for more than $12 billion, second only to the Czech Republic among the transition economies. Several CIS countries showed net declines, including Kazakhstan, Turkmenistan, and Ukraine. Loans increased by nearly $1 billion in the Baltic states.

Deposits in the CEE countries increased by nearly $42 billion, about two-thirds of the total deposits mobilized in transition economies during the period. The Czech Republic and Poland accounted for nearly half the growth, while FYR Macedonia saw a net decline. In the CIS countries deposits increased by nearly $18 billion—a positive development after the devas-

FIGURE 3.2

Loans and Deposits in Transition Economies, 1992–93 and 1995

Billions of U.S. dollars



Note: Loan data were derived from data from the IMF's *International Financial Statistics* on net domestic credit to enterprises and households but exclude claims on government. Data are the earliest after 1992 and 1995 if not available for those years (1993 in many cases, 1994 for Albania and Belarus).
Source: IMF, *International Financial Statistics*; authors' calculations.

tating effects of hyperinflation in the region. But Russia was responsible for all the gains, while all other CIS countries except Belarus had limited growth or none at all. Several CIS countries had net declines, including Armenia, Moldova, Turkmenistan, and Ukraine. Meanwhile, deposits in the Baltic banks increased by nearly $1 billion, slightly outpacing the growth in loans. This development too is important, given the crash of Latvia's largest bank, Bank Baltija. But Latvia's performance lagged behind that of Estonia and Lithuania, reflecting its 1995 banking crisis.

Loans and Net Domestic Credit

At the end of 1995 the 200 state banks in the transition economies had about $95 billion in outstanding credit.[9] That translates into an average credit exposure of about $472 million for state banks,[10] while private banks had an average credit exposure of only about $31 million (figure 3.3). The largest banks, both state and private, were in Central and Eastern Europe, mostly in the Czech Republic and Poland. Private banks in the Baltics and the CIS had particularly small credit exposures.

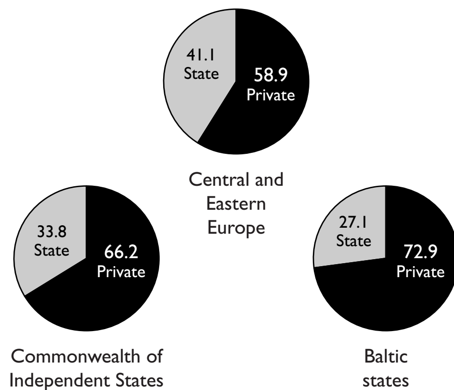
Like general asset values, loan values were broadly overstated and so were some overall credit values—as became clear when some CIS governments eventually defaulted on domestic debt. In most transition economies in 1995 loan quality was poor, and classification standards were neither strict enough nor properly applied. Had sound provisioning standards been in place at the time, the net loan figures on state banks' balance sheets would have been smaller.

Given the structure of most transition economies at the time, state banks would have had more credit exposure to state-owned enterprises in industry than to any other sector or class of borrower. (The industrial sector accounted for 21–42 percent of the economy, or an unweighted average of 33 percent.)[11] The second largest exposure would

FIGURE 3.3

State and Private Banks' Shares of Credit Exposure in Transition Economies, 1995

Percent



Note: Data for total number of banks are for 1995 except for Bosnia and Herzegovina. Total number of banks for Yugoslavia is estimated for 1995. The number of state banks is estimated for 1994. Data on credit exposure are for 1995 or the earliest year reported after 1995. No reliable data are available for Tajikistan, Uzbekistan, or Yugoslavia.
Source: IMF, *International Financial Statistics*; EBRD, *Transition Report 2001*; Claessens 1996.

have been to the agricultural sector. Services would have accounted for little of the outstanding credit. Although services were contributing to an increasingly significant share of GDP by the mid-1990s, most of the growth came from small private companies without access to bank financing.

Of course, stock measures of credit should not be confused with new loans. While balance sheet exposures to state farms and industrial enterprises remained high, these often represented delinquent loans that were rolled over without restructuring and with little increase in collateral backing or other measures to reduce risk. Moreover, even when loss-makers received new credit, they often used the funds to pay down arrears to employee wage accounts and to government accounts for social benefits. Enterprises still lacked the financing to replenish working capital, fund capital improvements, or take other actions to foster profitable production. Thus much of the stock of credit in transition economies in 1995 consisted of old, nonperforming loans, despite what the banks' formal books said.

Flow measures showed an increase in credit in most transition economies. As noted, borrowers often used the proceeds of new loans to reconcile accounts and pay down arrears rather than to invest or retool. In addition, controlling interests often diverted funds for uses that undermined the positions of both the debtors (enterprises) and the creditors (banks). These practices reflected the deep structural problems of many state bank clients as well as weaknesses in the legal framework and in corporate governance and management. In the end the bank losses flowing from the problems of loss-making enterprises became so severe that governments were unable to either fund them or come up with the investment capital to restructure and modernize without major job losses, debt write-downs, and the like.

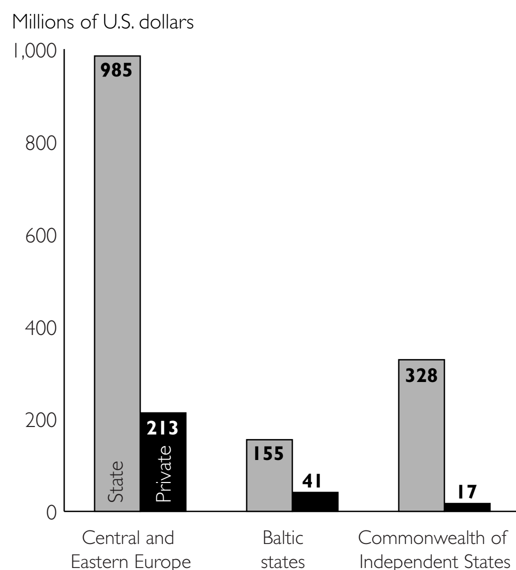
Assets

By 1995 state banks accounted for $131 billion in assets while private banks held $149 billion, or a little bit more than half the total in transition economies. In the CIS and Baltic countries state banks' share was larger, about 73 percent. In the CEE countries, where large banks remained in state hands, state banks still had 55 percent of assets. The CIS and Baltic countries had only 27 percent of assets in private banks.

The state banks in the CEE countries were significant even in 1995, with about $985 million in assets on average (figure 3.4). CIS state banks had an average of about $328 million in assets, while those in the Baltics were much smaller, with $155 million.[12] Private banks had only a fraction of the assets of state banks. Those in the CEE countries averaged $213 million in assets, while those in the Baltic states averaged $41 million and those in the CIS countries $17 million.[13] Even so, the private banks in the CEE countries had achieved critical mass by the mid-1990s. By contrast, in the CIS and Baltic markets only state banks seemed large enough to develop significant earnings. But

FIGURE 3.4

Average Assets of State and Private Banks in Transition Economies, 1995



Note: Data on total number of banks are for 1995 except for Bosnia and Herzegovina (1996). State banks are major state banks in 1994–95. Data on assets are for 1995 or earliest year reported after 1995. No reliable data are available for Tajikistan, Turkmenistan, Uzbekistan, or Yugoslavia. *Source:* IMF, *International Financial Statistics*; EBRD, *Transition Report 2001*; Claessens 1996.

the state banks' prospects were undermined by their poor loan quality as well as by poor service, weak systems, excess staffing, lack of innovation, and a limited array of financial products.

Deposits

Banks in transition economies held roughly $108 billion in total deposits in 1992–93. If most of this value was held by state banks (a reasonable assumption, given the prominence at the time of savings banks and of foreign trade banks holding hard currency deposits), average deposits would have been as high as $570 million.[14] But because most deposits were held in local currency and thus subject to the ravaging effects of hyperinflation in nearly every transition economy, many of the deposit accounts were wiped out.[15]

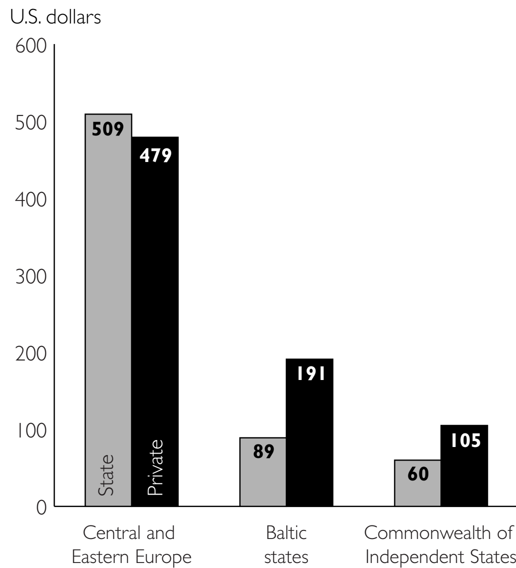
In the mid-1990s deposits held with banks were still relatively low, although they had increased about 56 percent since 1992–93. Despite the favorable trends, significant money was still held outside the banking system. Broad money measures routinely highlighted large shares of GDP circulating outside the formal system, particularly in the CIS, while the ratio of bank assets to GDP remained relatively low in most transition economies. From the point of view of individuals, there were many reasons not to place funds with banks. Neither state nor private banks gave households significant incentives to deposit their funds, paying interest rates that were generally negative in real terms. Confidence in the stability of the banking system remained low. And many relied on private cash or barter transactions rather than formal payment channels to avoid paying taxes.

By 1995 deposits in the transition economies amounted to about $169 billion. A large share (about 71 percent) were held in banks in Central and Eastern Europe, mostly in Poland, the Czech Republic, Hungary, and the Slovak Republic. Among CIS countries only Russia had any substantial deposit base. But with 15 times the population of the Czech Republic, Russia still had only 1.2 times the deposits held by Czech banks. And with a similar demographic advantage over Hungary, Russia held only 2.6 times as much in deposits as Hungary. Thus CIS banks had generally ceased to serve any useful savings mobilization role by 1995, with the possible exception of Russia's Sberbank, which accounted for at least a third of Russia's $42 billion in banking system deposits.[16] Per capita deposits in 1995 were nearly $1,000 in Central and Eastern Europe, but only $280 in the Baltic states and $165 in the CIS countries (figure 3.5).

Putting a precise figure on deposits held by state banks is difficult. But it is estimated that these banks accounted for a large share of the deposits because of the role played by state-owned savings banks and because the other large state banks that held major foreign currency assets generally were not privatized until after 1995. Even CIS countries

FIGURE 3.5

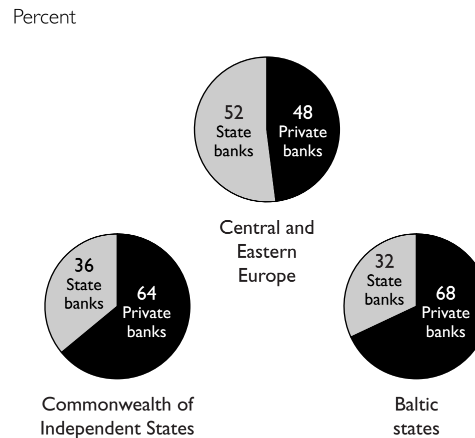
Per Capita Deposits in State and Private Banks in Transition Economies, 1995



Note: Per capita deposits were calculated based on data on aggregate and state bank deposits and total population, both for 1995.
Source: IMF, *International Financial Statistics*; EBRD, *Transition Report 2001*; World Bank data.

FIGURE 3.6

State and Private Banks' Shares of Deposits in Transition Economies, 1995



Note: Data on total number of banks are for 1995 except for Bosnia and Herzegovina (1996). State banks are estimated for 1994–95. Data on deposits are for 1995 or the earliest year reported after 1995.
Source: IMF, *International Financial Statistics*; BankScope (Fitch IBCA); EBRD; authors' calculations.

that transformed the ownership of their banks by "privatizing" Gosbank branches still generally had state-owned savings and foreign trade banks. Estimates for all transition economies in 1995 based on the state banks' share of total assets suggest that these banks had $79 billion in deposits, or an average of about $397 million,[17] far lower than the $570 million average two to three years earlier. In the CEE countries state banks had average deposits of about $612 million in 1995, while the average in CIS countries was $185 million, and in the Baltics, about $98 million.[18]

These estimates show that private banks had already begun to capture a fairly significant share of deposits by the mid-1990s (figure 3.6). Indeed, private banks held more than half the aggregate deposits in transition economies, even though they had smaller average deposit holdings than state banks.[19] As in other balance sheet categories, private banks in Central and Eastern Europe were markedly larger than their counterparts in the Baltic states and even larger than those in the CIS countries.

Capital

Data for 1995 show that state banks had about $47.5 billion in net capital on their balance sheets, about 46 percent of the total bank capital in transition economies.[20] State banks in the CEE countries had about $14 billion in capital at the end of 1995, much of it in Poland ($8.1 billion). Russia accounted for $7.1 billion, while Croatia and Romania each had more than $1 billion.[21]

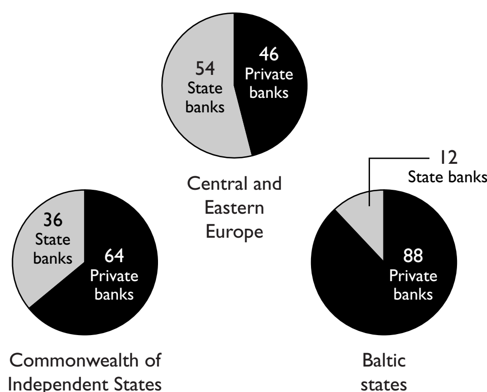
State banks had average capital of $112 million. The CEE countries again rank at the top in bank size: state banks in this region had an average $143 million in capital. State banks in CIS countries averaged $84 million in capital, although this was skewed by figures for Sberbank of Russia. Baltic state banks were generally very small, averaging only $4 million in capital.

Private banks accounted for about 54 percent of banking system capital in the transition economies in 1995 (figure 3.7). Most private bank capital was in the CIS countries, which accounted for $13 billion, or 52 percent of the total. CEE countries had $12 billion in private bank capital, while the three Baltic

FIGURE 3.7

State and Private Banks' Shares of Bank Capital in Transition Economies, 1995

Percent



Note: Data are for 1995 unless not available (1997 for Bosnia and Herzegovina). Capital is capital accounts plus or minus other items net. The state share of capital was calculated by applying the state share of assets to capital, with the private bank share the residual.
Source: IMF, *International Financial Statistics*; EBRD; authors' calculations.

states combined had only $193 million. Private banks were smaller than state banks, averaging only $7 million in capital, and in most countries were substantially smaller. While CEE banks had $28 million in capital on average, CIS and Baltic banks had only $3–4 million. The largest private banks in terms of capital were in the Czech Republic and Poland.[22]

Although private banks accounted for more than half the banking system capital in the transition economies in 1995, in 13 of the 27 economies state banks still held more than half. Thus it is fair to say that transition economies were at the midpoint of the shift from state to private. Regardless of ownership, most banks in transition economies were small, with only a handful of state banks showing relatively large capital positions by 1995.

State and private banks reported similar basic, nominal capital-to-asset ratios in 1995.[23] State banks reported average ratios of 16.8 percent, and private banks average ratios of 17.2 percent. But while many countries had high capital-to-asset ratios (and high capital adequacy ratios), these generally reflected improper classification, inappropriate assignment of risk weights, and a general understatement of risks (including off–balance sheet transactions and posted collateral values). Once adjustments were made, banks experienced major financial crises and severe deterioration in solvency. Because of the poor accounting and classification standards in most transition economies in 1995, the published data provide too little information to determine what would have been appropriate capital-to-asset ratios in that risk environment.

So while capital ratios were reasonable on the surface in 1995, they proved to be low for most state banks (and often for private banks) unless they had sound backing from their owners. That meant fiscal resources, access to international capital markets, some measure of monetary compensation (such as higher net spreads to recapitalize), or regulatory forbearance. The monetary and fiscal measures often proved costly to the economy and weakened the macroeconomic framework. And forbearance often led to a distortion in the competitive environment by at least partly shielding state banks from market discipline.

Emerging Role of Private Banks

Private banks played a very limited role at the outset of the transition, although many countries had already permitted their formation. While the largest banks through the mid-1990s were state banks, new banks emerged quickly once the monobank system was broken up. As early as 1991 there were more than 2,000 private banks in the formerly socialist countries of Europe and Central Asia, mostly in Russia and other CIS countries.[24] Non-CIS countries had 448 private banks in the early 1990s, with Poland and Bulgaria accounting for more than a third of all banks in Central and Eastern Europe.[25] The three Baltic states had 61 banks.

Foreign banks played a particularly important role during the transition, several moving quickly as strategic investors in the region. Thus, the number of foreign banks increased

TABLE 3.1
Number of Foreign Banks in Transition Economies

	1994		2000	
Country	Number of banks	Foreign owned	Number of banks	Foreign owned
Albania	6	3	13	12
Armenia	41	1	31	11
Azerbaijan	210	2	59	5
Belarus	48	—	31	6
Bosnia and Herzegovina	—	—	56	14
Bulgaria	40	1	35	25
Croatia	50	—	44	20
Czech Republic	55	13	40	16
Estonia	22	1	7	4
Georgia	226	1	30	8
Hungary	43	17	38	30
Kazakhstan	184	8	48	16
Kyrgyz Republic	18	3	22	6
Latvia	56	—	21	12
Lithuania	22	0	13	6
Macedonia, FYR	6	3	22	7
Moldova	21	1	20	11
Poland	82	11	74	47
Romania	20	3	33	21
Russian Federation	2,456	—	1,311	33
Slovak Republic	29	14	23	13
Slovenia	44	6	28	6
Tajikistan	17	—	17	4
Turkmenistan	—	—	13	—
Ukraine	228	1	154	14
Uzbekistan	29	1	34	6
Yugoslavia	—	—	—	—

— Not available.
Source: EBRD *Transition Report 2001*.

dramatically during the transition period, particularly in CEE and the Baltics (table 3.1) While many governments welcomed foreign participation, expecting that reputable investors would bring added stability, skills and knowledge to the region, the records of foreign banks have been mixed. This emphasizes the need to create the right incentives for banks—whether they are domestic or foreign—to lend and provide a broad range of financial services.

Some foreign banks tended to have limited balance sheet exposure to the transition economies but were involved in international payments and transactions (such as trade finance and donor-financed infrastructure projects). For example, Hungary, Poland, and Romania had about $2 billion in official credit exposure in 1992 (originating in the pretransition era) and about $2.2 billion in commercial credit exposure. And Yugoslavia had official and commercial credit exposure dating to the Tito era.

Private Banks Emerge with Strong Ties to the Government

Generally, however, private banks early in the transition period were small startups or privatized branches from the earlier Gosbank system. Most of these banks were little more than captive finance companies of state enterprises that insiders and shareholders used for personal gain and patronage.

In the CIS and Baltic states many of the initial private banks resulted from the rapid spin-off of branches of the Gosbank into private hands—or ownership transformation.

Particularly common in Russia and Ukraine, ownership transformation generally involved changing the legal status of small banks that had been spun off from the monobank system to joint stock companies and then selling these banks to new shareholders. This type of ownership transformation was a proxy for bank privatization in the absence of major capital investment in these banks. In most cases the new shareholders were traditional state enterprise borrowers, and the transformed bank took on the character of a captive finance company rather than a commercial bank. Some of these banks were new only to the extent that they sought licenses from the regulatory authorities with "new capital" based on low minimum capital requirements for entry. Poor lending decisions, bad governance, weak management, and the collapse of local currencies all pushed these banks into financial trouble within a relatively short period.

By the mid-1990s the CIS countries (and Estonia and Latvia) had most bank assets in "private" banks' hands. But because most private banks in CIS countries continued to operate as they had before—as pocket banks, or captives of the key state enterprises they financed—there was little change in lending activity and general banking operations. These banks were able to turn to the state for financing when they needed it, often calling on patronage networks and political ties. This practice contributed to the widespread corruption that has undermined development since the early 1990s.

In Central and Eastern Europe private banks proliferated in response to new incentives aimed at stimulating competition in the banking sector. In nearly all countries except Slovenia banks could obtain licenses with very low minimum capital.[26] This easy entry policy triggered a large increase in the number of banks. However, despite the rapid growth in private banks, which came to far outnumber state banks, most bank assets in Central and Eastern Europe remained in state-owned institutions.

The intermediation role of private banks remained limited through the mid-1990s in the transition economies. Part of the reason was that they were generally small to begin with, with few resources to lend. Hyperinflation had erased most of the value of local currency savings in the CIS, while in the former Yugoslavia war and cross-border disputes (including on the issue of frozen foreign currency deposits) undermined deposit mobilization and banking stability. Thus in all but a few transition economies domestic private banks had very poor development prospects early in the transition. Meanwhile, larger banks from abroad were seeking only the best of the corporate clients.

By 1995 private banks accounted for $110 billion in credit exposure in transition economies, about 56 percent of the total. On average, that is equivalent to only about $31 million in credit exposure per bank.[27] Private banks in the CIS were particularly small, averaging only $13 million in credit exposure, compared with $158 million for their counterparts in Central and Eastern Europe (table 3.2).[28] By international standards these were exceedingly small averages.

Private banks had made modest progress in attracting deposits away from the state banks by 1995, although both aggregate and average deposit levels remained low. Private banks in the CEE countries averaged $133 million in deposits, far higher than the average of only $10 million in the CIS and $22 million in the Baltics.[29] The low deposit levels reflect a variety of factors, including tax avoidance, the lack of confidence in the banks, the low real rates paid by banks on deposits, the lack of confidence in deposit guarantees (implicit or explicit), and the limited cash on hand among households and enterprises.

Private banks in all transition economies held about $90 billion in deposits. With the population totaling 414 million, that translates into per capita deposits in private banks of only $216.[30] While per capita holdings in

TABLE 3.2

Banking Intermediation Statistics for Private Banks in Transition Economies, 1995

(millions of U.S. dollars except where otherwise specified)

	Number of private banks	Credit		Deposits	
		Total	Average	Total	Average
Central and Eastern Europe	437	68,878	158	58,129	133
Baltics	68	1,547	23	1,471	22
Commonwealth of Independent States	3,081	39,957	13	29,943	10
Transition economies	**3,586**	**110,382**	**31**	**89,543**	**25**

Source: IMF, *International Financial Statistics.*

private banks were $479 in Central and Eastern Europe, they were only $191 in the Baltic states and $105 in the CIS countries (see figure 3.5). Even so, private banks had larger per capita holdings than state banks in the Baltics and the CIS. And there was growing convergence in Central and Eastern Europe, with private banks accounting for more than 48 percent of per capita deposits. These trends show that deposits were gradually migrating to private banks by 1995, even though traditional savings banks were still state owned in the major CEE countries.[31]

Diverging Approaches to Reform

In the wake of the initial breakup of the monobank system and, especially, the macroeconomic chaos and instability accompanying the early stage of the transition, there was fairly widespread recognition of the need for greater monetary and fiscal discipline by the mid-1990s (and sometimes sooner). Hyperinflation alone had led to massive shock in most countries, a problem compounded by fiscal revenue losses and the inability of government institutions to finance services and investment commitments.

In banking sectors these macroeconomic developments triggered and were reinforced by structural challenges involving financial, institutional, and incentive issues. Banking systems faced portfolio erosion, declining lending flows, loss of confidence in the banks' safekeeping capacity, a general decline in savings, lack of other borrowing sources, and persistently weak capital. In the absence of protection and support, banks' performance suffered from poor corporate governance, weak internal systems, inadequate management, related party abuse, poor accounting standards, an inadequate legal framework for secured transactions, weak formal debt collection and liquidation systems, and, for most enterprises, information inadequate for modern underwriting requirements. These weaknesses made it virtually impossible to move quickly to a financial system that was sound, stable, and commercially viable. Compounding the challenge was the huge cost of systems and human capital development required to carry out such a transition.

As early as 1995, however, there was evidence of regional disparities. CIS countries experienced far more adverse effects, while many CEE countries and the Baltic states showed growing fiscal discipline and lower vulnerability to hyperinflation. Hyperinflation and fiscal deficits were declining, thanks in part to the hardening of soft lending conditions through the banks. In many CEE countries and the Baltics the tightening of monetary policy was accompanied by a stricter prudential regulatory framework for banks emphasizing loan classification, provisioning standards, and more accurate accounting of profit and loss, retained earnings, and capital measures (including more suitable risk weights for capital adequacy measures). Many of the CEE countries, the Baltics, and some of the CIS countries also made efforts to strengthen banking supervision capacity. These efforts focused on early warning signals of financial sector instability, general off-site

BOX 3.1

Latvia's Successful Restructuring and Privatization of Unibanka

Latvia's Universal Bank of Latvia, or Unibanka, is a rare success story. While the bank initially engaged in activities that undermined the quality of its loan portfolio and put bank capital at risk, it was successfully restructured and, as a result, able to withstand systemic weaknesses in the mid-1990s and to attract strategic investment in the second half of the decade.

Unibanka was formed on September 28, 1993, from the rump of 21 branches from the newly reorganized Savings Bank. Most of the bad loans (40 percent of total assets in March 1994) were concentrated in these branches. As part of the rehabilitation process, these loans were taken off Unibanka's books and replaced with seven-year government bonds in the amount of 25 million lats (LVL), or about $50 million.

The government created Unibanka in part to provide an insurance policy against catastrophic failures in the private banking sector. This logic was put to a serious test in the first half of 1995, when the insolvency of the country's largest bank (Bank Baltija) triggered a systemic crisis in which about 40 percent of the assets and liabilities of the banking sector were lost and 7 banks, including 3 of the 10 largest banks, collapsed. The crisis had a big effect on both the large state banks, the Savings Bank and Unibanka. But Unibanka was not directly involved in the crisis, did not need to be closed or bailed out, and was less badly harmed than the Savings Bank. In fact, Unibanka benefited (and the Savings Bank suffered) from a flight to quality following the crisis as depositors reallocated assets toward banks that appeared better managed, better capitalized, and less risky. In surveys, Latvian banking professionals consistently rated Unibanka as the safest bank in Latvia.

Privatization procedures were launched at Unibanka on October 3, 1995. The board of the Latvian privatization agency approved basic privatization regulations providing that Unibanka would be privatized in four years. In the first stage, carried out in 1995, share capital was increased to LVL 11.5 million (about $23 million), and then a little over 50 percent of the shares were sold for privatization certificates. Of this 50 percent, 22 percent were sold publicly, 13.5 percent were sold to customers of Unibanka, and 14.5 percent were sold to employees. The privatization agency held the remaining shares. In October 1995 the bank's shareholders decided to reorganize the bank as a joint stock company, Latvijas Unibanka. And in January 1996 it became the first company to list on the Riga stock exchange.

The bank's privatization regulations called for increasing its share capital in the next privatization round by attracting capital from a strategic investor. In May 1996 Unibanka's share capital was raised by LVL 6 million (about $12 million), and the European Bank for Reconstruction and Development (EBRD) and Swedfund International AB purchased the newly issued shares. The EBRD gained control of about 22.6 percent of the total shares, and Swedfund control of about 7.5 percent. Over the next three years most of the remaining state-owned shares were sold in the international market through a global depository receipt program, and part were sold through special auctions at the Riga stock exchange. By the time privatization was complete in late 1999, the state had received LVL 66.1 million (about $113.4 million)—LVL 21.3 million in cash and LVL 44.8 million in privatization vouchers.

By September 2001 Unibanka's paid-up share capital amounted to LVL 37.1 million ($59.9 million). More than 98 percent belongs to the Swedish bank Skandinaviska Enskilda Banken (SEB). A major force in the banking sector consolidation in the Baltics, SEB initially purchased a 23 percent interest in Unibanka at a special auction at the stock exchange in late 1998. It then steadily purchased shares from the bank's other shareholders, including the EBRD.

surveillance based on regulatory reporting, and the coordination and scheduling of comprehensive on-site examinations.

Many countries had taken initial measures to strengthen banking supervision before 1995. But these measures were not effectively implemented until later. These delays were often due to the time needed to develop institutions and personnel for a broad range of supervisory functions. Another factor was the difficulty that supervisors often had in executing their mandate, particularly when state banks violated prudential norms and were out of compliance or when "private" banks with close ties to government officials obtained special favors. In some cases these mandates simply lacked

sufficient legal backing. Most important, banking supervisors often found weak political support for their mandate. This changed after banking crises had occurred in most transition economies and as international institutions encouraged greater observance of standard norms in support of financial sector stability.[32]

The performance of CIS and non-CIS banking systems had begun to diverge even as early as 1993–94. In many non-CIS countries recognition of solvency and liquidity problems triggered a series of recapitalizations and restructuring programs geared to restoring stability in the banking system and getting banks on track toward commercial profitability. Poland's 1993–94 restructuring program was followed in the late 1990s by a surge of strategic investment and privatization. In Hungary the decline in fiscal and balance of payments fundamentals by 1994 had prompted an acceleration of privatization throughout the economy starting in 1995–96, including a push for strategic investment in the banking sector. Estonia moved aggressively to liquidate weak banks in the early 1990s and to consolidate in the late 1990s, attracting foreign investment from Scandinavia and Europe as an anchor. Where problems were not identified and addressed early on, major collapses prompted intensified reform efforts to preempt a recurrence of widespread instability (such as in Latvia in 1995, Bulgaria in 1996–97, and Albania in 1997). In all these cases governments moved to restructure their banks under strict guidelines and with a clear objective of privatizing them, usually with some form of strategic investment (box 3.1).

Countries where reforms and performance have lagged have taken a different approach. State banks have often been kept afloat because of the perception of their importance to the economy. Others have been "privatized" through ownership transformation, resulting in the continuation of many of the lending practices that had gotten the state banks into financial trouble. Invariably, the results have been high levels of nonperforming assets, a drain on the budget and the economy, distortions in the competitive environment, and an erosion of confidence in civil institutions.

Notes

1. This figure excludes the many Russian banks in which the state had small stakes. There are no precise numbers on the state-owned banks in Russia in 1995, given the large number of banks in which the state or other public authorities had minority stakes. But the state continued to control the banking system from 1992 to 1995, dominating savings through Sberbank (which held 70 percent of household deposits) and providing directed lending to state enterprises through many new and regional banks. In 1992–95 the number of banks grew enormously, so that by 1995 there were more than 2,200 banks operating in Russia, although the largest 10 banks accounted for 50 percent of assets.

2. ING, ABN-Amro, Deutsche Bank, Société Générale, Citigroup, and HSBC were among the major banks operating in CIS markets in the mid-1990s.

3. See Borish and Noël (1996).

4. The Czech Republic, Hungary, Poland, and Romania had already attracted direct investment from euro zone and other Western banks into domestic banks or startups. Other countries (Bulgaria, the Slovak Republic, Slovenia) were also beginning to attract limited investment in the form of bank branches or small capital investments in banks.

5. See Borish, Long, and Noël (1995).

6. \$36,276 million/3,783 banks = \$9.6 million.

7. \$60,203 million/3,783 banks = \$15.9 million.

8. Loans are defined as banks' claims on enterprises and households. This is distinct from net domestic credit, which includes banks' claims on governments.

9. These figures are calculated by applying state banks' shares of total banking system assets to aggregate credit figures, which include claims on government. Credit exposure is defined here as on–balance sheet and does not account for off–balance sheet items because of data deficiencies.

Reviews of the banks' financial condition based on more recent data need to take such items and contingencies into account for a sound accounting of their status and risk.

10. $94,482 million/200 state banks = $472 million.

11. See World Bank (1997). Albania had the smallest share of industrial value added (21 percent), while Ukraine had the largest (42 percent).

12. CEE: $99,524 million/101 state banks = $985 million. CIS: $30,147 million/92 = $328 million. Baltic states: $1,086 million/7 = $155 million.

13. CEE: $92,852 million/436 private banks = $213 million. CIS: $52,899 million/3,079 = $17 million. Baltic states: $2,801 million/68 = $41 million.

14. $108,296 million/190 banks =$570 million.

15. Hungary and the Czech and Slovak Republics are the only transition economies whose year-to-year average CPI inflation from 1990 on never exceeded double-digit rates. All other transition economies experienced triple-digit rates at least one year in the period after 1989.

16. According to BankScope data, Sberbank held 65.6 billion rubles in deposits at the end of 1995, or $14.3 billion—a third of the total in Russia. But most reports put Sberbank's share far higher. These assessments could be more recent, reflecting losses by other banks resulting from the flight of hard currency deposits out of the country after 1995 and the loss of value of local currency deposits after the collapse of the ruble in 1998 (although the ruble collapse would also have affected Sberbank's household deposit base).

17. $79,477 million/200 state banks = $397 million.

18. CEE: $61,772 million/101 state banks = $612 million. CIS: $17,019 million/92 = $185 million. Baltic states: $686 million/7 = $98 million.

19. CEE: $58,129 million/436 private banks = $133 million. CIS: $29,943 million/3,079 = $9.7 million. Baltic states: $1,471 million/68 = $22 million.

20. The 1995 figures on capital are derived from the IMF's International Financial Statistics, with EBRD ratios of state bank assets applied to total assets. This calculation is not exact and probably overstates state bank capital while understating private bank capital. But because of poor accounting standards in 1995, capital for many private banks was probably also overstated.

21. The Czech Republic may have understated its state bank capital and overstated its private bank capital. The National Property Fund had large stakes in several banks that may have been considered private for statistical purposes.

22. The average for private banks in FYR Macedonia was $145 million. But this appears to be a statistical error given the earlier hyperinflation in the former Yugoslavia, the sanctions imposed by Greece, and the general difficulties the country had in dealing with banking sector problems early in the transition. Although FYR Macedonia launched structural reforms in 1995, it is the authors' view that average private bank capital was overstated.

23. Capital-to-asset ratios should be distinguished from capital adequacy ratios. Capital-to-asset ratios are direct balance sheet measures without adjustments for risk, while capital adequacy ratios are risk-weighted and more accurately measure the depth and quality of a bank's solvency. While state and private banks had roughly the same capital-to-asset ratios, these ratios would have to be adjusted for the risks of losses from nonperforming assets or for overvalued assets. Had that been done, the ratios for state banks and many private banks would probably have been far lower.

24. In the early 1990s transition economies already had 2,350 banks, most of them private (figures are from 1990 or the earliest year reported thereafter). Russia had 1,306 banks in 1991, while all CIS countries together had about 1,841.

25. Poland had 87 banks as early as 1993, and Bulgaria had 75 as early as 1992.

26. To encourage mergers and consolidation of the system, Slovenia increased its minimum capital requirement for a full banking license from DM 5 million to DM 60 million (about $35 million at the time) in 1993. By contrast, other countries generally had minimum capital requirements equivalent to euro 5 million or less, and most CIS countries had far lower requirements.

27. $110,382 million/3,583 private banks = $30.8 million.

28. CIS: $39,957 million/3,079 private banks = $13.0 million. CEE: $68,878/436 private banks = $158.0 million.

29. CIS: $29,943 million/3,079 private banks = $9.7 million. CEE: $58,129 million/437 private banks = $133.0 million. Baltics: $1,471 million/68 private banks = $21.6 million.

30. $89,543 million/414 private banks = $216 million.

31. Examples include PKO BP and PKO SA in Poland, OTP in Hungary, Ceska Sporitelna in the Czech Republic, Slovenska Sporitelna in the Slovak Republic, CEC in Romania, and DSK in Bulgaria.

32. This effort accelerated after the East Asian crisis in 1997, and in 1998 the urgency was reinforced by the collapse of the ruble and the deleterious effects this had on CIS economies.

Chapter 4

State Banks Since 1995: Continuing Problems

Recognizing the continuing problems related to state banks, many transition economies have intensified their privatization efforts. While many countries, particularly in Central and Eastern Europe and the Baltics made substantial progress in consolidating, liquidating, or privatizing many of their largest state banks, reforms moved at a much slower pace in the CIS.

Progress in Privatization

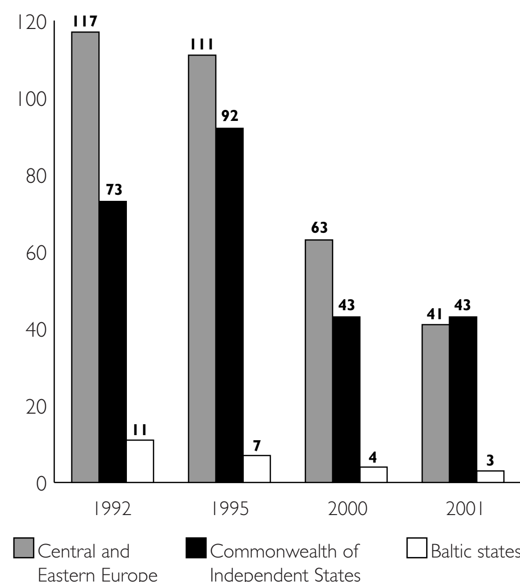
The progress in privatization since the start of transition is reflected in the sharp decline in the number of state banks throughout the region (figure 4.1 and table 4.1). While the number of banks has been reduced overall, many of those that remain, particularly in the Balkans and CIS countries, continue to dominate the banking sectors and pose important risks to the financial systems overall.

Progress in Central and Eastern Europe and the Baltics

In Central and Eastern Europe, Albania is expected to have a fully privatized banking system by end-2002, just a few years after state banks controlled nearly 100 percent of the assets. The acceleration in its privatization program was triggered by the damage done to the economy and the civil society by the pyramid schemes in 1997. While far less damaging, the buildup of fiscal and balance of payments deficits in Hungary served as a catalyst for its acceleration of privatization in financial services and the real sector in 1995–96. Hungary has finalized the privatization of major banking institutions with strategic investment, as have the Czech and Slovak Republics. Poland is down to two major state banks.[1] Bulgaria and Croatia recently privatized their largest state banks. And FYR Macedonia and the Baltic states have very little state investment remaining in their banking systems.

FIGURE 4.1

State Banks in Transition Economies, Selected Years, 1992–2001



Source: IMF; World Bank; EBRD; authors' calculations.

TABLE 4.1

Remaining State Banks as of End–2001

Country	Status of state banks
Albania	The Savings Bank is expected to be privatized in 2002.
Armenia	ASB was privatized in 2001.
Azerbaijan	United Universal is still undergoing consolidation. IBA is still state owned.
Belarus	Several banks remain state owned, with no formal program to move forward with privatization.
Bosnia and Herzegovina	Most state banks are being privatized or liquidated in 2002, although progress is slow in some cases.
Bulgaria	Two of the last three state banks are being offered for sale in 2002.
Croatia	Only HRB remains state owned.
Czech Republic	The major state banks, CSOB and Ceska Sporitelna, were privatized in 1999–2000. Four banks remain state owned.
Estonia	The system is fully privatized.
Georgia	No state banks remain.
Hungary	Two banks remain state owned.
Kazakhstan	The government reduced its 80 percent stake in Halyk (in December 1999) to the current level of 33.3 percent plus one share. The state initially planned to sell its remaining stake in 2001, but this tender has been postponed indefinitely.
Kyrgyz Republic	Kairat is 100 percent state owned, and Energo Bank is partly state owned. The Savings and Settlement Company is a state financial institution with a limited banking license.
Latvia	Full privatization is planned for the Latvian Savings Bank.
Lithuania	Only the Agricultural Bank is state owned.
Macedonia, FYR	Only MDB remains state owned.
Moldova	The system will be fully private after the sale of Banco de Economii.
Poland	Two large banks remain state owned (PKO BP and BGZ) along with two other banks that are comparatively large for the region.
Romania	Three banks remain state owned (the state holds about 40 percent of assets). Plans are to privatize one (BCR), to restructure and eventually privatize the savings bank (CEC), and to reorganize (and delicense) the EXIM Bank.
Russian Federation[a]	More than 460 banks are state owned, with as many as 679 having shares or stakes from all public institutions (including the central bank). The state (all-inclusive) held controlling stakes in 62 and blocking shares in 80. The state plans to divest all holdings of less than 25 percent, leaving Sberbank, Vneshtorgbank, Vneshekconombank, and a small number of new specialized banks (export-import, agricultural, and development banks) as state-owned institutions.
Slovak Republic	Several small banks remain state owned, but these are not viewed as highly distortionary. The major remaining state-owned bank is Postovna Banka.
Slovenia	The major bank remains state owned.
Tajikistan	Sberbank is the only remaining state bank.
Turkmenistan	Although data are limited, it appears that five state-owned banks remain.
Ukraine	Two state banks remain, including Oschadny (the savings bank).
Uzbekistan	One bank is fully state owned (the National Bank of Uzbekistan), and 15 others are joint stock companies with direct or indirect state ownership.
Yugoslavia	Four state banks are being liquidated. However, the government just opened a state-owned savings bank and plans to open a few more state banks. In addition to the "big six" banks, in 2001 there were around 20 smaller banks in which the majority of assets are controlled by the state or by socially owned enterprises and banks. Most of them are deeply insolvent and are scheduled for liquidation in the near future.

a. One report claims that as of October 1, 2001, Russia had more than 1,300 lending institutions, of which 638 were at least partly owned by the state if the central bank's shares in commercial banks and other lending institutions are included. See Builov (2002).

Source: IMF; World Bank; and EBRD.

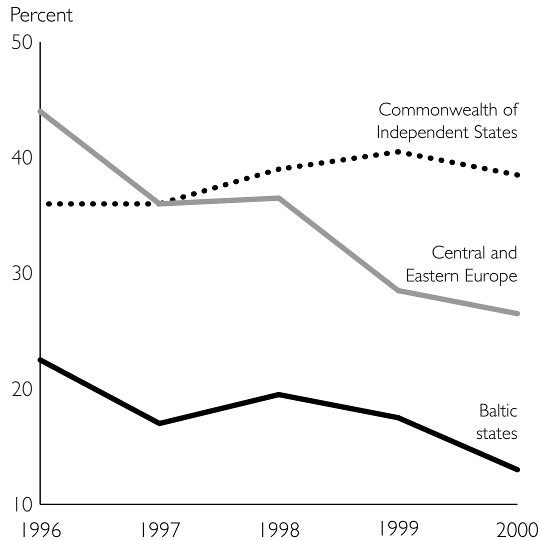
Progress in the Commonwealth of Independent States

Among CIS countries, Armenia and Georgia have fully eliminated state ownership.[2] The Kyrgyz Republic has only three nonprivate banks. Moldova's banking sector will be fully private as soon as the state sells its last shares in the Banca de Economii (the former savings bank). Kazakhstan has significantly reduced the share of state bank assets since 1998.

Across the transition economies, state bank assets have declined substantially (figures 4.2 and 4.3). At the end of 1996 state bank assets

FIGURE 4.2

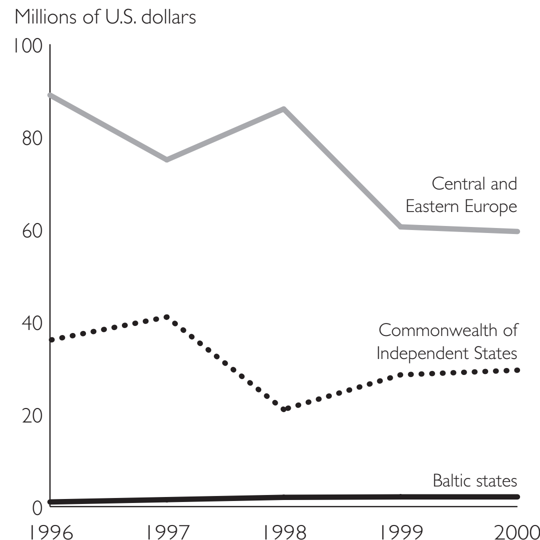
Share of Bank Assets Held by State Banks in Transition Economies, 1996–2000



Note: Data was used for previous years when not available for a given year in certain countries (Bosnia and Herzegovina, Moldova, Russia, Turkmenistan, Ukraine, Uzbekistan, and Yugoslavia). Data for Hungary for 2000 are for the third quarter only (for other countries end-year data was used).
Source: IMF; EBRD; authors' calculations.

FIGURE 4.3

Volume of Assets Held by State Banks in Transition Economies, 1996–2000



Note: Data was used for previous years when not available for a given year in certain countries (Bosnia and Herzegovina, Moldova, Russia, Turkmenistan, Ukraine, Uzbekistan, and Yugoslavia). Data for Hungary for 2000 are for the third quarter only (for other countries end-year data was used).
Source: IMF; EBRD; authors' calculations.

were estimated to be about $125 billion (these figures exclude Bosnia and Herzegovina, Tajikistan, Turkmenistan, Uzbekistan, and Yugoslavia, which would probably bring the total to about $130 billion). By 2000 this estimate had dropped by nearly a third, to about $88 billion.[3] The decline resulted primarily from the privatization of banks. But it also reflects balance sheet shrinkage in many remaining state banks where provisions have been more stringently applied to troubled loan portfolios, overvalued fixed assets and real estate have been sold or more appropriately valued, deposits have shifted to other banks, government and central bank financing (through loans or deposit placement) has diminished, and capital has been adjusted for declining asset values and reversals of income and accruals.

Still, several countries retain state banks in the hope that their franchise value will increase with time and eventually generate higher privatization proceeds—or, more immediately, that the banks can continue to serve as vehicles for directed credit. Countries in which state banks (without major subsequent ownership changes) still had asset shares exceeding 20 percent in 2000 included Azerbaijan, Belarus, Lithuania, Poland, Romania, Russia, Slovenia, Turkmenistan, and Uzbekistan.[4] And countries with smaller shares of bank assets in state hands still run the risk of systemic problems because of the strategic nature of the remaining state banks and their use for political patronage (Ukraine is an example).

Financial Condition of State Banks

In 2000 state banks accounted for about a third of the credit, assets, and deposits in the banking systems of transition economies, but for only about a fifth of the capital. Their capital ratios are far lower than those of private banks, although this cannot automatically be equated with lower quality or greater risk. In the CEE countries many of the state banks are simply

holding government securities and making fewer loans, both in recognition of the high risks flowing from the impaired business climate in those countries and to more easily comply with prudential norms governing liquidity and capital. Meanwhile, after-tax earnings have been relatively low in the CEE and Baltic states. CIS countries show better returns, although these are suspect because of weak accounting standards.

Asset growth among banks in transition economies was concentrated primarily in Poland and Russia, with little net increase among the other countries. Assets grew in both state and private banks, suggesting that the growth partly reflected broader macroeconomic trends rather than strictly structural developments. That Poland and Russia accounted for such a substantial share of the growth also reflects the continued cleanup and consolidation in the Czech Republic and Hungary, where banks had negative asset growth in 2000.

State banks had about $108 billion in total assets in 2000, equivalent to about 14 percent of the total GDP of the transition economies.[5] Most of the state banks had less than $1 billion in assets, although 20 had more than $1 billion (see annex 1). Five of these 20 banks have since been privatized (Komercni and VUB) or are being liquidated (Beogradska, Jugobanka, and Invest Banka).

At the end of 2000 state banks showed about $46 billion in loans, or 6 percent of recorded GDP.[6] A large share of these loans (71 percent) were concentrated in only about 10 banks, each with more than $1 billion in loans posted on its balance sheet.[7] Four of these banks have since been privatized (Komercni and VUB) or are being liquidated (Beogradska and Jugobanka). Excluding these four banks reduces the loan figures for the major state banks by about $8 billion.

On the funding side, deposits in state banks were about $82 billion, or 11 percent of GDP.[8] Deposits were even more concentrated than assets, with 14 banks accounting for 81 percent.[9] With total broad money for transition economies at 33 percent of GDP in 2000,[10] the figure for deposits in state banks suggests that they account for about 32 percent of total broad money in transition economies.[11] Estimates based on the same figures suggest that there is substantial liquidity among the major remaining state banks relative to their exposures, with loans only 56 percent of deposits. But this needs to be evaluated case by case, particularly as some banks are exposed in the interbank market and at risk, or dependent on government deposits for funding. The estimates also suggest that many banks are placing their deposits in government securities rather than in lending activities. This practice is often prudent and helps banks comply with regulatory norms for liquidity and capital. But it also reflects the use of state banks as sources of financing for fiscal and quasi-fiscal activities that often weaken prospects for economic growth and competitiveness.

State banks showed only about $10 billion in capital, or 9.3 percent of assets, in 2000. Most state banks are very small, as demonstrated by the fact that the six state banks with more than $500 million in stated capital accounted for 54 percent of the total.[12] That leaves $4.6 billion in capital spread across 71 banks reporting data (including some that have since been privatized or are being liquidated). After the six major state banks are excluded (and without accounting for adjustments for classified assets or other charges), state banks had an average of about $65 million in capital.

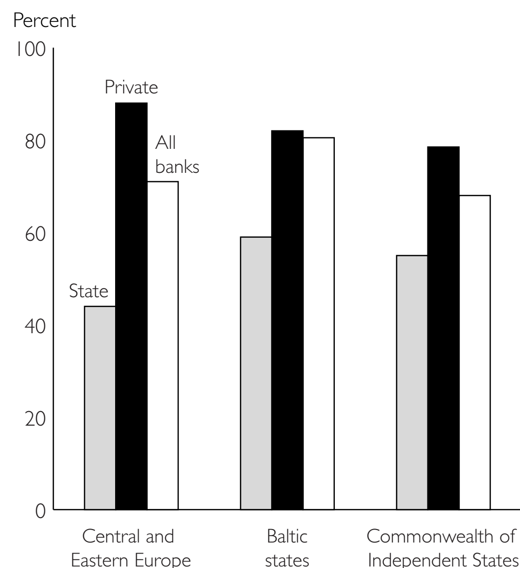
State banks reported about $329 million in after-tax earnings in 2000. But for banks other than Sberbank in Russia, PKO BP in Poland, Vneshtorgbank in Russia, and BCR in Romania, earnings were meager. Only eight state banks reported after-tax earnings exceeding $20 million. Thirteen reported losses, and 33 reported earnings at or barely above breakeven ($0–2 million). (See annex 2 for a range of financial ratios for state banks.)

Overall, state banks still possess sizable market share in many countries (see annexes 3 and 4). In Albania, Azerbaijan, Belarus, and

Slovenia state-owned banks held most banking system assets at the end of 2000, and in Romania about half. The state-owned share was particularly high in Belarus, where the six major state banks account for more than 90 percent of total assets. The story for loans is a little different, with Belarus the only country where state banks account for a majority of loans. This indicates that private banks are emerging as the major lenders, while state banks' earning assets (to the extent that they are generating income) are more often in government securities, fixed assets, or other items. Still, state banks accounted for more than half the deposits in Albania, Azerbaijan, Belarus, Lithuania, Russia, and Slovenia, and about half in Bosnia and Herzegovina and Romania.[13] But they accounted for more than half the capital in only two countries, Belarus and Romania, and about half in one, Slovenia.

FIGURE 4.4

Loans as a Share of Net Domestic Credit for State and Private Banks in Transition Economies, 2000



Note: Private loans were derived as total loans to state enterprises and the private sector (from the IMF's *International Financial Statistics*) less loans on state banks' balance sheets.
Source: IMF, *International Financial Statistics*; Bankscope (Fitch IBCA); authors' calculations.

Loans and Net Domestic Credit

State banks are less prominent than private banks in active lending to the real sector. Data for 2000 indicate that state banks had about $82.5 billion in net domestic credit on their balance sheets. Of this total, about $40 billion was estimated to be loans to households and enterprises, and $42.5 billion[14] to be claims on government, mostly in securities investments. Altogether, state banks accounted for about 36 percent of total net domestic credit in transition economies.[15]

About two-thirds of state banks' net domestic credit in 2000 was in the CEE countries,[16] where most of the largest state banks remain (apart from Russia). Russia and Poland alone accounted for half the total, largely because of Sberbank and PKO BP. These two countries, along with the Czech Republic, Slovenia, and the Slovak Republic, accounted for 78 percent of the total. Uzbekistan also has a large volume of state bank credit.[17]

Further analysis shows, however, that less than half the net domestic credit of CEE state banks takes the form of loans. In fact, loans account for only 44 percent of their credit, compared with 87 percent for private banks in the region (figure 4.4). This record lags behind trends in the Baltic states, where overall loans accounted for a larger share of net domestic credit and for private banks loans accounted for 84 percent of net domestic credit. In the CIS countries only 54 percent of state banks' net domestic credit took the form of loans, while the share for private banks was about 78 percent. Altogether, 71 percent of net domestic assets were in the form of loans, mainly from private banks in all three regions.

These differences matter for risk management. CEE state banks are more vulnerable to government (domestic debt) risk than to enterprise or household risk, while the reverse is true for state banks in the Baltic states and the CIS. Meanwhile, private banks in all three regions, but particularly in Central and Eastern Europe and the Baltics, are more vulnerable to the enterprise and household

TABLE 4.2

Loans and Net Domestic Credit Exposure of State Banks in Transition Economies, End-2000

(millions of U.S. dollars except where otherwise specified)

Country	Total bank credit	State bank share of credit (percent)	State bank credit	State bank loans
Albania	1,312	91.4	1,199	10
Armenia	229	1.3	3	3
Azerbaijan	544	93.6	>509	185
Belarus[a]	1,405	101.2	1,422	1,075
Bosnia and Herzegovina	2,064	7.8	161	89
Bulgaria	2,512	32.2	809	429
Croatia	9,741	14.1	1,375	647
Czech Republic	30,578	36.0	11,002	3,752
Estonia	1,407	0.0	0	0
Georgia	229	0.0	0	0
Hungary	18,230	9.1	1,657	599
Kazakhstan	2,750	24.0	661	385
Kyrgyz Republic	60	10.0	6	2
Latvia	1,683	18.3	308	149
Lithuania	1,983	14.8	293	201
Macedonia, FYR	755	1.1	8	8
Moldova	211	12.8	27	13
Poland	64,795	32.1	20,813	10,179
Romania	3,865	92.3	3,566	1,015
Russian Federation	52,100	41.1	21,400	10,234
Slovak Republic	12,497	35.3	4,408	2,723
Slovenia	8,877	74.3	6,600	3,499
Tajikistan	—	—	—	3
Turkmenistan[a]	1,887	104.0	1,962	1,803
Ukraine	3,963	13.1	519	322
Uzbekistan	5,040	77.5	3,906	2,525
Yugoslavia	—	—	—	—
Total	**228,717**	**36.1**	**82,614**	**39,850**
Central and Eastern Europe	**155,226**	**33.2**	**51,598**	**22,950**
Baltics	**5,073**	**11.8**	**601**	**350**
Commonwealth of Independent States	**68,418**	**44.5**	**30,415**	**16,550**

— Not available.

a. Data irregularities for Belarus and Turkmenistan account for state bank share credit exceeding 100 percent.

Note: Data are for 2000 unless not available (in which case data for 1999 were used). Net domestic credit includes claims on central and local governments. Loans include only loans to enterprises and households and exclude securities investments. The state bank share of credit is based on state bank statements, with private bank shares serving as the remaining share of credit. Data for Yugoslavia are excluded because of liquidation procedures being applied to big banks.

See annex 5 for the banks included in the data analysis.

Source: IMF, *International Financial Statistics*; BankScope (Fitch IBCA); authors' calculations.

sectors than are state banks. In the CIS, however, where private banks hold about 22 percent of net domestic credit in the form of government securities, private banks also need to be on their guard against domestic debt risk given past government defaults in some countries.

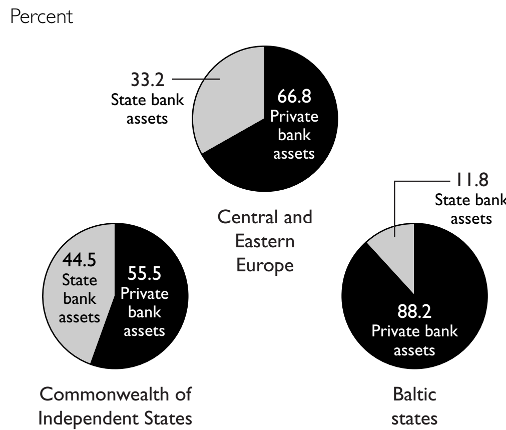
CEE countries had an (unweighted) average of about $4.7 billion in state bank credit, with $2.1 billion of this in loans, while CIS countries had an average of $2.8 billion in state bank credit, with $1.5 billion in loans. These figures are consistent with those above showing that less than half of state banks' earning assets are in the form of loans. In the Baltic states both credit and loans were negligible and have dwindled even more since 2001 with the privatization of Lithuania's Savings Bank.

The CIS countries had the highest share of net domestic credit in state banks at the end of 2000, at about 45 percent (table 4.2; figure 4.5). The CEE countries had about a third of net domestic credit on state banks' balance sheets. The Baltic state banks were

FIGURE 4.5

State and Private Banks' Shares of Net Domestic Credit Exposure in Transition Economies, End-2000

Percent



Note: Data are for 2000 unless not available (in which case data for 1999 were used). Net domestic credit includes claims on central and local governments. The state share of credit is based on state bank statements, with private bank shares serving as the remaining share of credit. Statistics for some countries appear inconsistent, such as for Belarus and Turkmenistan, where negative loans are shown for private banks. No data are available for Tajikistan.
Source: IMF, *International Financial Statistics*; BankScope (Fitch IBCA); EBRD; authors' calculations.

again relatively insignificant, accounting for about 12 percent of total net domestic credit.

Data on the net domestic credit exposure of state and private banks show a wide range of differences across countries. In 12 of 25 countries for which data are available, state banks accounted for less than 20 percent of total exposure (see table 4.2). But in 7 of the other 13, state banks accounted for more than 50 percent. Even more important, in many of the largest transition economies such as Russia, Poland, and the Czech Republic, state banks had 20–50 percent of the exposure.

Thus, on a weighted basis, state banks' shares of net domestic credit remained significant at the end of 2000. Moreover, state banks have the greatest amount of exposure in countries often considered to be advanced in the reform process. While some of the largest banks have been privatized since the end of 2000, such as VUB in the Slovak Republic and Komercni in the Czech Republic, state banks continue to hold significant stocks of credit.

State banks had an average $765 million in net domestic credit at the end of 2000, compared with only $67 million for private banks.[18] Thus state banks' average lending and investment in government securities has increased significantly since 1995 (when their net domestic credit exposure averaged $480 million), in part because of the large decline in the number of major state banks in transition economies (from 200 to about 108). And while private banks remain small, they too have expanded lending and investment activity, as reflected in the increase in their average exposure from only $31 million in 1995.

Growth trends show some consistency across regions. In the CEE countries state banks' average credit exposure increased between 1995 and 2000 (from $709 million to $846 million), as did private banks' (from $158 million to $243 million). In the CIS countries state banks also showed an increase in credit exposure (from $253 million to $707 million), while private banks remained small on average. In the Baltic states average credit exposure increased slightly among the few remaining state banks, and private banks grew.

Assets

In 2000 state banks had more than $97 billion in total assets on their balance sheets, about 31 percent of total banking system assets in the 25 countries for which data are available (table 4.3).[19] Thus while state banks in transition economies generally are relatively small, they remain influential in their markets.

Of the state banks' assets in 2000, about 86 percent were estimated to be in the form of net domestic credit, including securities investments.[20] About 61 percent of total state bank assets were in CEE countries,[21] with Poland and the Czech Republic accounting for $36 billion. Together with Russia, which had $27 billion in state bank assets, these countries accounted for 66 percent of total state bank assets.[22]

TABLE 4.3

Assets in State Banks in Transition Economies, End-2000

(millions of U.S. dollars except where otherwise specified)

Country	Total bank assets	State bank share of assets (percent)	State bank assets
Albania	1,993	61.7	1,230
Armenia	348	2.6	9
Azerbaijan	1,010	64.7	653
Belarus	2,207	77.1	1,702
Bosnia and Herzegovina	2,774	10.2	284
Bulgaria	4,622	20.1	931
Croatia	13,521	10.9	1,475
Czech Republic	49,265	25.9	12,757
Estonia	3,162	0.0	0
Georgia	322	0.0	0
Hungary	24,714	7.8	1,931
Kazakhstan	3,302	23.3	769
Kyrgyz Republic	96	9.4	9
Latvia	4,017	9.2	369
Lithuania	3,025	13.8	417
Macedonia, FYR	1,279	1.1	14
Moldova	323	10.8	35
Poland	87,744	26.6	23,315
Romania	7,607	60.0	4,564
Russian Federation	61,573	44.1	27,181
Slovak Republic	15,252	32.2	4,911
Slovenia	12,847	56.0	7,188
Tajikistan	—	—	9
Turkmenistan	2,075	100.0	2,075
Ukraine	5,799	13.6	790
Uzbekistan	4,432	100.0	4,432
Yugoslavia	—	—	—
Total	**313,309**	**31.0**	**97,050**
Central and Eastern Europe	**221,618**	**26.4**	**58,600**
Baltics	**10,204**	**7.7**	**786**
Commonwealth of Independent States	**81,487**	**46.2**	**37,664**

— Not available.

Note: Data are for 2000 unless not available (in which case data for 1999 were used). No reliable data are available for Yugoslavia. There are slight discrepancies between these figures and the analysis conducted for figure 5.6 below, suggesting some smaller state banks are included in the analysis used for figure 5.6 but not in this table.

See annex 5 for the banks included in the data analysis.

Source: IMF, *International Financial Statistics*; BankScope (Fitch IBCA); authors' calculations.

Many countries had large shares of their banking system assets in state banks. Among CEE countries, Albania, Romania, and Slovenia had more than half their assets in state banks at the end of 2000, while among CIS countries, Azerbaijan and Belarus did (see case study on International Bank of Azerbaijan). And Tajikistan, Turkmenistan, and Uzbekistan had virtually all their bank assets in state hands. As a group, the CIS countries had the highest share of banking system assets in state hands, at about 46 percent (figure 4.6). For the CEE countries the share was about 26 percent, and for the Baltic states, only 8 percent.

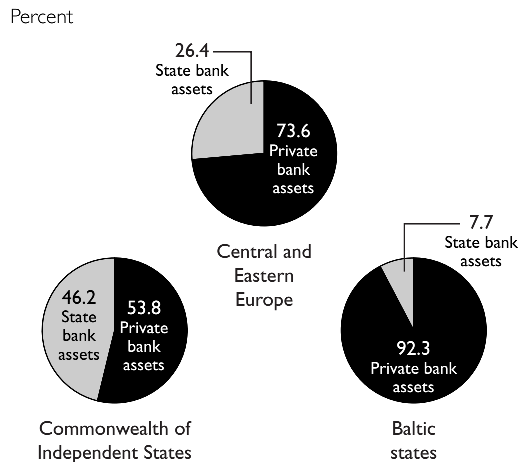
While the CEE countries have the largest aggregate amount of state bank assets, they also have significantly greater private bank assets and larger private banks. For example, state banks in Central and Eastern Europe had 1.55 times the assets of those in the CIS in 2000, but private banks in Central and Eastern Europe had nearly four times the assets of private banks in the CIS. Meanwhile, the Baltic states had the highest share of bank assets in private institutions at the end of 2000, at about 92 percent.

On average, state banks had about $900 million in assets at the end of 2000, compared with only $99 million for private banks. That shows

FIGURE 4.6

State and Private Banks' Shares of Assets in Transition Economies, End-2000

Percent



Note: Data for FYR Macedonia, Turkmenistan, and Uzbekistan are estimates. Figure excludes data for Yugoslavia because of expected write-offs of about $6 billion due to liquidation procedures for the major banks.
Source: IMF, *International Financial Statistics*; EBRD, *Transition Report 2001*; authors' calculations.

an increase in state bank assets from 1995, when they averaged $664 million. The increase occurred primarily in the CIS, where state banks' assets rose from an average $335 million in 1995 to $876 million in 2000. The growth of Sberbank of Russia accounted for much of the change, along with the decline in the number of state banks as a result of privatization, consolidation, and failure.[23] CEE and Baltic countries' state banks had roughly the same level of assets, with the Baltic state banks showing a slightly larger percentage increase.

Deposits

State banks had about $77 billion in deposits at the end of 2000, about 37 percent of the total for reporting countries (table 4.4).[24] About 62 percent of the deposits in state banks were in Central and Eastern European countries.[25] Russia and Poland accounted for 56 percent of the total, attesting to the importance of Sberbank and PKO BP in mobilizing deposits in transition economies. These two countries, together with the Czech Republic, Romania, Slovenia, and the Slovak Republic, accounted for 86 percent of total state bank deposits at the end of 2000.

On average, state banks in the CIS countries had the largest share of total deposits in the banking system, at about 58 percent, much larger than their share of credit (figure 4.7). Those in Central and Eastern European countries had about a third of total deposits, about the same as their share of credit. State banks in the Baltics also had closely matched shares of deposits and credit, though at only about 12 percent.

At the end of 2000 about a third of transition economies still had more than 50 percent of total deposits in state banks. These included Russia, with nearly 60 percent of deposits in state banks, mainly in Sberbank.[26] Another five countries had 20–50 percent of total deposits in state banks, including Poland, the country with the largest amount of bank deposits among the transition economies and about 30 percent of total deposits in these economies at the end of 2000.

On average, state banks had much larger deposits than private banks at the end of 2000—$714 million compared with only $60 million. The difference is most dramatic in the CIS, where state banks had an average $675 million in deposits, and private banks only $12 million. This disparity largely reflects the near monopoly that savings banks have had in CIS countries, particularly in local currency. CIS state banks experienced sharp growth in average deposits, up from less than $200 million in 1995. But as with other indicators, these averages would decline significantly if all banks in which the Russian state authorities had shares were included in the denominator.

State banks in the CEE countries also had large deposits at the end of 2000—an average of $779 million, more than three times the average for private banks in these countries. Average deposits grew for both state and private banks between 1995 and 2000, nearly doubling for private banks. Even so, the increase for state banks was about 1.4 times

TABLE 4.4

Deposits in State Banks in Transition Economies, End-2000

(millions of U.S. dollars except where otherwise specified)

Country	Total bank deposits	State bank share of deposits (percent)	State bank deposits
Albania	1,605	73.3	1,176
Armenia	167	5.4	9
Azerbaijan	546	88.8	485
Belarus	1,156	111.2	1,285
Bosnia and Herzegovina	834	18.9	158
Bulgaria	2,785	28.1	782
Croatia	8,085	8.9	720
Czech Republic	32,796	30.2	9,915
Estonia	1,590	0.0	0
Georgia	156	0.0	0
Hungary	17,814	7.4	1,314
Kazakhstan	1,981	32.7	648
Kyrgyz Republic	68	10.3	7
Latvia	1,447	19.4	281
Lithuania	1,946	16.5	322
Macedonia, FYR	531	0.0	0
Moldova	170	15.3	26
Poland	62,837	31.7	19,944
Romania	6,145	58.9	3,619
Russian Federation	39,903	58.0	23,156
Slovak Republic	11,265	34.8	3,922
Slovenia	8,277	72.3	5,988
Tajikistan	—	—	8
Turkmenistan	434	100.0	434
Ukraine	3,387	17.1	578
Uzbekistan	2,384	100.0	2,384
Yugoslavia	—	—	—
Total	**208,309**	**37.0**	**77,153**
Central and Eastern Europe	**152,974**	**31.1**	**47,538**
Baltics	**4,983**	**12.1**	**603**
Commonwealth of Independent States	**50,352**	**57.6**	**29,012**

— Not available.

Note: Deposits are customer and short-term funding. Total deposits for Turkmenistan and Uzbekistan are estimates. See annex 5 for the banks included in the data analysis. Data irregularities account for share of deposits exceeding 100 percent for Belarus.

Source: IMF, *International Financial Statistics;* BankScope (Fitch IBCA); authors' calculations.

that for private banks.[27] Private banks in the Baltics had smaller average deposits than those in CEE countries but larger deposits than those in the CIS countries, while state banks in the Baltics had smaller average deposits than state banks in both the CEE and CIS countries.

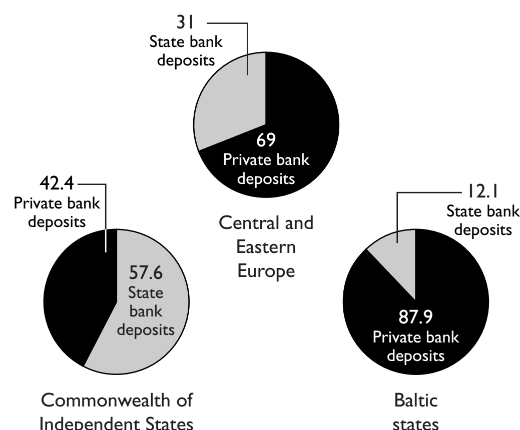
Average loan-to-deposit ratios for state and private banks at the end of 2000 suggest that most were conservative and prudent except those for private banks in the CIS countries (table 4.5). For these banks, loans were about 1.4 times deposits. Any erosion in loan quality among these banks would endanger the safety of deposits. Private banks in the CEE countries and the Baltics showed loans at about 85 percent of deposits. This ratio is about as high as is prudent, since classified loans in these countries averaged an estimated 16.3 percent of total loans at the end of 2000[28]—or about 12 percent of total deposits.[29]

State banks' loan-to-deposit ratios generally appeared fairly conservative. Their credit risk is a mix of government and company risk, with the balance of their net domestic credit in government securities. Central and Eastern European banks had the lowest average loan-to-deposit ratio, at 74 percent, with average ratios for banks in the Baltics and the CIS about 10–20 percentage points higher.

FIGURE 4.7

State and Private Banks' Shares of Deposits in Transition Economies, End-2000

Percent



Note: Deposits are customer and short-term funding. Total deposits for Turkmenistan and Uzbekistan are estimates. Figure excludes data for Yugoslavia because of liquidation procedures under way for major banks. Statistical irregularities are acknowledged by the authors for Belarus, where negative deposits appear for private banks.
Source: IMF, *International Financial Statistics*; BankScope (Fitch IBCA); authors' calculations.

Capital

At the end of 2000 state banks had about $9.7 billion in capital on their balance sheets, a little more than 19 percent of the total bank capital in transition economies (table 4.6).[30] This share is smaller than their shares of credit, assets, and deposits, pointing to the possibility that state banks are undercapitalized relative to their private counterparts. The smaller share of capital may also reflect in part more conservative risk weighting by state banks because of the larger proportion of government securities in their asset holdings, or implicit guarantees of state rescue should these banks face serious solvency or liquidity problems. Such rescues have already occurred in many transition economies, and they continue to pose a macroeconomic risk and the potential of competitive distortion in markets where state banks are particularly active.

State banks in the CEE countries had about $5.5 billion in capital at the end of 2000, mainly in Poland and the Czech Republic. Together with Russia, the other major market where state banks had a fairly sizable share of capital, Poland and the Czech Republic accounted for $5.9 billion in state bank capital, 56 percent of the total in transition economies.

Belarus, Romania, Turkmenistan, and Uzbekistan had the biggest shares of banking system capital in state hands. But their state banks held a total of only about $1.9 billion, with the largest part of it in Uzbekistan. State banks accounted for 20–50 percent of total capital in several countries of Central and Eastern Europe, including

TABLE 4.5

Bank Loans, Deposits, and Loan-to-Deposit Ratios in Transition Economies, End-2000

(millions of U.S. dollars except where otherwise specified)

	State banks		Private banks		All banks	
	Loans	Deposits	Loans	Deposits	Loans	Deposits
Central and Eastern Europe	22,864	47,538	90,034	105,436	112,898	152,974
Baltics	350	603	3,757	4,380	4,107	4,983
Commonwealth of Independent States	16,742	29,012	29,603	21,341	46,345	50,352
Total	**42,282**	**77,153**	**123,395**	**131,156**	**163,350**	**208,309**

	Loan-to-deposit ratio (percent)		
	State banks	Private banks	All banks
Central and Eastern Europe	48.1	85.4	73.8
Baltics	58.0	85.8	82.4
Commonwealth of Independent States	57.7	138.7	92.0
Total	**54.8**	**94.1**	**78.4**

Note: Loan data are unavailable for Tajikistan. Table excludes data for Yugoslavia because of liquidation procedures under way for major banks. Private loans were derived from total loans to state enterprises and the private sector (from the IMF's *International Financial Statistics*) less loans on state banks' balance sheets.
Source: IMF, *International Financial Statistics;* BankScope (Fitch IBCA); authors' calculations.

TABLE 4.6

Capital in State Banks in Transition Economies, End-2000

(millions of U.S. dollars except where otherwise specified)

Country	Total bank capital	State bank share of capital (percent)	State bank capital
Albania	292	11.3	33
Armenia	27	0.0	0
Azerbaijan	184	13.0	24
Belarus	378	85.0	321
Bosnia and Herzegovina	298	32.2	96
Bulgaria	1,027	11.2	115
Croatia	1,976	23.0	454
Czech Republic	5,335	21.4	1,144
Estonia	408	0.0	0
Georgia	100	0.0	0
Hungary	2,404	21.0	504
Kazakhstan	794	9.6	76
Kyrgyz Republic	11	12.9	1
Latvia	305	6.9	21
Lithuania	307	10.4	32
Macedonia, FYR	404	1.0	4
Moldova	90	4.5	4
Poland	12,758	14.6	1,857
Romania	594	—	—
Russian Federation	15,317	18.6	2,849
Slovak Republic	2,699	21.8	588
Slovenia	1,693	40.2	681
Tajikistan	—	—	—
Turkmenistan	21	100.0	21
Ukraine	1,225	4.9	60
Uzbekistan	851	100.0	851
Yugoslavia	—	—	—
Total	**49,496**	**19.6**	**9,718**
Central and Eastern Europe	**29,480**	**18.5**	**5463**
Baltics	**1,020**	**5.2**	**53**
Commonwealth of Independent States	**18,997**	**22.1**	**4,202**

— Not available.

Note: Data are for 2000 unless not available (in which case data for 1999 were used). Capital is capital accounts plus or minus other items net. The state share of capital was derived by applying the state share of assets to capital, with the private bank share serving as the remaining share. No reliable data on bank capital are available for Tajikistan and Yugoslavia.

See annex 5 for the banks included in the data analysis.

Source: IMF, *International Financial Statistics*; BankScope (Fitch IBCA); EBRD; authors' calculations.

Bosnia and Herzegovina, Croatia, Hungary, the Slovak Republic, and Slovenia. Several of these countries have reduced the state share since 2001.

State banks had about 21–22 percent of capital in the CEE and CIS countries at the end of 2000 (figure 4.8). In the Baltics, state banks' $53 million in capital accounted for only 5 percent of the total.

Private banks accounted for about 80 percent of total capital in transition economies at the end of 2000. Although private banks' share was largest in the Baltic states, it was fairly high in the vast majority of countries, with state capital still predominant in only a few. Across the transition economies, private bank capital totaled $39 billion, with about 60 percent of it in Central and Eastern European banks.[31]

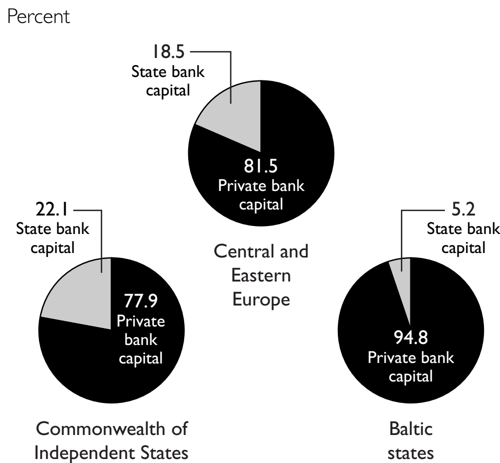
Most banks in transition economies remain small, with an average of only $22 million in capital at the end of 2000. Average capital was particularly small in the CIS, at $11 million. Baltic banks averaged about $25 million in capital, and CEE banks about $61 million.

But these averages conceal large differences between state and private banks. State banks had an average $97 million in capital, while private banks had only $18 million. By region,

FIGURE 4.8

State and Private Banks' Shares of Capital in Transition Economies, End-2000

Percent



Note: Data are for 2000 unless not available (in which case data for 1999 were used). Capital is capital accounts plus or minus other items net. The state share of capital is based on public bank statements. No reliable data are available for Romania, or no capital for Tajikistan or Yugoslavia.
Source: IMF, *International Financial Statistics*; BankScope (Fitch IBCA); EBRD; authors' calculations.

state banks in Central and Eastern Europe had slightly larger average capital ($101 million) than those in the CIS ($98 million) and much larger average capital than those in the Baltics ($13 million).

Private banks in Central and Eastern Europe were considerably larger than their counterparts in the Baltics and the CIS. Private banks in the CIS showed very little capital at the end of 2000, and the total private bank capital in all CIS countries was only $14.8 billion, equivalent to the total in Poland and the Czech Republic alone. Moreover, Russia accounted for $12.5 billion of it.

State banks show low ratios of capital to assets in most transition economies (exceptions are Belarus, Romania, and Uzbekistan). Capital-to-asset ratios for state banks averaged 3.3 percent at the end of 2000, only about a quarter of average ratios for private banks, at 12.5 percent (table 4.7). Capital ratios cannot automatically be associated with risk or asset quality—banks with high ratios can be insolvent, while banks with relatively modest ratios might be more financially sound. Even so, the 3.3 percent average ratio for state banks is low and would ordinarily require corrective action unless a bank is assuming no risk. But a bank assuming no risk raises questions about its earnings stream, its ability to increase capital from ordinary banking operations, and its long-term viability. Many state banks may have low capital-to-asset ratios because of heavy investment in government securities.[32] But is income from securities enough to enable these banks to recapitalize for long-term commercial viability—and if it is, is this the best use of fiscal resources in these countries? Conversely, if fiscal prudence keeps this earnings stream low, questions again arise about state banks' cash liquidity, solvency, and long-term commercial viability.

Private banks' average capital-to-asset ratio of 12.5 percent compares favorably with the Bank for International Settlements' (BIS) general guidelines (8–10 percent), although each bank's ratio would have to be tested for adequacy relative to the levels of risk assumed. Average ratios were at double-digit levels in about half the countries. In the countries where nonperforming loans were at high levels (equivalent to more than 50 percent of capital) at the end of 2000—Azerbaijan, Belarus, Bosnia and Herzegovina, Croatia, the Czech Republic, the Kyrgyz Republic, Poland, the Slovak Republic, and Ukraine—state or private banks, or both, may be undercapitalized.

Asset Quality

Bad loans in transition economies amounted to a troubling $26 billion at the end of 2000, equal to about 16 percent of total loans (table 4.8).[33] Nearly $19 billion of these loans were in CEE banks, and less than $7 billion in CIS banks. The figure for the CIS may be understated, however, as some CIS countries reported suspiciously low levels of bad loans. For example, Uzbekistan reported 0 percent nonperforming loans, and Turkmenistan only 0.5 percent.

There is also the larger issue of bad credit in the economy as a whole. Bad credit often exists

TABLE 4.7

Bank Capital-to-Asset Ratios in Transition Economies, End-2000

Country	Total capital (millions of U.S. dollars)	Total assets (millions of U.S. dollars)	Capital-to-asset ratio	
			State banks (percent)	Private banks (percent)
Albania	292	1,993	1.7	13.0
Armenia	27	348	0.0	7.8
Azerbaijan	184	1,010	1.9	16.3
Belarus	378	2,207	14.5	2.6
Bosnia and Herzegovina	298	2,774	3.5	7.3
Bulgaria	1,027	4,622	2.2	20.0
Croatia	1,976	13,521	3.4	11.3
Czech Republic	5,335	49,265	2.3	8.5
Estonia	408	3,162	0.0	12.9
Georgia	100	322	0.0	31.1
Hungary	2,404	24,714	2.0	7.7
Kazakhstan	794	3,302	2.3	21.7
Kyrgyz Republic	11	96	1.5	10.4
Latvia	305	4,017	0.5	7.1
Lithuania	307	3,025	1.1	9.1
Macedonia, FYR	404	1,279	0.3	31.3
Moldova	90	323	1.2	26.6
Poland	12,758	87,744	2.1	12.4
Romania	594	7,607	9.1	–1.3
Russian Federation	15,317	61,573	4.6	20.2
Slovak Republic	2,699	15,252	3.9	13.8
Slovenia	1,693	12,847	5.3	7.9
Tajikistan	—	—	—	—
Turkmenistan	21	2,075	1.0	—
Ukraine	1,225	5,799	1.0	20.1
Uzbekistan	851	4,432	19.2	—
Yugoslavia	—	—	—	—
Total	**49,496**	**313,309**	**3.3**	**12.5**
Central and Eastern Europe	**29,480**	**221,618**	**2.8**	**10.5**
Baltics	**1,020**	**10,204**	**0.5**	**9.5**
Commonwealth of Independent States	**18,997**	**81,487**	**5.2**	**18.2**

— Not available.
Note: Data are for 2000 unless not available (in which case data for 1999 were used). Capital is capital accounts plus or minus other items net. The state share of capital is based on state bank statements, with the private bank share accounting as the remaining amount. A statistical irregularity should be noted for Romania, accounting for the negative percent for private banks. No reliable data are available for Tajikistan or Yugoslavia.
Source: IMF, *International Financial Statistics*; BankScope (Fitch IBCA); authors' calculations.

outside the banking system in the form of arrears to utility companies, fiscal accounts, employee wage accounts, and obligations to other enterprises.[34] Arrears are particularly problematic in CIS countries and to a lesser degree in many of the Balkan states (see annex 6).

While the bad loans were equivalent to only 12.5 percent of total deposits, the amount was more than half the total bank capital in transition economies. This high ratio of bad loans to capital again points to the risk of undercapitalization. The problem appears to be most acute in the Czech Republic, Poland, and Russia, where banks hold an estimated $18.2 billion in bad loans. Data for 2000 for the major state banks reporting in these countries showed loan loss reserves in the range of 5–15 percent.[35] Further deterioration would probably trigger a need for additional injections of capital.

Overall ratios of bad loans to capital exceeded 75 percent for several countries in 2000, including Azerbaijan, Bosnia and Herzegovina, the Czech Republic, the Kyrgyz Republic, the Slovak Republic, and Ukraine. Some of these countries have already taken or are planning corrective measures. Bosnia and Herzegovina is liquidating and privatizing many of its remaining state banks. The

TABLE 4.8

Bad Loans and Bad Loan Ratios in Transition Economies, End-2000

Country	Number of loans: Total	State bank	Private bank	Value of bad loans (millions of U.S. dollars)	Bad loans as a percentage of: Total loans	Deposits	Capital
Albania	182	10	172	77	42.6	4.8	26.5
Armenia	0	0	0	0	6.2	0.0	0.0
Azerbaijan	446	184	262	166	37.2	30.4	90.3
Belarus	1,254	1,075	179	191	15.2	16.5	50.5
Bosnia and Herzegovina	2,052	89	1,963	322	15.7	38.6	108.1
Bulgaria	1,970	343	1,627	215	10.9	7.7	20.9
Croatia	7,258	647	6,611	1,430	19.7	17.7	72.4
Czech Republic	26,483	3,752	22,731	5,111	19.3	15.6	95.8
Estonia	1,332	0	1,332	20	1.5	1.3	4.9
Georgia	226	0	226	13	5.6	8.1	12.7
Hungary	4,469	599	3,870	139	3.1	0.8	5.8
Kazakhstan	2,338	385	1,953	136	5.8	6.8	17.1
Kyrgyz Republic	56	2	54	9	16.4	13.5	83.5
Latvia	1,399	149	1,250	88	6.3	6.1	28.9
Lithuania	1,377	201	1,176	149	10.8	7.6	48.5
Macedonia, FYR	643	8	635	173	26.9	32.6	42.8
Moldova	182	13	169	38	20.6	22.1	41.9
Poland	50,328	10,179	40,149	8,002	15.9	12.7	62.7
Romania	2,641	1,015	1,626	100	3.8	1.6	16.9
Russian Federation	33,420	10,234	23,186	5,113	15.3	12.8	33.4
Slovak Republic	10,105	2,723	7,382	2,647	26.2	23.5	98.1
Slovenia	6,767	3,499	3,268	575	8.5	6.9	34.0
Tajikistan	—	—	—	—	10.8	—	—
Turkmenistan	1,884	1,803	81	9	0.5	44.8	44.8
Ukraine	3,815	322	3,493	1,240	32.5	101.2	101.2
Uzbekistan	2,525	2,525	0	0	0.0	0.0	0.0
Yugoslavia	—	—	—	—	27.8	—	—
Total	**163,152**	**39,757**	**123,395**	**25,963**	**15.9**	**12.5**	**52.5**
Central and Eastern Europe	**112,898**	**22,864**	**90,034**	**18,792**	**16.6**	**12.3**	**63.7**
Baltics	**4,107**	**350**	**3,757**	**257**	**6.3**	**5.2**	**25.2**
Commonwealth of Independent States	**46,147**	**16,543**	**29,603**	**6,914**	**15.0**	**13.7**	**36.4**

— Not available.

Note: Data on bad loans are for 2000 unless not available (1998 data were used for Latvia, and 1999 data for Azerbaijan, Kazakhstan, and Turkmenistan).

Source: IMF, *International Financial Statistics*; BankScope (Fitch IBCA); EBRD; authors' calculations.

Czech Republic has privatized Komercni. The Kyrgyz Republic has essentially placed Kairat Bank under administration. And the Slovak Republic has successfully privatized VUB. In Ukraine, however, problems remain with several banks, including possible risks associated with the recently intensified lending activities of the wholly state-owned Oschadny Bank (box 4.1 and case study on Oschadny Bank).

The data on bad loans suggest that the problem is not an issue just for state banks but also for private banks. That raises several concerns for countries seeking to modernize their banking sector, including the drag on earnings that bad loans represent for banks and the effect of weak earnings on banks' ability to modernize. Considerable capital investment is still needed in Central and Eastern Europe where bad loans accounted for 64 percent of capital at the end of 2000, although modernization efforts are already well under way in many countries.

The CIS countries face greater obstacles to modernization. To begin with, the lower ratio of bad loans to capital in these countries may well be an error. It probably reflects an understatement of bad loans.[36] Moreover, it says nothing about the problem of the system of barter and arrears that has functioned

BOX 4.1

Ukraine's Oschadny Bank: Becoming Competitive—or Risking Failure and Crisis?

Oschadny Bank's asset size and retail network make it one of the largest banks in Ukraine. In late 2000 it had about 35,000 employees and controlled 25–30 percent of household deposits. Still, total household deposits amounted to only about $330 million in late 2000, small for a country of 50 million people. Thus while Oschadny is perceived as large in Ukraine, its significance in aggregate intermediation is small, reflecting the relative insignificance of banking and financial intermediation in the economy.

Like other state and quasi-state banks, Oschadny saw its financial situation deteriorate in the late 1990s. There are several reasons for this. Excessive branches and personnel and other operating inefficiencies have led to high operating costs. Government-directed lending has damaged the bank's loan portfolio, reduced earnings ratios, and led to after-tax losses. The bank faces ongoing governance problems—central and regional governments are involved in decisionmaking, and key business groups connected to the bank's management and related authorities also intervene, with a complete lack of transparency. The government is unable or unwilling to honor its financial obligations to the bank, whether payments on guarantees or capital contributions. And the bank has been slow to upgrade its management and information technology systems to lower costs—and slow to enforce central policies in its regional offices.

Oschadny suffered after-tax losses of $22 million in 2000, and there are concerns that its losses since may have been even more severe or that earnings may be artificially inflated by questionable loan classification practices. Meanwhile, despite its portfolio problems and its orientation as a traditional savings bank, Oschadny expanded lending rather than pursue a more prudent course of taking corrective action. In addition, in mid-2000 Oschadny was appointed by the government as the authorized bank to service clearing accounts of electricity utility companies and their branches. Oschadny performed this responsibility until October 2001. The losses that might have arisen from these operations and from the incremental lending remain to be seen.

Whether the problem of Oschadny can be solved depends largely on Ukrainian authorities' willingness and ability to take prompt action. Although strict market logic argues for closing the bank, its crucial place in Ukraine's social fabric makes that solution unlikely in the foreseeable future. To reverse current losses, the bank's management has pursued a cost reduction strategy, releasing staff and closing some nonviable offices (148 branches and 2,933 operational offices between January 1, 1998, and December 31, 2000). Despite these moves, it remains questionable whether Oschadny can become competitive without a big push to accelerate restructuring and reduce cost coupled with significant government assistance. Preliminary estimates in early 2001 showed that Oschadny would need to reduce its costs by about 40 percent to achieve breakeven.

The key is to avoid using Oschadny as a quasi-fiscal institution or as a vehicle for directed lending—as has so often been done in the past. These practices subject the institution—and the government, as its sole shareholder—to a high level of financial risk. At a minimum, firewalls and safeguards need to be put into place to ensure that Oschadny's decisionmaking is grounded in commercial principles. "Social" or "governmental" activity should be off–balance sheet and subject to commercial pricing. Any lending or investment should be explicitly guaranteed so that Oschadny assumes no risk.

The depth of Oschadny's financial distress raises a risk that the bank will seek to grow out of its problems, attempting to leapfrog from specialized savings bank to full-service universal bank. That move would be premature given the bank's weak financial condition and limited institutional capacity. Oschadny might be tempted to assume excess risk so as to generate high earnings and reverse its accumulated losses. The risk of adverse selection under those circumstances would be high, especially since the bank does not accurately measure risk and return.

almost in parallel with the formal banking and fiscal systems for nearly a decade. Thus while bad loans may be only about 14 percent of deposits and 37 percent of capital in the CIS countries, deposits and capital are also lower than in other transition economies. Thus the CIS countries face an even greater shortage of the financial resources needed to develop modern, competitive banking systems. Until these issues are addressed and confidence is gradually restored, the CIS will continue to lag behind Central and Eastern Europe and the Baltics, notwithstanding its lower bad loan ratios.

Earnings Performance and Solvency Issues

Earnings performance has varied among state banks. After-tax earnings among state banks in Central and Eastern Europe and the Baltic markets were generally poor in 2000, while earnings in the CIS countries were buoyed by the results of Sberbank of Russia. Sberbank's earnings performance was supported in part by a rebound in commodity prices and improvements in several CIS economies (such as Kazakhstan, Russia, and Ukraine). But there are questions about the accuracy of the CIS earnings data because of the weak loan classification standards, poor accounting and auditing practices, and investors' general view that risk-related information is insufficiently disclosed. These problems make it difficult to ascertain the real earnings of CIS state banks as well as measures of returns. These caveats need to be taken into account in interpreting the earnings performance of CIS state banks.

CIS state banks reportedly generated $710 million in after-tax earnings in 2000, most of it in Russia (table 4.9). These figures represent a 2.1 percent return on assets and a 19.3 percent return on equity. By contrast, state banks in Central and Eastern Europe (excluding Yugoslavia) generated only $118 million in after-tax earnings, about $2 million per state bank. The return on assets was only 0.2 percent, and the return on equity 2.0 percent. If Yugoslavia is included in these measures, they all turn negative, as table 5.11 shows.[37] The Baltic state banks showed better returns on assets and equity but only $5 million in after-tax earnings.

Total after-tax earnings in the transition economies, based on reports from about 65 state banks, were about $152 million in 2000. This figure is about $170 million less than other estimates from varied sources. Regardless of the figure used, there was clearly a high concentration of profits, with only three banks generating more than $100 million in after-tax earnings. State banks in several countries showed losses in 2000, including those in Croatia, Hungary, Kazakhstan, the Kyrgyz Republic, and Romania. Since then, some of the loss-makers have been privatized (Bank Agricola in Romania, Dubrovacka in Croatia) or placed under administration (Kairat in the Kyrgyz Republic). Several other state banks that showed low earnings have also been privatized (Komercni in the Czech Republic).

The $152 million in after-tax income appears particularly modest given the number of major state banks in 2000 and the size of some of them.[38] Banks' average after-tax earnings were only $1.4 million, far short of what is needed to modernize and become globally competitive. Moreover, netting out the $843 million for the four banks with more than $100 million in after-tax earnings in 2000 and offsetting the $681 million in losses in Yugoslavia leaves the other state banks with essentially flat net earnings (a $10 million loss across 100 banks). The average return on assets was only 0.2 percent for state banks, well below the 2–3 percent norms in OECD markets.

State banks (excluding those in Yugoslavia) had a total net capital increase of $1.7 billion in 2000, well above the reported $152 million in after-tax earnings (table 4.10). That suggests that state banks increased capital from retained earnings as well as from other sources. In stark contrast, however, is the increase in capital for private banks, which, at $5.8 billion, was about 3.4 times that for state banks. The capital increase for private banks probably represents a combination of retained earnings and direct investment. For state banks direct investment remains a more difficult prospect given the precarious monetary and fiscal positions in many economies where these banks play a prominent role. Moreover, the capital increase for private banks should not be overstated. Divided among the 2,181 private banks operating in transition economies in 2000, it amounted to an average net capital increase of only $2.6 million, far less than the average of $15.7 million for state banks.[39] Even when Sberbank's approximately $315 million capital increase is netted out,[40]

TABLE 4.9

After-Tax Earnings and Return Measures for State Banks in Transition Economies, End-2000

Country	After-tax earnings (millions of U.S. dollars)	Return on assets (percent)	Return on equity (percent)	State banks included in the data
Albania	26	2.1	–173.3	Savings Bank
Armenia	0	0.0	0.0	Armenia Savings Bank[a]
Azerbaijan	10	2.1	55.6	IBA, United Universal
Belarus	10	0.6	2.8	Belpromstroibank, Belagroprombank, Belbusinessbank, Belgazprombank, Belarusbank, Belvnesheconombank
Bosnia and Herzegovina	2	0.6	1.5	Investment Bank, Central Profit Bank, Gospodarska, Privredna
Bulgaria	13	1.5	12.4	DSK, Biochim, Central Cooperative
Croatia	–33	–2.2	–6.9	Dubrovacka[a], Croatia Banka[a], Croatian Bank for Reconstruction and Development, Hrvatska Postanska
Czech Republic	16	0.1	1.4	Komercni[a], Ceskomoravska Zarucni, Ceska Exportni
Estonia	0	0.0	0.0	No state banks
Georgia	0	0.0	0.0	No state banks
Hungary	–17	–0.8	–3.9	Magyar Fejlesztesi, Postbank
Kazakhstan	–5	–0.8	–6.7	Export-Import Bank, Halyk
Kyrgyz Republic	–1	–11.1	–82.5	Kairat, Energo Bank
Latvia	3	0.9	14.6	Latvian Mortgage and Land Bank, Latvian Savings Bank
Lithuania	2	0.5	6.5	Agricultural Bank
Macedonia, FYR	0	0.0	0.0	Macedonian Development Bank (estimated)
Moldova	3	10.7	136.4	Banca de Economii
Poland	19	0.1	1.0	PKO BP, BGZ, National Economy Bank, Bank Ochrony Srodowiska
Romania	–90	–1.8	–17.2	Banca Agricola (1999)[a], BCR, CEC, EXIMBank
Russian Federation	577	2.4	24.2	Sberbank, Medium- & Long-Term Credit Bank, Vnesheconombank, Russian Bank for Development
Slovak Republic	101	2.0	17.5	VUB[a], Investicna a Rozvojova, First Building Savings, Slovenska Zarucna a rojvojova, Banka Slovakia, Exportno-Importna
Slovenia	81	1.1	12.0	Nova Llubljanska, Nova Kreditna Maribor, Postna Banka, Slovene Export Corporation, Slovenska Investicijska
Tajikistan	—	—	—	Insufficient data available
Turkmenistan	3	0.2	15.4	Bank for Foreign Economic Affairs
Ukraine	9	1.3	17.0	Ukreximbank, Oschadny
Uzbekistan	104	2.3	13.5	State Housing Savings Bank, Asaka, Uzpromstroybank, National Bank for Foreign Economic Activity
Yugoslavia	–681	—	—	Insufficient data on banks available
Total	**152**	**0.2**	**1.6**	
Central and Eastern Europe	**–563**	**–1.0**	**–9.7**	
Baltics	**5**	**0.7**	**9.7**	
Commonwealth of Independent States	**710**	**2.1**	**19.3**	

— Not available.

a. These banks have been privatized or liquidated since the end of 2000.

Note: Data are for 2000 unless not available (in which case data for 1999 were used). No reliable data are available for Tajikistan. Profits for several banks were derived by applying the return on assets to average assets for 1999–2000.

Source: IMF, *International Financial Statistics*; BankScope (Fitch IBCA); authors' calculations.

TABLE 4.10

Capital Increases for Banks in Transition Economies, 1999–2000

(millions of U.S. dollars)

Country	Private banks 1999 capital	Private banks 2000 capital	Private banks Net increase	State banks 1999 capital	State banks 2000 capital	State banks Net increase	Total net increase
Albania	326	259	–67	–63	33	96	29
Armenia	36	27	–10	0	0	0	–10
Azerbaijan	15	0	–15	12	19	7	–8
Belarus	89	57	–33	404	321	–83	–116
Bosnia and Herzegovina	152	202	50	102	96	–6	44
Bulgaria	916	925	9	94	102	8	17
Croatia	1,451	1,522	71	504	454	–50	21
Czech Republic	5,957	4,191	–1,766	1,130	1,144	14	–1,752
Estonia	374	408	34	0	0	0	34
Georgia	95	100	5	0	0	0	5
Hungary	2,042	1,980	–62	362	504	142	80
Kazakhstan	524	718	194	74	76	2	196
Kyrgyz Republic	9	10	1	1	1	0	2
Latvia	169	284	115	20	21	1	116
Lithuania	252	275	23	30	32	2	25
Macedonia, FYR	392	400	8	4	4	0	8
Moldova	71	86	15	0	4	4	19
Poland	8,332	10,901	2,569	1,771	1,857	86	2,655
Romania	175	–96	–271	356	690	334	63
Russian Federation	8,265	12,468	4,203	1,914	2,849	935	5,138
Slovak Republic	1,679	2,111	432	573	588	15	447
Slovenia	1,045	1,012	–33	668	681	13	–20
Tajikistan	—	—	—	—	—	—	—
Turkmenistan	—	—	—	18	21	3	3
Ukraine	870	1,165	295	46	60	14	309
Uzbekistan	—	—	—	695	851	156	156
Yugoslavia	—	—	—	—	—	—	—
Total	**33,235**	**39,003**	**5,768**	**8,715**	**10,408**	**1,693**	**7,461**
Central and Eastern Europe	**22,467**	**23,407**	**940**	**5,501**	**6,153**	**652**	**1,592**
Baltics	**795**	**967**	**172**	**50**	**53**	**3**	**175**
Commonwealth of Independent States	**9,973**	**14,629**	**4,656**	**3,164**	**4,202**	**1,038**	**5,694**

— Not available.

Note: Data are for 2000 unless not available (in which case data for 1999 are used). No reliable data are available for banks in Tajikistan and Yugoslavia or for private banks in Turkmenistan and Uzbekistan.

Source: IMF, *International Financial Statistics*; BankScope (Fitch IBCA); authors' calculations.

state banks still showed average increases of about $12.9 million in 2000.[41]

While the after-tax earnings of state banks were positive, this does not account for tax breaks, forbearance, and other forms of "corrective action" needed to improve their solvency and liquidity positions. This suggests that there is little or no investment interest in these banks short of privatization, and keeping them afloat as going concerns will continue to require tax breaks, forbearance, and similar benefits. Moreover, many of these banks have heavy personnel loads and limited investment in new technologies, perpetuating inefficiencies that make it difficult for these banks to compete without preferential treatment or protection.

Many countries appear to have recognized the need to address undercapitalization as a fundamental step in reversing financial weakness and helping to build sound financial systems. Total assets for banks in transition economies increased from 1999 to 2000. Banks in Poland and Russia were responsible for most of the asset growth in 2000, while those in the Czech Republic and Hungary experienced major declines in assets (table 4.11).

TABLE 4.11

Asset Increases for Banks in Transition Economies, 1999–2000

(millions of U.S. dollars)

	Private banks			State banks			Total
Country	1999 assets	2000 assets	Net increase	1999 assets	2000 assets	Net increase	net increase
Albania	684	763	79	1,197	1,230	33	112
Armenia	279	339	60	9	9	0	60
Azerbaijan	423	357	–66	307	653	346	280
Belarus	369	505	136	1,836	1,702	–134	2
Bosnia and Herzegovina	2,775	2,490	–285	259	284	25	–260
Bulgaria	3,712	3,691	–21	795	931	136	115
Croatia	10,679	12,046	1,367	1,564	1,475	–89	1,278
Czech Republic	40,400	36,508	–3,892	11,975	12,757	782	–3,110
Estonia	2,725	3,162	437	0	0	0	437
Georgia	255	322	67	0	0	0	67
Hungary	24,607	22,783	–1,824	2,076	1,931	–145	–1,969
Kazakhstan	1,712	2,533	821	477	769	292	1,113
Kyrgyz Republic	84	87	3	9	9	0	3
Latvia	2,797	3,648	851	265	369	104	955
Lithuania	2,322	2,608	286	384	417	33	319
Macedonia, FYR	1,202	1,265	63	14	14	0	63
Moldova	231	288	57	21	35	14	71
Poland	55,494	64,429	8,935	20,751	23,315	2,564	11,499
Romania	2,656	3,043	387	5,296	4,564	–732	–345
Russian Federation	36,039	34,392	–1,647	21,367	27,181	5,814	4,167
Slovak Republic	10,144	10,341	197	5,458	4,911	–547	–350
Slovenia	5,685	5,659	–26	7,022	7,188	166	140
Tajikistan	—	—	—	—	—	—	—
Turkmenistan	—	—	—	1,827	2,075	248	248
Ukraine	3,470	5,009	1,539	586	790	204	1,743
Uzbekistan	—	—	—	4,703	4,432	–271	–271
Yugoslavia	—	—	—	—	—	—	—
Total	**208,744**	**216,268**	**7,524**	**88,198**	**97,041**	**8,843**	**16,367**
Central and Eastern Europe	**158,038**	**163,018**	**4,980**	**56,407**	**58,600**	**2,193**	**7,173**
Baltics	**7,844**	**9,418**	**1,574**	**649**	**786**	**137**	**1,711**
Commonwealth of Independent States	**42,862**	**43,832**	**970**	**31,142**	**37,655**	**6,513**	**7,483**

— Not available.

Note: Data are for 2000 unless not available (in which case data for 1999 were used). No reliable data are available for banks in Tajikistan and Yugoslavia or for private banks in Turkmenistan and Uzbekistan.

Source: IMF, *International Financial Statistics*; BankScope (Fitch IBCA); authors' calculations.

In Russia, however, the assets of private banks declined, while those of state banks grew. In Poland private banks were the primary drivers of the growth in assets, although state banks also showed increases. Overall, state banks had greater asset growth than private banks, the inverse of what happened in capital growth.

Notes

1. Hungary, Poland, and the Czech and Slovak Republics all have other, smaller state-owned banks. But these are not viewed as major competitors to the private banking system.

2. Armenia's last state-owned bank, the Armenian Savings Bank, was privatized in 2001. Before that, four other state banks had been rehabilitated by 1998 and subsequently privatized.

3. These figures are based on EBRD estimates of state bank assets as a share of total bank assets and differ from tallies from the financial statements of state banks. For example, in 2000 state banks' financial statements showed assets approximating $108 billion. With figures from the IMF's International Financial Statistics used as the denominator, this

would mean that state banks had a slightly larger share of total banking system assets than reflected in the EBRD estimates. But many of these additional assets are in banks that are being liquidated, such as more than $6 billion in major banks in Yugoslavia. Thus the figure is probably closer to about $100 billion, but could be closer to the $88 billion estimate once adjustments are made for write-offs and the like.

4. Albania, Bosnia and Herzegovina, the Slovak Republic, and Yugoslavia had high shares of state ownership of bank assets (more than 50 percent) in 2000, but privatization and liquidation have since reduced these shares.

5. $108 billion/$768 billion = 14.1 percent.

6. $46 billion/$768 billion = 6.0 percent. These figures include the $6 billion or so in loans reported by the big banks in Yugoslavia. These loans are excluded from several tables because of the liquidation process in place for these banks. If the $6 billion is excluded, the ratio is only 5.2 percent.

7. $32.6 billion/$46.3 billion = 70.5 percent. The banks with more than $1 billion in loans were (from high to low) Sberbank in Russia, PKO BP in Poland, Komercni in the Czech Republic, Nova Ljubljanska in Slovenia, National Bank for Foreign Economy in Uzbekistan, BGZ in Poland, VUB in the Slovak Republic, Vneshekonombank in Turkmenistan, Beogradska Bank in Yugoslavia, and Jugobanka in Yugoslavia. Noteworthy is the number of banks with large assets that do *not* have major loan exposures on their books.

8. $82 billion/$768 billion = 10.7 percent.

9. $67.0 billion/$82.5 billion = 81.2 percent. The major state banks with more than $1 billion in deposits at the end of 2000 were (from high to low) Sberbank in Russia, PKO BP in Poland, Komercni in the Czech Republic, Nova Ljubljanska in Slovenia, BGZ in Poland, VUB in the Slovak Republic, Vneshtorgbank in Russia, Vneschekonombank in Russia, National Bank for Foreign Economy in Uzbekistan, Banca Comerciala in Romania, Moscow Municipal Bank in Russia, Nova Kreditna Maribor in Slovenia, Savings Bank in Albania, and SKB in Slovenia.

10. $255 billion/$768 billion = 33.3 percent. Data for Turkmenistan are for 1999, while those for all other countries are for 2000.

11. $82 billion/$255 billion = 32.1 percent.

12. $5.4 billion/$10.0 billion = 54.0 percent. The state banks with more than $500 million in capital were (from high to low) Vneshtorgbank in Russia, Sberbank in Russia, National Bank for Foreign Economy in Uzbekistan, Komercni in the Czech Republic, PKO BP in Poland, and BCR in Romania.

13. Lithuania can be included only if deposits in the Savings Bank are combined with those in the still state-owned Agricultural Bank. The Savings Bank of Lithuania has been privatized since the end of 2000.

14. This figure differs slightly from some of the loan figures above because of differences in sources and methodologies. But the differences are not considered material for purposes of the analysis.

15. $82,537/$228,717 = 36.1 percent.

16. $51,521/$82,537 = 62.4 percent.

17. Banks that accounted for a major share of the net domestic credit in these countries in 2000 include Komercni (Czech Republic), Nova Ljubljanska (Slovenia), VUB (Slovak Republic), and the National Bank for Foreign Economic Activity (Uzbekistan).

18. These averages assume 108 state banks and 2,181 private banks at the end of 2000. In fact, there were more than 108 state banks, but these represent the major state banks. The others were primarily the nearly 700 banks in which nonprivate authorities in Russia held shares. The number of private banks is estimated from the total recorded in the EBRD's Transition Report 2001 less the 108 major state banks.

19. Three sources of data are used for bank assets—the IMF, International Financial Statistics, the EBRD Transition Reports, and BankScope (Fitch IBCA)—of which the last two are used for state banks. The data are not always identical, and marginal differences appear among some of the tables as a result. However, as with other balance sheet measures, the differences are not considered material for the analysis.

20. $82,537 million/$96,426 million = 85.6 percent.

21. $58,600 million/$96,426 million = 60.8 percent.

22. $63,253 million/$96,426 million = 65.6 percent.

23. The average asset size of CIS state banks would be considerably smaller if the nearly 700 banks in which the Russian government, central bank, or other public sector agencies had a minority share were included in the denominator.

24. Differences between this figure for total state bank deposits and those elsewhere in this report reflect issues in Lithuania, Slovenia, and Yugoslavia. The higher figures for deposits include the now private Savings Bank in Lithuania. They may reflect some double counting of deposits in Slovenia. And they include deposits in Yugoslavia's major banks that are excluded from the lower figures because of the liquidation process under way.

25. $47,538 million/$77,153 million = 61.6 percent.

26. Sberbank alone accounted for about three-quarters of the domestic currency deposits and about half the hard currency deposits in Russia in late 2001.

27. Average deposits in CEE state banks increased by $161 million from 1995 to 2000, while those in CEE private banks increased by $114 million.

28. $19 billion/$117 billion = 16.3 percent. CEE countries had higher levels of nonperforming loans than the Baltic states.

29. $19 billion/$158 billion = 12.1 percent

30. Capital is net, derived from the IMF's International Financial Statistics by subtracting (or adding, if positive) "other items net" from "capital accounts" for banking and deposit-taking institutions.

31. $23,327 million/$39,088 million = 59.6 percent.

32. Government securities are usually assigned a zero risk weight for regulatory capital (capital adequacy) purposes. But several countries (including Russia and Ukraine) have defaulted on their domestic debt, suggesting that zero risk weights should not be automatic and that capital should therefore be higher.

33. Bad loan percentages are based on an EBRD survey of central banks. They refer to substandard, doubtful, and loss loans as a percentage of total loans.

34. For more on this topic see Siegelbaum and others (2002).

35. For example, Komercni (Czech Republic) reported loan loss reserves of 14.03 percent of gross loans at the end of 2000, little changed from 14.56 percent at the end of 1999. Sberbank's loan loss reserves were 11.96 percent of gross loans at the end of 2000, down from 18.41 percent in 1999. Meanwhile, in Poland, PKO BP reported loan loss reserves of less than 5 percent, and BGZ had no data available but reported a reversal of provisions on its income statement in 2000. This suggests that the bad loan problem in Poland might be a greater issue for private banks than for state banks.

36. This problem is not restricted to the CIS. While the bad loan ratio for Yugoslavia increased in 2000 from earlier years (implying more overt recognition of bad loan problems), at 27.8 percent it is understated relative to the billions of dollars in loans that may eventually be written off with the liquidation of the major banks.

37. Beobanka Belgrade reported an estimated $500 million in after-tax losses in 2000, and Invest Banka $181 million in losses. These losses alone would turn the region's earnings into net losses.

38. Komercni, PKO BP, and Sberbank combined for only $568 million in after-tax earnings on $45 billion in average assets in 2000. That return on assets is only 1.3 percent, suggesting high costs, weak operations, inefficient use of assets, and insufficient earnings from other sources and activities.

39. Private: $5,768 million/2,181 = $2.6 million. State: $1,693 million/108 = $15.7 million.

40. Equity-to-asset ratio in 2000 was 7.55 percent on $20 billion in total assets = $1,510 million in equity. Equity-to-asset ratio in 1999 was 7.47 percent on $16 billion in total assets = $1,195 million in equity. Therefore, Sberbank's equity increased about $315 million.

41. $1,378 million/107 = $12.9 million. Meanwhile, PKO BP ($139 million) and Komercni ($43 million) accounted for $182 million of the remaining $1,378 million in state banks' capital increases. Thus excluding Sberbank, PKO BP, and Komercni, state banks averaged about $11.4 million in net capital increases in 2000.

Chapter 5

The Costs of Delay and Approaches to Reform

The role of state banks as overdraft providers for troubled state farms and enterprises in transition economies has steadily diminished over the years, though in response to different conditions. In most CEE and Baltic countries such lending declined once new prudential norms were introduced and enforced and as banks recognized the need to recapitalize. The banks saw that continuing to lend to troubled enterprises would only jeopardize their ability to comply with tighter prudential regulations, while investing in government securities was a far easier way to generate the profits. The changes in lending behavior in these countries have coincided with an improvement in the legal and institutional environment for creditors, resolution of problem assets, and enhanced financial discipline among private borrowers. The result of all this has been stronger returns and capital positions for banks, greater competition, a wider array of financial products, and improved service.

By contrast, in CIS countries lending to all sectors has eroded. Meanwhile, there has been no improvement in the environment for creditors or debtors, nor has confidence fully returned after hyperinflation and numerous banking crises. All this has led to a weaker deposit and capital base for banks, much lower financial intermediation, a limited range of financial products, and poor service.

The Costs of Maintaining the State Bank System

Continued state ownership in the banking system has often been harmful to transition economies. The presence of state banks has deterred prime-rated foreign investment from the banking market, and the potential distortions resulting from patronage or preferential treatment of state banks have deterred these and other banks from taking on more risk. Consequently, in countries where state banks continue to play a prominent role, lending has tended to be scarcer and costlier for enterprises. That has undercut financial intermediation: because enterprises find it difficult or uneconomical to borrow from banks, they have less incentive to place funds with banks. Most countries with extensive state ownership in the banking system have had large net spreads between loan and deposit rates that make borrowing costly for enterprises (table 5.1).

It is recognized, however, that poor portfolio quality and high intermediation costs are not only a function of ownership, but also are a function of the macroeconomic framework and standards of governance. In several countries where state ownership of bank assets has declined in recent years, nonperforming loans and net spreads have stayed high or increased (examples are Albania, Croatia, Georgia, the Kyrgyz Republic, FYR Macedonia, Moldova, Romania, and Ukraine). Part of this has to do with banks' need to increase earn-

TABLE 5.1

State Ownership of Banks and Net Spreads in Transition Economies, Selected Years, 1996–2000

(percent)

Country	1996		1998		2000	
	State ownership share of banks	Net spreads	State ownership share of banks	Net spreads	State ownership share of banks	Net spreads
Albania	93.7	7.2	85.6	8.5	64.8	13.8
Armenia	3.2	34.2	3.7	23.6	2.6	13.5
Azerbaijan	77.6	20.0	65.5	16.8	60.4	15.0
Belarus	54.1	29.9	59.4	12.7	66.0	30.1
Bosnia and Herzegovina	—	—	—	21.6	55.4	15.8
Bulgaria	82.2	48.8	56.4	10.3	19.8	8.4
Croatia	36.2	16.9	37.5	11.1	5.7	8.3
Czech Republic	16.6	5.8	18.6	4.7	28.2	3.7
Estonia	6.6	7.6	7.8	8.6	0.0	3.9
Georgia	0.0	27.3	0.0	30.0	0.0	28.6
Hungary	16.3	5.1	11.8	3.1	8.6	3.0
Kazakhstan	28.4	24.1	23.0	3.9	1.9	4.3
Kyrgyz Republic	5.0	28.3	7.1	37.6	7.1	33.5
Latvia	6.9	14.1	8.5	9.0	2.9	7.5
Lithuania	54.0	7.6	44.4	6.2	38.9	8.3
Macedonia, FYR	0.0	8.0	1.4	9.4	1.1	7.7
Moldova	0.3	11.3	0.3	10.6	9.8	10.5
Poland	69.8	6.1	48.0	6.3	24.0	5.8
Romania	80.9	14.7	75.3	16.6	50.0	20.3
Russian Federation	37.0	91.7	41.9	24.7	41.9	17.9
Slovak Republic	54.2	4.6	50.0	4.9	49.1	6.4
Slovenia	40.7	7.5	41.3	5.5	42.2	5.7
Tajikistan	5.3	13.0	29.2	34.0	6.8	–8.4
Turkmenistan	64.1	70.0	77.8	34.4	—	—
Ukraine	—	46.3	13.7	32.3	11.9	27.8
Uzbekistan	75.5	22.0	67.3	21.0	77.5	—
Yugoslavia	92.0	162.4	90.0	44.1	90.9	43.3
Regional averages						
Central and Eastern Europe	**53.0**	**23.9**	**43.0**	**12.2**	**36.7**	**11.9**
Baltics	**22.5**	**9.8**	**20.2**	**7.9**	**13.9**	**6.6**
Commonwealth of Independent States	**31.9**	**34.8**	**32.4**	**23.5**	**26.0**	**17.3**

— Not available.
Note: Countries for which no data are available are excluded from regional averages.
Source: IMF, *International Financial Statistics;* EBRD; authors' calculations.

ings to recapitalize, particularly as tougher prudential norms go into place and the government eliminates or reduces refinancing options for poorly performing banks.

The Costs of Delayed Reform in the Banking System

In most CIS countries and several non-CIS countries needed banking reforms have been delayed, governance remains weak, and state banks (and some "private" banks) continue to be used for noncommercial purposes. In many of the late reforming countries state banks still account for a large share of bank assets, loans, and deposits (though proper provisioning and write-down practices would reduce loan and asset values considerably). Meanwhile, poor asset quality undermines earnings performance, slows capital formation, and props up high real intermediation costs.

Delayed reforms in these countries have generally been correlated with sluggish economic performance.[1] Even where laws are

TABLE 5.2

Arrears as a Share of GDP in Selected Transition Economies, 1992–2001

(percent)

Country	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Azerbaijan	60.6	100.2	68.3	96.8	148.2	166.1	200.0	215.6	—	—
Belarus	—	—	30.4	13.5	18.2	13.3	23.1	19.2	22.4	19.1
Bulgaria	68.8	60.6	47.5	41.7	66.3	27.9	24.1	19.9	—	—
Croatia	—	—	3.4	6.2	7.4	8.1	11.4	20.1	14.4	11.6
Kyrgyz Republic	—	—	—	7.3	—	—	—	6.3	—	—
Lithuania	—	—	—	—	9.3	9.0	—	—	—	—
Romania	34.6	23.9	26.1	25.2	36.1	33.7	36.2	42.2	—	—
Russian Federation	—	—	14.8	13.3	23.4	29.1	47.8	30.3	23.7	—
Ukraine	8.0	6.0	13.0	20.0	24.0	85.0	98.0	—	—	—

— Not available.

Note: Enterprise arrears to government may not equal tax arrears, since tax arrears include those from households and enterprise arrears to government can include other forms of arrears.

Source: All data compiled by George Clarke from Tacis Programme (2000) for Azerbaijan; ECSPF (1998) and IMF (2000, 2002) for Belarus; IMF (2001) for Bulgaria; World Bank (2001) for Croatia; IMF (2000) for the Kyrgyz Republic; ECSPF (1998) for Lithuania; IMF (1998, 2001) for Romania; Bagratian and Gürgen (1997) and Russian-European Center for Economic Policy (2002) for Russia; and IMF (1999) for Ukraine.

adequate, institutional capacity has been slow to emerge. Many countries have not yet adequately addressed issues of financial discipline, loan default, collateral, veracity of financial information, and other staples of market-based banking. Where poorly performing banks have failed as a result, public confidence in banks has been undermined, particularly when people have lost their savings.

Meanwhile, the delay in reform has allowed for a weak financial system overall and permitted a wholesale shift away from formal financial institutions in many CIS countries. One sign of this is the huge stock of barter and arrears in the enterprise sector, equivalent to many times the outstanding credit of banks. In Ukraine, for example, net enterprise arrears are estimated at four to five times the total credit from banks to the enterprise sector, and in 1998 arrears were estimated to be 98 percent of GDP. In Russia arrears were estimated to be nearly 24 percent of GDP in 2000, most of them to nonbank accounts (suppliers, tax accounts, and off-budget funds). Similarly, Belarus has had arrears estimated at 19–23 percent of GDP since 1998 (table 5.2; see annex 6 for more detail).

Nor has this problem been limited to CIS countries. In Bulgaria state enterprise arrears amounted to about 20 percent of GDP in 1999, though that reflects a significant drop since 1997. Arrears to banks accounted for only a twentieth of the total, with the rest to suppliers, government, the state pension fund, employees, and other accounts. In Croatia arrears amounted to nearly 12 percent of GDP in 2001 and were as high as 20 percent of GDP in 1999. More serious, though, are arrears in Romania, which climbed steadily to reach 42 percent of GDP in 1999. Most are due to suppliers, government, and other accounts, with those due to banks equal to 6.4 percent of GDP.

The long-term overdue payables are symptomatic of major problems in the payment system. They also point to the cash constraints of enterprises, which continue to emphasize tax avoidance at the expense of long-term performance and competitiveness. Although most of these enterprises are state owned, some are "privatized" but run according to earlier methods. These operating practices have depleted cash and capital and reduced or eliminated creditworthiness as measured by traditional commercial banking standards. Moreover, the poor condition of enterprises has reduced tax payments, including for social insurance, exacerbating the poor state of public finances.

Where banks are still used for noncommercial purposes, they are often state owned. The banks' noncommercial approaches have

often been reminiscent of old-style management and governance—directed lending for political purposes, a traditional orientation toward state farms and enterprises, and a socially oriented banking culture that finances production to meet output targets, ensures that everyone has access to a bank branch, and maintains employment. Even where governments have recognized the unsustainability of these banking approaches, they have often put off hard decisions to privatize or liquidate those that are technically insolvent because of the political difficulties associated with such steps. Thus in the end noncommercial banking approaches have often led to a financial crisis in the banking system, high levels of corruption, and big costs for the government. And where traditional savings banks have been used for purposes other than savings (such as for channeling loans that later became nonperforming), this has raised concerns about deposit safety and public confidence in the banking system.

These problems point to weaknesses in corporate governance structures. Performance in corporate governance and the degree of preference for state banks has varied from country to country and still remains weak in many cases. But countries have gradually recognized the need to address weak corporate governance as a precondition for stable banking systems and to prevent damaging bank collapses. Several countries have taken concrete steps—improving the accounting framework, introducing tougher requirements for internal operations, strengthening the internal audit function, restricting the issuance of banking licenses when "fit and proper" standards are not met, and calling for more professional standards and qualifications for board members. Much of this has contributed to strengthening monetary policy, enhancing banking supervision, implementing stricter prudential norms, and meeting requirements for increased integration into the global marketplace.

Approaches to Resolving Problem Assets and Restructuring Banks—and the Costs

Transition economies have taken different approaches to solving the problem of bad loans and building viable banking systems. Achieving these goals clearly depends on a multitude of factors, not the least of which are stable business environments, functioning institutions, stable macroeconomic frameworks, and creditworthy and "equity worthy" enterprises and households. Trying to solve financial sector problems in the absence of progress in the enterprise sector has often led to frustrating results. Without a healthy enterprise sector, banks and other financial institutions have been unable to prosper even when inflation rates have been stabilized, banks have been reformed, and funds are available for lending and investment.

Most CEE countries and the Baltic states have broadly addressed the fundamental weaknesses in their financial sectors, with the exceptions of the Balkan countries that were torn by war. These countries are considered likely to be able to sustain financial sector stability, though there is always a potential for shocks and disturbances. Vulnerable are small open economies such as the Baltics, which can fluctuate from year to year with economic developments in major trading partners. And countries such as Romania face a risk of future instability because of delayed progress on structural reform, notwithstanding potentially large markets and improved economic performance. Still, CEE and Baltic countries are generally considered to have pushed ahead with many of the reforms needed to become competitive, driven by the lure of accession to the European Union.

What have been the costs of the bad loans and the delays in resolving structural problems in banking? Estimates have varied. One study estimated the cumulative costs of bank restructuring and deposit compensation in 1991–98 as 29.6 percent of 1998 GDP in FYR Macedonia,

26.0 percent in Bulgaria, 20.9 percent in the Czech Republic, 18.4 percent in Kazakhstan, and 12.9 percent in Hungary.[2] More recently, the National Bank of Croatia estimated the cost of bank rehabilitation in that country at about 26 percent of GDP from 1991 to 2000.[3]

Not all countries endured high *explicit* costs. Some, such as Estonia, Lithuania, Poland, managed to work out problems over time, while others have experienced limited growth and development in their banking systems such as Georgia, the Kyrgyz Republic, and Latvia.[4] Among these countries the costs of bank restructuring and deposit compensation ranged from 0.1 percent of GDP in 1991–98 in Georgia to 4.9 percent in the Kyrgyz Republic. But these figures do not necessarily take *implicit* costs into account. These include higher net spreads, forgone lending to sound companies for sound projects, forgone GDP growth, and the diversion of deposits from the banking system.

While estimates of the costs of bad loans have varied, there is broad agreement that long-term support has rarely succeeded without major financial, managerial, and operational restructuring. Several countries that deferred major restructuring of banks, experienced severe economic collapse late in the transition, such as Moldova, Russia, and Ukraine and thus were unable to rely on the financial sector as a source of stability. And several countries such as Bulgaria, Croatia, the Czech Republic, Hungary, Kazakhstan have had to recapitalize banks multiple times because initial measures proved insufficient (see case study on Ceska Sporitelna). For the countries that did take action, the question is whether banking systems were adequately restructured. Other countries that undertook less expensive restructuring, such as Estonia and Poland, did so only once and ultimately emerged as more competitive.

In most CIS countries enterprises, banks, and depositors were all left broadly exposed rather than bailed out through formal recapitalization mechanisms (there are some exceptions, such as in Azerbaijan, which consolidated and recapitalized four state-owned banks). But many state-owned or formerly state-owned enterprises received bailouts through other means—bank rollovers of de facto nonperforming loans and the run-up of arrears. These practices, still evident in many state-owned banks,[5] have undermined efforts to achieve competitiveness in the banking sector and the economy.

The practice of rollovers, rooted in imprudent loan classification and provisioning practices, has delayed recognition of asset problems that ultimately decapitalized banks. Once such problems were uncovered, often through external audits according to international accounting standards, many CEE and Baltic banking systems introduced stricter prudential frameworks. These banking systems generally moved on to restore confidence, improve credit management skills, boost resources and capital, and become more effective intermediaries. But where these problems have not been resolutely addressed, nonperforming loans have reduced bank liquidity and capital.

The Special Costs of Weak Laws and Regulatory Forbearance

Much of the problem for banks in lagging economies has related to distortions in the credit markets. Most important has been the lack of support for secured transactions in the legal framework. In most transition economies bankruptcy legislation and enforcement have been weak. Although some countries have made progress, building judicial capacity and restructuring incentives toward creditors (to increase their willingness to assume credit risk) has taken time. Where the legal environment remains weak, banks' prospects for seizing and selling collateral to recover part of the value of bad loans have been poor. Nonetheless, most banks have assigned collateral higher values or inadequate risk weights relative to its real market value. That has led to both an overstatement of asset and capital values and an understatement of risk.

Moreover, state banks have often been more willing to assume risk because they know they will be bailed out by the government. That has sometimes led to imprudent cross-ownership or traditional lending to affiliates and related parties. In the absence of consolidated supervision of the financial sector state banks are vulnerable to large losses from their exposures to leasing companies, insurance firms, pension funds, investment funds, and other financial services companies. In fact, these ventures have targeted state savings banks because of their household deposits and retail networks. In the end state banks' inability to manage these risks according to strict commercial guidelines has led to losses, undermining public confidence and often requiring costly intervention by the state.

While lack of consolidated supervision has contributed to the risk associated with imprudent cross-ownership, it is only part of the problem. Where good governance and sound management are lacking, imprudent cross-ownership has been harmful across the board. Many of the lingering problems faced by the Czech Republic relate back to weaknesses associated with cross-ownership. Banks' relatively recent ownership of investment funds in Romania has similarly raised questions about financial sector stability.

Regulatory forbearance has also added to the problem of state banks. While banking supervision has been tightening for years in transition economies, every system exercises some forbearance. But regulators have long allowed state banks disproportionate forbearance, to allow them time to restructure and recapitalize. This is legitimate where privatization is the objective, because private investors will not buy an insolvent institution. But the rehabilitation process has often been dragged out for noncommercial reasons, distorting the market. Several countries have protected their markets from foreign competition while their state banks restructure. But even when foreign investment is materializing in the banking sector, state banks often operate with some protection through regulatory forbearance. In the end the preference for state banks undercuts bank supervisors' ability to enforce their mandates in support of banking, financial sector, and monetary stability. This problem is widespread in transition economies.

Where state banks are protected and losses mount, there is ultimately a macroeconomic cost, as most transition economies have experienced. As the sole or major shareholder, the state has a financial obligation to recapitalize state banks as going concerns. Avoiding the failure of banks and the resulting loss of confidence may require fairly continuous recapitalization and liquidity support from monetary or fiscal resources. More recently, as central banks have become fairly disciplined and have focused on pricing stability, most of the leakage has come from the fiscal side. This support, political by definition, often lacks transparency. Governments often provide financial support for state banks from extrabudgetary sources or, where cash resources are constrained, through arrears (on taxes, social funds, electricity payments, and other obligations).

Progress and Challenges

Relative Progress in Central and Eastern Europe and the Baltics

Funding trends in many of the CEE and Baltic states—growing deposits, rising ratios of broad money to GDP, and increasing capital—suggest that these countries have put into place structures that have helped to restore the confidence of creditors, investors, and the public in banks. On average, CEE countries have seen the biggest improvement in deposit mobilization and capital formation, while the Baltic states have also shown positive trends (table 5.3). In the CIS countries deposit mobilization has been more limited, and banks have undergone significant decapitalization since 1995.

TABLE 5.3
Basic Funding Indicators in Transition Economies, 2000

Country	Change in deposits since 1995 (millions of U.S. dollars)	Ratio of broad money to GDP (percent)	Change in ratio of broad money to GDP since 1995 (percent)	Change in capital since 1995 (millions of U.S. dollars)
Albania	909	60.1	1.3	174
Armenia	130	14.7	7.0	–28
Azerbaijan	387	17.5	5.2	26
Belarus	–63	17.7	2.7	184
Bosnia and Herzegovina	247	27.6	12.8	3
Bulgaria	–4,420	34.8	–30.1	263
Croatia	4,111	46.1	21.2	–570
Czech Republic	–1,517	75.7	–2.9	373
Estonia	978	39.3	12.6	319
Georgia	108	10.3	2.8	28
Hungary	1,623	46.8	4.9	611
Kazakhstan	981	15.4	4.0	537
Kyrgyz Republic	–7	11.9	–5.3	–53
Latvia	815	30.4	7.0	184
Lithuania	1,033	23.3	0.0	299
Macedonia, FYR	163	21.0	8.8	–468
Moldova	36	22.4	3.2	28
Poland	28,506	42.7	8.8	1,500
Romania	581	23.2	–1.9	–627
Russian Federation	–1,871	22.1	4.2	–3,836
Slovak Republic	561	67.8	3.1	1,992
Slovenia	2,309	49.5	13.0	–188
Tajikistan	—	8.8	–12.0	0
Turkmenistan	298	14.9	–3.8	21
Ukraine	1,007	17.9	5.2	368
Uzbekistan	2,384	11.9	–6.3	851
Yugoslavia	—	20.3	—	—
Total	**39,289**			**1,991**
Central and Eastern Europe	**33,073**			**3,063**
Baltics	**2,826**			**802**
Commonwealth of Independent States	**3,390**			**–1,873**

— Not available.
Note: Data on broad money for Turkmenistan refer to 1999 rather than 2000.
Source: IMF; World Bank.

Bulgaria, the Czech Republic, and Russia all experienced net outflows of deposits from their banks between 1995 and 2000, and all experienced a major economic shock or similar development in that period.[6] But several other countries such as Ukraine that also experienced shocks had growth in deposits during the period.[7]

Broad money ratios continue to show that CEE and Baltic countries have higher intermediation levels than CIS countries. Broad money exceeded 30 percent of GDP in 8 of 12 CEE countries and 2 of 3 Baltic states in 2000. But among the 12 CIS countries none had broad money ratios in this range, and only Moldova and Russia had ratios above 20 percent. Thus the general funding base remains weak in the CIS countries. This weakness is made all the more apparent by the $1.9 billion decline in bank capital in CIS countries between 1995 and 2000, compared with the nearly $3.9 billion increase in CEE and Baltic countries.

In part these trends reflect differences in bank operations among the regions. CEE and Baltic countries have attracted greater foreign direct investment into their banking markets than the CIS countries. This investment has

helped domestic banks (directly, through acquisition, or indirectly, through competition) to strengthen systems and diversify product offerings, improving their earnings.

Still, most banks in transition economies have limited capital, particularly in the CIS but also in the Baltics and Central and Eastern Europe. With low levels of capital, banks are unable to access the international syndicated loan market or, in some cases, even the domestic interbank market. All this combines to make it difficult for small banks to mobilize deposits, because it undercuts their ability to invest in the products and services that would attract depositors.

Most CEE and Baltic countries have adopted a prudential framework that appears adequate to maintain stability in the banking system. While nonperforming loans remain high in many of these countries, there is better recognition of this problem than in earlier years. Moreover, as banking supervision capacity increases and private banks are required to report on prospective noncompliance and associated risks, banking systems are proving capable of containing potentially damaging risks. This capability has been tested in several countries in recent years. For example, the poor condition of Hungary's Postbank in early 1997 led to deposit withdrawals, but the system as a whole did not experience a major net outflow. Instead, depositors simply transferred their funds to stronger and better managed banks, essentially strengthening the system at the expense of some vested interests.

But not all countries are free from destabilizing effects. Weak regulation and supervision in Romania culminated in a challenge to banks in 2000 when rumors circulated about the financial condition of major institutions. The National Bank signaled its willingness to provide needed liquidity support, and Romania's major banks were able to handle increasing withdrawals. But the rumors might have had less effect if a stronger supervisory regime had been in place. The weak supervision reflects efforts throughout the 1990s to defer needed reforms in Romania. That delay translated into a more fragile economy, less public confidence in the banks, more difficult (and expensive) access to international capital markets, and lower capital levels.

Remaining Challenges in the Commonwealth of Independent States

The transition from a monobank system to a stable, well-funded, two-tier banking system and diversified financial sector has been far more difficult in the CIS countries. In the CIS the trend has been toward large state banks (in most of the resource-rich countries) and very small private banks that have served as pocket banks for insiders and controlling interests. Through the large losses stemming from their operations, pocket banks have undermined economic growth, compounding the aftereffects of hyperinflation and the loss of confidence in domestic currencies. Among the state banks, some have made efforts to professionalize and modernize. But the continued existence of the state banks has made it difficult to create an open, competitive environment for banking.

Banks such as Sberbank in Russia remain "strategic" and coveted because of their large share of deposits. Large CIS banks remain essential players in their countries—Oschadny in Ukraine, the International Bank of Azerbaijan, Halyk Savings in Kazakhstan, Vneshekonombank in Turkmenistan, the National Bank for Foreign Economic Activity in Uzbekistan, and Sberbank, Vneshtorgbank, and Vneschekonombank in Russia. Some of these banks remain important players because they still serve as vehicles of directed lending, others because they safeguard hard currency accounts and are responsible for payment and settlement for the economy's major enterprises. Meanwhile, much of the rest of the economy has fled the banking system, running up arrears

to other accounts. All this points to problems of funding in the real sector, weak governance and management in the economy, and the greater difficulties of CIS countries in dealing with the challenges of transition.

Notes

1. Exceptions include countries that have used cash from a strategic commodity to insulate the economy from the negative effects of slow reform. Several CIS countries have been able to leverage favorable oil and gas prices, for example. A decline in these prices would be expected to weaken economic indicators and, to the extent the banking system is exposed to these trends, banking sector indicators as well.

2. See Zoli (2001).

3. Maletic 2002.

4. See Zoli (2001).

5. See Builov (2002) on the financing of enterprises in Russia.

6. The Czech Republic has battled structural problems in the economy, Bulgaria faced economic collapse in 1996–97, and Russia experienced a collapse of its currency in 1998.

7. Ukraine experienced an economic shock in 1998 as a result of the Russian financial crisis.

Chapter 6

Findings and Recommendations

Despite more than ten years of financial sector reform, state-ownership of banks continues to plague many transition economies. In most CIS countries and several non-CIS countries governance remains weak, boards lack specialized banking skills, management is entrenched, accounting is incomplete or inaccurate, and state banks continue to be used for noncommercial purposes.

Most transition economies still have a few state banks (about seven on average), and in many these banks still account for a large share of bank assets, loans, and deposits, though proper provisioning and write-down practices would reduce loan and asset values considerably. For these troubled banks poor asset quality undermines earnings performance, slows capital formation, props up intermediation costs, and makes it difficult to make the investments needed to be competitive.

Main Findings

Following are some of the main findings associated with the continuing presence of state owned banks in the region.

- *Where state banks are still used for noncommercial purposes, their quasi-fiscal function poses a risk to macroeconomic and financial sector stability.* State banks' non-commercial approaches often include directed lending for political purposes, toward state farms or enterprises, or to meet social objectives. More often than not these practices have led to a severe financial crisis in the banking system, high levels of corruption, and big costs for the government. Where state banks are more modern, their ability to increase productivity, efficiency, and competitiveness is still constrained by excessive staffing, low skill levels, manual processes, outdated information systems, and lack of a service orientation.
- *Delayed reforms in the banking sector have generally been correlated with sluggish economic performance*. This has been shown throughout the Europe and Central Asia region, with the CIS countries, particularly in Central Asia, lagging behind others in the region in reducing state-ownership of banks.
- *Where state banks have failed or performed poorly, they have undermined public confidence in the banking system, particularly where there is no deposit insurance and people have lost their savings*. Such losses of confidence have harmed the long term development of the formal financial sector. While in Central and Eastern Europe and the Baltics the banking sector has seen favorable growth trends in recent years, in many CIS countries growth in financial intermediation has been limited, and the economy has shifted away from formal financial institutions. In these countries enterprises have operated often through barter, arrears, and netting arrangements. Facing cash constraints, enterprises emphasize tax avoidance rather than long-term performance. Their poor financial condition has further reduced tax payments,

including for social insurance, exacerbating the poor state of public finances.
- *Continued presence of state banks has severely limited financial sector and economic development in transition economies*. The accumulated effects of all these problems—poor structures, incentives, and governance along with weak laws, inadequate regulation and supervision, connected lending, and political patronage—have undermined confidence in banks and other public institutions and made it difficult for many transition economies to achieve sustained growth. These problems have not only hindered many CIS countries in their efforts, but the same fate has also impeded growth in Romania, triggered collapse in Bulgaria, and restricted efforts in many other countries in southeastern Europe.
- *Governments are better off moving quickly to reform, privatize, or liquidate their remaining state-owned banks*. Experience has shown that the costs of delay are large and in general prospects for privatization do not increase with slow and complex attempts to restructure.

The balance of this chapter provides recommendations for policymakers on how to resolve state bank issues and identifies some of the preconditions for a competitive financial sector. It compares various approaches to state bank privatization and resolution based and offers lessons the last decade of reform in transition economies.

Prospects for Privatizing State Banks

For most remaining state banks the prospects for privatization are poor. In fact, in many of the most troubled economies where state banks continue to play a key role, privatization prospects are less promising now than they were earlier. And they are less promising than prospects in countries that have entered formal negotiations for entry into the European Union. For CIS countries the lack of options has been a big disadvantage for the reform process.

Most state banks—uncompetitive, insolvent, loss making, and lacking in franchise value—have few privatization options. Some, such as specialized export-import banks, do have adequate systems and professional personnel who have been exposed to international norms of banking. In some CEE countries, for example, the former state banks that were the easiest to privatize were corporate banks with traditions of international exposure. In other countries, however, these banks were often among the most troubled institutions.

Savings banks are often considered exceptions because in many countries they are the only banks with a retail network. In countries with poor infrastructure, such a retail network could potentially have value. But more often than not countries with poor infrastructure have poor economies. Thus sorting through the problems of a state bank with high staffing levels, poor systems, and traditions of "social" banking is rarely worth the cost to the government of privatizing it, even if the price is zero.

There are other exceptions such as in countries with strategic resources, growing purchasing power, and more highly populated markets. But even in these countries definitive privatization or closure of banks combined with a stable macroeconomic and legal framework is a precondition for establishing a competitive environment for banking. Until open, competitive banking markets exist, it is unlikely that adequate capital will be in place for meaningful levels of intermediation. Without capital and a competitive banking environment, restoring confidence will take even more time.

Reforming state banks cannot be relied upon as a strategy to restore confidence to banking systems. This is a costly endeavor, especially given scarce resources, and risks that state banks tend to revert to traditional practices should there be a perception of market failure.

The high cost of these practices is precisely why transition economies need to move on to the final chapter of privatization in the

banking sector—privatization based on sound governance and management, accurate and timely disclosure of meaningful information, effective banking supervision, and well-developed legal systems reinforced by stable macroeconomic policies. However, because the state banks that remain are often among the least attractive to investors and the most impaired as institutions, closing this chapter is a difficult challenge.

Preconditions for Privatizing State Banks

Bank privatization does not occur in a vacuum, but in the context of a country's wider economic reform program. As a result, there are a number of factors that contribute to successful privatization of state banks and help create a stable financial system, as described below.

Macroeconomic Stability

Macroeconomic weaknesses reduce prospects for privatization and increase prospects for losses by banks. Macroeconomic stability is an area where most transition economies have made much progress. Even countries with weak economic performance have often improved from even weaker performance early on. While most countries have had to battle hyperinflation, today inflation rarely exceeds 10 percent in CEE and Baltic countries, and about half of CIS countries have single-digit inflation rates. And all transition economies generally manage to keep fiscal deficits below 4–5 percent of GDP. While this performance on inflation and deficits does not match that in strong economies, it represents a major improvement over earlier measures.

Sound Legal Framework

A reliable legal framework provides a conducive environment for financial firms to assume risk because it gives borrowers an incentive to be disciplined and shareholders an incentive to monitor their investments properly. It also provides a structure for orderly settlement of disputes out of court, with courts serving as a final arbiter if out-of-court methods fail. Courts can be reserved for disputes exceeding a minimum size, while smaller cases are automatically sent to specialized arenas. By contrast, where the legal framework and judicial systems are poorly developed, and decisionmaking is more arbitrary and less transparent, the unpredictability of the judicial process reduces the incentive for financial firms to assume risk. Most transition economies have the necessary laws in place but often lack court capacity, legal precedent and experience, commercial training, and alternative dispute resolution mechanisms.

Sound Financial Information

Sound financial information cannot be taken for granted anywhere and is particularly problematic in markets where information disclosure has not been a tradition. Moreover, because the market test for many asset values (such as real estate and collateral) is not in place in less advanced economies, valuation is a challenge. This is on top of the normal issues of loan classification, financial soundness of the government (as the underwriter of securities held by state banks), and general auditing standards. Many investors have uncovered additional bad loans in a bank after the privatization transaction has been closed. In some cases this may be the result of the acquiring bank's own deficiencies or of market developments that reduce the quality of assets not identified as risks before the transaction. But in other cases it may occur because of poor internal records, lack of consolidated accounting, and similar weaknesses. All this adds to the risk of investing in a market—discouraging investor interest, reducing the amount investors are willing to pay for a state bank, and increasing the cost incurred by the state to complete the privatization.

Sound Prudential Framework

Independent supervision based on a sound prudential framework is an important element of a stable financial system. While dealing with structural weaknesses and losses in the banking system always has interim economic and financial costs, failing to address these problems only perpetuates the myth that financial results are better than they are. Overstatement of loan performance and asset quality (through rollovers and capitalization of unpaid interest) can prolong the fiction that banks have high earnings, strong capital, and robust operations. But in the end, as they run short on cash and have to approach the government for refinancing, the need for corrective action will become clear. Tightening up bank prudential norms and providing the supervisory authorities with a mandate to enforce sanctions on banks (including state banks) for noncompliance can help move banks toward greater discipline and proper management. In many transition economies, if not most, the supervisory mandate has been extended to most private banks but has not been equally applied to state banks. This undue forbearance is costly in the long run and distorts the market.

Government Commitment to a Competitive Banking Environment

Government commitment to an open and competitive banking environment in most cases is an precondition for strong investor interest. It is also necessary to encourage intermediation. Continuing to float state banks in the market delays progress toward competitiveness and distorts the sector. Building a competitive banking environment takes time. Many small, weak economies would see little initial benefit from a wholly privatized banking system, as has been the case in some CIS countries (such as Georgia) and in the Balkans (such as FYR Macedonia, which has only one, relatively inactive state bank). But in many other economies movement toward privatization has generated benefits that would not otherwise have occurred.

Recommended Approaches to Reforming, Privatizing, and Liquidating State Banks

To avoid the risks associated with state ownership, it is recommended that governments design strategies to reduce or eliminate state banking from their financial systems. This can be done in a way that reinforces efforts to create a stable banking environment and helps to accelerate institutional capacity building for effective market performance. Many countries have already begun this effort to create a stable banking system by introducing BIS-recommended prudential norms and requiring banks to design their own corrective actions to come into compliance with liquidity, solvency, and other standards.

Governments working to eliminate state ownership have a few broad options. These include restructuring or rehabilitating banks, consolidating banks, liquidating bank, reorienting banks within well-defined mandates and risk parameters, and providing incentives for establishing nonbank lenders.

Restructuring or Rehabilitating Banks

Experience has shown overall that restructuring and rehabilitation is costly and time-consuming, and governments are often better off moving swiftly to liquidate their state banks. Many countries, however, have already engaged in significant restructuring and rehabilitation efforts, particularly in Central and Eastern Europe. While some have kept explicit costs down (Poland), many others have seen costs rise to a large share of GDP (Bulgaria, Croatia, the Czech Republic, Hungary, Kazakhstan, FYR Macedonia). Others have kept restructuring costs low, yet have little to show for their efforts

largely because of political and macroeconomic instability, and real sector weaknesses. There have been no cases of successful restructuring of state-owned banks in the region that has resulted in satisfactory performance.

In deciding how to deal with a state bank, one question is whether the investment in restructuring and rehabilitation will generate an adequate return relative to potential returns from other uses of those resources. Rather than the time-consuming process of restructuring and rehabilitation, a more efficient route to privatization might be to insist that the new owners undertake certain activities to ensure that the private sector has access to financing (with the government benefiting from the resulting fiscal revenue and employment generation) in exchange for concessions on the sales price.[1] For large banks, this approach would probably involve bigger concessions and a longer time horizon for the new owners and management to achieve the objectives.

For small banks, restructuring and rehabilitation has not proven to be worth the time and effort. Since most state banks have less than $300 million in assets and $50 million in capital, making concessions on sales prices and developing a 5- to 10-year time horizon for achieving financial and economic objectives through outside investment would probably bring greater benefits for the banking sector than working through a time-consuming rehabilitation and restructuring before privatization. Indeed, this choice appears preferable for most countries, though there are a few exceptions among banks.[2] Otherwise, banks that are not supervisory concerns and are not large ordinarily should be sold off quickly, with the long-term financial and economic objectives the main focus of negotiations for sale.

Providing Interim Technical Assistance

Many governments opt for interim technical assistance measures because they view privatization as infeasible politically or fail to find adequate strategic investors for their banks. In such cases, they consider restructuring of certain departments their only options. Experience has shown, however, that such interim measures fail to address the core issues of poor management, weak corporate governance, and lending based on non-commercial principles. They may help delay crisis, but not to avoid one overall.

Therefore, it is recommended that governments only engage in technical assistance in extremely rare cases and within a limited time-frame. It may be necessary—or even valuable—to keep a state bank alive for a limited period of time to maintain financial sector stability or allow for legal and regulatory reforms to take place or supervisory practices to take hold. However, technical assistance is not recommended as a strategy for continuing state-ownership in the long term. Technical assistance should always be geared toward the preparation for privatization or liquidation and without illusions of rehabilitation.

Countries that do opt for restructuring and rehabilitation should structure their approach around a strategic objective and include explicit performance indicators based on operational reforms, managerial changes, and financial requirements. Given the small capital of many state banks, one approach would be to seek a minimum threshold of absolute capital combined with specific capital adequacy targets that point to future soundness.

Consolidating Banks before or after Privatization

Lack of investor interest in banks might trigger a need to close these banks or to close unsalvageable parts of banks that have been privatized. This contingency should be planned for as a part of the negotiating process, since investors may not want the full franchise and the associated costs of spinning off or restructuring unwanted parts.

One alternative is postprivatization consolidation, such as through purchase and

assumption, in which unwanted parts of a franchise are spun off to another bank that might be able to give them some value. For example, a small bank wanting to develop a branch network might value the same branches that the potential owner of another bank does not want. While the ideal approach would be to sell the branches through the market, in many transition economies the market is limited. In these cases the transaction could be completed through the regulatory authorities, who would be in a position to know whether the potential acquiring or absorbing bank meets the financial and other conditions for the acquisition. Moreover, if the units being spun off are of questionable value, the regulators would know whether the acquiring bank has the capacity to turn them around. If such an approach poses risks to deposit safety or systemic stability, the assets could be offered to financial institutions that are not deposit taking or are not covered under the deposit insurance fund.

Although consolidating banks before privatization may help reduce the transaction costs of negotiating privatization transactions, it has often turned out to be difficult and costly, and the results often suboptimal. For example, the Czech Republic made an effort to help Ceska Sporitelna, a fairly narrow savings bank at the time, become a more diversified commercial bank by absorbing smaller regional banks. In the end Ceska Sporitelna was not privatized until 2000, five years later than it might have been without the consolidation strategy. The Polish bank Pekao SA (now owned by Unicredito of Italy), which had franchise value in the mid-1990s, was consolidated with three regional banks before privatization. This exercise turned out to be time-consuming and complex because of the regional specifics of the three smaller banks, and there are doubts about whether it added value or enhanced banking services in Poland. The results of these attempts suggest that most remaining state banks could be consolidated more efficiently by simply offering them for sale to banks—domestic and foreign—and relying on market mechanisms to achieve consolidation.

Where market mechanisms are not sufficient to consolidate the banking system, another option is the regulatory approach. A separate administration could work with specialists to establish a consolidation plan that includes a strategic objective with performance indicators. Under this approach the two or more institutions planning to consolidate would be required to establish an action plan and time line for achieving objectives, with financial results serving as the key measure of success. The plan could include performance incentives, although reasonable indicators would need to be set early on. For the state, the potential benefits would include cost savings and, in time, better intermediation. And if the consolidation involved at least partial privatization through outside investment, this would have the added benefit of improving solvency.

Liquidating Banks

Many governments have resisted the option of liquidating banks, particularly for savings or agricultural banks whose branch networks cater to households and underserved rural regions. Regardless of their financial condition, liquidating these banks has been difficult for political reasons and because there has been little alternative for people in rural areas. Savings banks have also catered to many older people who have small accounts and are uncomfortable changing banks or using electronic banking methods.

While these are understandable reasons for deferring closure, in reality these banks can often be liquidated with few of the feared social consequences. Alternative institutions fully capable of serving households and rural communities often exist—such as savings houses, credit unions, and microfinance institutions—but their development has often been stunted by politically motivated protection of savings and agricultural banks. Moreover, the meager

earnings of state-owned savings banks raise questions about their long-term sustainability.

Branches can be spun off to other interested parties—including nonbank financial institutions such as credit unions, microfinance institutions, or leasing companies—that focus on households, rural communities, and other market segments often neglected by mainstream banks. Under these circumstances the sale would simply involve a revocation of the institution's right to market itself as a bank, an explicit and well-publicized removal of the institution from deposit insurance, and other actions that would transform the bank into a nonbank financial institution.

In the long run, however, if a bank cannot be privatized or absorbed by a sound bank, it should be a candidate for liquidation. If the bank shows no potential for commercial viability, liquidation should occur promptly.

Mitigating Social Costs of Privatization or Liquidation

In reality governments often lack the political will to privatize or liquidate some of their largest state-owned banks because of the related social costs—both perceived and real—such as unemployment, and lack of services to poor, rural, or at-risk groups. For this reason, it is critical that governments explicitly build in social protection measures into their reform strategies. This includes specific measures targeted toward laid-off workers, providing them with decent severance packages, retraining, and assistance to obtain alternative employment. The government also should strengthen the social safety net for the long-term unemployed and the poorest.

If the government does move forward with privatization of a dominant bank, it must make sure that measures are in place to continue to provide critical financial services to the poor and target groups and to avoid a financial crisis. Measures include building up non-bank financial institutions and creating incentives for private banks to expand services to certain groups before the privatization or liquidation takes place.

Narrowing the Licenses for Savings Banks

Governments occasionally hesitate to close down failing banks, particularly savings banks, because they are the sole providers of financial services in certain regions or the poor. In such cases, governments may decide that it is necessary to keep a bank open for a limited period. When a government does so, however, it should take specific actions to limit the damages caused by such banks.

One alternative is to redefine the bank's license and narrow the range of permissible activities. One bank operating under this approach has been the Savings Bank of Albania, which was originally limited to a narrow range of activities and failed when it took on a more diverse role. Since 1998, the bank's activities have been narrowed with no lending allowed. It has now been sufficiently recapitalized and reorganized to be offered for sale to strategic investors.

The delay in privatization inherent in this approach poses risks, however. If the state savings banks cannot be privatized, an effort should be made to limit the kinds of lending and investment activities they can pursue, particularly if they hold a major share of the deposit market. CEC of Romania had exposures to an investment fund that collapsed in 2000, jeopardizing its financial position.

Placing strict limits on what savings banks can do has both potential benefits and risks. The strategy has a good chance of keeping the banks solvent. But because their high costs and low service levels translate into small earnings (or losses), limits on what they can do to generate income would almost certainly ensure that the banks would never be able to grow or modernize unless they retain a significant share of the deposit market (as Sberbank does in Russia). And this market

concentration is risky for systemic stability. Banks generally lack an inexpensive source of funding if they do not have a viable deposit base. That limits their resource base for lending and drives up lending rates. It also makes the interbank market highly dependent on a particular bank for liquidity, and it can create a vicious circle leading to collapse if the savings bank is closely intertwined with government finances. If the government depends on the savings bank for funding and experiences a major downturn in its own finances, a major erosion of the savings bank's liquidity could result, driving up rates in the interbank market or causing panic.

Developing Nonbank Financial Institutions

Transition economies have been slow to finalize privatization of banks in part because of the underdevelopment of other financial services. Because capital markets remain underdeveloped, insurance penetration low, and second- and third-pillar pension funds new or nonexistent, institutional investment and market development have both been limited.

On the lending side, there has been a shortage of nonbank creditors—such as specialized commercial finance, leasing, and factoring companies—which can provide loans without putting depositors at risk. Resolving legal, tax, accounting, and other issues related to these businesses could help encourage the entry of these institutions into the market in many transition economies. Similarly, improved creditors' rights and insolvency procedures would help create incentives for lending.

Governments should also encourage other nonbank financial institutions such as microfinance institutions and credit unions that offer financial products tailored to the needs of small and micro enterprises. Many of these have developed remarkably successful methodologies for savings and lending that offer financial services to the poor on a sustainable basis. Several microfinance institutions in the region have built quite large loan portfolios based on sound quality and performance standards.

These nonbank institutions often are far more appropriate for most households than the traditional state savings and agricultural banks. But there has been resistance to their formation because of the added cost for banking supervision. This view is an understandable one for supervisors, but with proper guidelines and staffing, nonbank financial institutions could play an important part in expanding financial intermediation.

Improving the Business Environment

Banks are affected by all the elements of business environment that surrounds them: the legal and regulatory framework, corporate governance, creditors' rights, auditing and accounting standards, and the judicial system. Weaknesses in these areas not only worsen the immediate situation of state banks, but also limit the prospects for growth of private banks and other financial institutions.

Therefore, it is critical that governments address the business environment as part of a broad overall strategy to strengthen the financial system. Governments should focus on developing comprehensive strategies including providing support for strengthening corporate governance, reforming judicial systems, building registries of collateral, modernizing accounting and auditing, reinforcing creditors' rights, reducing administrative barriers for business registration, and modernizing bankruptcy laws to facilitate corporate exits.

Notes

1. The government of the Czech Republic took this negotiating position when privatizing Ceska Sporitelna, requiring the purchasing bank to commit to a specified level of housing finance and venture capital as a condition for a government

guarantee on half of Ceska Sporitelna's loan portfolio. Other governments have taken similar positions when privatizing banks.

2. Examples include PKO BP of Poland (already undergoing restructuring with the objective of eventual privatization), BCR of Romania (the country's largest bank, already slated for privatization), and Sberbank and Vneshtorgbank of Russia.

Case Studies

Romania: Closing Bancorex

The story of Bancorex is one of inevitable failure.[1] The institution long served as the key financial intermediary for implementing the Romanian government's poor macroeconomic policies and sustained support for loss-making state enterprises. Those operations ultimately led to unsustainable losses and then to the bank's liquidation in 1999.

Bancorex was the largest and most troubled of the four fully state-owned banks in Romania before its closure in 1999. Accounting for about a fourth of total banking sector assets in the early to mid-1990s, the former foreign trade bank financed a significant share of Romania's energy import requirements as well as imports of capital goods. In addition, Bancorex was used by the authorities to subsidize the state-owned energy sector and the energy-intensive industrial sector, which was also controlled primarily by the state. Most of Bancorex's clients had poor prospects for repaying loans, not only because of their inefficiency and poor management practices but also because of external constraints (particularly price controls). In the wake of exchange rate and price liberalization in early 1997, the legacy of subsidized loans, years of mismanagement, and behind-the-scenes political dealings caught up with Bancorex. With heavy exposure to debtors that traditionally relied on directed credit and the highly subsidized exchange rate, the bank was clearly insolvent when the policy of directed credit was terminated and the exchange rate liberalized in 1997.

At the end of 1997 Bancorex received $600 million in government bonds (equivalent to 2 percent of GDP) to restructure its nonperforming loans. But the restructuring of Bancorex that was to accompany the recapitalization never took place. Although a new management team was appointed in April 1998 and other steps were taken, a comprehensive restructuring plan was never implemented and the bank's situation deteriorated further.

With Bancorex in crisis again in late 1998, the authorities considered restructuring measures with a view to privatizing the bank. International experience would have favored liquidation, but the authorities were concerned about the systemic risk involved. Instead, they proposed an up-front recapitalization followed by restructuring and privatization. By early 1999, however, it became clear that Bancorex was in much worse shape than expected and that privatization after recapitalization would be prohibitively costly. A recapitalization would have required up to $2 billion from the budget, or almost 6 percent of GDP.

An estimate at the end of February 1999 put Bancorex's nonperforming loans at $1.7 billion—about 85–90 percent of its loan portfolio or 5 percent of GDP (this estimate was increased as more became known about Bancorex during its closure). Most of the portfolio was in foreign currency. At the time

Bancorex accounted for a fourth of total banking system assets and 47 percent of foreign currency loans.

In April 1999 Bancorex finally collapsed in a liquidity squeeze as depositors lined up to withdraw their money. It became clear that rapid liquidation was the only solution that would avoid further runs on the bank and a systemic crisis in what was a fragile economic environment. In that same month, realizing the magnitude of Bancorex's problem, the authorities finalized a liquidation plan aimed at its orderly removal from the banking system.

The final resolution of Bancorex was completed as follows:

- After the appointment of a special administrator to replace Bancorex's management (in February 1999), all bad assets at the end of 1998 were transferred to the newly established Asset Recovery Agency for loan workout and debt recovery by July 31, 1999.
- Some deposit liabilities and most foreign debt liabilities were transferred to another state-owned bank, Romanian Commercial Bank (BCR), while a large share of the deposits were withdrawn before July 31, 1999, owing to delays in transfers. The National Bank of Romania (NBR) provided special credit to stanch the bank's financial hemorrhage. Both BCR and the NBR were compensated by government securities in corresponding currencies.
- The remainder of Bancorex was merged with BCR, which absorbed its balance sheet (the authorities viewed an actual liquidation as politically unacceptable and too lengthy a process to complete). BCR received government securities to compensate for the hole in Bancorex's balance sheet and was given the right of first refusal on any Bancorex assets transferred (on and off the balance sheet).
- The government approved the withdrawal of Bancorex's banking license on July 31, 1999 (effective August 2).
- The final absorption of Bancorex by BCR was completed in September 1999, while BCR continued to exercise its right of first refusal on the Bancorex assets (which were transferred to the Asset Recovery Agency in exchange for government securities) well into 2000. The Ministry of Finance agreed to guarantee Bancorex's more than $400 million in off–balance sheet items that were transferred to BCR.

The closure of Bancorex removed a large destabilizing element from the Romanian financial system, though at a very heavy cost to the taxpayers. And it removed some $2 billion in nonperforming assets from the banking system, helping to improve the general soundness of the system. In the process the government took on public debt amounting to $1.5 billion (net of provisions and other assets), or 4.5 percent of GDP, in 1999. To this cost should be added the 1997 recapitalization of $500 million, the assumption by the government of off–balance sheet items, and legal liabilities (the exact amount of which is still unknown).

The heavy fiscal costs associated with the liquidation and closure of Bancorex are mostly the realization of losses incurred before 1997, caused both by the use of Bancorex as a vehicle for quasi-fiscal payments and by the mismanagement of the bank. Estimates indicate that nonperforming loans amounted to about $1.5 billion before the recapitalization of 1997, and much of the off–balance sheet and legal liabilities had been incurred before then as well. Moreover, delays in the process may have increased the cost to taxpayers by as much as several hundred million dollars.

Note

1. Alexander Pankov is the author of this annex. Sources include C. James, *Banking and Financial Sectors in East and Central Europe*. Financial Times Management Reports, 1993; BankScope, Bancorex Report, 1998; IMF (2001k); and internal World Bank and IMF reports.

Case Studies

Ukraine: Liquidating Bank Ukraina

Bank Ukraina was one of the four state-owned specialized banks spun off from the Soviet All-Union banks when Ukraine gained its independence in 1991.[1] Throughout the 1990s Bank Ukraina remained one of the largest banks in Ukraine: in October 2000 it employed 16,600 people in a network of 512 branches. Bank Ukraina focused its lending activities in the agricultural sector, while the other state banks specialized in industrial lending (Prominvestbank), social programs (Ukrsotsbank), and household savings (Oschadny Bank). A fifth state bank, Ukreximbank, was formed in 1992 to process Ukraine's foreign trade payments.

All the specialized banks except Oschadny and Ukreximbank were corporatized (and thus nominally privatized) in 1992. This occurred primarily through ownership transformation, with a number of large state-owned enterprises taking substantial ownership shares in the banks that served their sectors. During the ensuing years the ownership structure of Bank Ukraina and other similarly corporatized banks became even more complicated, largely as a result of a 1993 government order requiring the transfer of all state enterprise shares in these banks to the Ministry of Finance. This prompted the banks to devise a method of transferring ownership through the distribution of shares to the employees of client enterprises and of the banks themselves. Thus ownership of Bank Ukraina and the other two former state banks became divided among tens of thousands of shareholders, most of them individuals.

Not surprisingly, the shareholders had no meaningful control over decisionmaking in these banks. Most major policy and personnel decisions were still made by top managers of the state enterprises that had been majority shareholders before the share redistribution. In the absence of a major outside entity owning a controlling stake, this meant that the state continued to exercise considerable indirect influence in the three banks' affairs. Moreover, the government exerted direct influence on decisionmaking in Bank Ukraina by retaining a residual shareholding of at least 13 percent until 1998, when it finally sold the holding for cash (the package was later alleged to be undervalued). The government appeared to manage the institution through the Ministry of Agriculture, the Ministry of Finance, and the National Bank of Ukraine. In addition, regional authorities appeared to exercise some control over regional offices. This complicated structure of governance, which effectively turned the bank into a set of regional banks operating under the same name, was harmful to the bank's financial position.

At the beginning of the transition personal links with the government appeared to be a good source of financing and profit for Bank Ukraina. Major decisions on channeling budgetary funds, financing projects, or attracting more lucrative enterprise clients were made with the agreement of government authorities.

But despite the benefits that Bank Ukraina received from the government during these years (such as free access to budgetary funds, state procurement contracts, and government guarantees for trade finance deals), by the late 1990s the bank had a large share of bad assets on its balance sheet. These were the results of poor-quality management, unmanageable liabilities, and serious external interference with the bank's daily banking operations and strategic decisions. To make matters worse, the bank's dire financial position was long obscured by inaccurate loan classification practices and low levels of loan provisioning that led to serious overestimation of assets and capital.

The continuation of government-directed loans to nonviable state-owned enterprises proved to be particularly harmful to Bank Ukraina's financial health, because most of the directed loans were never intended to be repaid. When the bank prepared a list of government-directed loans in 2000, the government formally acknowledged only 75 million hryvnias, or UAH ($13.8 million),[2] leaving UAH 433 million ($80 million) unacknowledged. Analysis of the loan portfolio also revealed highly controversial lending to shareholders of the bank, to daughter companies, and to affiliated companies.

Bank Ukraina's situation deteriorated dramatically beginning in 1998. Its share of bad loans became unsustainable even by Ukrainian standards, and the bank had to rely on central bank credits to maintain its liquidity position. A 1998 diagnostic review led by the International Monetary Fund confirmed the bank's deep insolvency. The state-protected bank came to be seen as having wasted the country's financial resources by subsidizing loss-making industries and the largely unreformed agricultural sector. In November 1998, after considering renationalizing the bank, the authorities finally put it into a rehabilitation program, and in June 1999 the National Bank of Ukraine instructed Bank Ukraina to sign a commitment letter aimed at bank recovery. But Bank Ukraina failed to meet the targets of the recovery program. Given the strong deterioration in its loan portfolio (of which about 75 percent was nonperforming by the end of 2000, or perhaps as much as 90 percent if reclassified under international accounting standards), negative liquidity, and capital erosion, the bank's financial condition was dangerous enough to threaten the entire banking system. That prompted the introduction of a provisional administration at the bank on September 25, 2000.

After extensive analysis of Bank Ukraina's situation by the World Bank in early 2001, the government came to realize that there was no alternative to immediate and orderly liquidation. Based on a balance sheet recast according to international accounting standards at the end of 2000, Bank Ukraina's capital shortfall amounted to UAH 900 million, with UAH 650 million of loan loss provisions (about 56 percent of total assets) required to cover the nonperforming loans. The analysis concluded that there was no prospect of the bank becoming commercially viable or self-sustaining, even if it were recapitalized to achieve minimum capital adequacy standards, because continued and rising nonperformance would steadily reduce the temporarily improved income stream. The government had no plans to cover the capital shortfall, and no third parties were willing to lend to Bank Ukraina or provide additional capital. There was thus no viable means by which the bank could obtain the liquidity and capital needed to continue its operations.

The analysis showed that Bank Ukraina's role as a provider of credit to Ukraine's vital agricultural sector would not be an obstacle to the bank's liquidation. First, in 1999–2000 Bank Ukraina had allocated only $25 million a year to agriculture, a negligible amount relative to the size of the sector (which has a turnover of about $8 billion a year). Second, Bank Ukraina had already ceased to allocate these credits since the appointment of the provisional administrator in late 2000. Bank

Ukraina simply did not have the resources to provide new agricultural loans.

On July 16, 2001, after three years of delays and political infighting, the National Bank of Ukraine annulled Bank Ukraina's banking license and effectively launched liquidation of the bank. In parallel, the Prosecutor General's Office launched a criminal investigation against the bank's board of directors, who were suspected of abuse of office. The liquidation procedure, prepared with technical assistance from the World Bank, is coordinated by the Agency on Bankruptcy Issues. The technical assistance focused on deposit compensation, loan workouts and debt recovery, staff retrenchment and compensation, and agricultural finance reform in the wake of Bank Ukraina's demise.

How to deal with the 1.5 million individual deposit accounts (totaling UAH 271 million, or $50.2 million) posed a special challenge to the authorities because of the potential for panic and the impact this could have on the banking system as whole. The liquidation plan entitles individual depositors to compensation from the Deposit Insurance Fund of up to UAH 500 ($92.60) per account. A small number of individual depositors whose accounts exceed this limit stand to lose substantial amounts. So do corporate depositors and Bank Ukraina's creditors (including the National Bank of Ukraine), which will have to wait for proceeds from the debt recovery process, expected to last at least two to three years.

Because the resolution process is so highly politicized, it is too early to judge the success of the long-delayed liquidation of Bank Ukraina or to estimate its final cost to the taxpayers. That cost is likely to be tens of millions of dollars. The National Bank of Ukraine alone has outstanding credit to Bank Ukraina of UAH 398 million ($73.7 million), a result of state-directed credits to agro-enterprises and liquidity support for the bank in 1996–99. It also remains to be seen how the government will handle the follow up to the Bank Ukraine liquidation. Already, vague plans have been proposed at the highest levels of government to re-create a state agricultural bank from the branch network and infrastructure left by Bank Ukraina.

Notes

1. Alexander Pankov is the primary author of this annex. Sources include World Bank mission reports; A. Roe, et al. "Ukraine: The Financial Sector and the Economy," World Bank Report, 2001; Intellinews reports; and the Ukrainian News Agency.

2. The acknowledged loans included loans to Ukraine's state-controlled energy company, NAFTA K, which was on both the list of the biggest borrowers and the list of government-directed loans. Bank Ukraina's total exposure to this company was UAH 179 million ($33.2 million).

Case Studies

Ukraine: Toward Restructuring Oschadny Bank

Oschadny Bank was formed as a specialized savings bank under the initial reforms introduced after Ukrainian independence in 1991.[1] Before that Oschadny had been part of the larger Gosbank system, as a traditional state savings bank specializing in deposit safekeeping, pension payments, transfers, utility payments, and other retail services. In contrast to the three other remnants of the Gosbank system (Bank Ukraina, Prominvestbank, and Ukrsotsbank), which were at least nominally privatized in the early 1990s, Oschadny remains fully state owned.

Although small by international standards, Oschadny is one of the largest banks in Ukraine. In late 2000, in addition to headquarters (in two buildings), Oschadny had 26 full-service regional offices, 450 branches (full-service district offices), 7,847 outlets, and 24 agencies. And it had 38,015 staff (35,227 on a full-time-equivalent basis). In many rural areas the bank is the only formal financial institution providing basic payment services and deposit safekeeping. The leading institution in mobilizing household deposits, mainly in local currency, Oschadny holds about 25–30 percent of the household deposits in the banking system. Nonetheless, general monetary patterns indicate that Oschadny holds only 9.8 percent of total deposits, suggesting that most enterprise and foreign currency deposits are placed with other banks (or held outside the banking system).

Thus Oschadny's aggregate deposit holdings are not so significant that a major change in its operations and status would be likely to destabilize Ukraine's financial markets. Household deposits in Ukraine totaled only about $330 million in late 2000, small for a country of 50 million people. Thus while Oschadny is perceived as large in Ukraine, its significance in aggregate intermediation is small, reflecting the low level of banking and financial intermediation in the economy.

Like other state and quasi-state banks, Oschadny's financial situation deteriorated in the late 1990s. The deterioration resulted from the lack of restructuring earlier in the decade as well as management and operating practices common to government-controlled banks in Ukraine that have proved to be financially unsustainable. The bank has a very large branch network, large staff, and high operating costs. Government-directed lending has weakened the bank's portfolio, reduced earning assets. And the bank has been slow to upgrade its management and information technology systems to lower costs—and slow to enforce central policies in its regional offices.

Oschadny suffered after-tax losses of $22 million in 2000. Moreover, these and other cumulative losses from earlier years (as well as since 2000) may be understated as a result of questionable loan classification standards and overvalued collateral. There is a risk that Oschadny's financial condition may worsen because of its aggressive efforts to increase

lending as a way to grow out of its problems. Oschadny was appointed by the government in mid-2000 as the authorized bank to service the clearing accounts of electricity utility companies and their branches. Oschadny performed this well until October 2001, and the potential losses from these operations and from the incremental lending remain to be seen.

Whether Oschadny's performance issues can be solved depends largely on the willingness of Ukrainian authorities to take decisive action. The bank's central place in Ukraine's social fabric makes privatization or liquidation an unlikely solution in the foreseeable future. To reverse current losses, the bank's management has pursued a cost reduction strategy, releasing staff and closing some nonviable offices (148 branches and 2,933 operational offices from January 1, 1998, to December 31, 2000). However, it remains questionable whether Oschadny can become competitive without significant financial assistance from the government. Preliminary estimates in early 2001 indicated that Oschadny would need to reduce its costs by about 40 percent to achieve breakeven.

At a minimum, safeguards need to be put into place to ensure that decisionmaking is grounded in commercial principles. During the restructuring, any "social" or "governmental" activity should be off–balance sheet and subject to commercial pricing. Any lending or investment should be explicitly guaranteed (in documented form) so that Oschadny assumes no risk.

There is a risk that the government, to avoid the social consequences of closure and liquidation, will permit Oschadny to seek to grow out of its problems by attempting to leapfrog from specialized savings bank to full-service universal bank. That would be an extremely high-risk strategy given the bank's weak financial condition and limited institutional capacity. Under the circumstances Oschadny would be almost certain to assume more risk than is prudent so as to generate high earnings and fund its accumulated losses.

Even with intensive government efforts, the bank's restructuring is likely to be costly and time-consuming. It is also likely to be complex, because of the weak information on its extensive branch network, the need for a more modern personnel management system, and the retrenchment needed to reduce its costs.

Note

1. Alexander Pankov is the primary author of this annex. Sources include World Bank mission reports; A. Roe, et al. "Ukraine: The Financial Sector and the Economy," World Bank Report, 2001; and the Ukrainian News Agency.

Case Studies

Czech Republic: Privatizing Ceska Sporitelna

In 2000 the Czech government sold Ceska Sporitelna, the state savings bank and the country's second largest bank, to Erste Bank of Austria.[1] The sale brought to a close one of the government's lengthiest and most difficult bank privatizations. It also helped pave the way for the privatization the following year of the Czech Republic's largest remaining state-owned bank, Komercni Bank. But the sale of Ceska Sporitelna came at great expense to the government. The transaction followed several years of consolidation and restructuring that culminated in a massive government bailout during the final year before the sale. The government strategy proved far more costly than originally expected and probably far more costly than it would have been had privatization been pursued more vigorously at an earlier stage.

First Phase of Privatization

Founded in 1825, Ceska Sporitelna was the state savings bank during the socialist era and remains the largest retail bank in the Czech Republic. In 2000 it had $12 billion in assets, a 34 percent market share in retail savings, and a network of 934 branches. As part of the Czech government's financial sector restructuring during the mid-1990s, Ceska Sporitelna was included in the first wave of Czech privatization programs.

Recognizing that the commercial banks created from the monobank system inherited large stocks of nonperforming loans from the central planning era, the government developed a two-stage program to financially restructure and then privatize the new banks.[2] A total of 37 percent of Ceska Sporitelna's shares were offered for vouchers and 20 percent were sold to towns and municipalities, while 40 percent were retained by the state. The government also pursued this policy for its other three major state-owned banks—Komercni, Investicni, and Obchodni—which together with Ceska Sporitelna accounted for 62 percent of banking system assets in 1995. By the end of 1995 the state had divested 47–63 percent of these four banks through vouchers, with the state-owned National Property Fund retaining the largest block. While not fully privatized, the banks were effectively "corporatized," and full privatization was expected to occur after additional restructuring and as accession to the European Union neared.

Acceleration of the Process: Toward a Strategic Investor

Despite these measures, Ceska Sporitelna languished in its quasi-privatized status until mid-1999, when the government began to speed up its planned sale of a majority stake in the bank. In the meantime the bank's prospects had been hurt by poor lending decisions that had increased its nonperforming loans. By mid-1999 the bank was expected to lose $389 million—the equivalent of more than half its

capital. According to reports at the time, the bank needed to cover the loss by writing off part of its capital, which would reduce its capital adequacy ratio to below the legal minimum set by the Czech National Bank. The state was forced to intervene by recapitalizing Ceska Sporitelna, increasing its incentive to privatize the bank.[3]

Although several foreign banks expressed an interest in Ceska Sporitelna, the government felt that some of their offers put insufficient value on the bank's franchise. Rather than launching a formal tender, the government entered exclusive negotiations with Erste. Although Erste raised its bid, in the end it paid only about 1.55 times book value for Ceska Sporitelna.[4] Moreover, the state was forced to make significant concessions. In particular, it gave Erste Bank five-year guarantees on about half of Ceska Sporitelna's loans. Before the sale the state had already assumed about $1.1 billion of Ceska Sporitelna's nonperforming loans and increased the bank's share capital by $201 million to bolster its attractiveness to foreign buyers.

The state had a strong interest in privatizing Ceska Sporitelna. Most important, doing so rid the state of responsibility for the bank's losses before its market position slipped further, reducing its appeal to a strategic investor. And in completing the transaction the government divested one of its last two major state-owned banks—a hurdle that had stood in the way of EU accession.

Ceska Sporitelna poses challenges for its new owner because it historically was a loss-maker and and it will need a strategy for dealing with its more than 16,000 employees and large branch network. Erste Bank took on the bank primarily because it has long-term interests in the region and was keen to establish a foothold in the Czech market.[5] It was also attracted by the potential for cost savings through a rationalization of operations. Both Erste and Ceska Sporitelna are retail banks offering a similar range of products, including investment funds, leasing, and insurance. In closing the deal, Erste also committed itself to a major capital increase at Ceska Sporitelna, setting aside $571 million for housing and small business programs and providing an additional $29 million for venture capital.[6]

The Ceska Sporitelna privatization offered important lessons for the government as it pursued its last major bank privatization the following year, for Komercni Bank. Like Ceska Sporitelna, Komercni Bank suffered huge losses from nonperforming loans and required two massive government bailouts. Many potential bidders were uninterested in Ceska Sporitelna because details of the bailout were unclear, and as a result the government entered a bidding process with only one major bidder. It proceeded with the Komercni privatization with those lessons in mind.

Notes

1. Sources include Borish, Ding, and Noël (1996); Economist Intelligence Unit country reports for 1999 and 2000; and U.S. Department of Commerce, National Trade Data Bank, November 3, 2000.
2. Borish, Ding, and Noël 1996.
3. Economist Intelligence Unit country reports for 1999 and 2000.
4. Economist Intelligence Unit country reports for 1999 and 2000.
5. Economist Intelligence Unit country reports for 1999 and 2000.
6. U.S. Department of Commerce, National Trade Data Bank, November 3, 2000.

Case Studies

Russian Federation: Holding onto Sberbank

Sberbank is by far the largest bank in Russia.[1] The state savings bank has more than $20 billion in assets, nearly 200,000 employees, and 21,000 branches, a larger network than any other bank. It has a virtual monopoly of the county's deposits, with an estimated three-quarters of retail ruble deposits in 2000 and 50 percent of foreign currency deposits in late 2001.

Recent indicators show that Sberbank controls about 23 percent of banking system assets. In addition, its share of total bank loans has grown rapidly since Russia's 1998 financial crisis, increasing from 12 percent in 1998 to more than 25 percent in 2000. In some regions it accounts for up to 75 percent of commercial lending.

The Role of Sberbank in the Early 1990s

During the past decade Sberbank has continued to play the role of a traditional state savings bank despite the many rapid changes in the banking sector. Sberbank was created as a joint stock company in 1991 when the government broke up the two-tier banking system, consisting of Gosbank (the central bank) and the five specialized banks that had existed in the Soviet Union since 1987. Allowing private banks to exist for the first time, this reform led to the creation of some 800 new banks, which took the capital of the previous state banks. Sberbank was the largest of these banks and one of the first to be "privatized," with the Central Bank of the Russian Federation becoming its major shareholder.

Sberbank's Role Since the 1998 Financial Crisis

The dominance of state banks in Russia, already high, has been increasing since the financial crisis in 1998. Sberbank emerged from the crisis with a stronger market position than ever before. While thousands of people lost their savings with the collapse of some of Russia's leading banks, including Inkombank and SBS-Agro, Sberbank benefited from a government retail depositor protection scheme that encouraged depositors to transfer their deposits to Sberbank. That helped strengthen Sberbank's public image as a secure financial institution and reinforced the perception that it was "too big to fail."

The 1998 crisis also led to a shift in some of the bank's operations. Before the crisis Sberbank had invested most of its assets in government securities. Since the crisis it has aggressively expanded its lending to the corporate sector. The bank has established itself as the dominant source of loans to large Russian corporations in the trade, chemicals, construction, and oil and gas sectors and to state and municipal bodies.

The Future of State Banking in Russia

Sberbank's continuing dominance in part reflects the slowness of the government to address some policy issues that affect the development of the financial sector. Sberbank has several advantages: a large branch network with a broad geographic distribution, the perceived state guarantee on deposits, a strong internal payment system, and a key role in distributing state pension payments. But its dominant position in the sector comes at a significant cost to the banking system as it can limit competition. Moreover, the government's involvement in Sberbank represents a conflict of interest: the Central Bank is not only the owner of the country's largest bank, but also the supervisor of the banking system and the state authority responsible for monetary policy.

The Russian government's involvement in the banking sector is not limited to Sberbank. A recent study commissioned by the government revealed that state organizations hold stakes in more than 469 banks throughout the country. While most of the stakes are small, the state has blocking shares in 45 banks. The government has announced plans to divest ownership in all banks where the public share is less than 25 percent. While this would dramatically reduce the number of state-owned banks, it would still leave Sberbank—and several large state-owned banks—in the hands of the state.

Note

1. Sources include Fuchs (2002); Aslund and Layard (1993); Sberbank (2000); and Builov (2002).

Case Studies

Latvia: Restructuring and Privatizing Unibanka

Unibanka is a rare success story in the transition economies.[1] While the bank initially engaged in activities that undermined the quality of its loan portfolio and put bank capital at risk, it was successfully restructured and, as a result, able to withstand systemic weaknesses in the mid-1990s and to attract strategic investment in the second half of the decade.

The history of Unibanka is at the heart of the transformation of Latvian banking from its monobank roots to the current two-tier system. Following the breakup of the Soviet Union, Latvia found itself in much the same position as the other newly independent countries. It inherited branches of the specialized Soviet banks: the Savings Bank (Latvijas Krajbanka), the Agricultural Bank, the Industry and Construction Bank, the Housing and Social Development Bank, and the Foreign Trade Bank. In addition to inheriting large nonperforming loan portfolios and management unused to lending along commercial lines, the branches were suddenly cut off from their former head offices. Moreover, the banks found that the authorities in Moscow were unwilling to pass on the assets needed to cover a substantial portion of their liabilities.

While most of the other newly independent countries converted the branches they inherited directly into nationally owned specialized banks corresponding to the old Soviet banks, the Latvian government placed all the branches of the specialized banks (except for those of the Savings Bank) under the direct supervision of the Bank of Latvia (the central bank). These branches dominated the credit business, since the Savings Bank initially did not make loans to enterprises. As a result, at the end of 1991 the 45 branches controlled 83 percent of all credit to business and held three-quarters of the demand deposits of enterprises.

This strategy allowed the Latvian government a wider range of options than those available to its Baltic neighbors, which generally kept the specialized banks separate. The government could sell the branches to the emerging private sector, privatize them individually or in groups, or structure one or more state banks. But the strategy also gave the Bank of Latvia a great deal of responsibility at a time that the sector and the central bank were both undergoing dramatic transformation. In practice, the Bank of Latvia neither actively promoted governance nor encouraged the branch managers to run the banks according to strict commercial criteria. The managers, who had little experience in commercial banking and little loyalty to their new managers at the Bank of Latvia, therefore found themselves with a great deal of discretionary power during extremely difficult external conditions. As a result of all this, the branches developed large volumes of nonperforming loans.

By 1993 the government settled on a strategy for dealing with the remnants of the state banking sector, using a combination of the three approaches mentioned above. It decided

to keep the Savings Bank in the public sector while providing considerable institutional development support and bringing in new management, and then eventually privatizing the bank. The government dealt with the main remnant of the banking system in three ways. First, it sold 9 branches to private commercial banks. Second, it consolidated 15 of the branches into 8 new private commercial banks. Finally, on September 28, 1993, it structured the rump of 21 branches into one state bank—the Universal Bank of Latvia, or Unibanka. Most of the bad loans (40 percent of total assets in March 1994) were concentrated in these branches.

Unibanka was subjected to intense institutional development efforts supported by the World Bank, the government of Switzerland, and the European Union. As part of the rehabilitation process, the bad loans Unibanka had inherited were taken off its books and replaced with seven-year government bonds in the amount of 25 million lats (LVL), or about $50 million. As a result of rapid growth in the credit provided by private banks, Unibanka accounted for only 7 percent of total credit by the end of 1994. But it was the country's second largest bank in terms of assets.

One of the main reasons cited by the government for creating Unibanka was to provide an insurance policy against catastrophic failures in the private banking sector. This logic was put to a serious test in the first half of 1995, when the insolvency of the country's largest bank (Bank Baltija) triggered a systemic crisis in which about 40 percent of the assets and liabilities of the banking sector were lost and 7 banks, including 3 of the 10 largest banks, collapsed. Although the crisis had a big effect on both Unibanka and the Savings Bank, neither was directly involved and neither needed to be closed or bailed out.

Unibanka, already healthier than the Savings Bank, was less badly harmed. Since most of the deposits in the failed banks were individual deposits, people probably lost confidence in the sector. That loss of confidence spread to the Savings Bank, which held primarily individual deposits. Between December 1994 and December 1995 individual deposits in the Savings Bank fell by almost 17 percent (in real terms), and total deposits by 13 percent. At the same time individual deposits in Unibanka increased by 16 percent, and total deposits by nearly 30 percent. (Meanwhile, Unibanka's assets increased by 33 percent in real terms, and its profits by 77 percent.) It appears that Unibanka benefited (and the Savings Bank suffered) from a flight to quality following the crisis as depositors reallocated assets toward banks that appeared better managed, better capitalized, and less risky. In surveys, Latvian banking professionals consistently rated Unibanka as the safest bank in Latvia.

In accordance with the government's decision, privatization procedures were launched at Unibanka on October 3, 1995. The board of the Latvian privatization agency approved basic privatization regulations providing that Unibanka would be privatized in four years. In the first stage, carried out in 1995, share capital was increased to LVL 11.5 million (about $23 million) and then a little over 50 percent of the shares were sold for privatization certificates. Of this 50 percent, 22 percent were sold publicly, 13.5 percent were sold to customers of Unibanka, and 14.5 percent were sold to employees. The privatization agency held the remaining shares. In October 1995 the bank's shareholders decided to reorganize the bank into a joint stock company, Latvijas Unibanka, and a new charter was approved for the bank. And in January 1996 Unibanka became the first company to list on the Riga stock exchange.

The bank's privatization regulations called for increasing its share capital during the next privatization round by attracting capital from a strategic investor. In May 1996 Unibanka's share capital was raised by LVL 6 million (about $12 million), and the newly issued shares were

purchased by the European Bank for Reconstruction and Development (EBRD) and Swedfund International AB. The EBRD gained control of about 22.6 percent of the total shares and Swedfund control of about 7.5 percent. Over the next three years most of the remaining state-owned shares were sold in the international market through a global depository receipt program, and part were sold through special auctions at the Riga stock exchange. By the time privatization was complete in late 1999, the state had received LVL 66.1 million (about $113.4 million)—LVL 21.3 million in cash and LVL 44.8 million in privatization vouchers.

By September 2001 Unibanka's paid-up share capital amounted to LVL 37.1 million ($59.9 million). More than 98 percent belongs to the Swedish bank Skandinaviska Enskilda Banken (SEB). A major force in the banking sector consolidation in the Baltics, SEB initially purchased a 23 percent interest in Unibanka at a special auction held in the stock market in late 1998. It then steadily purchased shares from the other bank's shareholders, including the EBRD. By early 2001 Unibanka's shares were no longer quoted at the Riga stock exchange.

Today Unibanka is the second largest bank in Latvia and the fifth largest in the Baltics (in terms of assets). As a universal bank, it provides a wide range of commercial and retail services, concentrating on the domestic market, where it has a solid franchise. SEB has helped Unibanka improve risk management and retail operations and implement credit controls. The bank's performance since the completion of privatization has been very satisfactory, and positive economic forecasts for Latvia bode well for future growth in its operations.

Note

1. Alex Pankov is the author of this annex. Sources include Fleming and Talley (1996); Fitch Credit Agency, Unibanka Rating Report, 2000; BankScope reports on Unibanka for 1999–2001; and the Baltic News Service.

Case Studies

Azerbaijan: Committing to Privatization of the International Bank of Azerbaijan

The Azeri banking system, a two-tier system established 10 years ago, remains at a critical stage of development.[1] While the government of Azerbaijan has made good progress in stabilizing the economy since 1995, its efforts to address structural issues in the financial sector have had mixed results. The government has made some advances in upgrading prudential regulations for banks, strengthening off-site supervision, and regulating foreign exchange markets. But the banking sector still suffers from poor management, weak governance, limited technology, problem loans, and insufficient capital. It is estimated that only 10–20 percent of the money in circulation passes through the banking system.

Tackling the issue of state-owned banks has proved to be one of the government's most complex tasks. Despite attempts since 1996 to recapitalize, restructure, and privatize state-owned banks, state ownership in the banking sector remains high, dominated by the International Bank of Azerbaijan (IBA). This bank was left with a near monopoly when the government consolidated its three other troubled state-owned banks into a single entity in 2000. While this step marked significant progress in reducing public ownership, the banking system remains highly concentrated and underdeveloped.

Consolidation of Three State Banks

Throughout the government's reform efforts during the mid-1990s, some of the biggest loss-makers in the sector were state-owned banks, including Amanat (the savings bank), Prominvest (the industrial investment bank), and Agroprom (the agro-industrial bank). Nonperforming loans were particularly problematic at Agroprom and Prominvest, accounting for more than 90 percent of their portfolios. By late 1999, after consecutive recapitalizations of these three banks had failed to improve performance, the government recognized that it needed to take more radical measures.

As a first step, in February 2000 the government merged the viable operations of the three banks into a new bank, the United State Industrial Bank (later renamed United Universal Bank). The government issued the entity a limited license that allowed it only to collect deposits, perform foreign exchange activities, invest in government securities, and provide cash payment services for the Social Protection

and Pension Funds and other budget entities. The terms of the license prohibited the bank from engaging in lending for two years, so that it will in effect operate as a narrow bank.

The government plans to develop the operational structure of United Universal and establish an effective lending capacity. The aim is to strengthen the bank and improve its efficiency, creating the conditions for its eventual privatization through the sale of a controlling share to a strategic investor.

Continued Dominance of the Banking Sector by the International Bank of Azerbaijan

With the decision to create United Universal, the government solidified IBA's position as the country's leading and best capitalized bank. IBA has 75 percent of banking sector assets and 40 percent of retail deposits. In 2000 its assets stood at $614 million, and its loan portfolio grew by 22 percent. The bank has close links to many government departments and state organizations, including the important Oil Fund, and acts as an intermediary for government-guaranteed credit lines to Azerbaijan.

IBA was established in 1990 as a replacement for the Azerbaijan branch of Vnesheconombank, the former Soviet foreign trade bank. In keeping with its origins, its foreign trade operations are well established. But IBA also accepts deposits from and issues loans to Azeri firms. And it is steadily increasing its retail operations. The bank has about 700 employees and 32 branches, a relatively large network given the country's small size.

Toward Privatization

In 2001 the government reiterated its commitment to privatizing IBA and issued a presidential decree to that effect. The Ministry of Finance owns 50.2 percent of the bank's shares. The EBRD, which has been providing support for IBA in the form of a credit line targeted to small and medium-size enterprises, has indicated an interest in taking on a 20 percent equity stake. The remaining state shares are expected to be auctioned later.

IBA, despite its dominance of the banking sector, faces many governance and management problems and is plagued by inefficiency. It showed weak profitability in 2000, with after-tax earnings of only $9 million. The slight increase in profit that the bank did see was due primarily to the net interest income earned on the placement of funds of the Azeri Oil Fund, revenues that were not expected to recur in 2001.

While the government's recent moves related to IBA and United Universal represent progress, privatization is only one element of the financial sector reforms needed. The broader challenge is to make banks more central to economic activity in Azerbaijan—mobilizing deposits, lending to businesses, and offering a greater array of services.

Note

1. Sources include internal World Bank documents from 1999–2000; BankScope (Fitch IBCA); Economist Intelligence Unit country reports; and EBRD Transition Reports.

Annexes

Annex I
Financial Profile of Selected State Banks

(millions of U.S. dollars except where otherwise specified)

Country/Banks	Assets	Loans	Deposits	Capital	Net income	Number of employees
Albania						
Savings Bank	1,230	10	1,176	33	26	—
Armenia						
Armenian Savings Bank	9	3	9	0	0	—
Azerbaijan						
International Bank of Azerbaijan	615	184	474	19	9	—
United Universal Bank	38	0	11	5	1	2,590
Belarus						
Belpromstroibank	299	149	239	44	5	5,192
Belagroprombank	283	220	153	113	5	7,267
Belbusinessbank	150	79	117	11	2	—
Belgazprombank	35	5	21	11	0	419
Belarusbank Savings Bank	779	579	622	108	–2	—
Belvnesheconombank	201	73	179	19	0	2,126
Bosnia and Herzegovina[a]						
Federation Investment Bank	62	25	—	59	—	—
Banjalucka Banka	42	19	27	10	—	—
Privredna Banka (PBS) Sarajevo	34	9	24	5	—	—
Central Profit	162	47	115	29	1	—
Gospodarska Mostar	24	8	19	3	0	82
Bulgaria						
DSK Bank	588	271	492	79	8	5,697
Commercial Bank Biochim	248	72	223	23	5	—
Central Cooperative	95	86	67	13	0	—
Croatia						
Dubrovacka Banka	401	153	231	14	–12	567
Croatia Banka	159	82	102	15	–11	—
Splitska Banka	997	462	884	67	6	1,070
Croatian Bank for Reconstruction & Development	693	298	223	397	11	—
Hrvatska Postanska Bank	222	114	164	28	–21	172
Riadria Banka	172	65	128	26	–5	—
Czech Republic						
Komercni Banka	11,000	3,000	9,000	1,000	12	—
Ceska Exportni Banka	631	17	153	51	2	—
Ceskomoravka Zarucni a Rozvojavo Banka	1,126	681	762	93	2	—
Estonia No state banks left						
Georgia No state banks left						
Hungary						
Postbank and Savings Bank Corp.	1,193	400	986	148	3	—
Hungarian Development Bank	738	199	328	356	–20	—
Kazakhstan						
Halyk Savings Bank	707	342	616	48	–2	—
Eximbank	71	43	32	28	–4	—
Kyrgyz Republic						
Kairat Bank	7	0	5	1	1	—
Savings and Settlement Company	5	0	3	1	0	—
Energo Bank	6	2	5	1	0	—
Latvia						
Mortgage and Land Bank of Latvia	123	87	59	13	1	—
Latvian Savings Bank	246	62	222	8	1	1,234
Lithuania						
Lithuanian Savings Bank	830	238	711	55	–8	3,586
Agricultural Bank of Lithuania	417	201	322	32	2	1,769
Macedonia, FYR						
Macedonian Development Bank	—	14	—	14	0	—

Annex 1 *(continued)*
Financial Profile of Selected State Banks
(millions of U.S. dollars except where otherwise specified)

Country/Banks	Assets	Loans	Deposits	Capital	Net income	Number of employees
Moldova						
Banca de Economii	35	13	25	4	3	—
Poland						
Powszechna Kasa Oszczednosci BP	16,627	6,872	15,129	594	153	—
Bank Gospodarki Zywnosciowej	4,408	2,033	3,776	214	24	—
Romania						
Banca Comerciala Romana	2,769	754	1,874	539	117	—
Savings Bank (CEC)	880	56	750	110	26	12,832
EXIM Bank 203	29	35	28	–2	—	
Banca Agricola	448	313	471	26	–85	5,837
Russian Federation						
Sberbank	20,000	9,000	18,000	1,000	403	197,122
Vneshtorgbank	4,414	962	2,704	1,599	170	3,669
Vneschekonombank	2,599	272	2,415	119	1	1,465
Russian Development Bank	168	—	37	131	1	105
Rosselkhozbank	—	—	—	—	—	—
Moscow Municipal Bank	1,525	848	1,348	85	1	—
Bahkir Republic Investment Bank	610	330	485	112	1	—
Slovak Republic						
Vseobecna Uverova Banka	3,887	1,873	2,722	278	67	—
Investicna a Rozvojva Banka	509	365	472	23	8	1,073
First Building Savings Bank–Prva Stavebna Sporitelna	834	463	643	51	16	449
Slovak Guarantee and Development Bank	140	2	21	103	6	93
Banka Slovakia	81	19	64	15	0	—
Slovenia						
Nova Ljubljanska Banka	5,051	2,633	4,289	429	52	4,271
Nova Kreditna Banka Maribor	1,563	674	1,344	158	28	—
Posta Banka Slovenija	259	108	223	11	0	209
SKB Banka DD	1,353	742	1,142	121	2	—
Slovene Export Corporation	182	2	31	73	1	—
Slovenska Investijska Banka	133	82	101	10	0	—
Tajikistan						
Savings Bank (Sberbank)	9	3	8	0	0	—
Turkmenistan[b]						
Vneshekonombank	2,075	1,803	434	21	3	341
Uzbekistan						
Uzbek State Joint Stock Housing Savings Bank	142	68	101	36	2	—
Asaka Bank	247	149	108	138	2	—
Uzbek Joint Stock–Commercial Industrial Construction Bank	435	245	338	55	2	—
National Bank for Foreign Economy Activity of Republic of Uzbekistan	3,913	2,227	2,071	662	2	—
Ukraine						
Savings Bank	390	98	333	28	–22	—
Export-Import Bank	400	224	245	32	10	2,239
Yugoslavia						
Jugobanka Bor	241	133	103	7	0	—
Beobanka Belgrade	489	137	668	–263	–500	4,124
Invest Banka	1,541	919	416	68	–181	—
Jugobanka Beograd	1,826	1,392	171	95	—	—
Beogradska Banka	2,018	1,804	322	209	—	—
Vojvodjanska Banka	560	324	176	93	0	3,215

— Not available.
a. No data available for PBS Srpska Sarajevo, PBS Doboj, PBS Prijedor, PBS Gradiska, PBS Brcko, UNA Bihac, Sipad, Postanska, Ljubljanska, Semberska, Postanska sed., Kristal, Rosvojna, and Agroprom.
b. No data available for Sberbank, Turkmenistanbank, Turkmenbashibank, and Daykhanbank.
Source: IMF; BankScope; Bulgarian National Bank; authors' calculations.

Annex 2
Financial Profile of Selected State Banks
(percent)

Country/Banks	Loan loss reserve/ gross loans	Equity/ total assets	Net interest margin	Return on assets	Return on equity	Net loans/ total assets	Liquid assets/ short-term funding
Albania							
Savings Bank	88.3	2.7	3.6	2.2	—	0.8	100.7
Armenia							
Armenian Savings Bank	—	0.0	0.3	–0.0	–1.2	0.3	0.1
Azerbaijan							
International Bank of Azerbaijan	12.5	3.0	3.7	2.1	62.1	29.9	80.2
United Universal Bank							
Belarus							
Belpromstroibank	11.4	14.8	18.8	2.2	18.5	50.0	39.3
Belagroprombank	—	39.8	22.3	2.5	6.0	77.8	11.4
Belbusinessbank	—	24.9	24.1	2.9	14.4	46.9	43.8
Belgazprombank	—	31.5	13.7	0.8	2.4	14.2	102.6
Belarusbank Savings Bank	—	13.9	11.0	–0.5	–3.1	74.4	19.1
Belvnesheconombank	17.6	9.3	11.0	0.1	1.4	36.4	48.4
Bosnia and Herzegovina[a]							
Federation Investment Bank	45.3	94.5	4.5	2.5	2.6	39.6	—
Banjalucka Banka	22.0	24.1	2.0	0.5	7.1	44.2	38.7
Privredna Banka Sarajevo	45.8	14.8	9.9	0.5	2.9	25.7	45.7
Central Profit	5.7	17.6	5.8	0.1	0.3	29.2	66.4
Gospodarska Mostar	15.1	13.1	6.1	1.7	11.9	31.7	81.7
Bulgaria							
DSK Bank	5.5	13.4	8.4	1.4	10.2	46.2	26.3
Commercial Bank Biochim	32.7	9.2	7.5	2.2	29.1	29.0	68.9
Central Cooperative	—	—	—	—	—	—	—
Croatia							
Dubrovacka Banka	20.6	3.6	1.5	–2.8	–59.5	38.2	25.1
Croatia Banka	43.4	9.6	3.3	–6.0	–53.7	51.4	39.9
Splitska Banka	10.4	6.8	4.1	0.6	9.7	46.4	26.8
Croatian Bank for Reconstruction & Development	16.3	57.3	5.0	1.7	2.8	43.0	63.4
Hrvatska Postanska Bank	11.7	12.6	2.6	–9.2	–55.0	51.4	40.5
Riadria Banka	—	15.3	6.0	–3.1	–17.7	37.6	16.5
Czech Republic							
Komercni Banka	14.0	5.2	3.7	–0.1	–1.1	31.1	44.9
Ceska Exportni Banka	—	8.0	5.2	0.3	3.0	11.2	8.7
Ceskomoravka Zarucni a Rozvojavo Banka	5.7	8.2	0.5	1.8	17.3	60.4	9.6
Estonia No state banks left							
Georgia No state banks left							
Hungary							
Postbank and Savings Bank Corp.	5.4	12.4	5.1	0.3	2.2	33.5	43.2
Hungarian Development Bank	5.2	48.3	1.8	–3.0	–7.7	26.9	0.0
Kazakhstan							
Halyk Savings Bank	4.1	6.7	6.0	–0.3	–3.7	48.3	44.8
Eximbank	—	45.4	7.6	–6.9	–14.5	69.9	14.9
Kyrgyz Republic							
Kairat Bank	2.0	52.0	—	–11.5	–86.0	0.0	25.0
Savings and Settlement Company	0.0	19.0	—	0.9	4.4	0.2	115.0
Energo Bank	11.1	12.0	1.6	0.2	1.5	36.0	64.0
Latvia							
Mortgage and Land Bank of Latvia	2.6	10.9	7.6	1.1	8.9	70.7	12.5
Latvian Savings Bank	4.5	3.3	5.6	0.6	17.8	25.4	8.3
Lithuania							
Lithuanian Savings Bank	2.1	6.7	5.2	–1.0	–13.6	28.6	28.7
Agricultural Bank of Lithuania	2.8	7.7	5.3	0.5	5.9	48.2	22.6
Macedonia, FYR							
Macedonian Bank for Development Promotion	—	100.0	6.7	3.2	3.2	—	—

Annex 2 *(continued)*

Financial Profile of Selected State Banks

(percent)

Country/Banks	Loan loss reserve/ gross loans	Equity/ total assets	Net interest margin	Return on assets	Return on equity	Net loans/ total assets	Liquid assets/ short-term funding
Moldova							
Banca de Economii	5.5	12.2	—	11.5	132.8	36.2	49.7
Poland							
Powszechna Kasa Oszczednosci Bank Polski SA	4.8	3.6	5.7	1.0	29.6	41.3	5.4
Bank Gospodarki Zywnosciowej	—	4.8	5.2	0.6	12.0	46.1	6.9
Romania							
Banca Comerciala Romana	—	19.5	10.3	3.6	20.1	27.2	47.4
Savings Bank (CEC)	0.8	16.5	13.6	2.7	17.6	5.8	28.1
EXIM Bank	—	13.7	8.0	–0.9	–7.0	14.2	99.1
Banca Agricola	13.7	–12.4	–9.3	22.2	—	12.6	41.9
Russian Federation							
Sberbank	12.0	7.6	9.5	2.2	29.9	44.0	48.3
Vneshtorgbank	18.2	36.2	6.0	4.7	15.0	21.8	115.1
Vneschekonombank	10.2	4.6	6.3	0.4	8.8	10.5	87.2
Russian Development Bank	—	78.2	17.8	0.5	0.7	—	450.0
Rosselkhozbank	—	—	—	—	—	—	—
Moscow Municipal Bank	2.3	5.6	0.3	1.0	16.1	55.6	40.6
Bahkir Republic Investment Bank	12.3	18.3	13.5	10.3	78.7	54.0	37.0
Slovak Republic							
Vseobecna Uverova Banka	13.9	8.6	2.9	2.2	27.2	58.0	32.9
Investicna a Rozvojva Banka	—	4.4	0.9	1.6	43.5	71.7	18.7
First Building Savings Bank– Prva Stavebna Sporitelna	—	6.1	1.5	2.0	35.2	55.4	12.9
Slovak Guarantee and Development Bank	—	73.7	8.6	5.0	6.6	1.3	522.9
Banka Slovakia	7.2	19.6	3.2	0.7	3.3	23.4	72.8
Slovenia							
Nova Ljubljanska Banka	6.8	8.5	4.7	1.1	13.1	52.1	13.1
Nova Kreditna Banka Maribor	—	10.1	6.8	1.9	19.4	43.1	14.0
Posta Banka Slovenija	—	4.4	4.6	0.1	2.0	41.5	18.1
SKB Banka DD	—	9.0	4.6	0.2	1.7	54.8	18.4
Slovene Export Corporation	36.7	40.3	2.2	0.4	0.9	1.0	479.4
Slovenska Investijska Banka	—	7.6	2.1	0.3	4.0	61.4	14.4
Tajikistan							
Sberbank	—	0.5	—	0.5	95.0	37.0	20.0
Turkmenistan[b]							
Vneshekonombank	2.3	1.0	0.6	0.2	15.5	86.9	48.8
Ukraine							
Savings Bank	—	7.1	—	—	—	25.2	—
Export-Import Bank	27.3	8.1	7.9	2.6	34.6	55.9	—
Uzbekistan							
Uzbek State Joint Stock Housing Savings Bank	6.0	25.6	19.5	2.1	8.8	47.7	42.3
Asaka Bank	4.8	55.8	7.6	33.4	69.7	60.4	63.7
Uzbek Joint Stock–Commercial Industrial Construction Bank	3.9	12.8	4.7	1.8	13.9	56.4	36.7
National Bank for Foreign Economy Activity of Republic of Uzbekistan	1.8	16.9	2.8	0.7	4.3	56.9	62.9
Yugoslavia							
Jugobanka Bor	3.1	2.8	—	0.0	0.3	54.7	—
Beobanka Belgrade	49.2	–80.9	—	—	—	28.0	—
Invest Banka	15.2	–6.3	—	—	—	59.6	—
Jugobanka Beograd	1.6	3.9	—	—	—	76.2	—
Beogradska Banka	5.4	5.3	—	0.1	0.9	89.4	—
Vojvodjanska Banka	0.0	16.6	—	—	—	57.9	—

— Not available.

a. No data available for PBS Srpska Sarajevo, PBS Doboj, PBS Prijedor, PBS Gradiska, PBS Brcko, UNA Bihac, Sipad, Postanska, Ljubljanska, Semberska, Postanska sed., Kristal, Rosvojna, and Agroprom.

b. No data available for Sberbank, Turkmenistanbank, Turkmenbashibank, and Daykhanbank.

c. Data provided for 2000, or 1999 if that is latest date available.

Source: BankScope; Bulgarian National Bank; authors' calculations.

Annex 3
Financial Profile of Selected State Banks

(percent)

Country/Banks	Assets/GDP	Loans/GDP	Deposits/GDP	Capital/GDP
Albania				
Savings Bank	33.2	0.3	31.8	0.9
Armenia				
Armenian Savings Bank	0.5	0.2	0.5	0.0
Azerbaijan				
International Bank of Azerbaijan	11.7	3.5	9.0	0.4
United Universal Bank	0.7	0.0	0.2	0.1
Belarus				
Belpromstroibank	1.0	0.5	0.8	0.1
Belagroprombank	0.9	0.7	0.5	0.4
Belbusinessbank	0.5	0.3	0.4	0.0
Belgazprombank	0.1	0.0	0.1	0.0
Belarusbank Savings Bank	2.6	1.9	2.1	0.4
Belvnesheconombank	0.7	0.2	0.6	0.1
Bosnia and Herzegovina[a]				
Federation Investment Bank	1.4	0.6	—	1.4
Banjalucka Banka	1.0	0.4	0.6	0.2
Privredna Banka Sarajevo	0.8	0.2	0.6	0.1
Central Profit	3.8	1.1	2.7	0.7
Gospodarska Mostar	0.6	0.2	0.4	0.1
Bulgaria				
DSK Bank	4.9	2.3	4.1	0.1
Commercial Bank Biochim	2.1	0.6	1.9	0.0
Central Cooperative	0.8	0.4	0.6	0.1
Croatia				
Dubrovacka Banka	1.8	0.7	1.0	0.1
Croatia Banka	0.7	0.4	0.5	0.1
Splitska Banka	4.4	2.1	3.9	0.3
Croatian Bank for Reconstruction & Development	3.1	1.3	1.0	1.8
Hrvatska Postanska Bank	1.0	0.5	0.7	0.1
Riadria Banka	0.8	0.3	0.6	0.1
Czech Republic				
Komercni Banka	22.0	6.0	18.0	2.0
Ceska Exportni Banka	1.3	0.0	0.3	0.1
Ceskomoravka Zarucni a Rozvojavo Banka	2.3	1.4	1.5	0.2
Estonia No state banks left				
Georgia No state banks left				
Hungary				
Postbank and Savings Bank Corp.	2.6	0.9	2.2	0.3
Hungarian Development Bank	1.6	0.4	0.7	0.8
Kazakhstan				
Halyk Savings Bank	3.9	1.9	3.4	0.3
Eximbank	0.4	—	—	—
Kyrgyz Republic				
Kairat Bank	0.5	0.0	0.4	0.1
Savings and Settlement Company	0.4	0.0	0.2	0.1
Energo Bank	0.4	0.2	0.4	0.1
Latvia				
Mortgage and Land Bank of Latvia	1.7	1.2	0.8	0.2
Latvian Savings Bank	3.5	0.9	3.1	0.1
Lithuania				
Lithuanian Savings Bank	7.4	2.1	6.3	0.5
Agricultural Bank of Lithuania	3.7	1.8	2.9	0.3
Macedonia, FYR				
Macedonian Bank for Development Promotion	—	0.4	—	0.0

Annex 3 *(continued)*

Financial Profile of Selected State Banks

(percent)

Country/Banks	Assets/GDP	Loans/GDP	Deposits/GDP	Capital/GDP
Moldova				
Banca de Economii	2.7	1.0	1.9	0.3
Poland				
Powszechna Kasa Oszczednosci Bank Polski SA	10.3	4.2	9.3	0.4
Bank Gospodarki Zywnosciowej	2.7	1.3	2.3	0.1
Romania				
Banca Comerciala Romana	8.7	2.4	6.5	1.7
Savings Bank (CEC)	2.6	0.2	2.1	0.4
EXIM Bank	0.6	0.1	0.4	0.1
Banca Agricola	—	—	—	7.0
Russian Federation				
Sberbank	8.0	3.6	7.2	0.4
Vneshtorgbank	1.8	0.4	1.1	0.6
Vneschekonombank	1.0	0.1	1.0	0.0
Russian Development Bank	0.1	—	0.0	0.1
Rosselkhozbank	—	—	—	—
Moscow Municipal Bank	0.6	0.3	0.5	0.0
Bahkir Republic Investment Bank	0.2	0.1	0.2	0.0
Slovak Republic				
Vseobecna Uverova Banka	20.5	9.9	14.3	1.5
Investicna a Rozvojva Banka	2.7	1.9	2.5	0.1
First Building Savings Bank–Prva Stavebna Sporitelna	4.4	2.4	3.4	0.3
Slovak Guarantee and Development Bank	0.7	0.0	0.1	0.5
Banka Slovakia	0.4	0.1	0.3	0.1
Slovenia				
Nova Ljubljanska Banka	28.1	14.6	23.8	2.4
Nova Kreditna Banka Maribor	8.7	3.7	7.5	0.9
Posta Banka Slovenija	1.4	0.6	1.2	0.1
SKB Banka DD	7.5	4.1	6.3	0.7
Slovene Export Corporation	1.0	0.0	0.2	0.4
Slovenska Investijska Banka	0.7	0.5	0.6	0.1
Tajikistan				
Sberbank	0.9	0.3	0.8	0.0
Turkmenistan[b]				
Vneshekonombank	47.2	41.0	9.9	0.5
Ukraine				
Savings Bank	1.2	0.3	1.0	1.2
Export-Import Bank	1.2	0.7	0.8	1.2
Uzbekistan				
Uzbek State Joint Stock Housing Savings Bank	1.1	0.5	0.7	0.3
Asaka Bank	1.8	1.1	0.8	1.0
Uzbek Joint Stock–Commercial Industrial Construction Bank	3.2	1.8	2.5	0.4
National Bank for Foreign Economy Activity of Republic of Uzbekistan	29.0	16.5	15.3	4.9
Yugoslavia				
Jugobanka Bor	2.7	1.5	1.1	0.1
Beobanka Belgrade	5.4	1.5	7.4	–2.9
Invest Banka	17.1	10.2	4.6	0.8
Jugobanka Beograd	20.3	15.5	1.9	1.1
Beogradska Banka	22.4	20.0	3.6	2.3
Vojvodjanska Banka	6.2	3.6	2.0	1.0

— Not available.

a. No data available for PBS Srpska Sarajevo, PBS Doboj, PBS Prijedor, PBS Gradiska, PBS Brcko, UNA Bihac, Sipad, Postanska, Ljubljanska, Semberska, Postanska sed., Kristal, Rosvojna, and Agroprom.

b. No data available for Sberbank, Turkmenistanbank, Turkmenbashibank, and Daykhanbank.

Source: IMF; BankScope; Bulgarian National Bank; authors' calculations.

Annex 4
Market Ratios of Selected State Banks in Transition Economies, 1999–2000

(percent)

Country/Banks	Asset share	Loan share	Deposit share	Capital share
Albania				
Savings Bank	63.6	5.8	71.8	13.6
Armenia				
Armenian Savings Bank	4.1	1.4	5.1	0.4
Azerbaijan				
International Bank of Azerbaijan	60.9	33.8	87.0	11.9
United Universal Bank	3.8	0.1	2.0	3.1
Belarus				
Belpromstroibank	16.0	10.6	20.7	12.0
Belagroprombank	15.1	15.6	13.2	30.9
Belbusinessbank 8.0	5.6	10.1	3.0	
Belgazprombank	1.9	0.4	1.9	3.0
Belarusbank Savings Bank	41.7	41.2	53.8	29.5
Belvnesheconombank	10.7	5.2	15.5	5.2
Bosnia and Herzegovina[a]				
Federation Investment Bank	2.2	1.2	—	11.3
Banjalucka Banka	1.5	0.9	7.1	1.9
Privredna Banka Sarajevo	1.2	0.4	6.3	1.0
Central Profit	5.8	2.3	30.3	5.6
Gospodarska Mostar	0.9	0.4	5.0	0.6
Bulgaria				
DSK Bank	12.2	10.7	17.7	15.7
Commercial Bank Biochim	5.2	2.9	8.0	4.6
Central Cooperative	0.9	6.6	2.0	1.8
Croatia				
Dubrovacka Banka	3.0	1.6	2.9	0.5
Croatia Banka	1.2	0.8	1.3	0.5
Splitska Banka	7.4	4.7	10.9	2.2
Croatian Bank for Reconstruction & Development	5.1	3.1	2.8	13.0
Hrvatska Postanska Bank	1.6	1.2	2.0	0.9
Riadria Banka	1.3	0.7	1.6	0.8
Czech Republic				
Komercni Banka	20.8	9.6	26.8	9.3
Ceska Exportni Banka	1.2	0.1	0.5	0.5
Ceskomoravka Zarucni a Rozvojavo Banka	2.1	2.2	2.3	0.9
Estonia No state banks left				
Georgia No state banks left				
Hungary				
Postbank and Savings Bank Corp.	4.4	1.8	5.5	5.1
Hungarian Development Bank	2.7	0.9	1.8	12.4
Kazakhstan				
Halyk Savings Bank	19.3	17.2	29.0	7.0
Eximbank	3.0	—	—	3.9
Kyrgyz Republic				
Kairat Bank	7.1	0.0	7.4	3.6
Savings and Settlement Company	5.7	0.0	4.4	4.0
Energo Bank	6.1	3.3	7.4	2.8
Latvia				
Mortgage and Land Bank of Latvia	2.8	4.8	1.9	3.9
Latvian Savings Bank	5.0	3.0	7.0	2.0
Lithuania				
Lithuanian Savings Bank	27.4	11.8	36.5	7.5
Agricultural Bank of Lithuania	13.8	10.0	16.5	4.4
Macedonia, FYR				
Macedonian Bank for Development Promotion	—	1.9	—	2.9

Annex 4 *(continued)*

Market Ratios of Selected State Banks in Transition Economies, 1999–2000

(percent)

Country/Banks	Asset share	Loan share	Deposit share	Capital share
Moldova				
Banca de Economii	9.3	7.0	18.9	3.8
Poland				
Powszechna Kasa Oszczednosci Bank Polski SA	18.9	9.4	27.8	7.2
Bank Gospodarki Zywnosciowej	5.0	2.8	6.9	2.6
Romania				
Banca Comerciala Romana	33.4	29.1	31.6	53.5
Savings Bank (CEC)	10.6	2.2	12.7	10.9
EXIM Bank	2.4	1.1	0.6	2.8
Banca Agricola	3.6	2.6	3.2	2.5
Russian Federation				
Sberbank	24.7	16.9	45.0	6.4
Vneshtorgbank	5.4	1.8	6.8	10.3
Vneschekonombank	3.2	0.5	6.0	0.8
Russian Development Bank	0.2	—	0.2	0.3
Rosselkhozbank	—	—	—	—
Moscow Municipal Bank	0.0	0.0	0.0	0.0
Bahkir Republic Investment Bank	1.9	1.6	8.7	0.2
Slovak Republic				
Vseobecna Uverova Banka	23.6	14.1	24.2	12.7
Investicna a Rozvojva Banka	3.1	2.7	4.2	1.0
First Building Savings Bank– Prva Stavebna Sporitelna	5.1	3.5	5.7	2.3
Slovak Guarantee and Development Bank	0.8	0.0	0.2	4.7
Banka Slovakia	0.5	0.1	0.6	0.7
Slovenia				
Nova Ljubljanska Banka	38.1	24.2	52.3	26.8
Nova Kreditna Banka Maribor	11.8	6.2	16.4	9.9
Posta Banka Slovenija	2.0	1.0	2.7	0.7
SKB Banka DD	10.2	6.8	13.9	7.6
Slovene Export Corporation	1.4	0.0	0.4	4.6
Slovenska Investijska Banka	1.0	0.8	1.2	0.6
Tajikistan				
Sberbank	—	—	—	—
Turkmenistan[b]				
Vneshekonombank	—	—	—	—
Ukraine				
Savings Bank	6.7	2.9	9.8	4.4
Export-Import Bank	6.9	6.7	7.2	5.0
Uzbekistan				
Uzbek State Joint Stock Housing Savings Bank	—	—	—	—
Asaka Bank	—	—	—	—
Uzbek Joint Stock–Commercial Industrial Construction Bank	—	—	—	—
National Bank for Foreign Economy Activity of Republic of Uzbekistan	—	—	—	—
Yugoslavia				
Jugobanka Bor	—	—	—	—
Beobanka Belgrade	—	—	—	—
Invest Banka	—	—	—	—
Jugobanka Beograd	—	—	—	—
Beogradska Banka	—	—	—	—
Vojvodjanska Banka	—	—	—	—

— Not available.

a. No data available for PBS Srpska Sarajevo, PBS Doboj, PBS Prijedor, PBS Gradiska, PBS Brcko, UNA Bihac, Sipad, Postanska, Ljubljanska, Semberska, Postanska sed., Kristal, Rosvojna, and Agroprom.

b. No data available for Sberbank, Turkmenistanbank, Turkmenbashibank, and Daykhanbank.

Source: IMF; BankScope; Bulgarian National Bank; authors' calculations.

Annex 5
State Banks Included in the Analysis for End-2000

Country	State banks
Albania	Savings Bank
Armenia	Armenia Savings Bank[a]
Azerbaijan	IBA, United Universal
Belarus	Belpromstroibank, Belagroprombank, Belbusinessbank, Belgazprombank, Belarusbank, Belvnesheconombank
Bosnia and Herzegovina	Investment Bank, Central Profit Bank, Gospodarska, Privredna
Bulgaria	DSK, Biochim, Central Cooperative
Croatia	Dubrovacka[a], Croatia Banka[a], Croatian Bank for Reconstruction and Development, Hrvatska Postanska
Czech Republic	Komercni[a], Ceskomoravska Zarucni, Ceska Exportni
Estonia	No state banks
Georgia	No state banks
Hungary	Magyar Fejlesztesi, Postbank
Kazakhstan	Export-Import Bank, Halyk
Kyrgyz Republic	Kairat, Energo Bank
Latvia	Latvian Mortgage and Land Bank, Latvian Savings Bank
Lithuania	Agricultural Bank
Macedonia, FYR	Macedonian Development Bank (estimated)
Moldova	Banca de Economii
Poland	PKO BP, BGZ, National Economy Bank, Bank Ochrony Srodowiska
Romania	Banca Agricola[a], BCR, CEC, EXIMBank
Russian Federation	Sberbank, Medium- & Long-Term Credit Bank, Vnesheconombank, Russian Bank for Development
Slovak Republic	VUB[a], Investicna a Rozvojova, First Building Savings, Slovenska Zarucna a rojvojova, Banka Slovakia, Exportno-Importna
Slovenia	Nova Llubljanska, Nova Kreditna Maribor, Postna Banka, Slovene Export Corporation, Slovenska Investicijska
Tajikistan	Insufficient data available
Turkmenistan	Bank for Foreign Economic Affairs
Ukraine	Ukreximbank, Oschadny
Uzbekistan	State Housing Savings Bank, Asaka, Uzpromstroybank, National Bank for Foreign Economic Activity
Yugoslavia	Insufficient data available

a. These banks have been privatized or liquidated since the end of 2000.

Annex 6
Different Types of Arrears as a Share of GDP in Selected Transition Economies, 1992–2001

(percent)

Country/Type of arrears	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Armenia										
Wage arrears							0.9	1.3	1.5	1.6
In industry							0.5	0.6	0.5	0.6
In agriculture							0.1	0.1	0.1	0.1
In transportation							0.0	0.0	0.0	0.0
In construction							0.1	0.2	0.2	0.2
In trade, material, supply, and procurement							0.0	0.0	0.0	0.0
In education and science							0.1	0.1	0.1	0.1
In credit and insurance							0.0	0.0	0.0	0.0
In general administration							0.0	0.1	0.1	0.1
In health							0.1	0.2	0.4	0.4
In other sectors							0.0	0.0	0.0	0.0
Azerbaijan										
Total arrears	**60.6**	**100.2**	**68.30**	**96.80**	**148.20**	**166.10**	**200.00**	**215.60**		
Belarus										
Total arrears			**30.4**	**13.5**	**18.20**	**13.30**	**23.10**	**19.20**	**22.39**	**19.08**
Bulgaria										
Total arrears	**68.8**	**60.6**	**47.5**	**41.7**	**66.3**	**27.9**	**24.1**	**19.9**		
To banks	11.0	12.2	4.2	4.6	7.2	1.7	2.3	1.0		
To suppliers	20.2	15.2	13.8	11.6	23.2	9.2	7.7	7.0		
To workers	2.9	3.1	2.4	1.6	2.3	1.1	0.9	0.9		
To government	7.8	7.5	9.5	8.5	10.4	5.5	6.1	4.3		
To pensions	2.5	2.6	2.1	2.1	2.1	0.7	1.0	1.2		
Other arrears	24.4	19.9	15.3	13.3	21.1	9.7	6.2	5.6		
Croatia										
Total arrears			**3.4**	**6.2**	**7.4**	**8.1**	**11.4**	**20.1**	**14.4**	**11.6**
Kazakhstan										
Arrears to workers				1.9	3.0					
Kyrgyz Republic										
Total arrears				**7.3**				**6.3**		
Lithuania										
Total arrears					**9.3**	**9.0**				
To tax accounts			1.1	1.1	0.8	0.7				
To energy suppliers		0.3	0.6	0.3	0.2	0.1				
To banks					4.4	5.1				
To other enterprises					3.9	3.1				
Macedonia, FYR										
Arrears to workers					5.9	5.7	5.5			
Arrears to government								16.0		
Moldova										
Wage arrears					4.6	4.1	7.0	4.5	2.8	2.0
In agriculture					2.1	2.1	2.4	1.1	0.6	0.5
In manufacturing					0.5	0.5	0.7	0.4	0.4	0.3
In construction					0.2	0.2	0.3	0.2	0.2	0.1
In transport					0.2	0.2	0.3	0.3	0.3	0.2
In real estate					0.1	0.1	0.2	0.2	0.1	0.1
In state administration					0.2	0.3	0.9	0.6	0.3	0.3
In education					0.7	0.3	1.0	0.7	0.3	0.2
In health care and social assistance					0.4	0.2	0.6	0.5	0.2	0.2

Annex 6 *(continued)*

Different Types of Arrears as a Share of GDP in Selected Transition Economies, 1992–2001

(percent)

Country/Type of arrears	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Romania										
Total arrears	**34.60**	**23.90**	**26.10**	**25.15**	**36.07**	**33.74**	**36.15**	**42.22**		
To suppliers	22.03	15.05	13.88	13.35	16.05	11.92	15.22	18.02		
To banks	4.03	1.42	2.07	3.12	6.22	5.81	6.06	6.44		
To government	0.00	2.37	4.83	5.11	6.89	6.62	8.08	8.29		
To others	4.51	3.64	3.25	3.57	6.90	6.21	6.78	9.46		
Russian Federation										
Total arrears		**9.5**	**14.8**	**13.3**	**23.4**	**29.1**	**47.8**	**30.3**	**23.7**	
To suppliers				6.5	10.7	12.8	21.4	13.0	10.1	
To tax accounts				3.1	4.6	6.0	8.3	5.8	4.9	
To off-budget funds				0.9	4.2	5.7	9.0	6.3	4.6	
To banks				2.8	3.9	4.6	9.1	5.2	4.1	
Arrears to workers	0.2	0.4	0.7	0.8	1.6	1.7	1.9	0.7	0.4	
In industry	0.1	0.2	0.4	0.5	1.0	1.1	1.2	0.4	0.2	
In agriculture	0.0	0.2	0.2	0.2	0.3	0.3	0.3	0.2	0.1	
In construction	0.0	0.1	0.1	0.1	0.3	0.3	0.4	0.1	0.1	
Ukraine										
Total arrears	**7.95**	**6.00**	**13.00**	**20.00**	**24.00**	**85.00**	**98.00**			
To workers						5.0	6.0			
To others		6.00	13.00	20.00	24.00	80.00	92.00			
Wage arrears				1.00	5.1	5.5	6.4	5.0	2.8	2.2

Note: Enterprise arrears to government may not equal tax arrears, since tax arrears include those of households and enterprise arrears to government can include other forms of arrears.
Source: Bagratian, Hrant, and Emine Gürgen, 1997; IMF; and World Bank.

Annex 7
The Study's Methodology

The study team relied on primary data from the following sources in assessing the current state of public sector banks in Europe and Central Asia:

- *Bank-specific data* are generally from Bureau van Dijk's BankScope and are based on banks' official annual reports. BankScope contains detailed information on 11,000 World Banks for research and marketing. It forms part of the Bureau van Dijk's collection of company information products on the internet. The data in BankScope for some banks (primarily in CIS countries) are unqualified, unaudited, or both. Internal World Bank data were used in a few instances (for Bosnia and Herzegovina, the Kyrgyz Republic, Uzbekistan, and Yugoslavia).
- *Aggregate data on banking sectors* were derived mostly from the International Monetary Fund's (IMF) *International Financial Statistics* from 1992 to 2001.
- *Data on stocks and flows of arrears* come primarily from official IMF reports and working papers, supplemented with data from externally distributed reports of the European Bank for Reconstruction and Development (*Transition Reports*), the European Union (Tacis Programme), and the World Bank.
- *Macroeconomic data* are primarily from the World Bank's World Development Indicators database.

The team used secondary data from the following sources to detail the history of state banking in transition economies over the past decade, including the case studies for selected state-owned banks:

- Official and externally distributed publications by the World Bank, IMF, European Bank for Reconstruction and Development (*Transition Reports* for 1998–2001), European Union (Tacis Programme Country Economic Trends reports), bank rating agencies (Fitch Research and Moody's Investors Service), Economist Intelligence Unit (various country reports), and Organisation for Economic Co-operation and Development (annual reports).
- Publications and Web sites of government agencies, including the central banks (annual, quarterly, and monthly reports on the financial sector) and the state statistical committees.
- Internal World Bank documents on the financial sectors of Europe and Central Asia.

Amounts given in U.S. dollars have been converted on the basis of year-end dollar exchange rates (for stock figures) or average exchange rates (for flow figures), unless already available in U.S. dollars.

All regional macroeconomic and financial indicators have been calculated as simple arithmetic averages or sums of country indicators, depending on the type of indicator. The averages have been calculated using all data available. When an indicator includes different countries for different years because of data availability issues, this is noted in footnotes.

Despite efforts to create comprehensive data sets for 1992–2000, gaps remain. Gaps occur particularly in aggregate and bank-specific data for the first half of the 1990s because of the poor data collection and accounting standards in many countries during the early period of transition.

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