

**HOW TO PRIVATIZE AND/OR SELL BUSINESS ENTERPRISES,  
FOR INSTANCE BANKS, TO FOREIGNERS?**

Ivan Ribnikar and Peter Zajc  
Faculty of Economics University of Ljubljana  
Ljubljana, Slovenia

This paper was motivated by the decision of the government of the Republic of Slovenia to sell 34% of shares of the Nova Ljubljanska banka (NLB) to the Belgium KBC bank. NLB is the largest bank in Slovenia, but still very small in international comparison. In the latest survey of the 1000 largest banks by the London based The Banker (2002) NLB ranked 561 (\$422 million of tier one capital). The selling price for the 34% stake in the NLB is around EUR 440 million. Selling the bank to foreigners per se does not deserve special attention. What is very special, is the explanation of why NLB should be sold to foreigners, and the privatisation procedure, which has excluded potential domestic investors at the very beginning. These two issues are relevant in a broader context of transition countries and warrant further research. The paper is structured into five sections. In the first two sections, we review ownership of public stock companies and banks. In the following section, we examine the way a country should privatise in order not to exclude domestic investors right at the beginning of the privatisation process. In the fourth section, we shed light on the problem of monetary consequences of selling enterprises and banks to foreigners. This problem is especially relevant for small open economies. In the last section, we deal with the question of what is the right strategy to privatise state property, especially banks. The privatisation method as well as the explanation of the privatisation for instance in the case of NLB turn out to be “unusual”.

## 1. Ownership of public stock companies

A key characteristic of public stock companies has been that their major and/or stable owners, i.e. shareholders, are not individuals or households but legal entities, i.e. nonfinancial and especially financial enterprises, also called institutional investors.

Mikdashi (1998) provides data on shareholders in five countries in 1995:

|                          | USA   | Japan | Germany | France | UK    |
|--------------------------|-------|-------|---------|--------|-------|
| Households               | 36,4  | 22,2  | 14,6    | 19,4   | 29,6  |
| Nonfinancial enterprises | 15,0  | 31,2  | 42,1    | 58,0   | 4,1   |
| Financial enterprises    | 44,4  | 35,8  | 30,3    | 8,0    | 52,4  |
| State                    | 0,0   | 0,5   | 4,3     | 3,4    | 0,2   |
| Foreigners               | 4,2   | 10,3  | 8,7     | 11,2   | 13,7  |
| Total                    | 100,0 | 100,0 | 100,0   | 100,0  | 100,0 |

The »final« owners, i.e. those who have claims on or are entitled to the net wealth of enterprises, except for the part which is owned by foreigners, are households (wealth of the state, as well as its debt, is ultimately the wealth of households, and the final or ultimate owners can only be individuals). Nevertheless, households directly own only a relatively small share of enterprises. Owners of large enterprises are other enterprises, which are in turn owned by again other enterprises (Scott, 1986). Enterprises are interconnected via intercorporate shareholding. They are not controlled by an outsider, i.e. by someone from outside the circle of intercorporate shareholding. Each enterprise controls other enterprises and is at the same time controlled by them.

This holds for nontransition countries, i.e. countries with a “normal” economic history. Ownership of enterprises, which evolved in transition countries, cannot be a reference point for Slovenia although the government has been taking it as a model or benchmark for over 10 years. In most cases enterprises in transition economies have become parts of foreign enterprises (subsidiaries and branches). In the »transition« version of the ownership story, foreign enterprises are owners of domestic enterprises, but the opposite does not hold, i.e. virtually no domestic enterprises own foreign ones. Initially, owners of domestic enterprises were residents, who received ownership certificates (vouchers) from the state. But the state somehow »forgot« to indicate that this was merely the first and an unimportant stage of privatisation. This ownership structure of enterprises directly after the abolition of social ownership in Slovenia, state ownership in other transition countries, and the current ownership situation are only indirect consequences of a 50-year black-out of economic history and normal development of economic institutions. Predominantly they are the consequence or the result of material interests of a small group, which gained political power.

## 2. Bank ownership

Institutions or legal entities and not individuals are the most important and/or stable shareholders of financial enterprises. Before looking at shareholders of banks, we look at the ownership structure of non-financial enterprises. Owners of non-financial enterprises are also banks. Their ownership share is relatively low in the USA, France and United Kingdom (0.2, 4.0 and 2.3%, respectively) but significantly higher in Japan and Germany (13.3 and 10.3%).

The largest shareholders of banks are other enterprises. If we exclude specific linkages of non-financial enterprises and banks in Japan, Germany, France and Spain (Heffernan, 1996), then in general non-financial enterprises are not an important shareholder of banks. According to Heffernan (1996), in most European countries non-financial enterprises are not allowed to hold ownership stakes in banks. Even if there are no legal barriers for non-financial enterprises to hold equity stakes in banks, this type of

ownership is very limited because the opportunity costs for non-financial enterprises are too high. Leaving non-financial enterprises aside, other banks and financial enterprises are the largest and stable shareholders of banks. In other words, financial institutions are owned by other financial institutions, and they are again owned by other financial institutions. This is a reflection of the fact that after excluding non-financial institutions and of course the state, only households remain potential important shareholders of banks.

In countries where institutional investor (insurance companies, pension and investments funds) play an important role, i.e. in countries where enterprises finance themselves also in financial markets by issuing stocks and bonds, non-financial enterprises can either be prohibited by law to hold shares of banks, or they are not bank shareholders even if there are no legal obstacles. Prohibition by law is based on the believe that the owner of the bank should not at the same time be its large shareholder – this would be the case with non-financial enterprises. This does not hold anymore today for large enterprises, which get funds predominantly in financial markets. In the USA, for instance, enterprises (small sized to large corporations) obtain already two-thirds of external funds in financial markets (The Economist, 17 April 1999). Large corporation, of course, entirely bypass banks in securing external funds. From this perspective, the argument against enterprises holding bank shares does not seem convincing. The question remains whether it is in the interest of enterprises to hold bank shares.

In countries where investment funds and especially pension funds have been introduced only recently and are therefore still small compared to the relative size of comparable institutions in the USA, they cannot be an important or large owner of banks. A smaller role of these institutional investors is in line with the lesser importance of external funding of non-financial enterprises. Until about a decade ago European enterprises were obtaining funds almost exclusively through banks. Only in the last ten years financial markets gained in importance and currently they account for about a third of external financing of non-financial enterprises (The Economist, 17 April 1999). Until recently, therefore, institutional investors in these countries had virtually no domestic securities to

include in their portfolios, and at the same time there were limited in investing in foreign securities. In the context of this study, it is important to note that institutional investors could not have helped to solve the bank ownership dilemma. Moreover, it is not unusual that non-financial enterprises have been an important element in the bank ownership structure. This kind of ownership is not peculiar even it may seem so from the US perspective. It is a bank ownership, which was and still is in a large part only possible if we exclude the state and households as the dominant shareholders.

Insurance companies have been the only institutional investors (“normal” owners) to play an important role in Europe. It is therefore logical that in Europe (Germany, Spain, France) links among banks and insurance companies started to grow strong. We are not primarily interested in the cross-selling of bank and insurance products, the so-called “bankassurance”, but in the capital links among banks and insurance companies. The example of Allianz becoming the majority owner of Dresdner Bank (The Economist, 7 April 2001) is the extreme and radical solution of the bank ownership problem. In Europe, cross-ownership among banks and insurance companies, for a long time the only financial institutions, has been very common. Sometimes the USA follow Europe. Gramm-Leach-Bliley Act, which replaced the 1993 Glass-Steagall Act, allowed closer links among banks and insurance companies (The Economist, 7 April 2001).

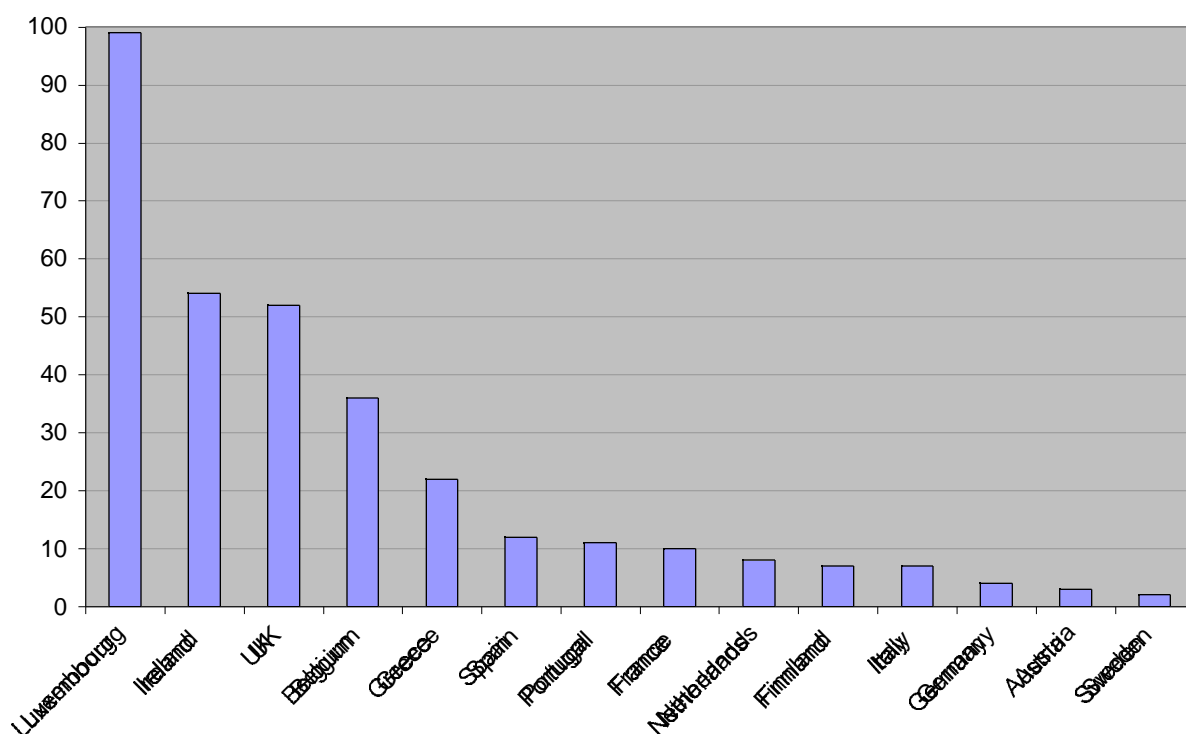
The common feature of bank ownership is that the dominant or stable bank shareholders are institutions (those, that exists) and not households. If there are “enough” financial institutions, then they are the dominant owners of not only banks but financial institutions in general. But if there are not enough financial institutions then non-financial enterprises have to play a more important role in the intercorporate ownership. No country has simply let foreign banks take over domestic banks simply because there were no domestic financial institution, which could have been the dominant owner of domestic banks.

If financial institutions are to be hard core and/or stable shareholders of other financial institutions, then intercorporate ownership among financial institutions is inevitable. To a

certain degree, only non-financial enterprises can be included into this ownership “circle”. Intercorporate ownership, which is not bilateral but multilateral, has also other implications. A bank (similar holds also for other financial institutions and non-financial enterprises), which is connected with other financial institutions via intercorporate ownership, is protected from a hostile takeover because the majority or controlling package of shares is firmly in hands of other financial institutions. Of course must the respective bank firmly hold shares of other financial institutions. This diminishes the power of shareholders and/or the role of the capital market in which only those shares are traded, which are not in hands of the hard core (“noyaux dur”) shareholders.

A bank takeover by acquiring its shares is not possible or at least is very difficult. According to Mikdashi (1998), these companies are locked in (“verrouillées”) by hard core shareholders. In EU countries, with the exception of Luxembourg and partly United Kingdom and Ireland, foreign bank ownership is relatively limited (Figure 1). Walter (1999) claims that the European system of linkages among financial and non-financial enterprises, which do not have only historic but also other reasons, lacks orientation or pressure to increase the shareholder value, as well as pressure of poor managers being replaced in a hostile takeover.

Figure 1: Share of foreign branches and subsidiaries in EU countries  
 (% of total assets, year 1997)



Source: ECB (1999).

This is in sharp contrast with the modern view of the importance of shareholder value as the only correct and legitimate goal to be pursued by the management of a stock company. Supporters of this view are the new capitalist management class (Dore, 2000) and the so-called “Davos Man”. The shortcomings of “locked-in” enterprises are well known. In Europe, locking-in of enterprise and bank ownership is relatively common. This can probably help explain the relatively small share of foreigners in ownership of European banks. Does it mean, that a small group of people or elite, holding key positions in enterprises, the government and the central bank, are pursuing their personal interests, which are in conflict with national and economic interests of the country?

### 3. How should and/or can the state privatise, i.e. sell enterprises to domestic investors?

If the state wants to sell enterprises to the domestic private sector, there cannot be financial constraints in the sense that the private sector would not have sufficient amounts of money, as we can often hear in small countries. Money, which would gradually flow to the state, would also be gradually coming back to the private sector as the state would be spending it. If the state were not to spend the money received from privatisation, then the central bank would have to replace it by increasing the supply of base money. Therefore, there can be no financial (monetary) barriers or constraints for selling enterprises to the domestic private sector.

Another issue is the question whether the domestic private sector has sufficient funds, i.e. capital (equity and debt capital), to buy shares in non-financial and/or financial enterprises put on sale by the state. The problem is that private sector capital, i.e. items on the liabilities side of the balance sheet (for households net wealth and debt), is completely allocated to different investments, which are reflected on the assets side of the private sector balance sheet. There we can also find money, which we could label as capital waiting to change from its abstract to a concrete form. The amount of this “transaction” money is only sufficient to provide the private sector with liquidity.

If the state merely decides to sell state enterprises, and appoints different commissions and foreign advisors to consult on how to best sell these enterprises, then it can sell them only to foreigners. If the domestic private sector were to buy state enterprises, then its assets would increase. They can increase only if on the right hand side of the balance sheet equity capital and net wealth grow as a consequence of increased saving.

Figure 2: Increase of the private sector balance sheet when the state sells enterprises to the private sector and does not buy back from it state bonds.

| $\Delta A$                           | Private sector | $\Delta L$                           |
|--------------------------------------|----------------|--------------------------------------|
| Shares of privatised enterprises (x) |                | Equity capital and/or net wealth (x) |

Assets, which the state can sell to the domestic private sector in give period of time, would be limited by the amount of saving of the domestic private sector in this period, if we do not consider obtaining funds abroad. The private sector might not be able to buy these enterprises form the state. Responsible for this outcome is the state because it did not enable or make it possible for the private sector to purchase the state enterprises. There is, however, another point. The capital assets of the private sector, which is generated by saving, is not an increase in capital assets from the macroeconomic perspective. Private sector has exactly that much more assets as the state has less. In other words, there is no macroeconomic saving despite saving by the private sector, and there is no macroeconomic investment despite investment by the private sector.

A normal state or government, i.e. a government of a nontransition country, must not allow these because of the privatisation, and considers it logical to prevent such an outcome. The government prevents it using privatisation revenues to buy back its bonds from the private sector. On one had, the state gradually sells shares of its enterprises, and on the other hand, it gradually buys back its outstanding bonds from the domestic private sector. France (Durupty, 1988) and Great Britain (The Economist, 14 January 1989) are -

from this standpoint - “normal” countries. Ribnikar (1990) discusses these issues in his analysis on which approach to the abolition of social ownership is feasible (affordable) and which not.

Figure 3: Change in assets of the private sector balance sheet when the state sells shares of its enterprises and at the same time buys back state bonds from the private sector.

| $\Delta A$                                 | Private sector | $\Delta L$ |
|--|----------------|------------|
| Shares of<br>privatised<br>enterprises (x) |                |            |
| State bonds (-x)                           |                |            |

As state enterprises are sold to the domestic private sector, its balance sheet does not increase and therefore they do not need additional capital (households do not need additional net wealth). However, the composition of the balance sheet changes (Figure 3). On the assets side, state bonds decrease and shares of privatised enterprises increase. If the state adopts this kind of approach to privatising state enterprises, then the domestic private sector, relatively small compared to foreign investors, has not been excluded from buying shares in state enterprises at the very beginning and can bid along with foreign investors. If the domestic private sector does not want to buy shares being sold by the state at the respective price, which is determined also by the demand by foreigners, then this indicates that the domestic sector prefers not to change its assets structure.

The point of talking about a normal state is not that domestic investors must buy state enterprises, but that they have the funds not generated by their ongoing saving, which enable them to buy shares sold by the state.

#### 4. How to prevent the undesirable monetary consequences of privatisation?

If foreigners acquire shares of state enterprises being privatised, the capital inflow can lead to monetary problems and/or problems with the exchange rate. A large real appreciation of the domestic currency is a matter of concern of every country. Let's examine some cases of privatisation and/or sale of enterprises to foreigners. These cases are: (a) privatisation of enterprises (not banks) by selling them to domestic entities, (b) privatisation of enterprises (not banks) by selling them to foreigners, (c) privatisation of banks by selling them to domestic entities, (d) privatisation of banks by selling them to foreigners, and (e) sale of banks and other enterprises by private domestic owners to foreigners.

Sale of enterprises but not banks to residents (a) or foreigners (b) are the most straight forward cases from the perspective of monetary consequences and implications for the exchange rate. This is, of course, only true if the state uses privatisation proceeds to retire its bonds, i.e. to reduce public debt. If the state wants to sell its enterprises to residents, it has to reduce its internal debt (retire bonds). However, if the state wants to privatise by selling enterprises to foreigners, it has to buy back its bonds held by foreigners, i.e. reduce its external debt. This prevents net capital inflow and real exchange rate appreciation. Real appreciation of the domestic currency would be temporary – only for the period the state would be selling enterprises to foreigners, and therefore it should be prevented by the central bank sterilised transactions on the foreign exchange market. It would not be a reflection of fundamentals, which determine the exchange rate. There are, therefore, two appropriate ways the state can spend privatisation proceeds from selling enterprises (not banks), buying back state bonds from residents and from foreigners.

Bank privatisation (c and d) warrants, due to the specific case of Slovenia, special attention. The state should use bank privatisation proceeds to retire bonds, which were issued to finance the process of bank rehabilitation being now privatised. The two state banks to be privatised became state owned only as they were put under rehabilitation.

These two banks still have rehabilitation bonds on the assets side of their balance sheets. At the beginning of the rehabilitation of the two banks, which did not receive money but long term state bonds, Bank of Slovenia passed a decree that the rehabilitation bonds would be retired once the respective banks are privatised. It is not entirely clear if the Bank of Slovenia decree is binding for the state, but let us assume it is. In such a case, the state would have to retire rehabilitation bonds also if the banks are sold to foreigners (c), and the Bank of Slovenia would have to sterilise the inflow of foreign currency into Slovenia to prevent exchange rate appreciation.

This case is special because the rehabilitation bonds, which the state must buy back using privatisation proceeds, are owned by the banks. Bank privatisation is not simply a financial swap in the private sector balance sheet, as it would be in the case of privatisation of enterprises and not banks (a and b). In this case, a simple swap would mean that banks become owners of themselves. A swap of assets between the state and the private sector is, however, not a swap of assets between a specific private or legal entity and the state. A share of an enterprises cannot be an adequate substitute for a state bond. If we speak of a swap, we only indicate that new funds, which are not a result of current saving, come to the financial market.

Bank privatisation would trigger a long chain of selling and buying of assets. This would go on until those entities, which would like to become bank shareholders, do not get hold of money. This “chain” of activities would also mean that some involved parties might borrow money at banks, which are being privatised. When the state buys back rehabilitation bonds, banks’ lending capacity increases. Banks should, however, sell rehabilitation bonds and give loans to the private sector before the state starts selling bank shares and retiring state bonds.

If the state uses privatisation proceeds to reduce its internal debt, then no funds accumulated by current saving are necessary for the privatisation process – merely the structure of the private sector assets changes. This approach to privatisation is the only correct one from the macroeconomic and financial point of view. It is not the question

whether potential domestic buyers have the capital but if the liquidity of financial markets is sufficient for the money to find its way into the hands of potential buyers. The second question is whether potential buyers exist.

Selling of banks to foreigners (d) is technically or from the viewpoint of the economy a simple operation, if the state can use privatisation proceeds to reduce its external debt. If the state has to buy back rehabilitation bonds from the banks sold to foreigners, then it has to sell foreign currency received from foreign banks (buyers). In this case Bank of Slovenia would have to sterilise. Therefore it would be better if the state reduced its internal and external debt when selling nonfinancial enterprises to the domestic private sector.

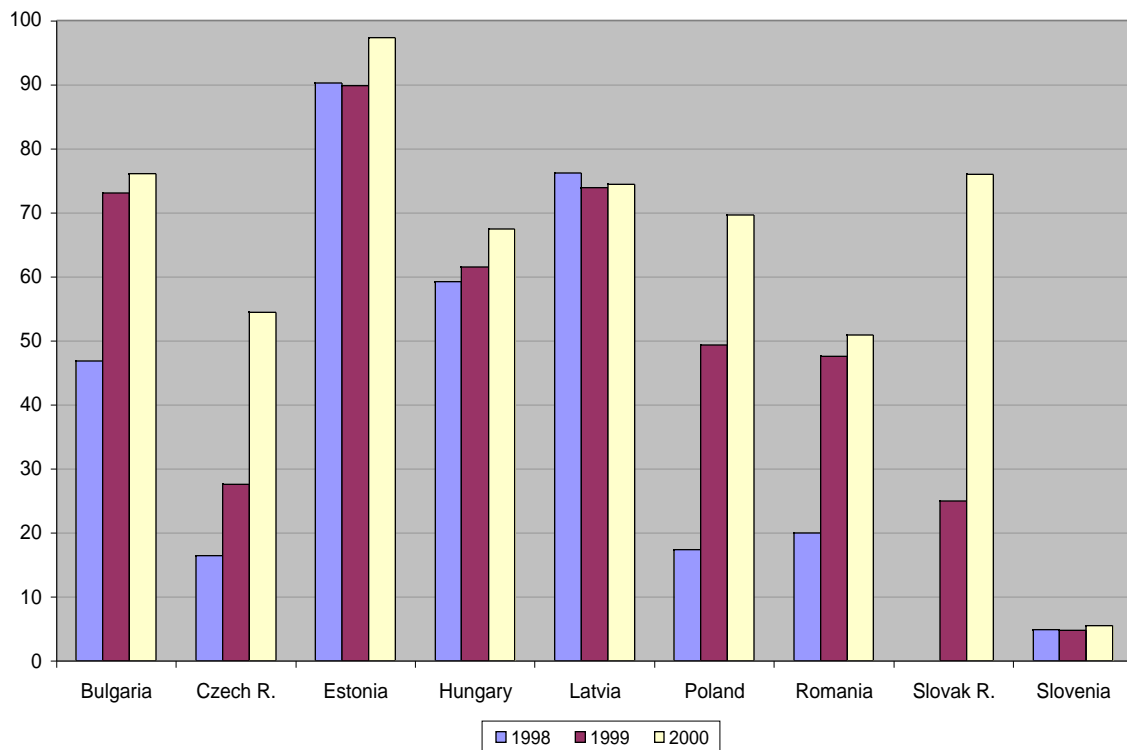
When analysing the implications of bank privatisation on the exchange rate and/or money in circulation, we finally turn to the private domestic sector selling enterprises to foreigners (e), which leads to capital inflow. Bank of Slovenia has to sterilize to prevent exchange rate appreciation. Domestic sector receives - for assets sold to foreigners - foreign assets (foreign currency). Foreigners exchange their assets or their currency for the acquired assets. External or balance-of-payments equilibrium is preserved through the adjustment process of “assets” and “stocks”, and not through changes in “flows”. If the adjustment took place via changes in flows, then the euro exchange rate would have to decrease for the current account deficit (decrease of exports and increase of imports) to absorb foreign currency, which came into the country when enterprises were sold to foreigners.

##### 5. What privatisation strategy should the state adopt?

So far we discussed the macro view of privatisation of banks. Foreign ownership of banks is typical for transition countries (Figure 4). We believe that this should not become a rule. As indicated above the state should enable the domestic private sector the acquisition of enterprises and banks being privatised by retiring its bonds. This alone, however, would not suffice as in Slovenia the majority of public debt is held by the

banks, and the financial markets are very illiquid. The domestic private sector still could not compete for banks and enterprises. In addition, an adequate liquidity of financial markets is required, because only then all the necessary assets swaps could take place and ultimately money would come to those who want to buy shares of state enterprises to be privatised. There are additional requirements when talking about banks. Majority owners, of banks must become financial institutions, which can only be the hard core shareholders.

Figure 4: Share of foreign banks (% of total assets)



Source: Central banks.

These two conditions or prerequisites for privatisation, i.e. commitment of the state to retire its bonds, and adequate liquidity of financial markets, are not intended to exclude foreigners from the privatisation process. The state cannot force the domestic private sector to buy banks, and it can also come to a conclusion that foreigners are better shareholders. The point is that the state should obey the core principles of the market

economy. It has to make sure – in our case it has to fulfil the two conditions for privatisation - not to favour one party over the others. Normal countries put residents in a favourable position. In contrast , transition countries seem to favour foreigners.

The state must create an environment in which the domestic private sector (financial institutions, individuals and nonfinancial institutions) can become owners of a bank or banks. The government of Slovenia has not done so in the case of the NLB bank. A priori it was know (claimed by the government) that the domestic private sector (a) cannot make SIT 100 billion, i.e. around EUR 440 million, available for buying the bank, despite the fact that it holds SIT 540 billion of long term state bonds, (b) could get together this money but it does not want to buy bank shares, and (c) could get the money together and wants to buy bank shares but it would not make a good shareholder. Because the domestic private sector would be sooner or later excluded from privatisation – the common believe is that the best scenario for a Slovene bank is to become a subsidiary of a foreign bank – it would be irrational and a waste of time to follow the path of nontransitional countries, which are privatising nonfinancial enterprises and banks? We are not aware that they would a priori decide for a bank (or nonfinancial enterprise) to be privatised to become a subsidiary of a foreign bank (or foreign nonfinancial enterprise). The government cannot a priori know whether the domestic private sector does not want to be bank shareholder, and the government cannot exclude it arguing that only foreign banks are appropriate and good enough to take over domestic banks

Even if the state conducts privatisation in a correct and acceptable way, there are still limitations of a small size economy. The number of financial institutions is and will remain small, which will make intercorporate shareholding look very alike in all banks. This does not change much even if we add other institutional owners (but not nonfinancial enterprises, which generally cannot be a core shareholder) and even foreign financial institutions and individuals. We would have several banks but the ownership structure would indicate that in fact we can only speak of one banks. However, this would not be surprising as it has been forecasted already years ago that ultimately we will have only one bank. A sufficient degree of competition will be generated by the presence

of branches of foreign banks, as well as by cross-border banking. Slovenia's ambitions regarding banks has to be scaled to our (small) economic size. Comparisons with other banking sectors, e.g. in the USA, are therefore irrelevant.

These and other limitations of a small country do not justify the government (a) not to enable the domestic private sector to get hold of funds to bid for the NLB, (b) not to explore if it would want to become NLB shareholder, and (c) to exclude the domestic private sector from NLB privatisation, if we stay with the case of NLB, only at the end if it came to the conclusion that foreigners, i.e. foreign banks, would be better bank owners. The government excluded the domestic private sector right up-front, i.e. a priori, demonstrating great »efficiency« where it should have not.

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