Banking sector consolidation in a post-communist economy

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The case from the Czech Republic

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1. Introduction

It has been more than two decades since the transition process in the Czech Republic started. Market practices, so usual in the Western Europe, were more or less unknown among people in the post-Soviet block of countries. Decades of discontinuity, market deprivations and lack of individual responsibility – all of that very typical for centrally planned economies – built a barrier for subjects representing both supply and demand sides to develop in a close cooperation, i.e. to influent each other on a base of market interactions.

Industrial organization in transiting economies was a major challenge for decision-makers after the fall of the Iron curtain. And, a transformation of the banking sector, "hearth and lungs" of each market economy, was one of the most important issues in all countries. After the fall of communism, post-communist states found themselves at the year "zero" – even though the Czech post-1989-banks quickly adopted market principles and new technological trends in banking, or because of this, an interest group demanding a consolidation of the banking sector ("polluted" by the bad loans) through special state-operated consolidation institutions was louder and louder. So the process has started…

The aim of this analysis is to describe the process of the Czech banking sector consolidation, to analyze tools used for that, and, last but not least, to stress the main threats of the "Czech way" of banking sector consolidation. The so called bad loans are primarily taken into account, not just because it was a typical heritage of inefficient communist economy, but also because it provides a very good base for an explanation of motivations and intentions of both state representatives and rent-seekers from the private sector immediately after some state starts to intervene.

2. Historical note – the situation before 1989

The financial system in Czechoslovakia worked under different conditions before 1989; we can state that in terms of legislation, operation and performance. The Alfa and Omega of the centrally planned economy[1] is the Plan. The Plan built a main barrier for firms' managements because it limited abilities and competences of a

[1] I will use the common term „centrally planned economy", which is usually preferred in these cases. However, we should strongly distinguish between "centrally planned economy" (the plan fully correspond with the reality, i.e. rulers are able to control the performance fully) and "centrally managed economy" (the economy is normatively controlled by the plan, although the reality does not follow the plan).

human factor in decision-making. Socialist firms did not seek for profit, but tried to meet or overcome levels of production set by the Plan (Kněz 1972). Both types of resources - assets as well as liabilities - were actually owned by the state, and all official economic activities were defined by the Plan (Central plan). If decision-making were left on managers, it would have meant a discrepancy between leading role of the government (state) on one hand and personal abilities of people in firms' managements on the other one. *"And that would be a mistake"* (Kyzlink 1989).

Roots of the consolidation in the Czech banking sector had been created by the fiscal experiment in 1965 – two hundred companies within the economy had implemented 'new elements of central planning'. All operational needs[2] (marked as 'stocks', basically 'working capital') of these firms were financed through special credit system managed by the SBCS. In 1967, the economy had implemented a new monetary system and credit system operated by the state, characterized by massive loans providing for operational needs of working capital. In 1968, overdrafts were transferred to a brand new group of loans – 'credits for constant need of working capital of socialist firm'.[3] That was the final step for building the system used from 1967 till 1990.

Let's have a brief look on the relationship between a firm and the SBCS. Declared by the Credit agreement, it was unilateral act made by a branch SBCS towards a firm built on positive assessment of credit application before formulation of economic and financial plan. Since the Law required crediting of working capital like that, branches of the SBCS or businesses did not have any choice but to follow it. A relationship between local branches of SBCS and firms had been long-term, intensive and without substitution (Polidar 1987). Credit instruments were provided by local branches on behalf of the SBCS and had to be in accordance with Quarterly plans of working capital, through instruments called Ultimate credit commitments. The commitment was some kind of a pledge.

There were several problems related to the system. According to the sustainability, the most serious complication was that nobody was really taking care about repayment of debts. Therefore, the system of operational funding had been

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[2] Operational needs could be described as a minimal level of working capital needed for meeting levels of production set by the Plan. This constant and continuous need was a basic element of the Plan because it was taken as a tool for forecasting distribution of economic factors of production (land, labor, capital). Stocks (inventories), trade receivables and other current assets (other assets, SBCS accounts and cash).

[3] It demonstrates how we can understand this specific financial tool; as overdraft accounts opened by the State for an indefinite period, of which continuously needed working capital was financed by loan.

cumulatively increasing the level of indebtedness of the firms. The old block of loans (bad loans), which was necessary to consolidate after the fall of communism, consisted mainly of these credits on constantly revolving working capital. A main driven factor for the development of this financial tool was the aim to set a total state control of all production and financial processes, carried out through statistically balanced state budget and strengthening of planning role and redistribution. A volume of socialist firms' production varied, so was a volume of working capital needed for planned level of firm's production.

3. Consolidation institutions in the Czechoslovakia (Czech Republic)

Immediately after 1989, it was clear that a majority of privatized firms (or to-be-privatized firms) were being in serious financial troubles. Their financial commitments were causing an excessive burden for establishing and developing of the market economy as well as the significant barrier in the privatization of banks. The domestic banking sector found out more than hundred billions CSK[4] (CZK) of loans – see the table 1. Serious problems with repayment were being expected in relation to those assets.[5] Most of them were loans to the constantly revolving working capital. A relationship 'state as a debtor' (state enterprises) on one hand and 'state as a creditor' (SBCS) on the other hand was transformed into the relationship 'an owner of private enterprise' as the debtor and 'a commercial bank'[6] as a creditor.[7] These liabilities could have destabilized an emerging banking sector and reduce an appetite of foreign financial groups to privatize Czech banks. That was why old bad loans had been transferred into the special institution (de facto a special branch of the public finance) that the then government established for this purpose.

The history of state consolidation institutions in the Czechoslovakia and further in the Czech Republic, as pointed on the picture 1, was intended by political circumstances. Besides the founding of the Consolidation Bank (CB) in 1991, an important milestone came in 1993: the Czechoslovakia has been divided into the Czech Republic and the Slovak Republic, as well as the Consolidation Bank, which split into the Consolidation Bank Praha (CBP) and the consolidation Bank Bratislava (CBB). Another important milestone followed in 2001 when the Czech Consolidation

[4] In 1993, the convertible rate 1 CSK = 1 CZK has been applied.

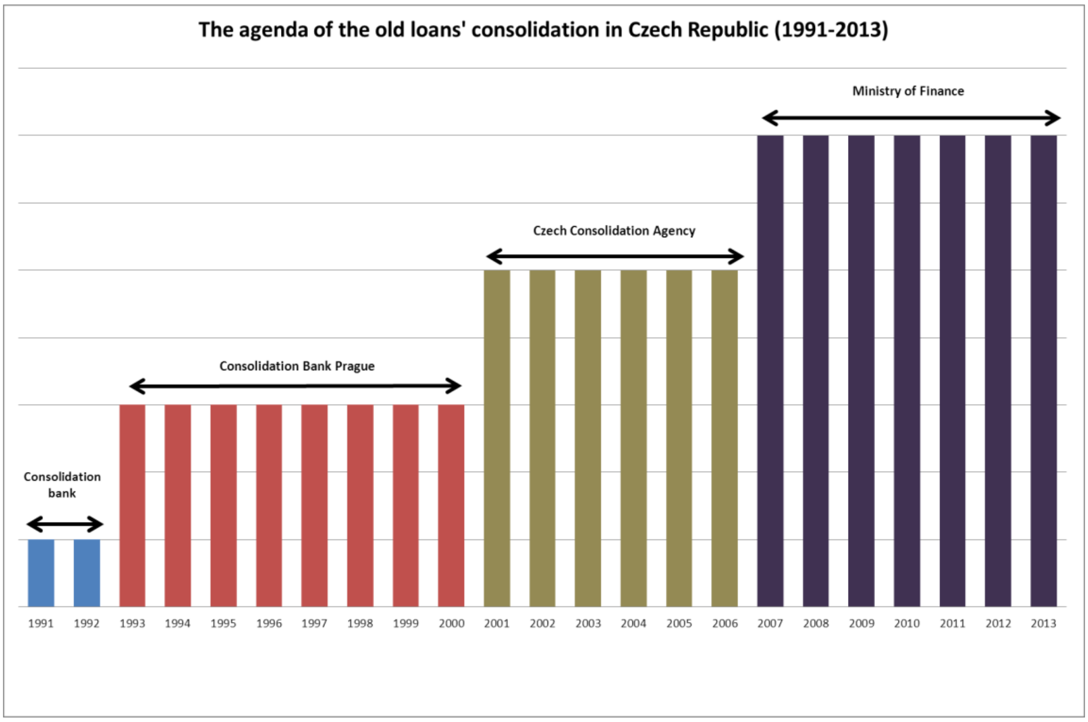
[5] These loans are also called "bad loans".

[6] Commercial banks, which credited majority of enterprises, were still owned by the state.

[7] Naturally, it was given by a deep change of legislation after 1989.

Agency (CCA) had been established (as a successor of the CBP), and finally in 2007 when the existence of the Czech Consolidation Agency was terminated. The remaining agenda was incorporated to the Ministry of Finance of the Czech Republic (MF). This institution played a major role in the final solution of the problem in 2013.

Picture 1: Consolidation institutions in the Czechoslovakia and Czech Republic



Source: Own production.

During the existence of consolidation institutions, a size of the block of old bad loans was being decreased. Following tables show changes made under individual consolidation institutions. However, political circumstances caused the fact that balance sheets of consolidation institutions had to deal with other bailouts (i.e. assets – see the picture 2).

Table 1: Loans and receivables from old loans administrated by the CB (1991 – 1992)

The CB (data in billions CSK)	**1991**	**1992**
Total assets	111.9	107.2
- the Czech share	*83.5*	*79.9*
Old block of loans	110.8	107.2
- the Czech share	*80.1*	*81.2*
Credits on constantly revolving working capital	110.8	92.7
- the Czech share	*80.1*	*66.1*

Source of the data: The CBP Annual Report, 1999

As observable from the table 1, the Consolidation Bank was administering almost 111 billion CSK of old loans. The Czech share created a majority of them. The table 2 provides an overview of the development of these assets under the management of the Consolidation Bank Prague. The volume had continuously decreased during the period. However, number of clients was not.

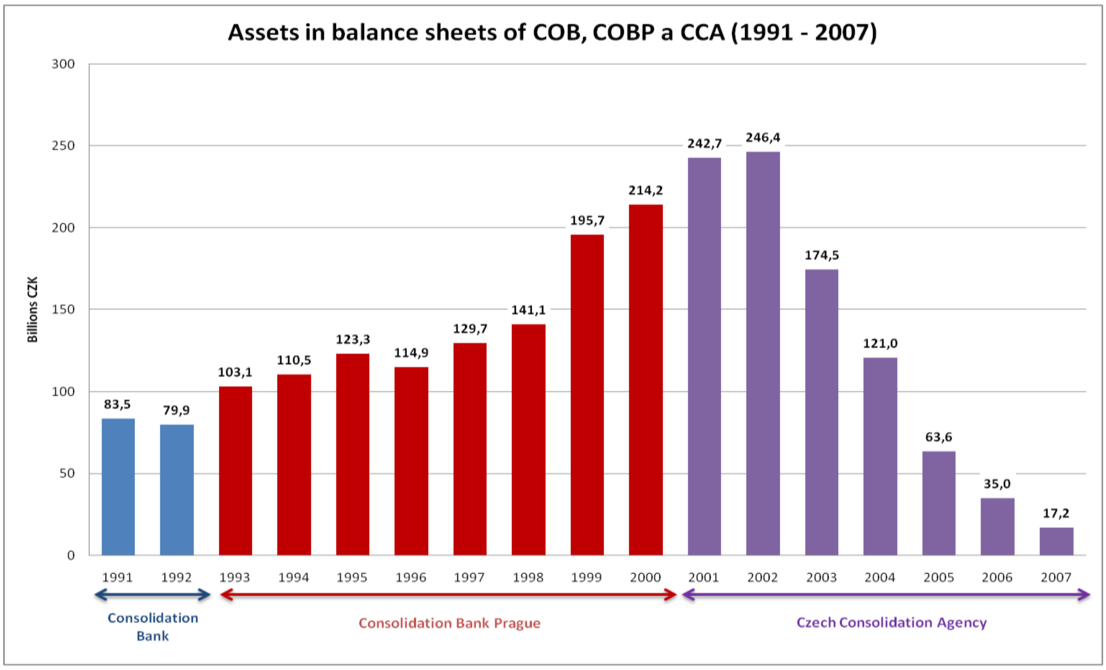
Table 2: The CBP - Receivables from credits on constantly revolving working capital

Receivables of the CBP	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
The old block of loans (bln. CZK)	74,6	67,9	63,8	60,8	59,4	58,0	53,3	39,5
- credits on constantly revolving working capital (bln. CZK)	*62,3*	*55,7*	*49,7*	*42,3*	*39,4*	*37,7*	*33,0*	*29,5*
- credits on constantly revolving working capital (%)	*83,5 %*	*82,0 %*	*77,9 %*	*69,6 %*	*66,3 %*	*65,0 %*	*61,9 %*	*74,7 %*
Clients of the CBP in total (number)	3816	3790	3996	4044	3950	4045	4748	3808
- clients of credits for constantly revolving working capital (number)	*3711*	*3715*	*3839*	*3752*	*3625*	*3655*	*3246*	*2146*
- clients of credits for constantly revolving working capital (% of total)	*97,2 %*	*98,0 %*	*96,1 %*	*92,8 %*	*91,8 %*	*90,4 %*	*68,4 %*	*56,4 %*

Source of the data: The CBP Annual Report, 2000

The CCA had just one goal – to settle as many clients' cases as possible. In those times, block sales of assets through public tenders were organized. That caused several problems – mainly that some debtors could re-buy own debts for a fraction of the nominal value and that rent-seekers could aggregate a huge volume of these commitments and misuse the state guarantee from 1991 in legal suits.

Picture 2: Clients of the CCA with old bad loans



Source of the data: Annual reports of The Czech Consolidation Agency.

4. The Exit

In 2007, the CCA terminated but some issues related to old block of loans and credits for constantly revolving working capital were still remaining "active". The MF has allocated a special department for managing the very small residual portfolio. From information mentioned in the previous chapter one could think that the credits on constantly revolving working capital had been over for long years. However, this is not true.

The main reason is the law No. 92/1991 Coll., about conditions for transfers of state property to other subjects, which was passed on February 26th, 1991 and become effective on April 1st, 1991. By this piece of legislation, the state has taken the full guarantee and responsibility for economic costs (damages) made before 1989, which would negatively influence a value of a private property restituted and privatized after 1990. The government wanted to encourage private subjects to participate hugely at the process of privatization and so to "unblock" underinvested state property and make it economically active. Nevertheless, a pressure made on the then politicians meant also increased opportunities for rent-seekers, speculators and profiteers. The process of individual and block sales of assets explained above included also credits for constantly revolving working capital. As a reminder these credits are nothing but receivables firstly owned by the monobank (SBCS), then by new banks established after 1989, then by Czech consolidation agencies and finally by buyers of assets sold through individual and block sales. Although the Czech Government has considered the situation as stabilized, or better said solved, there were entities that had started to buy these receivables raised from credits for constantly revolving working capital with this kind of construction:

These receivables emerged from credits for constantly revolving working capital. These receivables are hold against companies primarily owned by the state, which have been restituted or privatized into private hands then. So, the core of receivables originated before 1989. The fact that they haven't been repaid is economically harmful for a holder. The state has taken the full responsibility for damages originated before 1989. The case of receivables based on unpaid credits for constantly revolving working capital could be applied on this legal commitment of the Czech government.

And, this construction really works. Till the end of 2012, the Government had paid billions CZK to several subjects as an indemnification during the legal disputes between individuals and the state. However, in "a shadow" of every day political and economic issues a few cooperating entities continued in a massive buying and gathering this kind of receivables. Therefore, more than 160 legal suits against the state had been initiated by these rent-seekers and after that a negotiation with the government has begun. The amount that owners of assets required as a reimbursement from the state, was about 13 billion CZK plus interests, although some rumors mentioned much higher amount (app. 30 billion CZK).

The negotiations between rent-seekers and the Ministry of Finance of the Czech Republic went official in 2012. The Ministry got information and made an inquiry for several expert evidences and legal advisory about enforceability of state guarantees toward these assets. In October 2013, the government passed the agreement with the counterparty (owners of receivables) at the very special regime of secrecy. The off-court reimbursement was set at 1.38 billion CZK. The money was placed to a depository under the condition to be transferred to owners of receivables after withdrawing court actions against the state and also transferring the receivables to the state.

After all, this action can be understood as the final solution of the issue related to credits on constantly revolving working capital in the Czech Republic.

5. A solution of “the old bad loans” problem in Slovakia

It was mentioned above the receivables from credits on constantly revolving working capital existed for both the Czech and Slovak businesses, so I also describe the Slovak way of dealing with the problem. It is very different in comparison with the Czech one.

When the federative CB was formed, it had also the Slovak portfolio of assets and receivables based on credits for constantly revolving working capital at the level 30.4 billion CSK. In 1993 the portfolio, at that time 26.6 billion CSK (= CZK = SKK), was carried into the CBB. Problems emerging at the Slovak banking sector were even more complicated in the Czech Republic because it was necessary to build on a new system of currency after the separation and also to form an infrastructure for payments in Slovakia. Therefore, it has become clear in early 1990s that without a state intervention a transformation of the Slovak financial sector is not possible.

A way of management of receivables from credits for constantly revolving working capital differs in Slovakia because the government has chosen another strategy. It was partially determined by prearranged outline priority requirements, related to the new Republic and its institutional framework (especially the construction of political, economic and monetary infrastructure at central level and local levels). The main objective was to hold old claims safely "under the roof" of state entities (Hlavatý 2001). The CBB itself tried to enforce the repayment of receivables, support restructuring or initiated court proceedings and subsequent processes of executions, bankruptcies, settlement proceedings and liquidations. During 8 years of the existence, the CBB had decreased a volume of receivables from credits on constantly revolving working capital just by 4.3 billion CZK. Reword that in 1993 the Consolidation Bank Prague managed 81.2 billion CZK. In 2001, it was just 42 billion CZK of these receivables, so a half of that.

Although we can assume that, like in the Czech Republic, individual claims solutions in Slovakia had a higher yields potential than block sales in Slovakia, due to the costs related to the management of claims and also due to economic conditions in owned firms the KBB had deepened its loss. Since 1995, the KBB had begun to create adjustments to receivables with the classification of risky or loss (by the Regulation of the National Bank of Slovakia). The KBB had been terminated on January 31st, 2001 by the decision of the Ministry of Finance. The termination was set as “without liquidation”, but the legal successor, the Slovak Consolidation Limited, is a company with 100 % state ownership. A part of the contract covered also a heritage of claims from credits for constantly revolving working capital (22.3 billion SKK). The enforcement of receivables continued with all available tools – restructuring, repayment schedules, and available legal instruments.

For this purpose, the Slovak Consolidation has hired a distinguished team of lawyers specialized in litigation relating to mentioned claims. Their task was to strengthen the position of this state institution in litigation, develop and promote uniform professional arguments and the common strategy with participation of external advisory and legal subjects. Failed claims to be recovered were subsequently managed under bankruptcies and liquidation proceedings and – accounted by depreciation. The costs related to the portfolio of assets were covered by redistribution loans from the National Bank of Slovakia. Nevertheless, the Slovak Consolidation (similarly to the CBB) had not transferred the claims from credits on constantly revolving working capital to third parties as happening in the Czech Republic. No transactions through block sales of assets have been made.

Nowadays, the problem of claims from credits for constantly revolving working capital is almost done. According to the information by the Department of Communication at Slovak Consolidation Ltd., these assets represent 0.21 % compared to other receivables in the balance sheet of the institution.

6. Conclusion

The Czech way of banking sector consolidation was definitely very difficult goal, so it is not fair just to look back and criticize. Nevertheless, the fact is that between 1991 and 2005 it had cost more than 700 billion CZK, when operation costs (e.g. wages) and guarantees paid after this term are not included.

Table 3 – Costs of consolidation between 1991 and 2005

Transformation of the economy between 1991 and 2005 (bln. CZK)	
Banks' bailouts	370,4
Enterprises	136,6
Households	49,9
Other costs	135
SUBTOTAL	692
Guarantees paid for loans	20,6
TOTAL	***712,6***

Source: MF

It is important to maintain the story alive, because it brings several conclusions applicable to any case of consolidation of some part of economy through public institutions. Basically, there are always three main threats:

1. The consolidation would go out of the control because of political decisions and soft budget constraints of the public finance.
2. The legislation related to the consolidation would not cover all potential threats, recent ones or future ones.
3. Interest groups and rent-seekers would misuse information asymmetry and motivations of public representatives for making profit on account of the taxpayers.

One can safely say that consolidation institutions had played a big role in the transition of the Czech economy. Actually, it is exactly what Václav Klaus[8] wrote about the issue: *"Consolidation institutions had played important and irreplaceable role in our economic transition. The restrictive macroeconomic stabilization had decreased the rate of inflation, which protected real savings of residents. However, it largely maintained the value of old loans. A displacement of "bad loans" to Consolidation bank was the most logical solution. Another question is whether consolidation agencies weren't misused (used beyond the goal) for budgetary bailouts."* (Kočárník et al. 2007)

This nicely summarize why we cannot market the Czech way of consolidation as the best practice, but rather as the practice that could be used for the best.

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[8] Václav Klaus (professor in economics) is the former Minister of Finance and the former President of the Czech Republic.

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