Resolving Non-performing Assets in the Czech Republic: Theory and Practice

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Introduction

The ongoing global financial crisis is underlining the relevance of restructuring bank balance sheets. Questions regarding the methods available for assisting banks and other financial institutions are more pertinent now than ever before. Many of the methods described in this paper have recently been the subject of an economic policy debate in the Czech Republic and around the world.[1] Providing banks in difficulty with assistance that does not directly penalise shareholders and managers for crisis situations has proven to be risky and associated with high moral hazard. Where liquidating a bank and paying out insured deposits seems systemically risky – despite being the cleanest method from the market perspective – and where public money has to be used, the state should gain a majority stake in the problem bank. This gives it control over the bank and minimises the influence of existing shareholders and managers over the running of the bank, whose managers, with the shareholders' agreement, got the bank into difficulties to start with. The goal of this paper is to provide the reader with an overview of the Czech experience with problem bank assets, together with the theoretical background for asset management companies.

Theoretical approaches to working out problem assets in bank balance sheets

From the general accounting perspective, problem bank assets[2] can be worked out using two basic approaches – via the asset side and/or via the liability side of the bank's balance sheet. In the first case, the bank's problem assets are bought up by a state or other institution and replaced with other assets – usually securities issued specially for this purpose by the state. These changes primarily affect the bank's balance sheet on the asset side only. In the case of a liability side workout, the state provides financial assets to banks in various ways; either it finances the losses directly or it takes an ownership interest in them. This gives rise to changes in equity capital and, of course, changes on the asset side as well. These are just the basic approaches and can naturally occur in modified form. In this paper, we are going to deal purely with the first approach to problem bank assets, i.e., asset side restructuring.[3]

Asset management agencies[4]

One of the techniques for managing problem bank assets is to establish an asset management company (AMC) and then to transfer the assets to it. The ob-

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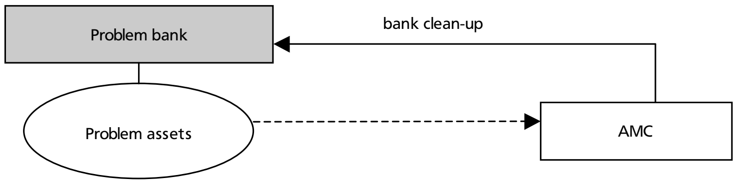
[1] When seeking solutions for problem banks it is important not to underestimate the risk of moral hazard and the adoption of unsystematic and incomplete solutions to bank crises.
[2] The primary reason for the occurrence of problematic and non-performing bank loans is poor lending policy. Consequently, it should be shareholders and managers who bear the main costs of their mistakes.
[3] See Kollár and Komárek (2006) for an overview of other methods dealing with problem bank assets.
[4] See Calomiris, Klingebiel and Laeven (2004, 32–43), BIS (2002), Terada-Hagiwara (2004), Enoch, Garcia and Sundarajan (1999), Woo (2000), Klingebiel (2000) or White (2004).

Figure 1



AMCs, unlike other market approaches to working out banking sector problems, avoid the disadvantages stemming from underdeveloped legal and institutional environments. This popular view is mistaken because of the aforementioned limiting effect of weak institutional environments on the ability of AMCs to achieve their objectives. AMC managers can be subject to corruption and political (if the ruling party changes) and other pressure to favour sub-optimal solutions. The politicisation of the whole debt restructuring process is greater the higher the ratio of claims transferred to the AMC is to the total debt in the economy.

jective of this technique is to accelerate the debt restructuring process. To ensure maximum transparency of this process, the life of a public AMC should be time-limited[5] and announced to market participants in advance, preferably when it is established. Figure 1 illustrates how public (state) AMCs function.

The main incentive for establishing an AMC is the existence of a large quantity of non-performing loans (NPLs) and the fact that banks themselves do not necessarily have experience in recovering NPLs. The advantages of AMCs include: (i) economies of scale (the problem loans of several banks or of the entire banking sector are worked out by just one institution, which can bundle problem assets and sell them en bloc)[6]; (ii) special powers granted by the government to expedite debt recovery even in an environment of weak market discipline and underdeveloped legislation; (iii) the breaking of "crony" connections between banks and businesses; (iv) the creation of a secondary market in problem (non-performing) assets,[7] as such assets cannot be sold on the secondary market unless such a market exists; (v) better returns on capital invested in banks. The technique also has its drawbacks: (i) a risk of a lack of sufficient skills, information and experience among the managers installed in the AMC by the government; (ii) the generation of complex legal disputes linked with the administrative demands of this technique; (iii) politicisation of the AMC's work; (iv) possible corruption pressures; and above all (v) the risk of moral hazard for banks that are relieved of NPLs.

All these factors combined make it difficult to estimate *ex ante* the net benefits of this technique. A World Bank study[8] corrects the popular view that

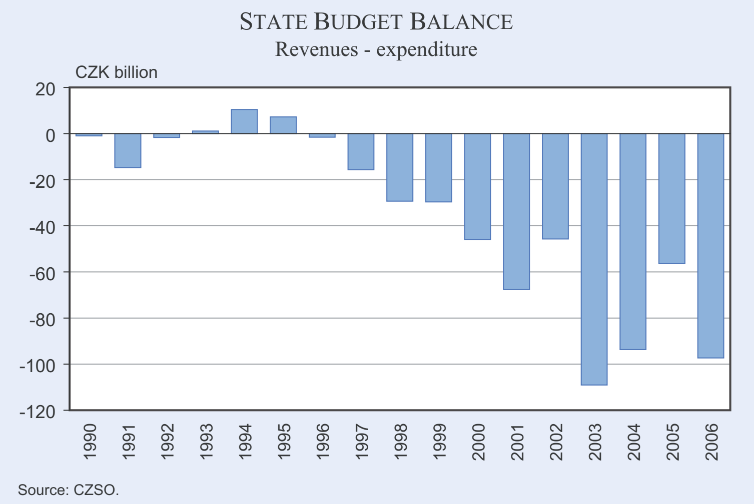
[5] Which was, by law, the case in the Czech Republic, see the section on the CCA below.
[6] Large bundles of assets can attract large potential buyers, which may ultimately expedite the securitisation of those assets.
[7] In the Czech case, the establishment of an AMC (the Czech Consolidation Bank/Agency) aided the creation of a secondary market in (problem) unpaid debts.
[8] Calomiris, Klingebiel and Laeven (2004).

Transferring non-performing loans to an AMC does not make them disappear from the economy and does not enable the economy to avoid debt restructuring. As a matter of principle, it would also be wrong to relieve banks (through a centralised AMC) of all their bad debts. To maintain the best possible conditions of market competition, state interventions should be as small as possible. Hence, only the most cumbersome loans should be transferred; less problematic ones should be restructured by the banks at their own expense. The rule of thumb in this area should be to achieve in the final stage an equal proportion of non-performing assets in all banks, i.e., in those which have received assistance and also in those which have sorted themselves out. This will to some extent limit discrimination against banks whose asset portfolios have not developed into such a bad state and whose NPLs have therefore not been purchased by a centralised AMC.

Macroeconomic context of the formation of Consolidation Bank

In the context of the post-1989 transformation of the Czech economy, changes to the banking system were planned and implemented in the early 1990s. These changes related primarily to the banking legislation and the ensuing institutional interbank relationship setup and involved a switch from a one-tier to a two-tier banking system (with central and commercial banking functionally separated). Given the restrictive monetary and fiscal policy in place at the time, the Czech Republic had a low-inflation economic environment compared to other post-communist countries. This low-inflation environment did not erode

Figure 2



the value of existing assets and therefore prevented a solution whereby higher inflation would reduce the value of existing corporate debt,[9] as was observed in other countries.[10]

The low-inflation environment was largely sustainable also because of a balanced budget policy[11] (see Figure 2) which avoided demand pressures. Fiscal policy had a positive effect on the overall state of the economy in the period 1990–97. Note that for the purposes of this paper we consider the exchange rate of CZK to be approximately 30 CZK=1 EUR

The establishment and later division of the federal Konsolidační banka (1991–93)

The Czech AMC – Konsolidacni banka (Consolidation Bank, further "KOB") was established on 25 February 1991 by the Czechoslovak Federal Ministry of Finance. It was set up primarily to deal with the consequences of central planning, specifically loans for so-called "perpetually revolving inventories" (known as TOZ loans) and the "old" loans of Komerční banka and Investiční banka. On the Czechoslovak financial market, following the January 1991 price liberalisation, TOZ loans were treated as standard short and medium-term commercial loans with high market interest rates (20–24 percent p.a.). This placed an excessive burden on businesses during the transformation period and increased banks' credit risk.

Under a government decision KOB therefore purchased TOZ loans from Komerční banka and Investiční banka at clients' request as part of an effort to restructure these banks and clear their debts. These loans totalled around CZK 110.8 billion (Czech share totalled CZK 83 billion) and the number of clients concerned was almost 6000. At the time KOB was established, a gradual outflow of good clients to other banks offering better conditions was expected.[12] This outflow was also supposed to provide the clean-up of the KOB's balance sheet. It was not considered appropriate in 1991 to expand KOB's activities in the field of support for uncreditworthy clients, so its purview was restricted to assisting in the clean-up of commercial banks' balance sheets,[13] which were owned by the state.

Development of the bank and expansion of its purview (1994–2001)

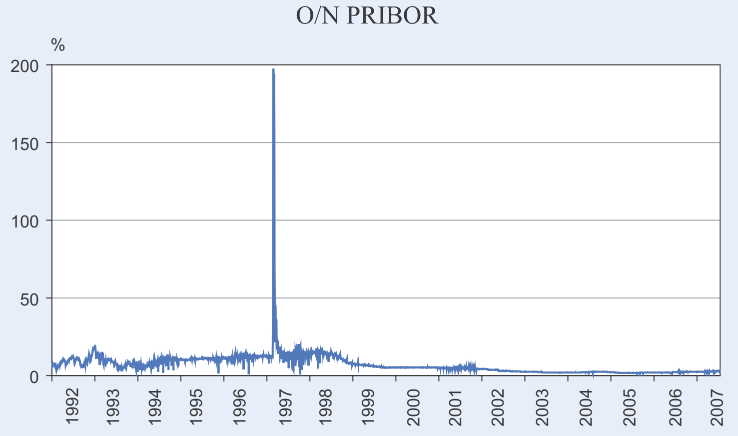
In 1993 Czechoslovakia split up into two sovereign states – the Czech and the Slovak Republics. KOB was also divided into two parts (the Czech part – Konsolidační banka Praha, further "KOBP"). KOBP expanded into other areas (restructuring, development programmes). To this end its banking licence was widened to include other activities and it began to engage in operations to restructure specific businesses.[14] The stated aim of these operations was to make the companies as cost-effective as possible, to identify their core areas of production and then to find strategic partners for them.

Banks amassed non-performing loans as a result of the 1997 financial crisis. The money market recorded high volatility (for example, the overnight PRIBOR neared the 200 percent level; from the medium-term perspective, increased instability and rate volatility was observed until the second half of 1998 – see Figure 3).

[9] … but thus also of savings.
[10] See Řežábek (2007).
[11] See Klaus (1992) and Holman (2001).

[12] The TOZ conditions at KOB were fixed at 12–13 percent p.a. repayable over eight years while the rates of commercial banks were decreasing.
[13] See, for example, the document prepared for the Financial Council Rekapitalizace Konsolidační banky [Recapitalisation of Consolidation Bank], April 1992.
[14] Examples of restructured companies: Tatra, Zetor, Vítkovice, Škoda Holding, Spolana, ČKD Dopravní systémy.

Figure 3



Source: CNB.

KOBP played a major role in preparing the privatisations of Czech banks and took on large quantities of bad debts and ownership interest and securities in largest and strategic Czech companies (Czech Airlines, Škoda Auto, ŠkodaHolding, etc.).

On the basis of a government decision, KOBP funded and supported huge development projects for major Czech corporations as well as long-term projects in the public interest in the fields of transport, communication and water infrastructure and environmental protection. Initially it focused on the network of international highways and motorways connected to the European transport network. After the 1997 floods, further programmes were established to rebuild and develop the flood-damaged transport and water management infrastructure. KOBP acted as financial manager and received credit from the European Investment Bank and the state budget for its development programmes. In 2000, the government decided to sell KOBP's development programme activities to Českomoravská záruční a rozvojová banka (the Czech-Moravian Guarantee and Development Bank).

Conversion of Konsolidační banka Praha into the Czech Consolidation Agency

On 1 September 2001, on the expiration of the time limit laid down in the Act on Banks, KOPB ceased to exist and its successor – a non-bank institution called the Czech Consolidation Agency (CCA) – came into being. The CCA was established as an incorporated legal entity under Act No. 239/2001 Coll.[15] The termination of CCA was set for 31 December 2007. It managed state assets, and the state guaranteed its liabilities. The CCA was not a bank under a special statute, so it was not allowed to accept deposits from the public or to provide loans. However, it was obliged to complete all the activities and transactions it had taken over from KOPB, to which end it was allowed to use all the rights, methods and instruments that had been available to the bank. The assets managed by the CCA were subject to inspection by the Supreme Audit Office.

The CCA's statutory body was a five-member board of directors appointed by the government at the proposal of the minister of finance. Under a government decision, the board of directors was also required to undertake commercial operations that, owing to the risks flowing from them, could not have been undertaken on prudential grounds. Significant powers were vested in a nine-member supervisory board elected by the lower house of the Czech parliament. The supervisory board approved among other things individual financial and asset transactions exceeding CZK 500 million and decisions outside the framework of the annual financial plan and budget.

Stabilisation, segmentation and new CCA close-down strategy

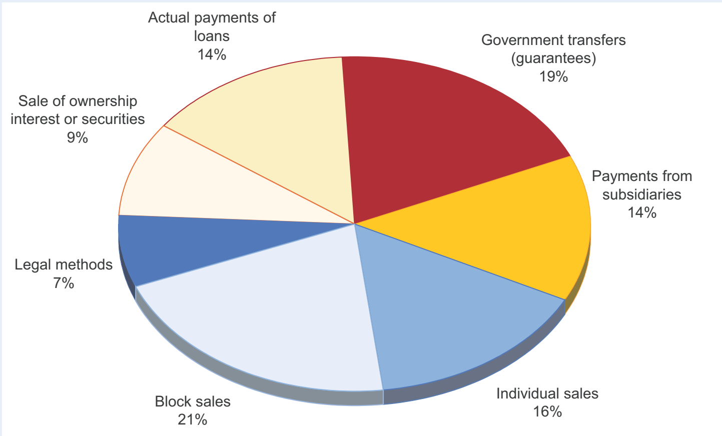
Aware of its new status as a non-bank institution with time-limited existence and of the need to wind up its activities quickly, the CCA stabilised its activities and segmented its portfolio. The segmentation of the portfolio was a crucial strategic decision of the ministry of finance and the board of the CCA as the portfolio was divided into segments where a different workout strategy could be implemented. These segments also included a very important segment of strategic companies where a governmental decision and a more careful approach was needed.

In early 2002, a rapid exit strategy for the assets in the CCA's portfolio was drawn up by its board of directors and approved by its supervisory board and by the minister of finance. The main instrument of this strat-

[15] A law passed on 21 June 2001 – there was very little time to implement it.

Figure 4

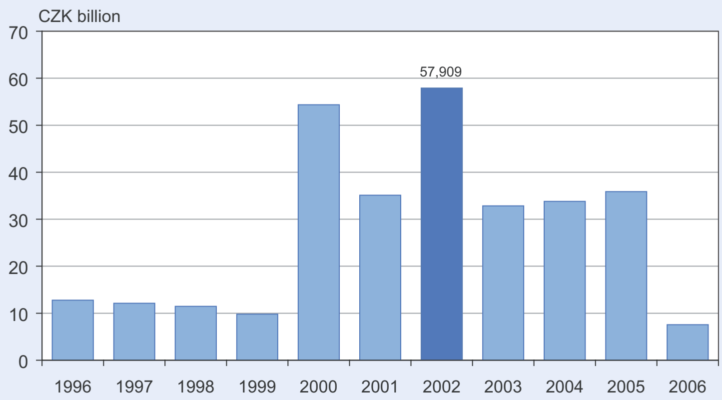
WORKOUT METHODS FOR THE CCA'S PROBLEM ASSETS
1 Sept. 2001–31 July 2003
in % of total assets



Source: CCA.

Figure 5

ANNUAL AMOUNTS COLLECTED BY KOB/CCA



Source: CCA.

egy was the sale of assets in blocks of tens of billions of koruna (see Figure 4). In 2002, a block sale of assets totalling CZK 37.8 billion was prepared and successfully executed. The return on the assets sold was 14.6 percent of their book value and 9 percent of their total value.[16] A specific block sale of bankruptcy claims was then conducted in 2003.[17] A plan for further block sales was prepared. This plan, based on the experience gained from the preceding block sales, responded to recommendations made by the European Commission and other international institutions for rapidly and transparently reducing CCA's balance sheet total. The plan set out a sequence of subsequent block sales to be held in 2003 and 2004. The objective was to significantly reduce CCA's balance sheet total to a minority level in the next few block sales,[18] with a view to closing down the CCA some time in 2005–07 depending on the extent and time schedule of asset transfers from commercial bank ČSOB.

Another effective asset sale instrument used by the CCA were individual sales of claims (the return on these individual sales in 2002 was 28.5 percent of the book value of the claims, or 37 percent excluding transactions that the CCA was obliged to perform under government resolutions).

In 2002 the CCA actively managed its clients in order to optimise the recovery rate. In addition to block sales and individual sales (including restructuring and sale of selected businesses to strategic partners in compliance with government resolutions), the CCA made use of the following workout methods: sale of ownership interests and securities, legal methods[19] (sale of collateral, liquidation, bankruptcy, execution, legal action) and resctructiring of the payments scheme and their actual payments. This active portfolio management enabled the CCA to collect large amounts of claims (see Figure 5).

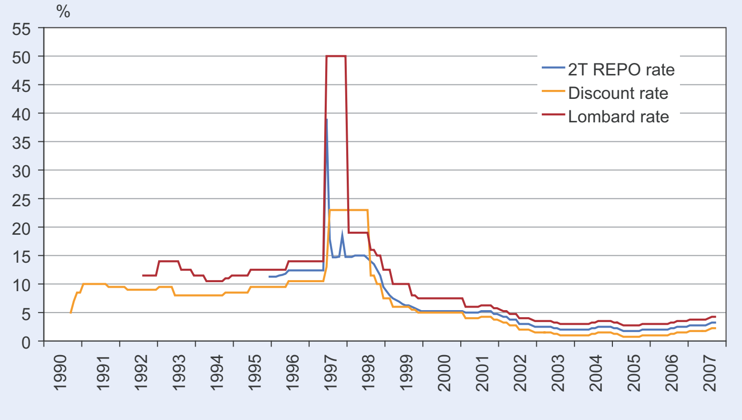
Balance sheet totals

The balance sheet of KOB (later Konsolidační banka Praha, KOPB) was initially stable,[20] fluctuating around CSK/CZK 100 billion. However, amid financial crises in the late 1990s, the balance sheet of KOPB (later the Czech Consolidation Agency, CCA) skyrocketed in 1999 because of new non-performing loans and assets transferred onto its balance sheet as

[16] For comparison, a pilot block sale held in 2001 contained assets totalling CZK 19.1 billion with a return of 11.4 percent of the book value and 7.1 percent of the total value.
[17] The sale involved claims on 2,773 debtors with a book value of CZK 42.0 billion and a nominal value of CZK 62.3 billion.
[18] By the end of 2003 the CCA had conducted 12 block sales.
[19] In view of the fact that legal environment was at this time not effective and legal proceedings were lengthy, the use of legal methods was limited.
[20] Thanks to minimal transfers of other assets.

Figure 6

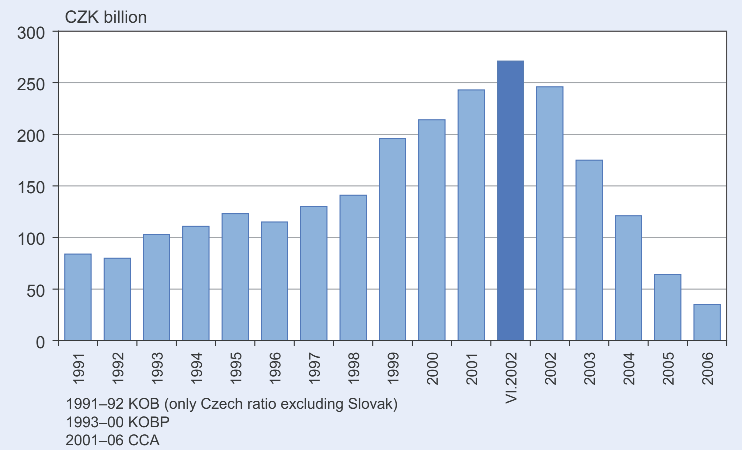
CNB INTEREST RATES



Source: CNB.

Figure 7

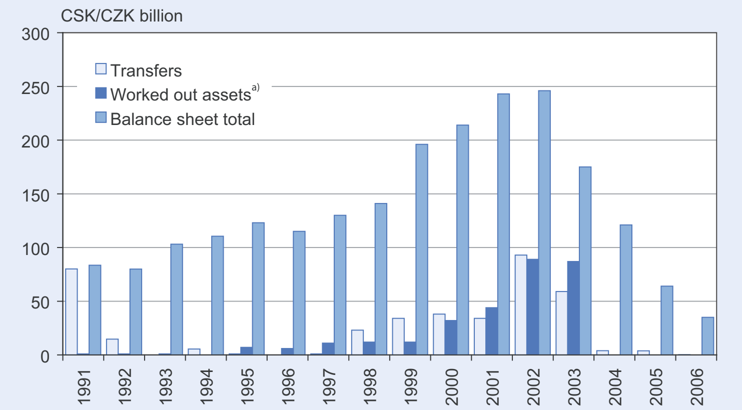
BALANCE SHEET TOTALS OF KOB/KOPB/CCA



Source: CCA.

Figure 8

TRANSFERS, BALANCE SHEET TOTALS AND ASSETS WORKED OUT IN KOB/KOPB/CCA



a) No data available from 2004–06

Source: CCA and author's calculations.

a result of the macroeconomic situation (extremely high and volatile interest rates[21] – see Figure 6), regulatory measures (e.g., supervisory actions undertaken by the CNB in 1999 in the area of non-acceptance of real estate collateral on risky loans), the manner of privatisation of some banks, and other government measures (e.g., a clean-up of the health insurance sector).

The CCA's balance sheet total peaked in mid-2002 at a record CZK 271 billion as a result of massive transfers of assets to the CCA (see Figures 7 and 8). Thanks, however, to the start of the CCA winding-up process and to the CCA's active portfolio management policy (for example, a record CZK 58 billion was collected that year), the balance sheet total remained at the 2001 level in 2002 and fell in each subsequent year.

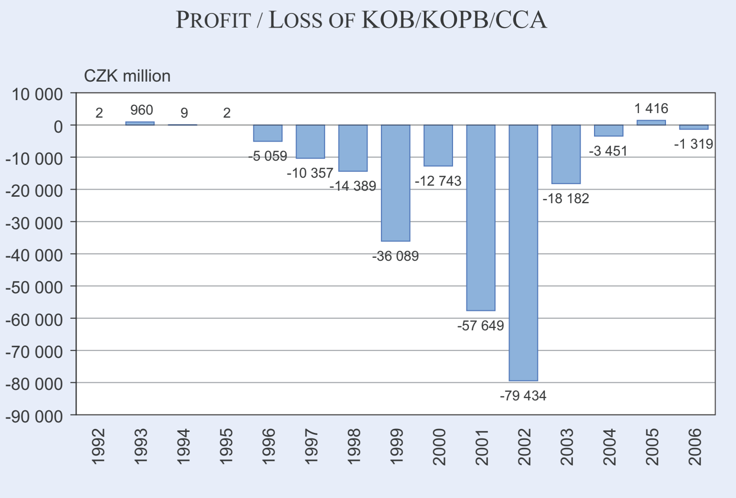
Losses of consolidation institutions

The consolidation institutions (CIs) posted a total cumulative loss of CZK 236 billion over their lifetime. The losses were due mainly to transfers from banks and other transfers of non-performing assets from other state institutions. The CIs purchased these transfers at prices far exceeding their market value on the basis of political decisions. According to bank regulations provisions and reserves were set aside for the transferred assets. These formed the CI's loss for the fiscal year. Perhaps the most visible are the 2001–02 losses, when assets were transferred from ČSOB to the CCA.[22] The to-

[21] On 16 May 1997 the CNB's Lombard rate was increased to 50 percent p.a., and on 4 June 1997 the basic 2-week repo rate was raised to 39 percent p.a. (for more details see Figure 6).

[22] Assets were also transferred from Komerční banka and Česká spořitelna.

Figure 9



Source: CCA.

tal loss from transfers from ČSOB alone was around CZK 120 billion (see Figure 9).

Another major loss-making factor was refinancing costs, which totalled CZK 117 billion in 1991–2003, because the CIs had to raise funds on the money market themselves in order to execute transactions ordered by the government. These funds were not directly financed by the state but had a governmental guarantee.

Due to different transfer prices and accounting methodology differences[23] it is impossible to simply compare the cumulative loss and the amounts of transferred assets to the CIs. For the purposes of this paper and lessons learned in the ongoing global financial crisis, we calculated a benchmark for the recovery rates of market based work-out methods:

- actual payments up to 100 percent (but due to loan restructuring over a much longer time span),
- individual sales 30 percent,
- block sales excluding assets related to bankruptcies 15 percent,
- mixed block sales 10 percent,
- block sales of consisting mainly of bankruptcies 3 percent.

The estimated total recovery rate in 2001 was 15 percent and 16 percent in 2002 in the Czech Republic. In comparison, the Slovak recovery rates were during the same period were around 6 percent. The reader should bear in mind that these recovery rates are very specific as they relate to non-performing assets originating in the process of an economic transition accompanied by a weaker legislation and different standards for granting the credits by banks.

Conclusion: Assessment of the work of the Czech consolidation institutions

KOB was established as a means of supporting the transition to a market economy. After 1997, however, KOBP started to be misused as a solution to the economy's woes. In particular, it was used to saturate the state budget, as KOBP/CCA bought up and saturated government-ordered, loss-making transactions which were not settled from the state budget until several years later. From a historical perspective, thanks to the good strategy and firm foundations laid in the early 1990s, the Czech Republic succeeded in creating a stable macroeconomic environment with stable interest rates (apart from some excesses in 1997) in comparison with other transition countries. The consolidation institutions – Konsolidační banka, Konsolidační banka Praha and the Czech Consolidation Agency – were instrumental in that success.

There remains the academic question of what would have happened in the second half of the 1990s had the aforementioned shocks not occurred in the financial market and had some banks not been hurriedly privatised, tripling transfers to the CCA and causing significant material and moral losses. More than CZK 400 billion was transferred to the CIs in the bank privatisation process (and over CZK 500 billion was transferred overall). Almost half of this total[24] consisted of assets transferred from ČSOB. Without the transfers from ČSOB the loss would have been 50 percent lower and the CCA would have been shut down several years earlier.

Despite the above-mentioned theoretical drawbacks of asset management companies, the situation in the transforming post-communist Czech economy war-

[23] Different transfer prices (market, book, total, value, etc.), refinancing costs, etc.

[24] Around CZK 190 billion.

ranted the establishment of an asset management company in Czech Republic and the transfer of bad loans from the banks' balance sheets into this institution. First of all, the Czech legal environment was very weak at the beginning of the transformation process. Second, all banks were state-owned at the beginning of the transformation. Third, the secondary market for non-performing loans was virtually nonexistent. Fourth, the three biggest state banks represented a systematically important majority of the Czech banking industry. And finally, foreign investors were unwilling to invest in large Czech state banks before their balance sheets were cleaned up and their capital base strengthened or without additional guarantees. Out of many possible theoretical possibilities, the Czech government could have either liquidated most of the banks and caused a major banking crisis, strengthened the capital base of banks without transferring bad loans from their balance sheets, or set up an AMC and gone through a long and painful process of bad debt restructuring. The Czech government chose the latter option.

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