



SECONDARY MARKET FOR LOAN RECEIVABLES IN THE TRANSFORMING ECONOMIES OF SLOVAKIA AND THE CZECH REPUBLIC

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The transformation of the banking sector to a stable and efficient banking system able to support economic growth was one of the most important issues in the transition over to a market economy. The issue of bad debts came to occupy the forefront, and handling this issue was the main precondition to transformation and economic growth. The burden of bad debts was blocking restructuring not simply through their existence, but mainly through their volume.

The search for a possibility of how to handle bad debts brought three approaches:

The decentralised approach, where the state enters a bank, injecting capital, and the capital covers losses from non-creditworthy assets. A subsequent step may be privatisation of the stake acquired in this manner. Banks then solve non-creditworthy assets at their own expense. This procedure was used in the privatisation of banks, for example, in Poland. A certain modification of this approach is the provision of a state guarantee for non-creditworthy assets. In the Czech Republic the state guarantee was partially used in the privatisation of Ceska sporitelna and Komerčni banka, where the new owners were issued guarantees for risky assets.

The centralised approach, in which non-creditworthy assets are bought up by central institutions (an AMC – Asset Management Company) which continue to administer them with a view to achieving the maximum yield on these assets, or with a view to restructuring these assets. These institutions may be owned by the state or a private entity. We differentiate between two types of such AMCs:

- corporate restructuring vehicles, whose aim is to concurrently restructure banks and key businesses,
- rapid asset disposition vehicles, whose aim is to quickly sell off non-creditworthy assets. This type of institution does not focus on any restructuring of debtors.

A third method is a combination of these two approaches. The restructured problem loans provided to large and key businesses are transferred to an asset management company; the rest of such loans remain in commercial banks.

Tools for restructuring banks' non-creditworthy assets

Transformation institutions classify non-creditworthy assets taken over according to set criteria (e.g. by debtor, branch, region, debtor's financial situation, expected further development of business) into the portfolio and subsequently move on to restructuring. The transformation institution must decide which instrument to use for restructuring the portfolio, while taking into consideration legal and tax aspects. Emphasis is also placed on the transparency of the restructuring process.

In restructuring non-creditworthy assets, various countries use several of the possible instruments:

- capitalisation of debts,
- settlement, out-of-court settlement,
- sales of the portfolio of assets which are made via an individual sale, sale of equity stakes, or via an auction via the Internet,
- bankruptcy,
- securitisation,
- sale of guarantees.

In Slovakia the restructuring of banks took place in two stages. The aim of the first was to achieve at least 8% capital adequacy in banks under restructuring and to reduce the share of classified receivables to a total of 25% – 35%. In order to achieve this aim part of the risky receivables was transferred from their portfolios and the share capital of these banks was increased. In the second stage the aim was to reduce the share of classified receivables to 20% and to prepare the banks for privatisation. With a view to strengthening the capital in banks the SR Government outlaid SKK 18.9 billion, thus strengthening at the same time the state's position in these banks.

Transformation institutions in the Slovak Republic

The solution of problem loans dates from the times of

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the Czech and Slovak Federal Republic, when measures for solving insolvency were adopted. The federal government allocated CZK 11 billion for restructuring potentially viable businesses and CZK 4 billion for strengthening banks' capital. Lack of experience with projects of this type in the country were apparent in the non-systematic approach to solving insolvency.

In order to deal with the situation the state financial institution Konsolidacna banka, was set up in 1990. It took over loans in the value of CZK 110 billion from large commercial banks. As countervalue the banks received from the state CZK 50 billion in government bonds, of which CZK 12 billion were for increasing their equity and CZK 38 billion for writing off loans to permanently revolving stocks. Konsolidacna banka unilaterally and formally changed the annual nature of loans from permanently revolving stocks to long-term stocks with an expectation of the repayment of these loans by 2000. Businesses confirmed the repayment regime set by Konsolidacna banka. Businesses ceased to differentiate individual types of loans, whereby on the one hand the problem of loans from the aspect of banks was solved, where this solution often meant an increase in the burden on businesses, and at the same time for the state meant a burden on the state debt for public finances.

The split of the Czechoslovak Federation led also to the division of Konsolidacna banka into two entities. The state financial institution Konsolidacna banka, established on 1 January 1993 by the Ministry of Finance, took over almost two thousand clients with loans totalling SKK 30.4 billion. Its main goal was the liquidation, or arrangement of receivables and liabilities connected with loans to the permanently revolving stocks.

The restructuring of the Slovak banking sector was solved in August 1999, when the SR Government issued the Restructuring Programme for Selected Banks and the Business Sector, which was connected with SR Government Resolution No 90/1999. In order to ensure transparency of the privatisation process the government cooperated with foreign consultancy companies. The project was prepared in cooperation with the European Commission and the World Bank by means of the PHARE programme with the aim of creating a mechanism that would ensure the distribution of the overall loss from the whole process to the owners of debtor businesses (through a loss of assets), creditors (through incomplete satisfaction of receivables), including banks (using reserves and provisions) and the state (covering the remainder of the non-covered loss). An important step were legislative measures such as the Act on Bankruptcy and Settlement, acts on banks, tax laws and the updating of the Commercial and Civil Codes.

The new Act on Banks (483/2001) brought about limitations that Konsolidacna banka could no longer fulfil, therefore the government decided in June 2001 to transform it. Subsequently the government sold Konsolidacna

banka at a symbolic SKK 1 to the state controlled Slovenska konsolidacna², a.s., together with its assets of the value minus SKK 30 billion. Before this, a transfer of the problem-free part of assets and liabilities worth almost SKK 7 billion was made to the state financial institution Slovenska zarucna a rozvojova banka, (Slovak Guarantee and Development Bank). Slovenska konsolidacna emerged as a joint-stock company with the following stakes: Ministry of Finance – 24%, and the banks VUB, SLSP, IRB and Konsolidacna banka – 19% each. The main objective of Slovenska konsolidacna, a.s., resulting from the mentioned document, was to achieve the accelerated and efficient settlement of classified receivables assigned to its portfolio in the framework of the pre-privatisation restructuring from the banks owned in the past by the state – Vseobecna uverova banka, a.s. (VUB), Slovenska sporitelna, a.s. (SLSP), and Investicna a rozvojova banka, a.s. (IRB).

The decision as to which institutions the classified receivables were to be directed depended on the state's participation in each particular receivable. Loans provided with a state guarantee as well as loans subsidised by the state (e.g. loans for cooperative apartment construction) were transferred to Konsolidacna banka. At the same time classified loans towards those businesses that had undergone conversion, loans to towns and municipalities, of some agricultural businesses, receivables with a guarantee from Slovenska zarucna a rozvojova banka were also transferred here. The reason for these receivables being shifted to Konsolidacna banka was that it was a state financial institution subject to the NBS supervision and also the fact that the state could, from its position of the owner, control the manner of settling these receivables and handling revenues from them. Only loans from the first stage were transferred to Konsolidacna banka, where the volume of SKK 19.5 billion formed 17% of all risky receivables transferred.

With regard to the fact that pre-privatisation stage of restructuring VUB, SLSP, and IRB had been realised back in December 1999, the company had to concurrently begin performing also its specific activity connected with the administration and recovery of receivables. In the initial stage the administration and recovery of receivables was undertaken by the banks themselves on the basis of mandate agreements, and this continued until the moment when SKo, a.s. took over individual receivables into its internal administration. Naturally, several problems accompanied the overlapping of both tasks,

² Slovenska konsolidacna, a. s., (SKo) was founded by SR Government Resolution No 908 of 21 October 1999 as a specialized financial institution, having share capital of SKK 1 billion with the following stakes: Ministry of Finance – 24%, VUB, SLSP, IRB and Konsolidacna banka 19% each. At 13 September 2000 the Ministry of Finance SR became the sole 100% owner.



where efforts to overcome these put increased demands on the still emergent company.

Over the course of 2000, SKo, a.s., realised the pilot sale of a package of receivables under the title "Pilot Project I", which included receivables of 119 debtors in the total nominal value of SKK 13.314 billion. The company carried out an international tender in close cooperation with the international consultancy consortium – Barents Group L.L.C. Then a public tender was held, under the working title "Tender I – OVS I", the subject of which was the assignment of receivables of 14 companies, with a total volume of SKK 3.591 billion.

In the second half of 2000 a tender was held to select external companies for the purpose of performing mandated management of receivables and public selection proceedings were held to select analyst companies. In this way 28 external lawyer's offices were selected for legal representation of the company. In the framework of the pre-privatisation restructuring of Vseobecna uverova banka, a.s., Slovenska sporitelna, a.s., and Investicna a rozvojova banka, a.s. classified loans in the total nominal volume of SKK 62.7 billion were transferred to SKo, a.s. in the first stage, and in the second stage receivables in the nominal value of SKK 34.2 billion.

SKo, a.s., collected, over the course of 2001, funds from the realisation of receivables in the volume of SKK 1,260.3 million and at the end of 2001 was managing receivables in the total nominal value of SKK 78,208.4 million, of which a major part (71.1%) were receivables in bankruptcy and settlement.

In 2002, on the basis of a contract on sale of a business between SKo, a.s. and the National Property Fund SR, the company acquired the assets and liabilities of the state financial institution Konsolidacna banka Bratislava, in the value of approximately SKK 33.13 billion. In July 2002 the third wave of assigning of receivables from SLSP, a.s. was made in the nominal value of approx. SKK 639 million. In 2002 SKo, a.s. collected funds in the total amount of SKK 1.620 billion, though this was significantly negatively affected by the unsuccessful realisation of the Joint Enterprise Project as well as the failure to sell a shareholding in Postova banka, a.s.

The year 2003 was already the fourth year of SKo's existence. It marked also a turning point in company's volume of sales of receivables. The company also underwent several principal organisational and systemic changes that made its internal mechanisms and activities more efficient and professional. A key project of 2003 was the sale of a package of receivables in the nominal value of approx. SKK 42.9 billion, which SKo, a.s., realised in cooperation with the international consultancy consortium CA IB. It was a one-off sale of a package of problem receivables with the highest nominal value in the history of the Slovak financial sector. The result of the international tender was the winning bid by the company Majetkovy Hol-

ding, a.s., which represented revenues of SKK 820.64 million. The nominal value of the portfolio administered fell significantly, thus SKo, a.s., coming closer to the fulfilment of the set objectives at its establishment and confirmed the justification for its existence. Over the course of 2003 SKo, a.s., collected funds from the recovery and realisation of receivables in the total volume of SKK 744.3 million, which were used in particular for repaying a part of the principal and interest on a redistribution loan of the NBS and early repayment of a loan provided by SLSP, a.s., which served for covering assigned classified receivables in the 3rd wave. The share capital of SKo, a.s., was gradually increased from the original SKK 1.0 million to the value of SKK 93.607 billion and at the close of 2003 it was reduced to the value of SKK 12,294,926,010.

The situation in 2004 was as follows: Slovenska konsolidacna, a.s. throughout the period of its existence had dealt almost exclusively with the management and recovery of receivables. Thanks to the stabilised professional staff, sophisticated system of internal regulations and procedures, and organisation of work, it was fully prepared for the continual takeover of further problem receivables from institutions from the sphere of public finance. SKo, a.s. recorded as at 31 December 2004 in its portfolio receivables from restructured banks in the total nominal value of SKK 49.23 billion. In accordance with the adopted strategy for solving receivables from loans to agricultural and food-processing businesses a transfer against payment of receivables from loans to agricultural businesses to Slovenska zarucna a rozvojova banka, a.s. (SZRB) was also made. Conversely, an increase in the nominal value of receivables administered in the portfolio of SKo, a.s. at the end of 2004 was caused by a takeover of receivables from tax offices of the SR, in the total nominal value of SKK 24.6 billion. SKo, a.s. was thus as at 31 December 2004 managing in total SKK 73.83 billion. The share capital of SKo, a.s. as at 31 December 2004 stood at SKK 22.949 billion.

In the legislative field, on the basis of negative experience connected with problems in the interpretation and application of the current applicable legal regulation of bankruptcy proceedings in administering and recovering receivables, SKo, a.s. had prepared source documentation for a member's draft bill for amendments to the applicable Act on Bankruptcy and Recovery No 328/1991 Coll. This draft bill was passed by parliament with effect as of 1 January 2005.

Assigned receivables from Slovak banks in 2005

| | VÚB | SLSP | IRB |
|-----------------------|----------------|----------------|---------------|
| Number of receivables | 3 035 | 2 0646 | 104 |
| Number of debtors | 1 832 | 2 070 | 52 |
| Nominal value in SKK | 58 641 201 709 | 33 895 547 962 | 4 969 241 330 |

Source: Slovenska konsolidacna, a.s., Bratislava



Help in financing costs in restructuring the economy was also provided from the World Bank in the form of the Country Assistance Strategy, approved at the beginning of 2000. On basis the basis of this the provision of funds totalling USD 415 million was agreed, of which a restructuring loan for business and financial sectors – EFSAL – represented USD 300 million. Its repayment is distributed over 15 years, with deferred repayment for 5 years, interest being set at a quarter of a percentage point above the level of the World Bank base rate.

Receivables transferred

1. Management of transferred receivables

In its work with receivables transferred SKo, a.s. uses all standard methods, which include the assignment of receivables against payment, capitalisation of receivables, realisation of a right of lien, execution, court recovery, out-of-court agreement, entrusting receivables to mandate administration or recovery, division, combining or exchange of receivables, as well as netting and writing off of receivables. The most frequently used method of the agency was the assignment of receivables against payment.

2. Recovery rate for receivables

The source for financing restructuring costs were to be yields achieved by consolidation agencies from the sale of classified receivables. Their recovery rate was expected to be 10%, i.e. SKo, a.s. was to obtain about SKK 10 billion from the loans transferred. The situation was made the more difficult, since banks had not worked with some loans for a considerable period of time and a further hindrance was that prior to the loans' transfer no independent audit of these assets had been carried out. Therefore SKo, a.s. attempted to ascertain the recovery rate of receivables via two projects. The first project focused on ascertaining the reference recovery rate by means of a portfolio which contained all possible types of receivables. In the second project the agency, in cooperation with the World Bank, attempted to identify that part of receivables whose recovery rate was zero. In Slovakia up to two fifth of debtors were bankrupt, approximately 28% of SKo's clients were in execution; therefore the only thing to do with many of receivables was to write them off. Almost a half of receivables did not have any security. Yields from receivables were at the same time reduced by relatively high fees paid in the form of court deposits and to executors.

Transformation process in the Czech Republic

Steps for mitigating the adverse situation in the banking sector were solved by the Czech Government and central bank with the help of measures that may be divided into three fields:

- legislative and regulatory measures (strengthening of banking supervision and the Securities Commission's powers, insolvency legislation, new laws on banks),
- aid to depositors, afflicted by banks' insolvency,
- direct aid to banks or their new owners.

In restructuring the whole banking sector, as well as state firms, a centralised approach was chosen, where non-creditworthy assets were bought up by a state asset management company having the nature of a restructuring institution. The transformation task of restructuring institutions was to remove from the banks' balance sheets loans which were a result of the state's economic policy from the past regime and to enable businesses to begin their functioning without a burden of these loans, which could deform their decision making on the allocation of new loans. Their further task was to take over non-creditworthy assets from Czech banks in their privatisation and subsequently to realise these assets. In the Czech Republic the restructuring institutions had yet another task, this being aid to small banks that had got into serious difficulties and in their subsequent stabilisation through the declaration of Consolidation Programmes I and II.

Transformation institutions in the Czech Republic

Ceska konsolidacna Agentura (Czech Consolidation Agency – CKA) is the legal successor of the state financial institution Konsolidacni banka Praha. The original Konsolidacni banka was established by the state in 1991 and was to at the beginning solve the consequences of certain decisions from the period of the centrally planned economy and continued in managing receivables taken over or purchased from commercial banks. Up until 2000 it also focused, as a specialised bank, on financing development projects in the field of transport, connections and water management infrastructure and ecology. On 1 September 2001 Konsolidacna banka was wound up and was replaced by CKA. CKA was established on the basis of special Act No 239/2001 Coll. on the Czech Consolidation Agency. It is a non-bank financial institution that does not receive any deposits and does not provide loans. Its main mission is to actively, transparently and quickly resolve most of problematic assets with the aim of maximising the yield for the state. The agency will lapse together with this law on 31 December 2011 without liquidation. Substantial influence in the agency is held by the Supervisory Board, appointed by parliament. The bank's management of is appointed by the Czech Government.

The main activity of CKA is the management and realisation of assets, restructuring of businesses selected by the Czech Government and the court solution of assets taken over. Liquidation of assets is problem-free in the



case of clients who duly repay. Loans that are not being repaid are solved by assigning receivables to third parties, realisation of the right of lien, or auction. In the framework of a court solution of debts the option of bankruptcy, liquidation or submission of petitions is used. In the case of subsidiaries the block sale of loan receivables is made. In companies which are able to prove their viability and fulfil their obligations, CKA applies a strategy of restructuring, or repayment strategy. In the case of businesses designated by the government, where there is interest in their sale to a strategic investor, CKA searches for a partner. The agency has gradually bought up non-creditworthy assets in the amount of approx. CZK 400 billion. Besides buying receivables from commercial banks, it has also taken over receivables of health insurance companies in the amount of CZK 4 billion. The great increase in the balance-sheet total has been offset by the active solution of receivables. The main aim of CKA is to achieve the maximum economic return in the shortest possible time at minimum administration costs. Emphasis is placed in particular on three things: that the processes be made in a transparent and standard way according to the current segmentation in the environment of the newly-built information system, that a client-based approach be applied, and that each debtor be solved in accordance with a strategy agreed in advance, or in the case of a change to the conditions in accordance with an updated strategy.

KONOPO, s.r.o. was founded by Komerční banka as a sole founder, which transferred its classified loans to this company. On the basis of a contract of transfer of business stake, CKA became its sole partner. Its line of business is to buy up and sell loan receivables, the management of receivables, recovery of receivables and real estate activity. In 2002 non-creditworthy receivables in the volume of CZK 60 billion were bought from Komerční banka, a.s. KONOPO uses the individual and block sale of receivables for restructuring. In total it had sold receivables for CZK 4.12 billion.

PRISKO, a.s. was set up in 1992 on the basis of a privatisation project of the company Skoda Mlada Boleslav with the aim of taking certain obligations of the original business outside the newly privatised automobile company. CKA holds a 100% stake in a shareholding.

REVITALIZACNA AGENTURA, a.s. was created in 1999 as a special division of KOB for solving several large and complex cases. Since 2001 it has not performed any activity and now is in a process of liquidation.

SANAKON, s.r.o. was founded by Konsolidacna banka Praha in January 2000. Its line of business is the provision of administrative-technical services serving for the support of business at banks.

ČESKÁ FINANČNÁ (CF) was founded by the Czech National Bank, since 2000 it has been a 100% subsidiary of KOB (since September 2001 CKA). CF manages assets that it took over in the framework of programmes for strengthening the banking sector's stability and for consolidating small banks, and manages equity stakes, where in connection to the value of the stake held it efficiently exercises asset and shareholder rights. The main activity of CF is primarily the administration of assets (i.e. loan receivables, CPO, equity stakes), which it took over in the framework of programmes for strengthening the stability of the Czech banking sector. The stabilised programme is financed by CKA and the National Property Fund on the basis of Czech Republic Government Resolution No 539/1996 and a contract concluded between KOB and the NPF of 4 February 1997.

The restructuring of non-creditworthy assets is performed by transformation institutions with the help of a whole range of instruments, of which the most frequently used are individual sales, block sales of non-creditworthy assets, capitalisation of debts, the sale of equity stakes, bankruptcy and liquidation, realisation of the security.

The sale of non-creditworthy assets arranged into packages in the SR and Czech Republic is given in the following table:

Block sale of non-creditworthy assets in individual years

| Year | CKA | | SK | |
|------|--|--------------------|--|---------------|
| | Volume in the total value of CZK billion | Recovery rate in % | Volume in the total value of SKK billion | Recovery rate |
| 2001 | 19.10 | 7.10 | 13.30 | 3.30 |
| 2002 | 37.80 | 9.00 | 54.00 | no sales |
| 2003 | 62.00 | neuvádza sa | 54.00 | 0.07 |
| 2004 | | | 15.06 | |

Source: Annual reports of CKA and SK.

As regards the future of consolidation institutions, the situation is not yet clear. It is expected that the Czech Consolidation Agency will function until 2011. Slovenská konsolidacná, a.s. has had its originally expected life of 5 years, thus it should be gradually wound up. Its portfolio still contains a significant package of receivables (see above). The agency has its working procedures and control mechanisms created, as well as personnel background for successful further activity. One of the possibilities of using the potential of both the consolidation agencies is to use them in the implementation of European Commission Communication 2004/C/244/02 on state aid for rescuing and restructuring firms in difficulty.

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