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RESTRUCTURING THE BANKING SECTOR: SLOVAKIA'S FIRST MAJOR ECONOMIC REFORM

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Introduction

Between the end of the World War II and the 1989 Velvet Revolution, the then Czechoslovakian financial sector was fundamentally different from the standard economic model taught in Western universities. After the fall of communism, the establishment of a standard financial sector was seen as a basic precondition for restructuring from a "Soviet-like" economic system to an open market economy. This paper aims to describe this process, highlight its pros and cons, and present analysis to help others that may face such a transition in the future.

I. Banking Under Communism

The centralized bank system that existed in Czechoslovakia until 1989 consisted of one quasi-central bank and four quasi-independent commercial banks. The State Bank of Czechoslovakia (SBCS), a communist-era model of a central bank, played a major role in the financial sector, although with a far different status and investment portfolio compared to the standard central bank model. On top of common central bank duties, such as issuing banknotes and operating the national payment system, the SBCS has also served as the country's main corporate depositor and creditor. In addition, there was one saving bank (Czech Savings Bank and Slovak Savings Bank, or SLSP) in each of the republics which administered state-guaranteed household deposits, provided loans for individuals, and deposited the remaining funds with the SBCS. Individuals' foreign exchange transactions were under the charge of Zivnostnenska Banka (Merchant Bank), while enterprises' trasactions fell under the competence of the Ceskoslovenska Obchodna Banka (Czechoslovak Trade Bank, or CSOB). The CSOB also represented the state in international financial markets.

Lending activities of SBCS were confirmative of the decisions taken by the state's planning and administrative bodies. Neither the relevance of the business activity, nor the credit risk associated with it played any role in decision-making process on a new loan. Fresh funds were not provided on a profitability basis, but rather on politically dictated criteria. The misallocation of resources was widespread: performing companies were in fact bailing out the bad ones. The system lacked self-control, risk mechanisms, and competitiveness and, as such, was distorted.

II. Banking After the Fall of Communism: The Early Stage

Following the Velvet Revolution, the banking system entered a new era of evolution. The first phase called for establishment of the classical two-tier system in which SBCS retained its main function of a central bank but eliminated its commercial lending mandate. Lending activities were shifted to three newly-emerged commercial banks. Vseobecna Uverova Banka (General Credit Bank, or VUB) and Komercni Banka (Commercial Bank) assumed commercial credit and deposit activities in the Slovak and Czech Republics, respectively. Investicni Banka (Investment Bank), with a mandate to operate nationwide, assumed part of the long-term credit lending industry, mainly those financing housing and agricultural sector projects. In January 1992, Investment Bank was divided, with Investicna a Rozvojova Banka (Investment and Development Bank, or IRB) emerging in Slovakia and Investicni a Postovni Banka (Investment and Postal

Bank) in the Czech Republic. Under the Act on Banks (passed in 1991), all of the existing banks were granted a universal banking license.

Despite sectoral diversification, one key feature remained unchanged – all the banks were extended government bodies with little, if any, inclination to behave as commercial entities. Thus, it is of little wonder why they were not able to resist political pressures and continued politically-motivated lending to nonviable companies long after the removal of the central credit allocation mechanism. Such behavior led to a subsequent decrease in the quality of the corporate sector. Although the enterprises, most of which were fully controlled by the state, did not perform effectively the banks allowed them to draw new loans, gradually increasing overall indebtedness.

Voucher privatization, which was expected by many to change the status quo, did little to improve anything. In fact, it contributed to further deterioration in the sector. VUB and IRB were transformed into joint stock companies and publicly offered through voucher privatization. The state's stake diminished to 50.8 percent in VUB and 35 percent in IRB. However, the change in ownership led neither to improvement in the management of the banks, nor to a change in their business objectives and practices. The SLSP was transformed into a joint stock company only in 1994, but remained fully controlled by the state.

Following the split of Czechoslovakia, SBCS was divided into two central banks, with the National Bank of Slovakia (NBS) assuming the role of central bank in Slovakia. NBS was set up as an independent body with the dual objective of maintaining currency and price stability. The number of banks grew from seven in 1991 to twenty-three commercial banks, two branches and ten foreign bank offices by the end of 1998.

While the total indebtedness of the Slovak corporate sector was KCS 19 billion in 1992, it has risen to SKK 370 billion, or 50 percent of the GDP, in 1998. The bad financial position of the corporate sector has been mirrored by the banks' loan portfolios. The corporate sector's insolvency crisis largely eliminated lending profits. Large state-owned enterprises enjoyed easy credit and their failure to repay debts constrained the provision of new credit for companies with profit-making operations. The crippled state of Slovak banking has resulted in a situation where most banks were making few new industrial loans, and spreads were high.

III. Restructuring: A New Era in the Slovak Financial System

When the government of Prime Minister Mikulas Dzurinda took office in late 1998, the banking sector appeared on the verge of bankruptcy. This forced the state administration to look for the fastest and most efficient curative action plan.

The total assets of Slovakia's banking sector increased by 2.5 percent to SKK 796.3 billion in 1998, after rising 8.8 percent in 1997. Classified loans of SKK 141.6 billion represented more than 40 percent of the total volume of loans provided, or 17.8 percent of total assets in the sector, or 30 percent of GDP. The core of the problem lied with the three largest state-owned banks, VUB, SLSP and IRB. In 1993, these three controlled 88 percent of deposits and 66 percent of the total assets in the sector. At the end of 1998, their share of the deposit market dropped to 52 percent and that of total assets to 46 percent. However, the trio “owned” SKK 118.1 billion, or 69 percent, of the total classified loans in the sector. While other banks and subsidiaries of foreign banks posted a profit of SKK 351 million in 1998, the VUB, SLSP and IRB suffered an aggregate loss of 4.2 billion for the same period. The total estimated uncovered loss in the banking sector, almost fully associated with the three banks, accounted for SKK 23.3 billion at the end of 1998, up 92.5 percent from 1997. Poor quality loans inherited from the past and ineffective management resulted in a situation where classified loans brought two of these banks to the brink of insolvency.

Extraordinary levels of loan defaults at the state controlled banks and the resulting risk of collapse of the weakest banks forced the Finance Ministry in October 1999 to embark on a bank restructuring and privatization plan. Slovakia was the last country in the so-called Visegrad region (the Czech Republic, Hungary, Poland and Slovakia) to start a massive bailout in the financial sector.

The aim of restructuring was to ensure that at the time of privatization the designated banks would meet the international standard for capital adequacy of 8 percent and that classified loans would not exceed 20 percent of their portfolios. The capital adequacy, or so-called Cooke ratio, fell to 0.31 percent at VUB, 6.62 percent at SLSP, and was negative at IRB by the end of 1998.

Size and performance of the Slovak banking sector before the reforms (in %), June 1999 **Table 1**

Bank assets/GDP	Bank loans/GDP	Classified loans (2-5)/Total loans	Classified loans (3-5)/Total loans	Capital Adequacy Ratio	Return on equity
83.0	50.3	54.7	39.3	0.7	-13.1

Source: The National Bank of Slovakia
Loan classification as follows: category 1 – standard, category 2 – watch, category 3 – doubtful, category 4 – substandard, category 5 – loss

The first phase of restructuring, completed in December 1999, included an increase in the banks' registered share capital (capital infusions or, alternativly, re-capitalization). This plan was fully subscribed to by the Finance Ministry but was funded by the National Bank of Slovakia (NBS), the central bank. The starting point was acceptance by the NBS Banking Board of a government guaranty on redistribution credits it had provided to Konsolidacna Banka (KBB). In turn, the guaranty enabled the NBS to transfer loan-loss provisions on the credits worth SKK 17.8 billion to the Ministry of Finance. The ministry then used the funds to increase its equity in the banks.

Although KBB has functioned as a collection agency for old debt, the Ministry of Finance decided to establish a new agency, Slovenska Konsolidacna (Consolidation Agency), to hold title to, manage, and sell assets removed from the state banks. The ownership of the agency was spread over the Ministry of Finance (24 percent) and the three major banks (i.e. VUB, SLSP and IRB) and the KBB, which each held a 19 percent share. (NOTE: The Finance Ministry has later taken it over to improve the sale prospects of the banks, since equity participation in the consolidation agency would have introduced valuation concerns and potentially complicated privatization).

The VUB was the largest beneficiary during the first stage of restructuring, with its share capital increased by SKK 8.9 billion and SKK 37.4 billion in classified assets transferred to the debt agency and SKK 7.6 billion, to KBB. As result of this transaction, the total share of classified loans on VUB's total loans has improved to 32 percent, from 46.1 percent in 1998, and the Cooke ratio of the bank increased above the recommended "safety" level of 8 percent, to 9 percent. The re-capitalization has boosted the state interest in the VUB to 84.54 percent.

The SLSP received a capital infusion of SKK 4.3 billion. The subscription of the new equity increased the state control in the bank to 97.18 percent. The cleanup in the SLSP included SKK 20.4 billion of non-performing assets transferred to the agency and SKK 2.4 billion to KBB, cutting the share of classified loans on SLSP's total portfolio to 38 percent, from 44.7 percent in 1998, while its capital adequacy was strengthened to 8.5 percent.

The share capital of IRB was increased by SKK 8.7 billion, with classified loans worth SKK 5 billion transferred to the consolidation agency and SKK 1.5 billion, to the KBB. The IRB used the equity increase to pay off its debt towards the central bank, allowing it to cancel a two-year forced administration of the IRB. Following the bailout, classified loans in the IRB represented only 10 percent of the total loan portfolio and its Cooke ratio improved to 9 percent.

Classified loans on the balance sheets of all three affected banks were replaced by claims against the new Consolidation Agency and the KBB, with each covered by a state guaranty and bearing an interest rate of between 8.8 and 10.8 percent. The banks then dissolved their provisions on the loss-loans and subsequently used these funds to create provisions for classified loans still on their books.

These transactions had a dramatic impact on year-end results for the banking sector. Total claims amounted to SKK 556 billion as of December 31, 1999, of which standard claims were SKK 392.7 billion. As a consequence of the asset swap, previously mentioned "watch" claims (payments overdue by up to 30 days) fell to SKK 38.2 billion by December 31, 1999 from SKK 64 billion at September 31, 1999. Classified assets in the whole sector reached SKK 125.1 billion, down from 174.5 billion in September. (Classified assets were divided into three categories; 'substandard' represents payments overdue by at least 90 days but not more than 180 days; 'doubtful and litigious' are overdue by 180-359 days, and 'loss' payments overdue by at least 360 days).

Selected banking sector indicators				Tab. 2
	1997	1998	Q3 1999	1999
Number of banks	29	26	26	25
Of which: without foreign capital	11	10	11	11
TOTAL ASSETS	776.9	796.3	743.1	782.8
Total classified loans	119.2	141.6	169.3	118.1
Classified loans as % total assets	15.3	17.8	22.8	15.1
Provisions	32.5	41.6	46.9	46.4
Profit/loss	-1.3	-3.7	-9.5	-16.9
Memorandum: of which large banks (%)				
Total assets	51	46	46	45
Total classified claims	70	69	67	49
Provisions	53	62	58	63
Profit/loss	224	223	65	88

Year-end figures except for Q3 199;, in SKK billion except for first two rows
Excludes Konsolidacna Banka; Q3 1999 is before implementation of the first phase of the government's restructuring program, year 1999 figures are after the first phase
Source: The National Bank of Slovakia

In spite of the fact that classified claims should be fully provisioned, the total volume of provisions accounted for only SKK 46.4 billion versus a required SKK 88 billion as of December 31, 1999. The capital adequacy for the sector was 13.7 percent, excluding the KBB, which had become refuge for bad loans, or 5.4 percent if KBB was included. The balance sheets of the state banks contained provisions of SKK 29.4 billion, versus a recommended capital adequacy level of SKK 41.4 billion.

Nevertheless, the transfer of SKK 74 billion of bad assets was not enough to reduce the share of classified assets in the state-run banks to the target level of 20 percent, which had been decreased to 27 percent at the end of 1999 from 42 percent prior to restructuring. Therefore, in May 2000 the Slovak government revised its former bank restructuring action plan and agreed to remove an additional amount of almost SKK 35 billion of bad assets from state owned banks to the Consolidation Agency, SKK 21.3 billion in troubled assets from the books of the VUB, and SKK 12.9 billion from the SLSP. As with the classified loans covered in the first wave of bank asset restructurings, the assets were substituted by claims against the Consolidation Agency. As result of this operation, non-performing loans not covered by the system's provisions have fallen from 25 percent of total loans in 1998 to 8 percent at the end of 2000.

In early 2001, all claims against the Consolidation Agency and the KBB in the books of the affected banks were replaced by state bonds in a total volume of SKK 105 billion, an issuance equaling 12 percent of GDP. The bonds were issued with three maturity dates and two interest rates, and were initially floated at the Bratislava Stock Exchange (*see table 3*).

Issuance Calendar (Banking Bailout 2001)				Table 3
Issue	Date	Interest rate**	Maturity	Volume*
I.	Jan	Fix	5Y	35.4
II.	Jan	Float	7Y	27.8
III.	Jan	Float	10Y	20.5
IV.	Mar	Fix	5Y	9.1
V.	Mar	Float	7Y	4.7
VI.	Mar	Float	10Y	7.5

**In SKK billion*

*** Floating rate is based on 6M BRIBOR (Bratislava Interbank Offered Rate) average from the preceding quarter*

BOX: Shakeout hit also small banks

The same problems working their way through the state banks have also affected small and medium-sized banks, some of which thrived during the pre-1999 government's cronyism culture. Some of these banks lacked risk management systems and, in some cases, industrial shareholders were their main clients while several had a significant level of government control. Their credit risk, with loan activity concentrated in a small number of large loss-making firms, was enormous. And their cash-strapped shareholders lacked the funds necessary for restructuring.

The first failure occurred in 1999, when the central bank imposed forced administration over the 12th largest Slovak bank, Priemyselna Bank (Industrial Bank, or PB), after it had defaulted on obligations, repeatedly failed to meet minimum reserve requirements, and postponed payments ordered by large clients. It was the first administrative action by the central bank since the takeover of IRB in 1997. PB, which had SKK 17.2 billion in assets during this period, ran into trouble in 1998 after it guaranteed a $60 million deposit of the SLSP which was being held in Russian banks. When the Russian bank defaulted, SLSP was later forced to absorb the PB to avoid losing its deposits. The PB had been previously controlled by the government-run insurance company Slovenska Poistovna, the Slovak state power company, and the Slovak state gas company.

On December 1, 1999, Slovakia witnessed its first withdrawal of a banking license after the central bank decided to liquidate AG bank, one of the country's smallest banks with SKK 6.2 billion in assets. The central bank attributed its action to persistent liquidity problems, violations of criteria on prudent banking practices, and continuously unfavorable financial indicators. Only a significant capital increase could have saved the bank, according to the central bank, but AG's owners had failed to approve such action.

During 2000 and 2001, the implementation of new operational standards coupled with banking sector "normalization" effectively elminated an additional three small banks, i.e. Dopravna Banka (Transport Bank), Slovenska Kreditna Bank (Slovak Credit Bank) and Devin Bank.

The final bill for liquidation of the four small/medium-sized banks and paying off their depositors came at the cost of approximately of SKK 20 billion, or 2 percent of estimated 2001 GDP. The money owed to insured depositors was paid by the Deposit Insurance Fund, which borrowed from the central bank to honor its obligations. However, it is important to note that this has also placed an undue burden on the solvent banks, which have been subject to high contributions to the fund.

IV. Banking privatization – the final stage of the reform

The SLSP, the largest Slovak bank in asset terms ($4.16 billion in 2000), was sold at the end of 2000. Die Erste Bank der Osterreichischen Sparkassen of Austria won the tender, purchasing 87 percent of shares for EUR 425 million, or about 1.78 times the estimated book value. In June 2001, Die Erste agreed to sell a 19.99 percent stake in the SLSP to the European Bank for Reconstruction and Development (EBRD) for EUR 98 million. In 2005, the Austrian majority shareholder exercised its option on a buyback of a 19.99 percent stake from the EBRD, gaining 100 percent control over the SLSP.

A tender for the VUB, Slovakia's largest commercial lender, was concluded in June 2001 with IntesaBci of Italy outmaneuvering the French bank Societe General. The Italian banking group offered EUR 550 million for a 94.5 percent stake in the bank, which included 69.5 percent held by the government and 25 percent jointly owned by the EBRD and the World Bank's International Finance Corporation**.** (NOTE: VUB's two-stage sale began in February 2001, when the EBRD/IFC team bought a combined 25 percent stake in VUB for USD 46 million). VUB's assets totaled $3.5 billion at the end of 2000.

The IRB, the smallest (assets of $547.8 million at the end of 2000) and most troubled of the three state banks, was forced to write down its registered capital by SKK 7.656 billion in July 2001 to SKK 1.044 billion to offset its accumulated losses from 1997 and 1998 and prepare for privatization. Its sale finished in November 2001, with Hungary's largest commercial bank, OTP Bank, buying 69.56 percent of shares from the Slovak government and 22.99 percent from the insurance company Slovenska Poistovna, for SKK 700 million in total. After increasing the bank‘s share capital, OTP Bank has since gained a 96.85 percent controlling stake in the bank.

Along with the technical phase of Slovakia's bank restructuring, the government passed a series of new laws reforming the sector, including new regulations involving the central bank, banking, insurance, securities, and the Financial Market Authority – all of which have contributed to the ongoing progress of structural reform.

Conclusion

Banking sector restructuring and privatization was crucial to start unavoidable changes in the enterprise sector.

The process of restructuring proved that the banks couldn't be sold to private investors without the bailout preceding their privatization.

The banking rehabilitation resulted in a sounder asset structure, higher capital adequacy of the banking sector as a whole, and a reduced share of classified loans in total loans.

The transfer of bad loans and their replacement by government bonds freed-up funds previously locked, to cover non-performing assets.
The process of privatization showed that open, competition driven privatization tenders with no exclusivity led to better results..

The entry of strong foreign owners strengthened the credit culture and governance in the Slovak banking sector, and brought in new risk management credit systems. It also put the necessary pressure on the corporate sector, improving its controlling and reporting mechanisms, as well as the overall corporate governance.

The positive effects of restructuring and privatization reflected in cheaper funding. As the cost of funds decreased, the average interest rates on deposits and loans dropped. This allowed banks to participate in several important workout cases, e.g. steel industry

Overview of the Slovak banking sector (1995 –2003) **Tab. 4**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Number of banks	31	29	29	26	25	23	21	20	21
Number of branches	n.a.	n.a.	n.a.	n.a.	1,229	1,101	1,052	1,020	1,029
Number of employees	22,075	24,053	23,868	23,905	23,171	22,332	21,324	19,794	19,797
Return on assets *(ROA)*	0.9	-0.02	0.09	-0.5	-2.3	1.5	1.0	1.17	1.17
Return on equity *(ROE)*	n.a	n.a	2,8	-13.4	-36.5	25.2	22.7	29.43	27.15
Capital adequacy *(%)*	8.4	7.7	8.1	6.7	12.6	12.5	19.8	21.3	21.59
Non-performing loans *(% of total loans)*	41.3	31.8	33.4	44.3	32.9	26.2	24.3	11.2	9.1
Spread *(difference between lending and deposit rates)*	6.6	7.0	7.5	5.8	3.6	5.2	5.0	5.3	4.8
Private sector deposits *(% of GDP)*	56.0	55.8	57.5	55.1	57.1	60.5	61.1	58.7	53
Loans to private sector *(% of GDP)*	51.9	58.4	53.9	50.3	48.4	44.1	32.9	30.9	31.9
FX loans *(in % of loans to private sector)*	7.3	9.5	12.0	14.5	15.0	13.7	17.0	17.1	20.3
Maturity structure of loans *(long-term loans in % of loans to private sector)*	63.3	59.4	59.8	59.6	67.4	63.2	68.9	69.1	72.6
Bank assets/GDP *(in %)*	103.7	109.6	109.0	102.4	92.7	91.3	92.2	92.8	83.2
Market share of state-owned banks *(assets, in %)*	61.2	54.2	48.7	50.0	50.7	49.1	4.9	2.9	2.46
Market share of foreign-owned banks *(assets, in %)*	n.a.	n.a.	n.a.	34.2	34.1	44.7	90.1	n.a.	96.28
Market share of foreign-owned banks *(capital, %)*	32.7	39.6	39.2	37.3	24.6	28.1	60.5	85.3	88.9

Sources: The National Bank of Slovakia, IMF, EBRD, Bank Austria Creditanstalt

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