
The Old Bad Loans Problem: The Czech Experience

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Source: *Eastern European Economics*, Mar. - Apr., 1997, Vol. 35, No. 2 (Mar. - Apr., 1997), pp. 29-40

Published by: Taylor & Francis, Ltd.

Stable URL: <https://www.jstor.org/stable/4380080>

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The Old Bad Loans Problem

The Czech Experience

Banks play a vital role in economies, requiring governments to approach them in a different manner than other economic players. A collapse of the banking system would affect all other sectors and would endanger macro-economic stability. It is no wonder that the problem of so-called “bad debts” or “bad loans” became a threat, since all developed countries have had to face it at some point since the end of the 1980s. Their banking systems did not collapse, suggesting that solutions are possible and that they were found by these countries. The approaches were different, because there is no universal recipe. What they all had in common was that it cost something, since there is no such thing as a free lunch, and that somebody had to foot the bill.

The countries in transition wrote a new chapter in the history of bad debts. Apparently they had the same problems to solve, so why should they not learn and use already verified and standardized methods? There was a difficulty, however: the fundamental basis and size of bad debts in advanced economies was radically different from those existing in countries that are at the beginning of their economic transformation. Basically, the common factor that lies behind the whole bad-debt problem in advanced countries is the depreciation of the bank’s assets. For example, financial deregulation and the subsequent increase in investments in real estate led in several developed countries such as the United States to the appearance of a “bubble” based on the price increase of real estate. Also, banks that provided large loans to developing countries had their assets depreciated, and so forth.

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However, although the absolute amounts of such bad debts are significant, in comparison to the total credit portfolio or to the gross domestic product of the lending countries, the situation does not seem so serious. In solving the bad-debt problem, the emphasis falls on the most efficient protection of the depositors. Although in this process there is a certain amount of state financial involvement, and hence of taxpayers, the losses are mainly supported by financial institutions and, therefore, by the agents who, through their decisions, contributed to the appearance of the bad debt. The appearance of bad debts in transition economies is tied to deeper causes: the performance of national banking systems is inseparable from the monetary system of centrally planned economies. Concretely, the causes that make these countries face a bad-debt problem are (a) the fact that up to now there was no independence of bank management in decisions concerning credit policy and commercial banking; and (b) the management of state-owned companies, the banks' main debtors, was often poor, bringing no profit and causing the accumulation of bad debts. In other words, the bad debts in transition economies stemmed from the national economic system itself, not only from the bank's management, as is the case in developed countries. Meanwhile, the amount of bad debt in the newly reformed economies is large not only in an absolute sense but, what is worse, also when compared to total credit and economic output.

In order to achieve progress in the solution of the bad-debt problem in transition economies, it is absolutely necessary to reform the mechanism that led to such debts in the first place. This means not only improving management but also reforming the entire economic system. The appearance of an independent banking sector plays a major role in this, as does the reinstitution of the central bank's position in the sense that "each must pay his own bills."

How can the countries with a transition economy deal with this "skeleton in the closet"? Who should pay the old bills, which cannot be simply thrown away and ignored? How can the situation be avoided in which old outstanding debts became new ones, although with new debtors, and their payment remains a time bomb for the future? In this case, a mechanical repetition of the methods of advanced countries would be inefficient. Each transition economy had to answer these questions according to the actual situation. Even if the menu of reforms had the same basis, the order and the timing of the courses were different. In the end, however, the only difference was in the question of whether there was a pocket from which the debt would be, at least partially if not entirely, paid.

In the following material, we will analyze the "Czech road," its route and milestones. We will attempt to summarize the experience in solving the

problem of inherited bad debts, which means we are talking today about past events that could still, however, influence the future—the first stage of the transformation of the Czech economy and the Czech banking system.

The Situation at the Beginning of the Transformation

From today's point of view, the problem of so-called bad debts was given surprisingly little consideration during preparations of the banking reform. It was seriously discussed only in the beginning of 1990, after the initiation of bank reform. That was the first time that the "cleaning" of banks' balances was mentioned. In the "preparatory" period of 1990, the economic situation was relatively stable, including a reasonable interest rate. The government's attention was then focused on the elaboration of a viable scenario for the economic reform and on establishing the best macro-economic parameters for its initiation; there was no reason to pay excessive attention to the problem of bad debts.

By 1991, however, the situation had already changed. The inflation rate and, therefore, the interest rate increased significantly after the first round of various reforms. For state companies and organizations, the level of interest rates ceased suddenly to be more or less ignorable; in fact, it became clear that some companies and organizations were unable to finance their indebtedness. Simultaneously, the "scarcity" of money increased in an unprecedented manner, access to loans could no longer be taken for granted by firms, and their total indebtedness, including their old debts, played an important role in the decision-making process of granting new loans. For the newly created commercial banks, the situation was not simple either. The new conditions caused them to analyze their balances seriously,¹ and in that process it was discovered that their portfolio selections were of a rather poor quality. At the same time, commercial banks were suffering from a lack of capital. The available capital was wholly unsatisfactory, varying between 1 and 2 percent of assets, even if we calculate the simple ratio between the bank's capital and total assets. All of a sudden, from the point of view of both banks and companies, the old debts became an important issue.

In the beginning of 1991, the question was, what was to be done with the banks' existing credit portfolio? In other words, what was to be done with the companies' bad debts? In order to answer this question, both quantitative and qualitative aspects were considered.

In the first quarter of 1991, in Czechoslovakia, the size of companies' debts was approximately 570 billion koruny. The biggest part of this "bad" debt was loans for fixed assets, which reached 169 billion koruny. A second part included a wide range of loans: dubious export loans, 27 billion koruny; loans for integrating the Soviet Union's exports, 12 billion koruny; loans

for the construction of nuclear power plants, 12 billion koruny; loans for real estate construction, including loans to individuals and small firms, 30 billion koruny; social loans, 30 billion koruny. Apart from this, it was estimated that approximately 120 billion koruny in factory loans were unpayable. In conclusion, approximately 400 billion koruny, which represented 60 percent of the entire credit of banks, were to be considered bad loans. It is certainly possible to debate what really belonged in the bad-debt category. For example, loans for real estate construction are considered "bad" not because they cannot be recuperated but because they have a long period of return and a small, unchangeable interest, and so on. For this reason, there were different estimates of the real amount of the bad debts, ranging from 75 percent at the beginning of transformation, an estimate coming from central bank representatives; to 66 percent, based on a Working Paper of the Czechoslovak Central Bank; and to 29 percent, the estimate of the World Bank.

Even if we consider 1991 as a milestone for bad debts, we must emphasize that their appearance was a heterogeneous process. The greatest part of the bad debt came from the past, and it was connected with the planned-economy system. The shock created by the first stage of the economic transformation and the sudden disappearance of existing commercial relations caused a second part of the bad debt. It should be stated, then, that the problem of bad debts has a double nature:

1. "old" bad debt, dating from the days of a planned economy, when, among other factors, there was no clear separation between fiscal and monetary policies. An important segment of this debt was in fact made up of gifts, quasi gifts, or compensations; and

2. "new" bad debt, loans accumulated in the first stage of the economic transformation:

- (a) loans related to foreign trade, especially because of the collapse of the Council for Mutual Economic Assistance (CMEA); and

- (b) "pioneer" loans, especially to private companies.

Among the inherited loans, we then include the old bad loans, created before 1989, and also a part of the new bad loans, created after 1989, but still related to the heritage of the past, in particular to the orientation of foreign trade. In other words, from the banks' point of view, these were loans whose appearance did not originate as an independent management decision based on their evaluation of the risks.

Bad Debts and Government Policy

The Czechoslovak government soon identified the potential danger to the economy, which stemmed from the accumulation of these bad debts. The

state's attitude could have ranged from accepting complete responsibility for all the bad debts to complete noninvolvement, leaving the bad debts to resolve themselves through hyperinflation. To transfer all the state companies' debts into the state budget, a method partially recommended at that time by international institutions, would have been unbearable from the point of view of state debt growth and its management in the future. On the other hand, to allow banks to bear the weight of the bad debt was not an option either, since the banks were suffering from a lack of capital and the companies' loans were covered about 60 percent through deposits from the population. It thus followed that the state had to find a middle road between these two extremes.

The state's approach to solving the problem of bad debts consisted of the following:

1. the banking sector was involved, in one way or another, in the majority of measures;
2. each measure was emphasized as being a unique step, never to be repeated in the future.

This attitude on the part of the state was informed by an awareness of the risk that banks would be tempted to believe that the state would continue to offer them financial support. We should not forget that in the beginning of the 1990s all seven "old" banks, that is, banks that were in existence before 1990 and that were formed through the separation of commercial banks from the central bank, were owned by the state.

In order to improve the banking system, the state worked on strengthening the balances of commercial banks, particularly those that inherited the loans of the monobank before 1990, loans that were more or less bad. Another priority was to solve the bad loans in the balance of the Czechoslovak Bank of Commerce (CBC).

The state strategy consisted of assisting the banks by increasing their capital, creating means to transfer bad debts from each bank, and replacing the bad debt with official state notes.

In order to finance these steps, two means were employed:

1. the National Property Fund (NPF); and
2. the state budget

The NPF was responsible for, that is, paid for, one-time measures, thus the amount taken directly from the state budget was significantly smaller. Even in the present, and for the future, the NPF supports the inherited debts. However, the state budget gained ascendancy as the source to improve the banks' balances. This is not direct state involvement but a way to help the banks create means and reserves that would allow them to solve the problem of the new bad debts.

The measures the government adopted in order to solve the old bad debts consisted of both orthodox and less usual steps aimed at strengthening the banks' balances. This was a progressive process, using both global and individual measures.

The main global steps were executed in 1991:

1. The first major step was to create a consolidation bank.
2. The second major step was the so-called "action of de-debtedness and recapitalization of banks."

The government later used methods that we could call "individual" during 1992–96:

1. The most important individual steps consisted of clearing the balance of the Czechoslovak Bank of Commerce.
2. Important steps were taken in the creation of a consolidation bank.
3. Other steps had a variegated character and a smaller amplitude.

Steps on the Way to the Progressive Rehabilitation of Banks

Solving the old bad debts was in fact part of the progressive rehabilitation of the Czech banking sector. The employed measures all had the same goal, strengthening the banks' balances, but they were different in many ways. Some measures were taken to strengthen the banks in such a way that they could "carry" the burden of the bad debts, and other steps were intended to transfer the bad debts from the banks' balances. It was also questioned whether a specific step was planned in order to eliminate the bad debts completely or if some steps meant just a move in time, which means the debt was eliminated progressively. We could divide the adopted measures into four categories by their nature.

Debt Transfers

(a) The first and the most extensive step of the government in its effort to solve the problem of the bad debt was the so-called "operation fixed assets," that is, the creation of a consolidation bank. This institution of state monies was founded in March 1991 by the federal Ministry of Finance as an institution whose role was to manage the bad debts. Later, in 1992, this body was divided into two banks, a Czech bank and a Slovak bank.

At that moment, the main part of the unpaid debts for fixed assets, approximately 80 percent of industrial factories' loans and about 50 percent of commercial organizations' debts, more than 110 billion koruny, of which almost 30 billion were loans to Slovak companies, was excluded from the

commercial banks' balances (Komerční banka [KB], Všeobecná úverová banka [VUB], Investiční banka [IB]) and transferred to the Consolidation Bank. On the liabilities side of the balance, the Consolidation Bank counted the so-called redistribution credit, obtained from the central bank and offered at a discount rate, and deposits and savings transferred from commercial banks, with a higher interest rate.

From the debtors' point of view, the principle of this operation was to restructure the debts, that is, to reschedule the payments over time and at a more bearable interest rate. The Consolidation Bank restructured the loans on fixed assets, turning them into loans for an eight-year period with an annual interest rate of 13 percent, a rate that only recently increased by 1 percent. It is obvious that for companies this was a preferable situation when compared to short-term loans with an interest rate as high as 24 percent. The amount of credit transferred from commercial banks to the Consolidation Bank accounted for approximately 16 percent of the total credit. With this measure, the commercial banks' balances improved significantly. Although this was not a definitive solution for companies, since they still had to pay those debts, the conditions were more reasonable. Not all of them were able, however, to honor their debts, and this part of the bad debt was left for the Consolidation Bank to handle.

(b) At the end of 1992, part of the assets and liabilities of the Czechoslovak Bank of Commerce was transferred to the state. Among the liabilities of the CBC there existed a significant amount of loans accepted earlier, in hard currency, for about 56 billion koruny, included in the so-called central hard-currency reserves, which had to be paid. On the other hand, among the assets of the CBC there was a large amount of loans, 77 billion koruny, in nonconvertible currency.

The fact that the governments, both Czech and Slovak, accepted the obligations and assets of the CBC saved this institution all its credit, currency, and liquidity risks, helping to clear its balance. For the CBC, this operation meant escaping from a major burden of the past. The debt was transferred to the state and led to an increase in the state debt.

Debt Shifts

(a) The second major measure was the so called de-debtedness. At the end of 1991, commercial banks received a commitment from the National Property Fund with a total value of 38 billion koruny, which was subsequently honored by the Fund. This was given in exchange for erasing an equal amount of the companies' debts. The companies involved were state enterprises burdened by old debts but with good economic prospects. Four

Czech banks (KB, IB, Československá Obchodní banka [CSOB], and Komerční a Obchodní banka [KOB]) received in this process more than 22 billion koruny. Later on, the same route (NPF to the bank to the company) was followed by other individual cases; the sums involved were, however, much smaller. During this partial debt elimination, companies escaped from their debts and banks ended up with an improved balance. The cost of the entire operation was supported by the National Property Fund, which covered it from its income.

(b) During 1992, the Consolidation Bank started the second round of debt operations. The bank took dubious assets, created before 1990, from commercial banks, with a nominal value of 15 billion koruny and a 20 percent discount, therefore paying 80 percent of the total amount, and simultaneously accepted a deposit of 12 billion koruny from these banks.

In this instance, the companies did not get rid of their debt; they had to pay it to the Consolidation Bank. For commercial banks, however, this step meant an improvement in their balances, since they already had started to compensate for the losses attached to those debts. The Consolidation Bank acquired the bad debt "more cheaply," together with a source to cover it. However, if the companies will not pay it, the bank will have to create its own funds in order to compensate for the loss.

(c) State grants were a complementary type of state involvement in the problem of bad debts. At the end of 1992, the ministries of finance of the Czech and Slovak republics took from the Investiční banka the loans that were earlier granted as part of state-sponsored projects in CMEA countries. This amounted to more than 13 billion koruny. For the banks' balance this meant, again, an improvement. However, if the companies do not pay their debts, the state will have to support the losses.

(d) At the end of 1993, the ministries of finance of the Czech and Slovak republics created so-called *inkaso* units, which acquired more of the low-quality assets of the CBC. In total, the Czech Inkaso Society, Ltd., accepted more than 25 billion koruny in assets. The CBC is refinancing both *inkaso* units. The payments, however, are not related to the amount actually paid by the debtors. Payments by the created units to the CBC are granted by the Ministry of Finance.

This operation is part of the second part of the CBC transformation, combined with the clearing of its balance. It is thought that the foreign debtors will pay only part of their debt, and the *inkaso* units will not have means with which to honor their obligations. In this situation, the Ministry of Finance will have to intervene, supplying the necessary amounts.

(e) In 1994, the government decided to use 7 billion Czech koruny from the National Property Fund's assets to pay the old bad debts of the collective

agricultural cooperatives, which were returned to their original owners. With this maneuver, the involved banks improved their balances, the “‘new’ old” owners did not have to pay back debts for which they were not responsible, and the final cost was supported again by the National Property Fund.

Recapitalization

(a) Capital strengthening was part of the second major step taken by the government at the end of 1991. The largest banks, which belonged to the state at that time, KB, IB, CSOB, and Česká spořitelna (CS), received a “capital injection” with a total value of 12 billion koruny. Their capital was strengthened by obligations distributed by the National Property Fund. There were no interest obligations, which in the following five years could have been exchanged for stocks in privatized enterprises. A result of this “global” recapitalization was a certain improvement of the capital adequacy of the banks.

(b) The next recapitalization was individual. The Consolidation Bank’s capital was strengthened in 1993 with obligations from the National Property Fund, 3 billion koruny, and the capital of the CSOB received 1 billion koruny in the same way. Simultaneously, the Ministry of Finance and the Czech National Bank contributed to the capital strengthening of the CSOB with 2 billion koruny.

(c) Other forms of capital strengthening were involved, although not in the form of indirectly attributed capital. In 1992, the Czech National Property Fund issued 23 billion koruny in obligations, which were deposited as a subordinated debt in two large banks (the KB and the IB). This increased their capital base. The obligations were given as guarantees for the payments that companies that had already been privatized owed to those banks. These obligations were honored in 1993, since there were no bankruptcies, as had been initially assumed. Another measure consisted of strengthening the general reserves of the Consolidation Bank through obligations from the National Property Fund. The entire process took place in two steps in 1994 and amounted to a total of more than 30 billion koruny. These means were to be employed only for bad-debt compensation, not for financing other actions of the Consolidation Bank.

The recapitalization represented an important contribution to banks’ rehabilitation, since it increased their capital sufficiency through transfers. Although for companies this measure was not direct aid, since it did not forgive debts, the indirect effects were obviously positive in terms of an increase in their credit capacity, a decrease in the pressure to declare bankruptcy, and a decrease in pressure concerning interest margins. The

cost of the recapitalization was fully covered through public funds, in particular from the National Property Fund.

Other Operations

The range of adopted measures was much broader than those discussed above. Not all of them were perceived as direct measures taken in order to solve the bad-debt question. They included deposits from the National Property Fund, either as aid in covering the debts of foreign companies in deposits at the CBC, or as guarantees for domestic companies' debts in deposits at the IB. The refundable loans from the National Property Fund were also employed in closing the circle of reciprocal debts among companies. Another option, which was not used in the end but which was taken into consideration at that time, was to buy the assets of the Consolidation Bank or those of the forfeiting companies with funds from the National Property Fund. This action was taken later, but on a much smaller scale. Among the quantitatively significant measures for the solving of the bad-debt problem, we could include the following two categories:

(a) The state budget covered certain losses or debts that would otherwise have been passed onto the companies or banks as part of the old debts. At the end of 1990, the state provided 10 billion koruny in order to cover the losses and debts created by the koruna's devaluation. Another 3 billion were used for the conversion of the weapons industry and yet another 1.5 billion for covering the losses created by the freezing of commercial transactions with internationally embargoed countries.

(b) The state budget, or sometimes the National Property Fund, also pays property compensation to banks that prior to 1989 provided long-term loans at a low interest rate. The CS and the *Investiční a poštovní banka* (IPB), banks that provided loans for housing construction to companies and individuals, are among the beneficiaries. These banks receive financial compensation that represents the difference between the present discount rate and the interest rate established in the past for the loans, ranging from 2 billion to 3 billion koruny a year. Although this still does not make those loans very advantageous since they gain in interest less than they could on a commercial loan, from the point of view of the bank's balance they are not bad loans. In addition, the state financing allows the recipients of the loans to manage their debt without severe pressure on the part of the bank for a rapid repayment of the loan.

Conclusions

The main characteristics of the "Czech road" in solving the old bad-debt problem can be summarized by the following:

1. The approach chosen to solve the bad-debt problem, being one that goes step by step, allowed the sequencing and decoupling of the applied measures. Although, in the beginning, there was a large amount of bad debt in the banks' balances, it did not lead to the collapse of the banking system or to mass bankruptcies among companies.

2. The first steps of this process were rapid and substantive. This was important, since the property structure of banks changed rapidly. Decisions about the next steps in the situation, when big banks became more or less private, were more difficult. They acquired a political tone, each government regulation interfering with different interests of banks.

3. The problem of the bad debt inherited from the previous regime was not solved exclusively by the banks, which would not have been possible, and state intervention was necessary.

4. An important point in the rehabilitation process of commercial banks was the creation of special bodies that took a significant part of the bad debt from the banks' balances.

5. The main financial means employed in helping the banks were obtained from the privatization process; the government, in its effort to maintain a balanced budget, was not willing to give money from the state budget for the compensation of bad debts.

6. The state's assistance continues even after the privatization of the banks. A condition of state support is that funds provided are to be used exclusively for losses incurred because of loans granted during the former regime.

7. During the transformation process, new bad loans appeared. This made it necessary to separate the problems of the "old" from the "new" bad loans and to use different methods to resolve them. Currently, the central bank plays more of a role in solving the problem of bad debt and banks' consolidation than the government. Doubtless, the measures used in the Czech Republic to solve the problem of inherited loans prevented mass bankruptcies due to indebtedness, while at the same time rehabilitating the banking sector. The costs were not small and were covered with public means, since there was no other source. This did not lead to a dramatic increase in the state debt. It is obvious that not all inherited debts were liquidated. However, I do not think that this unfortunate heritage meant a direct threat to the bank and entrepreneurial sectors as regards the economic stability of the country. In this sense, we could talk about a good "public investment."

In the process of economic liberalization, it is unavoidable to confront a certain amount of bad debts. The methods used to deal with them will be different than those employed in solving the inherited debt. The main effort

should be directed toward wasting as little of the taxpayers' money as possible.

What experiences from developing countries could be useful to us? The following measures come to mind:

1. Along with the liberalization of banks' operations, measures should be taken to strengthen the risk management of banks in such a way that the credibility of the banks' management would not be lost in times of financial deregulation

2. A mechanism should be instituted that would allow us to avoid potential abuse from bank management.

3. In order to avoid a threat to the entire system, either an improvement in the activity of deficient banks should be initiated or they should be declared bankrupt. How far we have traveled on this road is a subject for another article.