Allocation of funds to high-yield assets

One way to measure the quality of a commercial bank is to look at the share of productive assets in its total assets. Productive assets are lending operations producing a certain interest, which is becoming a decisive source of income for commercial banks nowadays. In advanced banking systems, it is a standard to have productive assets make up over 90% of a bank’s total assets. Bank assets are dominated by loans, interbank assets and securities operations. Their yields have a major impact on the profitability of individual banks and, hence, the entire banking sector. There are two factors to consider when a bank is looking where to put its money. Namely, the risk of an asset, represented by its recovery rate, and its price, i.e. the interest rate. Since loans, as indicated above, are a fairly risky investment under our conditions, in 1998 commercial banks shifted their sights to interbank operations and securities deals. That what one reason. The other one was the Slovak banking sector’s quest for capital adequacy, still running short of the standard, which forced banks to tilt their asset portfolios towards the less risky securities. Banks undergoing transformation would fill their portfolios primarily with government securities. While a mere 6.36% in 1993, the share of securities in total productive assets rose to 8.84% in 1994 and on to 13.53% in 1995. Seen over a 5-6 year period, investments in securities more than doubled in the banking industry. It was mainly in 1997 and 1998 that banks went on a spree to shop for high-income low-risk Treasuries.

The main reason why banks treated loans with caution was in their high inherent hazards. At a time of rampant corporate insolvency, loans are one of the riskiest transactions a bank can make, and the loan portfolio suffers from an usually high default rate which can ultimately drive it to the point of loss.

The price of banking assets depends on market conditions, i.e. the demand and supply. At the same time, though, the average interest income depends on the correlation between an asset’s price and risk. The riskier an asset, the higher its price, and vice versa. If a bank moves its portfolio structure towards less risky assets, it must expect to see its profits fall.

The losses commercial banks sustained as a result of loan principal and interest defaults have stifled further development and sapped the profitability of the entire banking sector. Not even a highly pitched interest rate can make up for the losses resulting from provisions for classified loans.

Investments in securities, in contrast, bring in profits even if margins shrink. This philosophy of allocating funds to securities slowed down financial flows into the corporate sector, leading to widespread borrower defaults – hitting in particular the transforming banks – with the logical adverse effects both on liquidity in these banks and business performance in others. That is why an improvement in the quality of Slovakia’s banking sector must start with a treatment of the country’s largest state-held banks. If they are not straightened out, the future of the entire banking sector could be in danger, and the impacts on the whole Slovak economy might be very severe.

Pre-privatisation restructuring of the banking sector

The need to address the problems described above prompted the adoption of a workout package under the Slovak cabinet’s resolution No. 90/1999. The NBS teamed up with the Slovak Ministry of Finance to draft a „Proposal for Restructuring Banks and the Corporate Sector.” The paper was followed up by a Slovak cabinet resolution No. 908, passed in October 1999, which contained a concept for the first stage of pre-privatisation restructuring of selected banks.

The principal task at the first stage of pre-privatisation restructuring was to sort out the problems associated with the treatment of Všeobecná úverová banka and Slovenská spořitelňa. The two most important issues to deal with were:

1. to ensure that the banks reach the standard 8% capital adequacy by criteria defined by the Basle Committee for Banking Supervision; and
2. to cut the share of classified assets in the banks’ total assets to 25 – 35%.

This goal was achieved by two operations:
• by boosting the banks’ capital – by increasing their share capital; and
• by spinning off a portion of risky loans from their portfolios.

The first stage of pre-privatisation restructuring was carried out in 1999, when some Sk 18.9 billion of fresh capital was pumped into the banks, with VÚB, a.s. taking Sk 8.9 billion, SLSP Sk 4.3 billion, and IRB Sk 5.7 billion. The first-stage bailout included a transfer of a sizeable portion of the banks’ risky loans to the state-held Konsolidačná banka, š. p. ú., and to Slovenská konsolidačná, a. s. The carveout amounted to Sk 82.2 billion, including Sk 8.1 billion worth of IRB’s co-operative housing construction loans shipped off to Konsolidačná banka, š. p. ú. in September 1999 already.

The second stage followed in June 2000, when the banks dispatched another Sk 34.2 billion of bad loans to Slovenská konsolidačná, a. s. (for details, see table below).

After the second loan carveout, the pre-privatisation restructuring of the banks concerned was as good as finished. However, the overall banking industry recovery will not be complete before the whole corporate sector, i.e. the banks’ customers, gets in shape. The bank workout scheme made a good start for restructuring the business landscape, as healthy banks with strong capital backing can do a lot to help businesses sort out their complicated problems. Solid enterprises will in turn become the users of commercial banks’ credit funds. It is an interaction between the banking and corporate communities where only strong and sound businesses can carry the positive synergetic effects benefiting the entire national economy.

### State retaining control in the largest banks

A part of the ongoing transformation of the banking sector is, or rather was, the issue of ownership or privatisation of prominent commercial banks. The majority in Slovakia’s largest banks is, or was, held by the state, which exposed them to the threat of abuse for short-term political interests by the controlling shareholder.

Strictly theoretically speaking, we can perceive ownership as an institution (meaning a set of rules and norms of behaviour intended to maximise the effect of the ruling elite; an institution is designed to control the behaviour of individuals) which represents a certain symbiosis of neither purely legal, nor purely economic nature. Ownership lies somewhere at the intersection of these two planes, and is influenced by other factors of a society’s life – traditions, history, education, etc.¹

To owners, a property title entails a series of rights and obligations. The obligations and responsibility usually tend to be forgotten. What is crucial, though, is to precisely define the limits of ownership rights. If this essential condition is not met, then we are bound to see the obligations, liabilities and, most often, costs shift from the actual „legally proven“ owner to other economic entities or, as case may be, the entire society.

In mainstream economic theory, private ownership is considered to be more effective than public ownership. This assertion is based on different motivation forces coming along with different types of rights. However, private ownership as such is not necessarily a guarantee of higher efficiency (as a number of privatised enterprises in Slovakia demonstrate). The efficiency of private ownership needs to be stimulated by „near-perfect“ competition, flawless national legislation preventing abuses of private ownership rights damaging the society, and clear-cut ownership rights which drive the owner to take initiative, make innovations and pursue efficiency.

The modern ownership theory (based on the interest groups and games theories) sees ownership rights as the product of a struggle for power between groups involved in the government. Owners in power, or in the position to exert influence, can push through their interests, i.e. their ownership which the government protects as such. Howe-

---

ver, the dependence runs the other way around. For ownership to be ownership (i.e. what it is), it has to be protected by state, i.e. the government.

Since the privatisation of the banking sector – as a way of creating private ownership – entails a redistribution of ownership rights, it is extremely crucial to make sure it is done right.

Banks have entered the ownership reform process in the early 1990s on two levels:

1. the level of ownership restructuring; and
2. the level of production-relevant restructuring.

The banks played a double part in the process:

a) as the privatisation process financiers, financing purchases of production, trade and other capacities and facilities bought by private entrepreneurs; and

b) they played an untypical active role in the privatisation process by setting up and running investment privatisation funds. Banks became important players in the privatisation scheme, as they were in the position to control and influence a huge amount of assets in privatised companies without any major capital costs.

In the first wave of coupon privatisation, almost 6 million ex-Czechoslovak citizens „bought“ a share of state property which was up for distribution with their investment coupons. Some 72% entrusted their investment coupons to investment funds, most of which were founded by banks, with VÚB, a. s., IRB and Slovenská státna sporiteľňa the strongest ones in the race. This gave rise to a new kind of two-way dependency between banks and businesses which goes beyond the classic credit financing relationship. It has bred a „sort of secondary ownership“ or „mixed ownership.“ According to K. Kouba (see c.d.), privatisation is a process of redistributing ownership titles, which become a source of economic control over corporations.

Mixed ownership structures, or cross-ownership, give a lot of room to moral hazard in a variety of obscure activities. It is nothing unusual to hear of illegal transfers of property administrated by investment fund managers and bankers.

Owing to their special role in national economy, banks can not only influence financial flows, but also the growth or recession of individual economic segments and, ultimately, the entire national economy. It is for that reason, and for the sake of growing profitability and competitiveness, that we need to address the issue of ownership in state-held banks.

The privatisation of state-held banks did not really begin until early 2001, with financial advice from J. P. Morgan and legal advice from the White and Case agency. The privatisation process is already through at Slovenská sporiteľňa after the selff of an 87.18% stake to Die Erste. The contract was signed on 11 January 2001.

In January 2001, the government gave the green light to a sale of 25% of VÚB, a. s. to the International Financial Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD). Two other investors were interested in a due diligence exercise – Banca Commerciale Italiana, Italy, and Société Générale, France.

Subject to approval by the cabinet, VÚB’s new owner is going to be the Italian financial group IntesaBci. In addition to the 68.6% share package held by the state, the group also bid to buy the 25% stake of EBRD and IFC. In return for almost 95% of equity of Slovakia’s second biggest bank, the Italians offered to pay EUR 550 million, i.e. around Sk 23.6 billion.

According to the Italian bank’s officials, despite the change of owners, VÚB, a. s. is to retain its name, character and local management. As to its strategy, the investor seeks to develop both corporate and retail banking.

Another bank awaiting privatisation is Investičná a rozvojová banka, a. s.

Following the privatisation of VÚB, a. s., the bank ownership structure will be as follows:

Table 2 Shares of individual countries in Slovak banking industry assets as at 31 December 2000 (based on the country of incorporation of the controlling holder)

<table>
<thead>
<tr>
<th>Country</th>
<th>Share in Slovak banking industry assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>40.0</td>
</tr>
<tr>
<td>Italy</td>
<td>26.0</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>13.0</td>
</tr>
<tr>
<td>Belgium</td>
<td>8.5</td>
</tr>
<tr>
<td>Germany</td>
<td>4.4</td>
</tr>
<tr>
<td>Netherlands</td>
<td>3.6</td>
</tr>
<tr>
<td>United States</td>
<td>3.0</td>
</tr>
<tr>
<td>Other</td>
<td>1.5</td>
</tr>
</tbody>
</table>


Table 3 Slovenská sporiteľňa, a. s., and Všeobecná úverová banka, a. s., at 31 December 2000, in Sk billion

<table>
<thead>
<tr>
<th></th>
<th>Slovenská sporiteľňa</th>
<th>VÚB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>190.8</td>
<td>174.8</td>
</tr>
<tr>
<td>Stake sold (%)</td>
<td>87.2</td>
<td>94.5</td>
</tr>
<tr>
<td>Privatisation proceeds (at 43 SKK/EUR)</td>
<td>18.4</td>
<td>23.6</td>
</tr>
<tr>
<td>Treatment costs</td>
<td>36.7</td>
<td>75.2</td>
</tr>
<tr>
<td>Capital injections</td>
<td>32.4</td>
<td>66.3</td>
</tr>
<tr>
<td>Equity after treatment 1)</td>
<td>8.4</td>
<td>14.4</td>
</tr>
<tr>
<td>Privatisation proceeds/equity 2)</td>
<td>2.5</td>
<td>1.8</td>
</tr>
</tbody>
</table>

1) Equity includes after-tax profit for 2000, the better part of which will be used to cover losses outstanding from previous years.

2) Privatisation proceeds adjusted to 100% shares

3) Source: Kováčová, J.: IntesaBci’s Bid for VÚB, a. s. was Better, Trend 11, No. 25, section 1, p. 1.

---

2See, for example: