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Lessons Learned: The Slovak Debt Resolution Process

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LESSONS LEARNED

THE SLOVAK DEBT RESOLUTION PROCESS

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1. Background

This report on the lessons learned in Slovakia about the complex web of issues facing the debt resolution process has been drawn from four recent USAID funded initiatives, namely:

- A Slovak Enterprise Restructuring and Debt Conciliation project, including a Phase 1 diagnostic study of ten enterprises and a Phase 2 effort to develop restructuring plans for four of those enterprises;
- A report on the Slovak Debt Resolution Process which analyzed the situation as a whole and represented an initial attempt to recommend solutions to the problem;
- A Regional Bankruptcy Project, which presented an overview of the bankruptcy laws in East and Central Europe, including Slovakia;
- A Macroeconomic Report on structural reforms, debt resolution and the implications for Slovak economic growth.

2. Introduction

Slovakia's transition to a free market economy after the collapse of communism has not been an easy one. It has been marked by sharp falls in output, rising unemployment and double digit inflation. The economy shrank by some 25% between 1990-1993 as a result of the dislocation of traditional markets, and average unemployment peaked around 15% in a country of five million inhabitants. Consumer prices rose steeply, particularly in 1991 when the annual increase was nearly 60%.

The situation has now stabilized, with the economy registering growth for the first time since the events of 1989. GDP grew by 4% in 1994, whereas unemployment and inflation both came down to around 14%. This turnaround has basically been assisted by import restrictions, coupled with an increase in exports sustained by a slight depreciation of the Slovak crown last year.

Slovakia's return to economic growth is still at an early, tentative stage. The import restrictions include a 10% surcharge on consumer goods and certification requirements on all imports, which mostly affected Czech companies. The benefits of the surcharge, however, are temporary since they will be nullified by the GATT treaty due to take effect this year. The Czech Republic is still Slovakia's main trading partner and will no doubt continue to remain so for the foreseeable future.

A significant feature of Slovakia's economic difficulties has been the inability of enterprises to service debt, creating liquidity problems for both banks and the companies. Some of the debt in question was inherited from the pre-1989 mono-bank system. More notable though was the sharp increase in bank lending during early years after the fall of communism as enterprises turned to the newly established banking sector in lieu of the state for financing.

Most of this financing was used by Slovak enterprises for capital investments in equipment and machinery. In addition to fulfilling the investment plans of previous years, companies generally assumed that they would need to modernize in order to meet the challenges of the market economy. Little analysis was made though, by either the banks or enterprises, of whether the companies could support debt on commercial terms. To complicate matters these commercial loans were poorly structured, with the banks focusing on collateral and short maturities instead of risk and cash flow.

Unfortunately, the banks granted such loans at the same time that the companies lost Slovakia's traditional markets, an occurrence which was particularly exacerbated by the disintegration of the Soviet Union after 1991. It is estimated that half of all Slovak industrial enterprises are now unprofitable.

The banking sector's bad loans have not only resulted from the overall economic decline, but are now a constraint to future sustainable growth. The continued subsidization of these enterprises, either directly by the government or indirectly by the commercial banks, represents a financial drag on the state budget and the ability of banks to provide fresh capital into the economy. The banks are suffering from a liquidity squeeze as a result of their bad loans. *Indeed new credit expansion in 1994 was estimated at only 1% in comparison to the 4% increase in economic growth.* Resolution of the debt problem is therefore crucial to restore the banks financial health and to improve the availability of credit.

3. Legal Framework

Lesson 1: The legal environment which presently exists in Slovakia can be viewed as both contributing to the debt problem of banks and enterprises as well as hindering its resolution.

Laws concerning bankruptcy, taxation, as well as housing, adversely affect the debt problem in terms of providing disincentives to solutions which would normally be pursued in the West. For example, they may inhibit adequate provisioning and write-offs of bad loans by banks, or a company's ability to carry out an active disposal policy of inherited social assets. The bad debt situation is also not helped by a relatively lax supervisory regime for the banks.

Lesson 2: The banks maintain doubtful loans on their books, and, irrespective of the fact that debtors in default may be clearly unable to repay either principal or interest, banks continue to accrue interest and pay tax on such unrealized income

The bankruptcy and tax laws in particular would seem to have been enacted without consideration for the collective negative impact they may have. Accordingly, banks do not receive tax relief for write-offs unless a company has been officially declared bankrupt, an impractical and time-consuming process at present. Compounding the problem is the lack of a clear regulatory guideline for the recognition of doubtful loans.

Lesson 3: The legal system as a whole can be considered generally inadequate and unprepared to meet the changes brought about by the transition from communism to capitalism.

Slovak judges are inexperienced in bankruptcy issues, the court system is overloaded, and consequently there are not enough judges able to hear petitions or to control and monitor subsequent proceedings. As for taxation, there is considerable uncertainty in dealing with tax issues as no case law exists. This in turn inhibits effective long-term tax planning and can affect corporate restructuring.

3.1 Bankruptcy

By way of background, the current Slovak Bankruptcy Act was introduced in 1991 and covers both conciliation and conventional liquidation procedures for insolvent entities. Under Slovak law the conciliation procedures are debtor initiated, either prior to or during insolvency proceedings in court. An amendment in 1993 now provides for a mandatory out-of-court conciliation process, which involves a period of negotiation between debtors and creditors, and the development of a restructuring plan by a domestic creditors committee.

Despite existence of the bankruptcy law, it appears that no formal bankruptcy procedures have been initiated by debtors, only by creditors. The 1993 change was thus introduced as an amendment to involuntary bankruptcy, in order to allow for some form of conciliation to take place.

Lesson 4: No personal liability is incurred under Slovak law by the management or directors of insolvent companies that continue to operate and increase liabilities.

Whilst the absence of voluntary procedures may be partly explained by the relative unfamiliarity of troubled companies with the bankruptcy law, as well as the perceived stigma that attaches to bankruptcy itself, in fact the absence of any personal liability attaching to management is a considerable disincentive to adapting to market forces.

Lesson 5: Debtors are not protected from creditors' actions during bankruptcy proceedings

This is another disincentive to voluntary bankruptcy given that there is no equivalent of Chapter 11 in the US or Administration in the UK which provides debtors with protection in order to work out an agreement with creditors.

Lesson 6: Not all creditors are treated fairly under the present Bankruptcy Act.

Considerable disincentives also exist for creditors to pursue bankruptcy actions, as they are not all treated equally. Large creditors, for instance, are disadvantaged as all creditors, irrespective of amounts due, have the same voting rights. The mandatory conciliation procedures particularly discriminate against foreign creditors, who have no right at all to vote at creditors' meetings or to be represented on creditors' committees.

Lesson 7: Due to the unequal treatment of creditors, there is no incentive to bind creditors together on a fair basis in an agreed out-of-court restructuring proposal.

Furthermore, secured creditors, including the government or municipalities for tax claims, are not bound by any agreement which may be reached under mandatory conciliation. To complicate matters, environmental liabilities are treated preferentially, even over secured creditors, though they are only assessed after any bankruptcy ruling.

Lesson 8: Companies too have been reluctant to recognize bad debts and incur appropriate losses since, like the banks, they do not receive any tax relief except for unpaid receivables of companies officially declared bankrupt.

Informal out-of-court negotiations between troubled debtors and creditors therefore do not appear to have been particularly successful either. On the one hand, trade creditors are reluctant to write-off bad receivables. On the other hand, close inherited trading links between debtors and creditors often make trade creditors, who may be in a similar precarious position, disinclined to initiate bankruptcy proceedings.

Lesson 9: Slovak banks are generally underprovisioned by international standards with weak capital bases, and have to-date been reluctant to initiate bankruptcy proceedings, which would force them to recognize losses.

The main Slovak banks continue to be state-owned or are only partially privatized. This is another factor which inhibits them to be pro-active in dealing with bad loans on three accounts:

- As state-controlled financial institutions, there is always the government to subsidize losses;
- They do not wish to precipitate bankruptcy proceedings in an environment in which the state has on-going interests in large industries; and
- There is an informal understanding that the banks should not call loan guarantees issued by the Ministry of Finance or the National Property Fund, which in any case are not in a position to honor all their contingent liabilities.

Lesson 10: Since statutory tax relief for provisions and write-offs is limited and there is no clear regulatory guideline dealing with the recognition of bad debts, banks for their part continue to accrue interest on overdue loans.

Existing statutory tax relief for provisioning is not commensurate to the size of the bad debt problem, and moreover there are no clear guidelines for the recognition of doubtful loans. The resultant capitalization of interest, which is contrary to international practice in insolvency cases, only compounds problems for both borrowers and banks. Debtors' unpaid liabilities can often grow exponentially, thereby decreasing the likelihood of successful conciliation.

Lesson 11: Investment funds, which are the principal shareholders of privatized companies, are unlikely to initiate bankruptcy proceedings since their fee income is based on the value of their holdings.

In addition to an unwillingness to precipitate a potentially large write-down of their holdings, the funds also do not have the capacity to closely monitor events at companies or to force major changes. Unlike institutional investors in the US or UK, the Slovak fund managers only see themselves as being financial investors. The investment funds are thus more likely to trade shares rather than push for changes in troubled companies.

While the funds may have board representation, they view this as a means of keeping tabs on the management, in terms of preventing abuse or dealing with basic incompetence. The funds have been known to replace management at their AGMs, however the replacements are not outsiders but are also members of the rank-and-file. In short, the Slovak investment funds do not get involved in the day-to-day management of companies.

Lesson 12: More significantly, the largest investment funds are also subsidiaries of the major banks.

Neither are the funds likely to get involved in discussions with the Slovak banks about providing debt relief or additional financial assistance to companies. They view such issues as the banks' domain to deal with credit risk. Consequently they are unlikely to press for new loans which the banks are not prepared to make, nor are they willing to initiate bankruptcy proceedings which could result in losses for the banks.

Lesson 13: The National Property Fund's role as a major shareholder in Slovak companies is a passive one.

The NPF was originally conceived as an institution that would simply be the vehicle by which state enterprises would be transformed into joint-stock companies prior to the distribution of shares under voucher privatization or through other, more standard methods. Following the first wave voucher privatizations, it retained substantial interests in some five hundred former state-owned enterprises.

Lesson 14: Involvement in corporate affairs can only come from decisions taken at the Presidium of the NPF, which is effectively a political body.

In general, the NPF does not seek to influence companies to take specific actions. Any involvement is viewed as unique and can only result from exceptional votes taken at the Presidium. More generally, the NPF relegates itself to nominating employees of the companies or the NPF to act as their supervisory board representatives. Their role is more akin to that of a relationship manager, keeping the NPF informed of developments, rather than a typical board director in the west.

As far as political influence is concerned, certain entities deemed strategically important and state-owned enterprises receive exemptions from the bankruptcy act. In the case of non-privatized companies, these are still under the control of their founding ministries who alone can decide whether to initiate bankruptcy proceedings.

However, such action is still rather the exception, having been used in a few instances by the government in the divisional reorganization of previously very large state conglomerates.

Lesson 15: Inordinate delays in bankruptcy proceedings are a major disincentive to both creditors and debtors.

It is estimated that the process can take between three-to-five years after a bankruptcy order is granted. Where petitions have been made, claims against debtors are often deficient, resulting in an additional work load for judges who have not received any specialized training in bankruptcy law. These deficient claims are due both to the inexperience of creditors, as well as the result of attempts to put pressure on debtors.

Lesson 16: There is a lack of experienced administrators, and moreover under Slovak law, they have unlimited personal liability but are unable to obtain professional indemnity insurance.

In addition to the overloaded court system and the inexperience of Slovak judges in bankruptcy issues, there is a lack of experienced administrators. Rather than being appointed on the basis of competence, they are selected on a rotational basis. As a result of this and the shortcomings of the local insurance market which does not provide them with professional indemnity insurance, Slovak administrators therefore are unwilling to act without a court decision, thereby causing more delays.

3.2 Tax Code

For the present, changes in the tax code have tended to be taken only with a short-term perspective to plug the budget, rather than assist the banking sector to address the thorny issue of bad loans, to create favorable long-term conditions for investment and growth, or to broaden the compliance net.

It is understood that the Ministry of Finance is now preparing amendments to the tax law which would give the Slovak banks greater incentives by way of tax relief to deal with problem loans. Details of the proposals, which are anticipated to be announced by mid-1995, are not available as yet.

Lesson 17: While general provisioning on the order of 2% of a bank's earning assets might be considered adequate by western standards, it would appear to be understated by local conditions.

As things stand, tax relief for banks is allowed for general provisions up to 2% of their total loan portfolio. However, it must be recalled that the banks sharply increased their lending activities in the years immediately following the collapse of communism, without the benefit of possessing the experience or credit skills to support such expansion. This undoubtedly understates the problem and consequently acts as a deterrent to a more appropriate provisioning level to adequately address the scope of the problem.

Lesson 18: Since bank regulations do not stipulate when a loan should be placed on a non-accrual basis, banks tend to rollover their problem loans together with interest due.

Relief for specific provisions up to 10% of problem loans are permitted for loans which are overdue in excess of 90 days, which is generally the time limit allowed by international regulators before loans must be placed on a non-accrual basis. In reality, Slovak banks only place their problem loans on a non-accrual basis when they internally transfer loan files to their legal department. Again this level of specific provisioning is unlikely to be sufficient to address the issue, particularly of bad loans whose values are certainly impaired by more than 10%.

Lesson 19: Tax relief is only allowed for write-offs in the case of a court issued bankruptcy ruling.

Given that there is no tax relief to write-off loans in the absence of a court ruling against a debtor, the banks have little incentive to clean-up their balance sheets. Furthermore in light of the lengthy delays that bankruptcy proceedings may take in Slovakia, the general under-provisioning for bad debts that exists to date and the many sensitive domestic political issues involved in initiating proceedings against large industrial enterprises, banks only seek to write-off loans on an exceptional basis.

Aside from the issue of providing banks with appropriate incentives to deal with problem loans, there exist other tax considerations which presently do not encourage enterprises' recovery or necessary investments for their future growth.

Lesson 20: Tax loss carry forwards are limited to one year's loss prior to a return to profit.

In other words, a troubled company that had a series of annual losses can only use the loss which arose in the year immediately before returning to profit again. Given that a company's recovery is likely to be gradual rather than sudden, then any tax loss carry forward which might have been available from a year in which heavy losses were incurred is simply forfeited. The severe restrictions on such tax relief is a major disadvantage to Slovak companies in their transition to a market economy.

Lesson 21: Corporate restructuring and reorganizations are likely to be inhibited by the taxation on asset transfers and double taxation within a group.

At present all asset transfers are subject to value added tax, since changes in ownership are considered to be the equivalent of an asset sale. Since companies seeking to restructure are likely to be short of cash, they may find that they do not have the option to transfer assets. Another barrier to reorganization is the issue of double taxation. Within a corporate group, earned income and upstreamed dividends are both subject to tax in Slovakia, thereby limiting the amount of cash that might otherwise be available to it.

Lesson 22: The government does not currently give any tax assistance to companies which need to make capital investments for future growth.

Tax incentives to induce Slovak enterprises to make appropriate capital investments for the future do not exist at present. A tax allowance of 10%, for example, would provide an encouragement to enterprises to invest.

In general, there is a great deal of uncertainty surrounding taxation in Slovakia since no case law exists which could serve as a basis for making appropriate long-term corporate tax plans. Long-term tax planning is also not assisted by the quality of the government's tax staff which is perceived to be low, with most only possessing the equivalent of a high school education. Where companies are found not to be in compliance with the tax code, the government imposes very stiff penalty rates of 0.3% per day, or the yearly equivalent of 110%.

3.3 Other

Lesson 23: Another barrier to the resolution of the bad debt problem is the difficulty companies face if they seek to raise cash by disposing of so-called social assets, which are compounded by housing and rent laws.

All large enterprises inherited assets such as apartment buildings, recreation facilities and kindergartens, which were an integral part of the enterprises' role under socialism. Today many enterprises would merely be content with disposing of these assets just to cease incurring the associated expenses.

Although actual disposal values may not be high, since companies generally cannot expect to receive more than net book value, there tend to be few, if any, interested buyers. Apartment buildings are usually aging, pre-fabricated structures which require substantial investments for repairs and modernization. In many instances, tenants are not even interested in acquiring their apartments free-of-charge, because they do not want to incur the maintenance expenses or make necessary improvements to the buildings. Municipalities also take a similar position with regard to social assets.

If potential investors in apartment buildings could be found, they would have to recoup their investments in modernization by charging higher rents. There are, however, limits to such increases since rents are strictly controlled.

As an alternative to being unable to sell the apartments, eviction by the companies is not a feasible option since Slovak law guarantees the housing of its citizens. In any case many of the residents are likely to be employed by the enterprises in question, and furthermore as landlords, companies would have the legal obligation to find new homes for them. This however is not realistic in a country which has a perennial housing shortage.

4. Enterprises

The lessons learned from the Enterprise Restructuring project revealed a broad range of difficult issues facing Slovakia's large industries. The Phase 1 diagnostic studies covered a diversified group of ten companies, representing key sectors of the Slovak economy throughout different regions of the country. These industries include steel, aluminum, coal mining, shipbuilding, defence contracting, bearings and other manufacturing sectors.

Lesson 24: The difficulties facing Slovakia's post-communist enterprises are not just debt problems, as had been assumed, but rather result from a fundamentally different approach to doing business.

The diagnostic studies provided a synopsis of the existing financial situation of the companies, with a view to assessing the potential viability or non-viability of each and identifying some of the key points that needed to be addressed in the development of actual restructuring plans. While all the companies generally had suffered from declining markets and had difficulties servicing debt, the analyses clearly showed that the underlying profitability of all these companies was weak as a result of deeply-embedded inefficiencies. This was often manifested by rather large administrations, a unique corporate focus on production activities, complete vertical integration of services, maintenance and energy generation in order to be self-sufficient, and the fulfillment of social functions which in western social democracies would be the responsibility of government. As a result, basic operating cash flow tends to be diverted into non-core areas and is insufficient to meet financial obligations.

Lesson 25: There is good underlying value in many of Slovakia's industrial enterprises.

Because of the enterprises' orientation to production activities, many companies have core businesses that are very capable of producing high quality goods that meet international standards. They have good industrial engineers with years of experience, who have often shown themselves to be very self-reliant and adept at improvising under difficult conditions. Some companies do possess modern, state-of-the-art equipment and some have begun to penetrate lucrative international export markets.

Lesson 26: Although many Slovak enterprises are capable of producing quality goods, there is a basic lack of management skills to deal with the transition to a market economy and a consequent inability to effectively deal with their debt problems.

Under the command economy, companies emphasized production, not marketing or finance. The companies' production targets were established by their respective ministries, and the sale of goods were handled by specialized trading companies. Financially, companies were expected to have balanced books, although deficit funding was provided by the government. Funding for investments was established by the ministries under long-term economic plans. As a result of these circumstances, present day Slovak managers, even though they may be good industrial engineers, do not possess the know-how to effectively sell their products or to manage their finances properly.

Lesson 27: Without marketing, operational and financial skills, which are taken for granted in the west, Slovak companies face considerable drawbacks in addressing the many problems involved in the development of a market economy.

Marketing still tends to be a rather haphazardous affair, even at companies that were privatized three years ago during the first wave voucher program. Many still maintain a passive approach to this vital role, with their marketing department only taking down customer orders as and when they come in. On organization charts it is not uncommon to find the Marketing Dept. at the bottom in a small box attached to the Production Dept.

Lesson 28: The use of foreign trading partners or distribution agents as a substitute for direct sales still does not address the need to establish coherent, long-term marketing strategies to maximize profits

Others have sought to replace the role fulfilled by the specialized trading companies by entrusting the marketing of their goods to joint ventures with foreign partners, often on an exclusive basis. While this may be a useful interim means for selling their products, it reduces their margins and ultimately takes control of marketing and pricing out of management's hands. Whether or not companies actually cover their costs under such arrangements is another issue. Experience to date suggests this approach to increasing output has not improved the ability of Slovak companies to generate enough cash to resolve financial problems.

As an alternative to joint ventures, companies will approach numerous distribution agents in the hope of picking up orders. Where they have been able to sell through agents, the orders tend to be relatively small-sized, one-off purchases. Consequently the production runs are generally not economical. In either case, the companies still do not have a real idea of who their end users are, and production may also be diverted into low value-added goods..

Lesson 29: The lack of effective accounting systems means that companies often do not have any clear idea of how much it actually costs to produce a particular good.

The lack of proper financial controls extends to most areas, from basic cost accounting to managing their working capital needs and external indebtedness. In short managers simply do not know how much it actually costs to produce a particular good. This in turn means that management does not know how to price its goods, nor do they know which ones they should be focusing on.

A system of internal transfer pricing can contribute to this predicament. In effect, different cost centers may show a profit, but companies as a whole will be in the red. This is counter-productive and only serves to obscure the inefficiencies of enterprises.

Lesson 30: The absence of someone exercising the role of a financial, western-style comptroller means that companies do not ensure that liabilities can be supported.

Surprisingly, most companies today still do not have proper finance departments to deal with basic financial issues, only traditional bookkeeping functions. As noted, most enterprise indebtedness was the result of active borrowing during 1990-92. A substantial part of these loans were used to finance capital investment programs drawn up by production managers, rather than a finance director. The question of whether companies might be able to service their indebtedness was not addressed.

This area is an important one that will have to be addressed if Slovak companies are to resolve their debt problems. By comparison, western companies facing similar financial difficulties will appoint a financial director to pro-actively deal with their problems and have a mandate to undertake necessary cost reductions to stabilize such situations.

Lesson 31: Although the inability to adequately service debt confronts many Slovak industrial enterprises, it is actually more a symptom than a cause of underlying problems.

For the most part, the relative level of bank debt in comparison to the size of Slovak enterprises is not the main issue. Indeed most Slovak enterprises are not over-geared and the banks are normally well secured by borrowers' assets. Rather, the companies financial problems of are often the direct result of poor operating cash flow, not merely indebtedness.

Lesson 32: Although state-owned enterprises know they have problems, they have yet to face the reality for operational change and do not either accept or understand the need for corporate restructuring.

Operational restructuring, when combined with increased turnovers and margins through improved marketing and proper pricing will, in time, help Slovak companies to generate healthier levels of cash flow. For most, however, time is not a luxury that these companies can afford. Instead many managers of state enterprises continue to believe that the source of their problems are caused by external factors. In the absence of the hard constraints of the marketplace, there is still the lingering assumption that the state will ultimately provide them with financial assistance to sort their problems out for them.

Lesson 33: Privatized Slovak companies, too, are slow to accept the need for drastic action to deal with operational inefficiencies.

Although managers of privatized companies are more aware of the constraints of the marketplace, they have yet to adapt to its realities in significant ways. This is partly due to the fact that many have so far been able to continue operating in much the same way as before, so long as the banks have been unwilling to call their loans. For their part the Slovak investment funds, as noted above, do not exercise shareholder rights to oblige management to restore underlying profitability.

Lesson 34: Typical Slovak managers lack the knowledge and experience needed to produce realistic business plans which are essential to deal with their problems.

The inertia hindering operational restructuring is also directly related to the lack of western-style managerial skills to cope with the change to a market economy. They do not possess western marketing, operational and financial concepts. Moreover, their information systems are inadequate, and what information is available is of questionable value due to poor coordination between departments. As a result of this lack of experience and proper management information systems, Slovak companies are not driven by realistic business plans.

Lesson 35: In light of the fact that the companies are clearly not able to demonstrate how they will address the critical issues facing them, it is not surprising that they do not have access to new loans.

If Slovak companies are to resolve their debt problems, it will also be necessary to convince the banks to provide funds for working capital or minimum investments necessary to fulfill new orders, which in turn can generate more cash flow. At present, most requests for new loans are poorly prepared and consequently fall on deaf ears. The lack of concise plans to address the ultimate issue of debt repayment only reinforces the banks' view that they have done all they can for the companies.

5. Financial Sector

Lesson 36: Banks are rigid in their attitude to past-due borrowers, insisting on repayment of interest and principal without attempting to address the problems of their corporate clients

In addition to constraints imposed by the legal framework and the inherent problems of Slovak enterprises, resolution of the debt problem is contingent upon resolving issues in the financial sector. Some issues are specific to the banks and deal with policies, procedures and the need to improve technical skills. Other issues concern the supervision of banks. The net effect is that banks have been uncompromising in their demands for repayment of interest and principal without seeking to work out the problems of their corporate clients.

5.1 Banks: Policies, Procedures, Skills & Incentives

Lesson 37: Banks lack essential credit and financial skills to deal with problem loans.

For their part, the banks were only too eager to lend to large industrial enterprises during the early years of Slovakia's transition to a market economy. Without possessing either traditional credit skills, or the ability to analyze investment projects on a future cash flow basis, Slovak banks lent money without appreciating the risks involved.

Lesson 38: Banks today still tend to focus on security issues, in terms of the amount of collateral or guarantees they hold, rather than the quality of their loans.

Their basic view sees the quality of their loans as a function of the value of their security and short maturities. This often results in poorly structured loans, which for example mismatch borrowers cash flows with inappropriate repayment schedules or finance investments in fixed assets on a short-term basis.

Lesson 39: The emphasis on short-term maturities has resulted in rather inflexible lending policies for Slovak banks.

It would appear that as a matter of policy the banks prefer to keep their customers on a short leash. Although they have established guidelines regarding maximum maturities for different types of loans, they invariably tend to short-term in nature. This in turn contributes to the development of problem loans, which ultimately cannot be repaid within their original terms.

Lesson 40: The lack of effective credit monitoring at head offices contributed to their loan problems and so far has hindered its resolution.

Slovak banks have pursued a policy of decentralization for their branch network, a practice which is still followed today. This localized approach to corporate lending often meant that branches competed for similar business, complicating the monitoring of credit risk. In effect there did not exist a centralized means for banks to assess overall exposures to single borrowers. This encouraged companies to make loan applications to several branches of the same bank with a view to obtaining maximum financing.

Lesson 41: The branches at the same time were also encouraged to expand their loan portfolios, which were judged on the volume of loans and income being booked.

This generated substantial fee income in addition to accruing interest income. To compound matters however, internal branch procedures were also lax. Even though individual branch lending limits exist, it was not unusual for branch managers to make a number of separate loans to the same borrower, each within their limits but which collectively breached them.

Lesson 42: To date there has been little coordinated effort to work out problem loans with borrowers in difficulty.

The branches still have primary responsibility for their loans, problem or otherwise. Since companies usually have multiple borrowing relationships with Slovak banks, this results in an uncoordinated, free-for-all approach to dealing with problem loans. Simply put, the branches are only concerned with the repayment of loans due to them and not to the bank as a whole. Head offices of banks have only recently come around to the realization that problem loans will best be handled by dedicated work-out departments.

Lesson 43: For the most part, banks chose the option of rolling over past due loans, together with interest in the event that companies could not pay interest either.

When confronted with the fact that large corporate customers were unable to repay their loans, Slovak banks simply did not have any previous experience to guide them. Consequently, they chose the easy option of renewing loans on a short-term basis and often extended new loans to pay themselves interest. At both the branch and bank level, this manages to keep the appearance of a healthy loan portfolio, but only results in avoiding the issue of dealing with the inability of borrowers to meet their obligations.

Lesson 44: Branch managers have no performance incentive to recognize doubtful loans or to propose debt forgiveness.

The performance of the local branch managers is evaluated on the basis of accrued interest, thereby encouraging them to rollover past due principal and interest. This unfortunately perpetuates lending relationships even though they are not in the interest of the bank, its depositors or shareholders.

Lesson 45: Capitalizing interest and charging penalty rates accelerates the growth of problem loan portfolios.

In most cases the capitalized interest, which the banks regard as overdue loans, attracts penalty rates of interest. By western standards the penalty rates are usurious, often in excess of 30%, and only have the effect of further increasing the amount of their bad loans. In addition to literally compounding the problems of their borrowers, it also has the effect of increasing the likelihood of greater bank write-offs in the future.

Lesson 46: Slovak banks are reluctant to lend more money to assist troubled companies.

Having been burnt after their lending spree two-three years ago, the banks are extremely reluctant to provide further assistance to troubled companies. However if the debt problems of Slovakia are to be resolved, the only option to pulling the plug may indeed involve lending Slovak companies sufficient working capital to revive moribund businesses.

Lesson 47: To offset losses the banks penalize good customers, creating the potential for more problem loans.

Another unfortunate side-effect of the bad debt situation in Slovakia is that banks tend to charge "creditworthy" borrowers higher rates of interest in order to offset non-payment by bad debtors. Contrary to normal market practice where lower risk is associated with lower interest rates, the banks penalize good customers. This places an undue cash burden on those clients, stifles their growth, and increases the chances of creating more problem loans.

5.2 Supervision & Regulatory Environment

Lesson 48: There is a shortage of trained staff and the banking supervision department of the central bank is consequently both inexperienced and under-resourced.

For the National Bank of Slovakia, the liquidity of the banking sector is their greatest cause for concern. The principal commercial banks are to a large extent dependent on the central bank for refinancing. Bank deposit bases are insufficient to fund existing loan portfolios, which of course include unrecognized bad loans. However the central bank does not have sufficiently qualified staff to comprehensively deal with the issue of doubtful loans, and the banking supervision department is consequently both inexperienced and under-resourced.

Lesson 49: There are no firm guidelines as to when banks must stop accruing interest on sub-standard loans.

The current practice of capitalizing interest and continuing to carry impaired loans as good assets is contrary to international standards for dealing with troubled borrowers.

Although Slovak banks can create specific provisions for loans that are overdue by more than 90 days, the central does not specifically insist that banks must stop accruing interest on sub-standard loans. This is in effect left to the discretion of the banks themselves, who as noted perpetuate the fiction of good loans by rolling over existing unpaid principal and interest.

Lesson 50: The non-recognition of sub-standard loans by Slovak banks causes liquidity problems and drains them of vital cash resources.

As well as constraining the resolution of their problems, the non-recognition of bad debts has a double negative impact on the banks. Firstly, they have to fund the carrying cost of non-performing loans, resulting in liquidity problems. Secondly, they have to pay tax on unpaid interest income.

Lesson 51: Bad loan provisioning only tends to be done in accordance with minimum statutory requirements.

In view of the limits on tax relief, the banks are unwilling to make greater provisions than allowed for under the tax code. Moreover, the only time banks have to place loans on a non-accrual basis is when they submit credit files to their legal department to begin bankruptcy proceedings. This however is viewed as a last resort. Since bad loan provisioning only tends to be done in accordance with minimum statutory requirements, Slovak banks therefore have weak capital bases and are hesitant to initiate bankruptcy proceedings which would force them to recognize losses.

Whether or not banks may choose to pursue the bankruptcy route depends on a number of sensitive issues, including domestic political ones. In certain instances they may ultimately attempt to recover their bad loans through liquidation. Based on the sample we have looked at, the break-up value of some over-indebted companies appears to be greater than the banks' loan exposure, even if the realizable value of the companies' assets is significantly scaled back.

Lesson 52: The option of pursuing debt-equity swaps does not appeal to Slovak banks for both statutory and tax reasons.

Holding equities is presently seen by Slovak banks as impractical on two basic accounts. Firstly, swapped shares would impact their overall level of equity investments on which they must maintain reserves with the central bank. Secondly, they do not receive any tax deductions for equity write-downs. Consequently the banks carry equity investments at nominal value but do not believe that this would accurately reflect the value of any swapped shares, against which they must set aside cash reserves.

The banks are also limited to holding a maximum 10% interest in an enterprise, although this may rise up to 20% provided that they sell their excess holding within a year. The capital markets in Slovakia are at an early stage of development, and such equities could be illiquid and might consequently have to be sold at a deep discount.

6. Government

There are multiple participants involved at different levels in the debt resolution process on behalf of the Government of Slovakia. Although so-called founding ministries such as the Ministry of Economy may have an interest in enterprise indebtedness, the principal participants in the process are:

- Ministry of Finance
- Ministry of Privatization
- National Bank of Slovakia
- Prime Minister's Office

Lesson 53: The political situation in Slovakia has so far been characterized by a transitional nature, leading to an overall lack of direction in the government to address the debt overhang.

Slovakia has been going through a series of political changes since its establishment as an independent state. This in turn has led to a general lack of cohesion within the government, resulting in earlier initiatives being sidelined. Specifically with regard resolving the debt problems of the country's banks, the previous government established a Financial Restructuring Committee to provide an overall perspective. Its leading members are now in the political opposition. Given the lack of an all-party consensus, there is consequently a need to reconstitute the committee if it is to regain momentum.

As for the banks, the government has so far not shown an inclination to put pressure on them to resolve the bad debt issue. Moreover, in view of the political orientation of the government, it is thought unlikely that the Prime Minister's office would favor bankruptcy proceedings against insolvent state-enterprises which would result in increased unemployment.

Lesson 54: The transition to a market economy carries its own momentum, and necessary changes will most likely evolve in spite of the delays resulting from political uncertainty.

Recently a number of initiatives appear to have been set in motion, although it is too early to judge what changes will be made as a result.

Ministry of Finance

The MoF is presently drafting proposed changes to the Slovak tax code. Among the changes are thought to be measures which would give banks tax incentives to help them resolve their bad loan portfolios. No details have been released, nor is it known when such changes may eventually take effect.

Ministry of Privatization

Following the new government's decision to revoke fifty-nine privatization projects approved under the previous government, the MoP suspended the second wave privatization program. They are currently reassessing details of all proposed privatization projects, and mid-1995 is now the assumed to be the relaunch date for the second wave.

National Bank of Slovakia

The central bank is understood to be working on a proposal which would form the basis for a one-time solution to the problem of inadequate provisions for bad loans. They have advised the banks that the solution will not be applied retroactively to any actions the banks may take independently to make provisions or write-off loans. This effectively puts the resolution process on hold. The bank's governing board has approved the framework for a solution, but no announcement date has been set for their proposal.

Prime Minister's Office

A number of proposed policy changes have been made by the government or leading members of the ruling coalition. These have set the tone for the government's agenda and would appear, in some instances, to suggest that external assistance may become more difficult to implement. Some of the policy changes include:

- Privatization - In addition to over-turning a number of approved projects, the current review of the entire privatization process has clearly borne out their election pledge to favor existing management of state enterprises. In sharp contrast to the first wave, future privatizations will see only a small portion of shares allocated to private individuals by means of vouchers. The express intent is to reduce the involvement of the investment funds to which the majority of individuals entrust their vouchers.

- Investment Funds - In addition to seeking to limit their involvement in the second wave, legislation has been proposed which would effectively reduce the number of funds. Proposals call for establishing two classes of funds. One would be considered "strategic" investment funds, which would retain shareholder voting rights. The other would be for "portfolio" funds, which would only have dividend rights. The legislation also calls for limits on the fees charged by the funds to be set at a maximum of 1% of the funds' value, cutting existing market practice by half. Concurrently, the Ministry of Finance has launched an investigation into the investment funds to determine irregularities which could be sanctioned by a withdrawal of licenses.

- Capital Markets - The Ministry of Finance has proposed changes which would effectively limit dealings to the official Bratislava Stock Exchange, which trades on a spot basis. The highly successful Bratislava Options Exchange, which has traded since April 1993 and pioneered dealings in one-day forwards and computerized data processing, has had its previous requests for a spot license declined by the Ministry. The Ministry now intends to cease trading in one-day forwards, even though it has been actively used by brokerage houses, investment funds and banks. The only other exchange is the RM-System which is primarily used by individual investors.

- The Press - The government had recently drafted a bill which proposed to increase value-added-tax for newspapers on the basis of ownership and whether they were deemed to be commercial or non-commercial in nature. Depending on the level of foreign ownership, VAT was proposed at either 25% or 50%. VAT on domestically owned journals was proposed at 25% if classed as commercial media, which would have affected most independent journals. Other non-commercial papers would have VAT remain at 6%. Although the bill was turned down in a parliamentary committee, its appearance is unlikely to be an encouragement for foreign investment in general.

7. <u>Privatization/Ownership/Corporate Governance</u>

The large-scale privatization of Slovak state-enterprises was initiated by the former parliament of the ČSFR, although the basic law governing privatizations has been amended on several occasions. In all, some 1,300 large Slovak enterprises were earmarked for privatization in two broad waves. The first wave included 751 companies with a net asset value of Sk 170 billion or approximately $5.5 billion.

These companies were privatized using both standard and non-standard methods. Non-standard methods include voucher privatization as well as transfers of ownership to municipalities or retention of shares by the NPF. Direct sales, public tenders and auctions were used as standard methods. The great majority of first wave companies were, in fact, privatized by the voucher method.

<u>*Lesson 55: The first wave, which began in 1991 and officially ended in September, 1993, left the state, via the NPF, with residual holdings in about 500 companies.*</u>

Although the NPF was not originally intended to perpetuate government ownership of Slovakia's state enterprises, it has by default become the vehicle by which the state retains an interest in a broad range of industries. These holdings include a substantial number of minority interests, plus clear majority stakes in 120 companies. The NPF intends to include a small portion of these residual holdings in the second wave.

The wave two large-scale privatizations actually began in mid-1992 and involved some 514 entities which currently have a net asset value of Sk 254 billion or about $8.2 billion. The companies represent some of the largest Slovak enterprises in the fields of heavy industry, construction, transportation, telecommunications and the energy sector. Slightly more than half of the companies have now had their privatization proposals submitted to the MoP for processing by their founding ministries. Only about a quarter of the total projects have actually been forward to the NPF for implementation. However these are now being reviewed again by the government.

<u>*Lesson 56: The government now prefers to sell companies to management and to retain long-term stakes in key industries.*</u>

Following the suspension of the privatization program by the Mečiar government, it has now been made it known that the voucher method will account for no more than

Sk 40-50 billion, or a maximum 20% of net assets being privatized. The present government prefers privatization by means of direct sales. The state also intends to retain long-term participations in second wave enterprises deemed strategically important in an amount equal to about Sk 90 billion of net assets.

Lesson 57: Despite the evolution of the NPF's role it is unlikely to exercise a corporate governance role.

As noted, the government via the NPF does not exercise active ownership rights or concern itself with corporate governance matters. It was never intended to perform these functions, nor does it have the expertise that is required for such roles. The NPF is basically entrusted with an observer's role to monitor events at the enterprises. Only in exceptional circumstances will it become involved as a result of decisions voted at meetings of the NPF's Presidium.

Lesson 58: The government is likely to seek a reduction of the role played by investment funds in future privatizations.

The shift in favor of management and long-term state holdings also corresponds to an attempt by the government to reduce the perceived influence and excesses of the investment funds. In addition to wanting to reduce the absolute number of funds, there have been suggestions by members of government that the funds should have their shareholder voting rights curbed. Another proposed change would be an enforced 50% reduction in the funds' fees, which are currently charged at around 2% of average annual share values. The Ministry of Finance is currently investigating the funds for possible regulatory violations. This may only be political posturing, however voucher privatization is not expected to recommence until new legislation concerning investment funds has been passed.

Lesson 59: The role of the investment funds in exercising shareholder rights has been marginal to-date.

The funds do not have the skills or resources to closely monitor the companies in which they have holdings, which for the larger funds can include over two hundred entities. Thus, although private shareholders tend to be viewed with some trepidation by managers who previously were not held accountable for their performance, the investment funds in fact do not exercise day-to-day influence in privatized companies. Rather the major funds, which in any case are owned by the banking industry, view their roles purely in terms of fee-generating portfolio management businesses.

Clearly though private investment funds are not favored by the government. The irony is that the actual influence of the investment funds is not as great as one might expect, particularly in comparison to the role that institutional investors play in the west with regard to maintaining shareholder rights. The Slovak funds appoint representatives to sit on the boards of companies in which they have larger holdings, however they stress that these representatives do not have any legal obligation toward the funds, only a moral one. Like the NPF, these representatives basically undertake an observer's role.

8. Political Environment

Lesson 60: The dynamics of the Slovak political environment have not always benefited the debt resolution process.

Following the parliamentary elections last autumn, there existed a political vacuum for several months as extensive negotiations among the various parties were carried out to form a new government. As can be expected, during this time no decisions of substance were made by the caretaker government regarding economic, financial or political issues.

As noted, one action however was taken during this interlude period which may have implications for the debt resolution process, namely the decree pushed through the interim parliament by the HZDS party revoking previously approved privatization projects. This was done on the basis that the MoP had continued to approve projects after the official start of the election campaign.

Lesson 61: Second wave privatizations are likely to see continued state involvement in major sections of Slovak industry for the foreseeable future.

Privatization is still anticipated to go forward, albeit in a modified form. Nonetheless the prospect of continuing, long-term state interests in a sizable portion of large Slovak industrial companies, entrenched management, and the consequent implications this has for sustained government assistance does leave cause for concern. Changes may ultimately come, but are likely to be deferred.

Lesson 62: Slovak politics are presently characterized by a new government with a lack of clear vision on how to effectively deal with pressing problems.

While a new coalition was eventually formed by HZDS, government policies dealing with major issues are still being worked out. Despite pronouncing general statements of intention, actual decisions regarding the debt problem have yet to be made. Invariably the change in government has also led to changes in key people, which results in delays and differences of opinions. Consequently, this gives rise to the impression key problems are not being addressed.

Even prior to the elections and the formation of a new government, there was uncertainty concerning the resolve to deal with the economic and financial issues facing Slovakia in its transition to a market economy. This resulted, for instance, in the World Bank reviewing its previously proposed structural adjustment loan to recapitalize the banking system. As long as there was no indication of a clear commitment by the government or the banks to effectively deal with the problem loan situation, the proposal was shelved. Likewise, although representatives of the Slovak government initially signaled their approval-in-principle for the debt resolution proposal contained in the Haswell report, to date the new government has not actively pursued its recommendations.

9. Debt Overhang

Lesson 63: Part of the difficulty in resolving the debt overhang lies in the very fact that its exact nature a matter of disagreement in Slovakia.

Indeed. there is actually no consensus in the government on the magnitude of the bad debt problem. The mere existence of differences of opinion makes the issue a political one and accordingly more difficult to resolve.

By one estimate provided to the government, the size of the bad debt problem is relatively large for the banking sector, placing it on the order of Sk 60-70 billion or around $2.2 billion. This would represent about a third of all Slovak bank loan portfolios.

The central bank itself has judged the total size of bad loans to be less, perhaps only as much as half of this amount or about 15% of total loans held by Slovakia's banks. Still yet another survey commissioned by the central bank estimated that of the four main banks, two were actually insolvent whereas the other two were only marginally solvent.

The government's view, as expressed by the Prime Minister's office, believes that these estimates are exaggerated. Moreover, the government believes that the question of bad loans is an issue that should best be left to the banks themselves to sort out. As for the banks, they are even more reluctant to acknowledge the existence of the problem, let alone the size of it. In their view, existing provisions are adequate to deal with bad loans. Under such circumstances, it is hardly surprising that little has been done so far to deal with the problem in any concerted fashion.

10. Conclusions & Principles

From a western point-of-view solutions to debt problems are generally straightforward. Sound business plans, commitments to meet deadlines for operational changes, changes in management, reschedulings of debt, extending new finance, write-offs, debt-equity swaps, liquidations, divestitures, mergers and acquisitions are all well-known methods leading to the resolution of over-indebtedness.

Implementation in Slovakia, however, will require a lot of hard work and determination by enterprises and banks who have little or no experience in such matters. Furthermore, there needs to be a consensus among Slovak institutions that influence business and finance to remove some of the structural impediments. *The problems confronting the enterprises, banks and institutions are multi-faceted and deep-rooted.*

Whether Slovakia develops a concerted approach in order to resolve them as rapidly as possible will, to a large extent, depend on the political will of the government to address the issues involved. Experience in other countries shows the rewards for a rapid conciliation process are sustained, higher levels of economic growth than would have been achieved by a slow, piecemeal alternative.

Recommendations have already been made to the Slovak government, the World Bank and USAID on proposed methodologies to enact a comprehensive debt resolution process. Regardless of the exact form that such a process may take, it would, however, be useful to highlight some of the following basic principles which will re-inforce debt resolution.

Besides the need for a clear sense of purpose to advance such a process, the government of Slovakia should clearly define the role it intends to play in the economy. Whatever its political outlook, there should be no ambiguity as to which areas of the economy it will continue to be actively involved in. By the same token, it should be made perfectly clear as to which sectors of the economy will be entrusted to private enterprise. For any transition to a market economy to be successful, the confidence factor has to be strong. Investors, whether they are domestic or foreign, need to be convinced that the Slovak economy is stable and moving in the right direction.

Although the government may wish to maintain strategic interests in some sectors of the economy, this should be kept to a minimum. By creating the right environment for investment, further privatization of banks and enterprises will alleviate the debt problem. To the extent that entities remain within state ownership, the government must force them to adapt by tough fiscal discipline and price liberalization. *Only by making the banks and enterprises respond to market forces, and thereby distancing them from political decisions, will they effectively address the problem as well as the issues that were responsible for the development of bad debts in the first instance.*

International experience suggests that bad debt estimates are often initially below the real situation. *An accurate assessment of the full extent of the problem is thus needed in order to determine appropriate solutions.* When applying solutions, however, care must be taken to distinguish valid claims for debt relief from exaggerated ones. Once a realistic appraisal of the situation has been made and appropriate strategies have been determined, decisive action will be required to address all problem areas comprehensively. To do otherwise is likely to result in continuing future constraints on Slovakia's economic growth.