

Restructuring the Banking Sector in Slovakia

MA Thesis

Martin Berka

Supervisor: Professor Ugo Pagano

Central European University, Budapest
Department of Economics

June, 1998

Acknowledgement

I am very grateful to Professor Ugo Pagano for his indispensable guidance and divine patience. I would also like to thank Professor Fabrizio Coricelli for making the writing much easier. Many thanks to Martin Šuster for his comments and Zuzka Rapàkova and Vladimìr Dohnal from SymSite, Ltd. for their data. My research trip to the Università degli studi di Siena was financed by CEU in Budapest. Thanks, folks.

Contents

1	Introduction	1
2	Early banking in Czechoslovakia	3
3	Evolution of the Economy During Socialism	5
4	Industrial Restructuring after 1989	11
4.1	Industrial Restructuring in Czechoslovakia	11
4.2	Privatization in Czechoslovakia	11
4.3	Privatization in Slovakia	13
4.4	Enterprise Restructuring in Slovakia after 1993	16
5	Current State of Corporate Governance in Slovakia	18
5.1	Ownership Structure	18
5.2	Ownership Structure	20
5.3	Corporate Debtholders	20
6	Banking Sector During Socialism	22
7	Evolution of Banking After 1989	23
7.1	Legal Framework in Slovakia	23
7.2	Privatisation of the State Owned Banks	25
7.3	Development of Lending	25
8	Current State of Bank Governance in Slovakia	27
9	Bad Debt Problem	28
9.1	What Has Been Done	31
9.2	Size and Importance	33
9.3	Costs of Bad Loans	34
9.4	Why restructure?	35
10	Slovak Model of Corporate Governance	37
10.1	Agency Costs in Slovakia	37
10.2	Comparison with Other Models	38
10.3	Comparative Institutional Efficiency	40
10.4	Normative Implications for the Corporate Governance	41

11 Restructuring the Banks and the Industry	44
11.1 Theoretical Arguments	44
11.2 Why Bank-led Restructuring Will Not Work	44
11.3 Suggested Solution	47
12 Conclusion	51

1 Introduction

The purpose of this paper is to show that in a transitional economy banks should not be allowed to lead the restructuring of corporate sector. As I do not base my argument on any particular theoretical model, I focus its logical flow on only one country - Slovakia. The sources of my motivation to research this topic were twofold. Firstly, the urgent problem of restructuring the enterprise and banking sectors is obviously intertwined, which exponentially increases the policy options available, further complicating the selection of an appropriate scheme. The second source of my motivation comes from my personal involvement in the loan workout assistance programs, which exposed the inability of large state banks to deal with this issue.

I start by developing an argument that the evolution of the economy during socialism contributed to the creation of a specific system of corporate governance in Slovakia. Despite its proximity to the Czech system due to the evolutionary elements, different privatization methods shaped the Slovak model closer to the German one. By applying the agency cost theory I show that this evolution was optimal given the structure of the economy and that Slovak model should outperform the others from the agency costs of equity point of view due to concentrated insider control of firms. Comparing the institutional efficiency of different systems of corporate governance becomes less equivocal when one considers the implications of the clan-based intertwined ownership structure present in Slovakia. I show that the way privatization was carried out contributed to this structure and that, given the legal environment, this structure has created some mechanisms of self-sustenance. Even though the difference between German and Slovak models seems to be non-existent in ownership of corporate debt (which leads to similar agency costs of debt), I show that the structure of ownership decreases the efficiency of Slovak system in this respect.

As the problem of poor loan quality is closely related to that of corporate restructuring, I examine the issue of bad debts in detail. Despite being acknowledged as a problem area from the very beginning, little was done to deal with it in a systematic way. A high ratio of bank loans to GDP in Slovakia amplifies the adverse effects of any inefficiencies of financial on enterprise sector, which makes the bad loan still more worrisome. However, the scheme aiming to solve this problem hinges critically on the role banks are to play in an economy which in turn depends on the system of corporate governance. Utilizing my previous arguments, the conclusion is that, indeed, the role of banks in an economy like Slovak should be similar to the role they play in the German system to minimize the agency cost springing from the structure of the economy.

While one would think that the proximity of the Slovak and German systems connected with their shown optimality in respective environments should lead to banks leading the restructuring process, I argue the opposite. Despite the doubtless similarities, the German system is operating in a stable 'mature' economy while the Slovak in a transitional one. The particular feature making the transitional economy different for my purpose is the need for restructuring. I argue that the efficient restructuring has to satisfy two conditions: (a) to generate diverse views of alternative asset uses, and (b) to select the best one, the one maximizing the value of the firm. In a transitional economy, we are dealing with a situation when the correlation of past information and potential use of assets to be restructured is very small. Utilizing the argument of Irena Grosfeld (1994) that banks are optimal in eliminating the moral hazard problem by collecting information while markets are better in eliminating the adverse information problem by generating information on the value of firms, I state that banks should be restricted to information providers as they are unable to fulfil the above roles. The best available method for an effective enterprise restructuring is a very simple - an open competition of ideas.

After elaborating upon the idea of market - led restructuring in the last part I strive to present normative implications by drafting a comprehensive bank and corporate restructuring scheme that would be compatible with my arguments. A common hurdle along the way is represented by a potentially small number of participants on the side of investors resulting mainly from insufficient market depth and the inefficiencies of the legal system in the countries of transition which is supposed to limit market incompleteness. I suggest to eliminate the former by creating a multi-country scrap asset market on the side of suppliers, and the latter by locating the market in a legally efficient place.

2 Early banking in Czechoslovakia

In the 19th century, banking inside the Austro-Hungarian empire was concentrated in Budapest and Vienna, mainly due to favourable tax policy and the strong power centralisation. Despite the fact that 80% of industry were located in Bohemia, the first bank on the territory of former Czechoslovakia only emerged in 1857¹. The number of banks surged to 19 joint stock companies by 1872, with a total capitalisation of 44 million Florins (then equal to 17.8 million USD)². The banks have been largely established for the needs of growing trade and agricultural production. Weak reserves of banks triggered the 1873 Vienna crisis which decreased the number of banks to 6, a number not to be changed for the following 25 years. The industrial growth at the turn of the 19th century increased the scope for banking activities, leading to rise of 20 new mainly Czech banks, said to originate to counter the German monopoly in banking services. The banking in Slovakia has been largely undeveloped until the World War I, with needs being served by banks from Budapest. Czech banks came out as winners from the World War I when compared to their German counterparts, mainly due to significantly lower levels of inflation and to peasants' savings remaining deposited confidently.

In 1924 there were 37 banks in Czechoslovakia, with a total assets of CSK 25 billion. When compared with the situation at the end of 19th century, the ratio of Czechoslovak to German assets changed from 25:75 to 60:40³.

In the Western Europe, industry appeared long before banking, with banks serving primarily commerce and trade activities, as reservoirs of capital as well as deposits from population. Only the last of the functions was common with the Central Europe⁴, however. Here, it was largely on banks to establish the industry and assist enterprises with the trade connections. These gave rise to what became known as German-type universal banking systems, characterised by close bank-borrower relationship, which was mirrored in bank assisting in strategic as well as operational decisions, and in lending more on a longer side. In Czechoslovakia, this development was also supported by a slow industrial growth leading to a limited number of companies with large amounts of capital, thus making the participation of

¹A branch of Viena Oestereichische Creditanstalt fur Handel und Gewerbe.

²The only bank that remained until these days in the Czech Republic is Zivnostenska Banka, founded in 1869.

³Of the Kcs 25bn, 10bn was of German and 15 of Czechoslovak origin. Capital of the banking sector grew from Kcs 400m (1900) to Kcs 1.055bn (1910), Kcs 5.254bn (1918) and Kcs 19.457bn (1924). These increases were only nominal, however, accompanied with a proportionate (of a factor of 4 and 14 in 1918 and 1924, respectively) depreciation of Koruna.

⁴Said to contain Italy, Germany, Austria, Hungary and Czechoslovakia.

banks in financial and organisational issues of firms necessary⁵. Eventually, banks held 10 - 30% of companies' capital. When combined with the credits extended, this amounted to a significant control of the enterprises.

⁵The banks themselves grew up from small co-operatives, with the ownership spread among a wide range of classes.

3 Evolution of the Economy During Socialism

Despite a slower growth over the forty years relative to its neighbours, Czechoslovakia had one of the highest GDP per capita levels of all socialistic countries in 1989, possibly also due to the high level at the beginning of the period⁶. The structure of its economy in 1948 resembled that of western countries (in particular that of Germany), with 30% of active population working in the agriculture and 45% in mining and manufacturing⁷.

The most important change in the economy after the Communist Party (CP) led the coalition government in 1946 was the nationalization of 61% of the industry measured by the employment level. At the beginning there was little resemblance of the Soviet-type planning inside the state sector, as little interference in firm governance was imposed by the state authorities. The problems with achieving the planned levels of output and investment were blamed by the CP on the remaining private firms, which were still strong primarily in the investment-intensive construction sector⁸. The coalition interlude ended after the CP assumed complete power following the events in February 1948. The immediate consequence was another nationalization, leading to a 95% of industry owned by the state⁹.

As the Czechoslovakia had the most intensive relations with the western economies from the CMEA (Council of Mutual Economic Assistance) countries, its exposure towards foreign trade changes was relatively high¹⁰. The traditional export products (mainly the consumer goods such as textiles) had an unstable and limited demand and relied heavily on imported materials. Hence the plan was to follow the pre-war developments shifting the industry structure towards exporting heavy engineering and chemicals. As these were also the sectors which flourished during the Nazi occupation, and as Germany temporarily vanished as a competitor, the prospects of becoming the machinery producer of Eastern Europe seemed bright, mainly from the Soviet point of view. Resistance to such a major structural shift was strong. Its relinquishment only came after Stalin vetoed Czechoslovak participation

⁶During the interwar period, per capita national income was 70 and 60% above its levels in Poland and Hungary, respectively.

⁷The same shares for Hungary were 54% and 22% and for Poland 67% and 18%.

⁸Which consisted by 87% of private firms when measured by employment.

⁹Private business decline could be also illustrated on the decline in number of workers employed from over 500.000 in 1948, to 50.000 in 1952.

¹⁰The reversal of the starting position was striking - by the end of the 50s, Czechoslovakia had the lowest share of its trade with advanced capitalist countries of any CMEA members with the export structure most vulnerable to recessions (Myant, 1989).

in the Marshall Plan in 1947 and as soon afterwards, any attempts for a “specific” development of the economy (understood as one not in line with the Soviet plan) were viewed as a dangerous deviation. The Czechoslovak-Soviet trade agreement of February 1950 committed the country to the production of machinery and equipment that it had never made before. The result of these steps was a rise in the foreign trade share with socialistic countries from 40% of total in 1948 to 78% in 1953.

The changes in the geographical trade reorientation were closely related to a shift from consumer goods to heavy machinery and chemicals production. The results of the policies were quite unexpected: some sectors with declining employment (mainly light industries) also experienced a rapid growth in productivity due to large gains from rationalization. Consolidation of the priority sector of engineering led to even faster growth, supported also by investments to complete 24 new factories countrywide. A major difficulty with the shift in the industry structure was that of amplified bottlenecks in the extraction of raw materials. Ever since, coal industry was amongst the worst performers thus requiring large additional investments and decreasing the overall productivity and growth of the economy. Similarly, there were no large reserves of iron ore in Czechoslovakia, despite the bold proclamations of Stalin. As these bottleneck problems could not be effectively solved by the investment, productivity rises in the supported industries were smaller than expected. Paradoxically then, the 1950s enjoyed a rapid growth in labour productivity (much of which was not due to the investment) and a high level of investment (much of which could be associated with a stagnant level of labour productivity).

Beginning of 1950s was characterized by a definite shift from applying general principles and specific elements towards copying Soviet model, which was primarily done by allocating the resources in a more centralized manner¹¹. The key step in doing so was the detailed planning with an aim to cover 80% of 1951 industrial output with a 1,100 individual tasks planned in quantity terms¹² with targets set not according to some objective criterion but as to what was judged important to the economy from the strategic (and political) view¹³. The distinctive feature of Czechoslovak economy was its limited scope for transfer of resources from investment to consumption.

¹¹In 1951-52, only the products of communal and co-operative enterprises were not allocated from ministry or governmental level.

¹²Heavy engineering was to move from 15 named tasks representing 20% of all production in 1949 to 70% in 1951.

¹³It could have been otherwise hardly argued that while in western enterprises the value added per worker varied over a range of 1:7, in Czechoslovakia it was 1:60, and still the nonviable enterprises were not closed (Nesporova, 1993)

As the concerns over living standards of population became more voiced, the need to increase consumption levels forced some 'regrouping' of the economy, with a light industries maintaining priority for several years. The explosive year 1956 left Czechoslovakia rather untouched - with its rising armaments exports (mainly to the Near East), the country could import cotton, wool and wheat to restore its consumer goods industries and sail safely on the stormy political seas of that era.

1950s were also a period of decentralization in directing the economy. Planning was to be improved to achieve higher stability and better management of the economy by several measures.

1. Mainly due to taking a longer term 'perspective' view at one side and allowing the enterprises to bargain and enter into *long-term contractual links* on the other. State Planning Office was supposed to check the compliance of these with the long-term interests of the plan. Rather than a decentralization, this merely amounted to a demarcation of power between different levels with the center taking care of the planning. Eventually, this led to a development of another source of centralization: multi-enterprise bodies standing as authorities between the ministries and the companies. In order to improve planning, profit indicator was taken as a consolidated performance measure to be used for production targeting.
2. Stability was also to be achieved by a *price-setting mechanism* every five years, despite the growth in the distortions.
3. On a more micro level, *reduction of the product ranges* and a consecutive switch towards mass production should also make the economy more manageable.
4. In order for this change in the organizational structure to lead to a higher international competition, substantial *investments in a new machinery* were necessary. The result was a change of sources of growth from intensive to more extensive ones¹⁴.

The instability of the international situation of Czechoslovakia was mainly caused by the disproportion between the growth in the industrial output and its raw material base. As most of the exports were sold on credit, the amount of foreign exchange available for food or sophisticated machinery imports was

¹⁴The ratios of growth in productivity to growth in fixed assets declined from 1948 until 1973 for all industries, especially in textiles, energy and food industries.

limited, which increased the vulnerability of the economy. The need for imports of deficit goods to achieve the plan targets only aggravated the problem. In response to the balance of payments crisis, state administration decided for an across-the-board cut in the investment (with the exception of investments covering the depreciation) so as to keep the private consumption and needed imports untouched. Also, the call for a higher degree of centralization to enforce needed production led to the abolishment of dual organization of investment in 1963¹⁵.

Despite the popular work of Brush in 1964, the picture of Czechoslovakia was diverting from that of a specific path of socialism to a Marxian understanding of socialism as an 'absolute negation' of capitalism (hence towards complete planning)¹⁶. This approach was softened when the political situation eased in the late 60s, with calls for limiting the influence of CP in the economic decision making by clearer definition of authority competencies. As a result, the number of multi-enterprise associations declined from 254 to 90 in 1965¹⁷.

The intentions of the government to avoid economy overheating did not prevent another investment boom in 1968, as the pressures from the enterprise levels intensified. It seemed that the structure inherited from the past generated pressures for investment in order to reproduce itself (Myant, 1989). As the new investments were viewed as a best guarantee against closures, most of the pressures came from the least productive sectors which in turn received the highest levels of investment¹⁸. After the Soviet military invasion, the era of "normalization" returned the whole system of planning and management back to the 50s.

Despite the relative prosperity, 1970s were a period of gradual loss in competitiveness, with an average annual growth rate 3.7% compared to the CMEA average 4.4%. The traditionally strongest areas of machinery exports to CMEA countries deteriorated significantly¹⁹. The era can only be judged

¹⁵That is the existence of centralized and decentralized projects was changed in favor of centralized ones only.

¹⁶For more on criticism of the philosophy of planning see Myant (1989), pp. 115.

¹⁷Another surprising result of the changes was a recognition of wage inequality as a necessity for inducing higher work effort. Relative salaries of 'Engineering-Technical Employees' and 'Administrators' consistently declined as compared to that of 'Workers' from 1.65 and 1.24 in 1948 to 1.32 and 0.84 in 1970, respectively. Some authors (e.g. Sik) argued that this was a sign of well functioning labor market reflecting the low demand for work in the priority industries of mining and energy.

¹⁸Shares in total investment rose in heavy industry from 15% (1967) to 20% (1968) and 30% (1969).

¹⁹Czechoslovakia's share in Soviet machinery imports dropped from 21% in 1965 to 11% in 1975. Machinery exports to other European CMEA members declined as well,

successful from the point of view of population, whose living standards were kept stable. This was achieved thanks to a new CMEA pricing system (using a 5-year moving average of world prices), implicit subsidies Czechoslovakia received from the Soviet Union in the form of underpriced oil deliveries²⁰, increased foreign borrowings²¹ and rising trade deficit. A consequent hard-currency squeeze as well as observation of destabilizing impact of foreign debt in Poland led the authorities to undertake drastic restrictions aiming to eliminate the foreign debt by the end of 1980s. Due to problems with exporting machinery, focus changed to raw material and low sophistication exports, mainly those of wood and cellulose, as well as to decrease in exports. The effects of these measures were most pronounced in investments, where new start-ups were cut by 37% by 1981. A normative source of discontent is justified from the point of view that as the raw materials price index (excluding oil) rose just marginally faster than the price of manufactured goods, and as oil shock was virtually non-existent within the CMEA block, Czechoslovakia should have been performing better than the capitalist countries, which was not the case.

In 1982, Soviets yielded to the temptation of rising world oil prices and cut their supplies to Czechoslovakia (by 1985, oil deliveries declined by 12%), forcing some degree of substitution of the energy sources with gas. Despite a decline in investments on aggregate, energy sector investments rose, taking 31% of total in 1982. The problems in oil cuts were eased by an improved energy utilization²² as well as by a rise in socialist machinery exports, as the CMEA members' hard currency reserves ran low forcing them to import from Czechoslovakia, which made the bias towards machinery beneficial for once. Inability to earn necessary hard currency presented another bottleneck that kept the growth of the economy in check. This was further reduced by a decline in the productivity growth in labour and fixed assets.

The structure of the Czechoslovak economy led to several problems. It was very rigid, mainly due to a strong lock-in effect of few large sectors which over time, with the help of economic lobbying, gained political influence that kept the structures alive despite the inefficiencies. The rigidity made the structure very fragile, thus turning the temporary advantage into a disadvantage when the economy was forced to face the fast-changing world economy. The high

eventually remaining in balance with imports by 1978.

²⁰Some authors estimate the value of this subsidy to USD 6 bn during 1973-8.

²¹After the 1973 oil price shock, availability of western credits improved and the net indebtedness of Czechoslovakia reached USD 3 bn.

²²Despite these measures, Czechoslovakia occupied the fourth place in the world in the energy consumption per head (after USA, Canada and GDR), mainly due to its highly energy-intensive industry structure.

level of specialization (usually, there were only a few variations of a good available) in combination with the socialist system of management developed into inflexibility and caused problems with international integration as well as with internal specialization when many companies have been working on the same type of research. Hence the companies that have received the largest share of investment relied on this extensive growth path and were exporting sophisticated products to socialist countries only (capitalist countries were only importing unsophisticated products) while the extremely low number of consistently good performers were typically smaller enterprises with long traditions which did not depend on research nor did they need to rely on extensive links with domestic producers²³. On the other hand the priority industries were extremely energy-intensive and required a significant amount of additional investment when energy constraints became binding and hence limited the development of other sectors.

Being a less developed part of the country, Slovakia enjoyed faster growth in all indicators, when consumer spending per capita grew from 68% of Czech level in 1953 to 93% in 1983. Industrialization pulled up Slovak per capita national income from 65% of Czechoslovak average in 1948 to 72% in 1953 and 81% in 1981²⁴. Lacking any traditional industry base, the basis for this development were the priority sectors of steel, heavy engineering and petrochemicals.

Hence during socialism the problem did not lay only in the soft budget constraints of the enterprises, acting in general as input maximizers. In most of the priority sectors (chemicals and heavy industry), government was allowing projects for which banks had no choice of not granting credits even if the companies were expected not to have any resources to cover for them. Money were thus reduced to a purely formal accounting role acknowledging the decisions made according to different criteria (Myant, 1989).

To summarize, the major source of inflexibility and problems (apart from the usual Hayek's argument) was the deviation from the abstract model of planned economy towards one where orders are set after bargaining with lower levels. This led to the practice of using every opportunity (including but not limited to party, local government and trade unions) to press for their sectional interests. Lacking any objective evaluation criteria, this was what the system was not intended to and had proved to be extremely unable to deal with.

²³Among these there were mainly textile, jewellery and glass industries.

²⁴See, e.g. Myant, (1989), pp. 261.

4 Industrial Restructuring after 1989

4.1 Industrial Restructuring in Czechoslovakia

Manufactured goods importers in the USSR did not exert any product innovation pressure on Czechoslovak exporters, thus contributing to their inability to export to western economies, further locking-in the exporters to their present market and widening the quality gap.

Government reform program started in August 1990 with elimination of the state budget deficit, decentralization of investment decisions and removal of food price subsidies²⁵. Soon afterwards, the national currency was devalued in three steps by a total of 46%²⁶. Almost all remaining prices as well as foreign trade were liberalized in January 1991. As the inflation was brought under control, a negative trend with respect to a newly emerging private sector arose. Inflexibility of the high nominal interest rates, beneficial in an inflationary period to avoid demonetization of the economy, caused a surge in the real interest rates after the inflation was kept in check thus creating a barrier of entry to the newly emerging private sector.

From the structural view, the period of 1989-91 was characterized by an overall decline, mainly due to the transition recession, further amplified by the CMEA break-up, resulting in a loss of major markets. The industries most affected were those depending on inputs from CMEA countries (chemicals, non-ferrous metallurgy) and those facing lower demand (building materials and fuels due to rising prices). In 1991, falling demand hit the consumer goods industries (glass, textile, garments and food), and half a year later also heavy industries, with only metallurgy experiencing an investment growth. Consequently, output fell 40% in light and 30% in primary industries. Tendencies became more evident in 1992, with chemicals, building materials, textiles, paper and food processing leading the recovery.

4.2 Privatization in Czechoslovakia

Starting from almost complete lack of private sector, the urgency for privatization seemed to be higher in Czechoslovakia than in the neighbouring transition economies. Government strategy was to start from less complicated small business units ('small' privatization) and later move to more sophisticated mass privatization programme transferring the whole bulk of firms

²⁵The corresponding gain was channelled to households in form of transfers.

²⁶For an interesting explanation of the role of expectations in devaluing CSK, see Nesporova, 1993.

at once ('large' privatization), which was supposed to be carried out in two phases ('waves').

1991 saw the beginning of small privatization, aimed at selling 40,000 small business units. By the end of the year, 14,200 and 7,300 units were sold in Czech and Slovak Republics respectively (in Slovakia, they totalled app. SK 12bn), mainly by public auctions. Early 1990s witnessed a large amount of SOE breakups in Czechoslovakia, when starting from about 700 enterprises with a workforce over 25 employees, their number increased to 2,000 by the middle of 1992, most of them being a result of SOE breakups. Despite the fact that it is difficult to evaluate the performance effects of the enterprise spinoffs in transition²⁷, Lizal et. al estimate that this had an immediate significant effect on enterprise profitability and efficiency, with the outcome being positive for small and average-sized spin-offs and negative for large ones. This supports the view that despite the presence of economies of scale in large socialist firms, they have suffered from inefficiencies. Would they have suffered from diseconomies of scale, performance of both spin-offs and parent companies would improve. Instead, findings of Lizal et. al support the idea that the either the smaller spin-off subsidised the rest of the firm or it was conveniently created as the best pre-privatization asset-stripping move of the management to increase their chances of winning the parent-company shares (by then having a much lower value) in the privatization sales. An implication of this for banking sector structure would be that the companies would eventually merge again and thus the average corporate size would not decline that much. Nevertheless, data shows the opposite happening - see Table 2 in the Appendix.

The first wave of large privatization started on May 18, 1992 with an offer of 1,491 enterprises having a total book value of CSK 300bn. Terminating at the end of 1992, this extremely speedy sell-off resulted in a transfer of 93% of the offered property, of which 65% was done by vouchers (held by the population, often indirectly via the Investment Privatization Funds), 15% remained in the National Property Fund (an agency set-up to take care of the state property until it is sold), 12% was transformed into the state capital participation in financial institutions, 3% were sold to foreign firms and 5% were restituted to former owners²⁸. The second wave was carried out in

²⁷This was mainly because changes also came from a simultaneous opening up to the world markets which led to an increase in competition (negative effect on performance) as well as rise in exports (positive). Of course, these may differ due to the asymmetries in the freedom of trade. In case of Czechoslovakia, Lizal et. al (1997) argue the cumulative effect was positive.

²⁸As the industry structure in Slovakia prior nationalization was very poor, this last method applied mainly to Czech Republic.

compliance with the plan in the Czech Republic, while substituted with a different method in Slovakia (see below).

4.3 Privatization in Slovakia

Calculated in 1996 prices, the total value of privatizable property was SK 427.6bn or 74% of GDP (see Table 1 in the Appendix). Of this, 52% was sold using various methods: 19% via voucher privatization, 33% via standard methods (i.e. direct sales to new owners and a limited amount of public tenders). As of the end of 1996, 27% of the property still remains in the possession of the National Property Fund (NPF), half as temporary custody and half as permanent custody (the ‘essential’ companies) and other property. At last, 21% of privatizable shares are still held by the founding ministry²⁹. In 1997 government intentions were to sell SK 60bn out of the SK 110bn left for the privatization. If newly set-up businesses are included, the private sector produced 80% of the GDP in 1996 (IMF, 1997).

After the voucher privatization took place, most of the activity stopped due to a political instability and contradictions. Definite cancellation of the second wave of voucher privatization (that was about to distribute SK 51bn worth of shares of 152 companies, or 12% of all privatizable property) came in October 1994, forcing a dissolution of 160 Investment funds set up for that purpose. Instead, the method has been changed to direct sales and “bond privatization”, with the scope narrowed to exclude the strategic enterprises (a number of companies where the state has a special interest; this has declined from 45 to 12 in 1996).

Under the *direct sales* method, the role of the NPF has grown in importance relative to other government agencies. Led by the desire to create a managerial and ownership group that would have a strong enough equity interest to pursue strategic issues, property has been primarily sold to local³⁰ insider stake-holders and outsiders under favourable financial terms. The enterprises sold in this manner were generally larger than those sold in the first wave of the voucher privatization.

The *bond scheme* has been set up as an alternative to the original voucher scheme. For a small registration fee, citizens received bonds totalling SK 33bn

²⁹The World Bank study on Slovakia (1998) divides the last two categories as: essential enterprises (to be excluded from privatization) of assets SK 100bn (app. 23% of the total privatizable property), and enterprises left for privatization with assets of SK 110bn (25%). With this in mind, they conclude that the government still controls some 50% of the former state property (data as of the end 1996).

³⁰It is questionable whether foreigners would be willing to participate anyway, as the process uncertainty accompanied frequent changes in the legislature increase the risk.

(6% of GDP) issued on January 1, 1996, with each of face value SK 10,000 (app. USD 300, or almost double the average monthly salary) maturing in 5 years, and bearing an interest rate equal to the discount rate of the central bank. The bond is a tradable security (subject to a minimal price requirement of SK 7,500) which can, apart from holding it until maturity, be used for several other purposes by the individuals³¹. Most interestingly, bonds can be purchased by the companies and used (for their full face value) to decrease their obligations vis-à-vis the NPF.

As I have presented above, the inherited industry structure in Slovakia is very concentrated. Therefore there were only “a few” companies to be sold, most of them very large³². As any disruptions in production of these large firms would have strong adverse consequences on the economy, it seemed natural for the government to try to control the newly emerging ownership structure. Moreover, there was some negative experience from the second wave of voucher privatization in the Czech Republic, where the Investment Privatization Funds, set up to mirror the mutual funds in the Anglo-Saxon countries, acquired large control stakes of companies and were blamed for excessively short-term orientation. The funds have been said to have little experience in the sectors and companies they have managed which had contributed to sales of the stakes to other parties³³. Their ownership structure lead to some doubts as well. Their frequent ownership by banks lead to a high concentration of power within the banking sector when banks could use their equity stakes to speed up their debt repayments. This has led to two adverse effects. Firstly, the debt monitoring is much more narrowly defined than an equity contract. Hence using the latter as a tool to support the former deteriorates the role of equity in the firm which then leads to a loss of competitiveness (as inputs are not used in the most effective manner) and worse company performance. Secondly, banks’ reliance on equity stakes to pursue their debt collection interests leads to poorer debt quality and consequently inferior bank performance. Hence there should be little surprise that the government, having in mind its objectives, chose a more focused approach.

³¹These are: purchases of company shares at special auctions (amounted to SK 8bn in a list of 156 companies), acquisitions of complementary health insurance, means of payments for certain type of apartments and for shares in special auctions held by the NPF.

³²Top 20 companies in Slovakia in 1996 produced 30% of gross industrial output, while employing only 7% of labor. These were mainly metallurgy, energy, chemical, machinery and paper industries. Moreover, in 1989 companies over 500 (1,000) workers employed 98.8% (91%) of the workforce.

³³This was one of the reasons why the IPFs were viewed as “dangerous” and the maximum share they were allowed to hold in companies was reduced from 20 to 10% (in the Czech Republic, it still remains at 20%).

When compared to the voucher-type privatization, transferring the property to a large shareholder has the advantage of preventing the fragmentation of ownership that may effectively block the management of the company and make it vulnerable to even small changes in the ownership structure, mainly with non-existent minority shareholder protection laws (a small group of shareholders would be able to manipulate the company). Direct sales lead to a greater initial concentration of ownership, which could lead to a faster recovery of the enterprises. On the side of the citizens, the bond scheme is more protective than the voucher scheme, giving the option of a fixed return with a probability close to one³⁴(limited loss). In principal, bond privatization could be understood as a two-staged equity-debt swap with the NPF absorbing risk that citizens hold in the case of a voucher scheme. So theoretically, bonds still allow the citizens to benefit from the privatization (thus being philosophically in accord with the expectations), while taking the burden of monitoring the enterprises off their shoulders, as they have been inefficient in it anyway.

However there have been several problems with this approach. Firstly, the lack of enterprise experience in Slovakia put insiders in a better position. Secondly, the whole scheme proved to be very vulnerable to corruption, especially as the decisions have been done in a very secret and non-transparent way, mostly not by sales to the highest price bidders, which made the benefits of effective corporate governance questionable. Thirdly, selling to insiders makes it difficult to obtain additional equity financing from outsiders, forcing insiders to rely on debt financing. This have proved especially disastrous in Slovakia, where most of the bad loans emerged after 1989 came exactly from a negligent (and unskilled) lending to the newly-privatized companies. It is therefore reasonable to argue that the government has contributed, by exercising the privatization in this manner, to the development of the post-1989 bad-loans.

All in all, the comparison of these two methods bears some resemblance to comparing kingdom with democracy. While kingdom allows for efficient outcomes faster if the emperor is good and wise, democracy often has to settle for the second best in the short run in hope to obtain the best results in the long term. However, the kingdom is much more fragile, the emperor happens to lack all those qualities (not to say bears the opposite ones), the adverse developments can not be prevented by any automatic stabilizer.

³⁴Recently, there have been some doubts as to whether NPF will be able to repay its obligations, due to poor collection of its own receivables.

4.4 Enterprise Restructuring in Slovakia after 1993

Since 1990, the number of firms in Slovakia rose more than fourfold. To complement, the average size declined from 1,283 to 319 employees (see Table 2 in the Appendix). The trend was for a growth of small and medium enterprises, which accounted for 35% of gross industrial output by the end of 1994. Their growth was mainly concentrated in the fabricated product and textile sectors, that is in the sectors with the largest comparative advantage. On the other hand, the top 20 companies in Slovakia in 1996 produced 30% of gross industrial output, while employing only 7% of labor. These were mainly metallurgy, energy, chemical, machinery and paper industries. Twelve of these firms are still owned by the state or other state companies. So despite the fact that the share of the private sector in GDP grew to 68.2% in 1996, the influence of the state remains strong, mainly in the heavy engineering and energy sectors.

When compared to the developments in the Czech Republic, enterprises in Slovakia were characterized by a higher rate of layoffs (8.2% vs. 5.9%), a higher rate of gross profits on GDP (14.5% vs. 8.9%) but also a higher rate of gross losses on GDP (5.7% vs. 4.6%). This suggests a relatively flat distribution of companies in Slovakia, with a large group of highly profitable but also highly loss-making enterprises. The profitable group is mainly formed by state monopolies in the energy sector and few large private firms (these are the firms with the highest productivity growth and the lowest value added). The loss-making group primarily consists of state owned and state supported industries of manufacturing³⁵ and raw materials, protected by the legal bias towards debtors (see p. 26). Notwithstanding the legal brakes, a high degree of state interference can be identified here: by vertically integrating industries which can be influenced and minimizing profits of participating companies, state is trying to decrease the price of the product. Restructuring of the loss-making state enterprises is often induced by a capital participation of some profitable state company (mainly the energy sector). The restructuring strategy of the government does not aim to achieve higher product competitiveness. Instead, it assumes poor marketing is the reason for low demand and accordingly focuses its investments³⁶. This seems to be a reoccurrence

³⁵Losses in manufacturing totalled 5% of GDP in 1996, mainly concentrated in metal products, heavy machinery and transport equipment, all of them industries that were created during the 70s industrialization era. Slovak manufacturing companies seem to be in worse situation than the Czech ones, with 10% of large ones unable to cover wages (0% in CR) and 27% unable to cover depreciation (19% in the CR) in 1995 (World Bank, 1998).

³⁶Examples could include the Export-Import Bank (which is out of the supervision of the NBS), Export Support Fund (with obligatory contributions of all exporters) and

of the approach of 70s, when investment rise was the primary reaction to a need for a profound restructuring.

establishment of a denser network of trade representatives.

5 Current State of Corporate Governance in Slovakia

5.1 Ownership Structure

Due to a very effective marketing campaign, the 165 Investment Privatization Funds (IPFs) in Slovakia had received two thirds of the voucher privatization coupons, amounting to 12% of privatizable property. Nevertheless, ownership by IPFs was less concentrated than in the Czech Republic, exceeding 20% in 78% of companies (93% in CR) privatized by coupons. Complementary, small shareholders owned more than 50% in 52% of cases (32% in the Czech Republic)³⁷. Later the small shareholders declined in importance, as their vouchers were bought with premiums mainly by insider groups. The trend of ownership concentration was mirrored by an increase in Herfindahl Index of concentration from 0.126 (1993) to 0.172 (1995) (World Bank, 1998, p. 33). Role of the IPFs has decreased, with the second wave of voucher privatization being cancelled and the government initiating a legal action against several IPFs (forcing their dissolution in some cases) as well as a decline in the maximum involvement of a fund ownership in a company from 20% to 10%. Due to the way the direct sales privatization was carried out, it may be safe to say an absolute majority of companies is controlled by insiders and their groupings. It is probable that this type of privatization will not lead to a speedy reconstruction, as needed funds are lacking (owners are still repaying their instalments to the NPF, often using the depreciation expenses) and, as Marcincin (1997) has shown using a simple model of Aghion (1990), it is unlikely for the managers or the employees to sell their shares when they are facing a possibility of unemployment³⁸.

Despite many of them being universal, banks hold only minor stakes in Slovak companies³⁹ (For a short comparison of models of corporate governance, see Appendix.). This is partially caused by a non-existent proxy-voting as the share of small shareholders is minimal, and partially due to banks' awareness of investing into shares of nonperforming businesses. Banks do hold the company shares for trading purposes, though.

Unlike banks, clan-like groups do exert a significant share of control in Slovakia by owning large stakes of industries. Often created by people that profited from the direct sales method, this group is naturally very closely interconnected with the high level politics. Their emergence can be easily

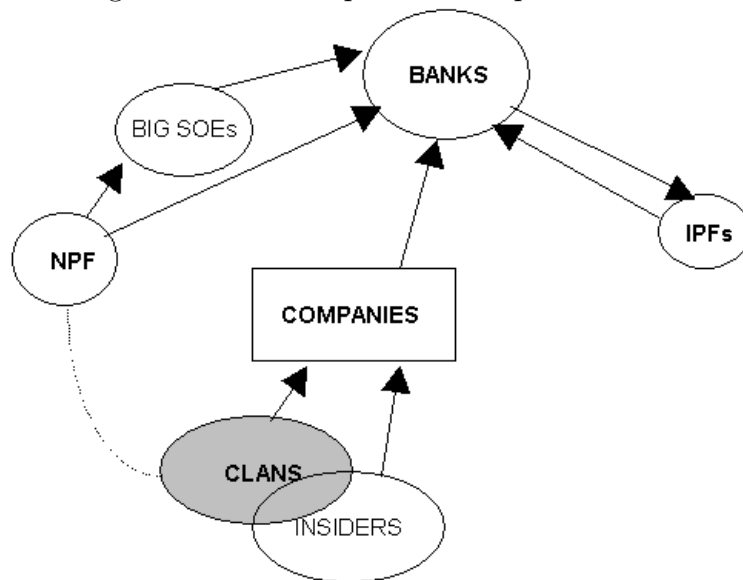
³⁷For a more detailed survey, see Marcincin, 1997.

³⁸He presents it as a channel for unemployment to deter restructuring.

³⁹Unlike in the German or Japanese systems of corporate governance.

explained in an evolutionary way: after privatizing several companies, their connection with politics had to grow closer⁴⁰ and at the same time their access to credit improved, allowing them to bid for larger companies. Even though there are about 20 clans, the main control is exerted by two clans situated in Kosice⁴¹ and in Trnava⁴². When not majority owners, these clans are able to control the companies using their influence in the National Property Fund. Only a relatively small number of firms is purely manager-owned, mainly in the chemical and petroleum industry. Hence, the ownership structure could be depicted by the following figure.

Figure 1: Ownership relationship in Slovakia



⁴⁰The corruption and non-transparency of the privatization process was overwhelming, with the NPF obviously not maximizing the price stated officially, but the share that went to the decision-makers (bribes). As was publicly acknowledged by the president of the NPF, if he would disclose who were the real owners standing behind a freshly created companies, his life would be threatened.

⁴¹Headed by A.Rezes, a former transportation minister and a president and majority owner of VSZ, this clan owns majority of non-state machinery firms, several banks (significant stakes in IRB, Slovak Insurance Company, Industrial Bank, Transportation Bank, Post Bank) and some investment companies.

⁴²Headed by V. Poor, head of the regional HZDS (the ruling party in Slovakia) headquarters, this clan owns large pharmaceutical and paper industry firms, the only large petro-chemical refinery in Slovakia, a private TV channel and controls most of the activities of VUB and AG Banka.

5.2 Ownership Structure

With the legal system being built similarly to the European one (mainly German), governance boards play a more significant role in the corporate governance than in the Anglo-Saxon countries. There are two governance boards: Management Board and Supervisory Board, with two thirds of the latter one always elected by the shareholders' meeting (the last third by workers' council) and the former one that is in most cases elected by shareholders' meeting as well but can be changed by the statute of the company. In general, commercial code allows for a large degree of freedom, so that in most cases Supervisory board does not really have the powers to dismiss management, only to suggest any changes to the shareholders' meeting. In fact, Management Board is often formed by majority shareholders. Unlike in the German system, the role of workers' representatives in the Supervisory Board is minimal, and workers' councils are non-existent. The legal looseness in defining the exact positions of governance boards actually leads to majority owners directly managing the company which limits the agency costs inside of the firm.

5.3 Corporate Debtholders

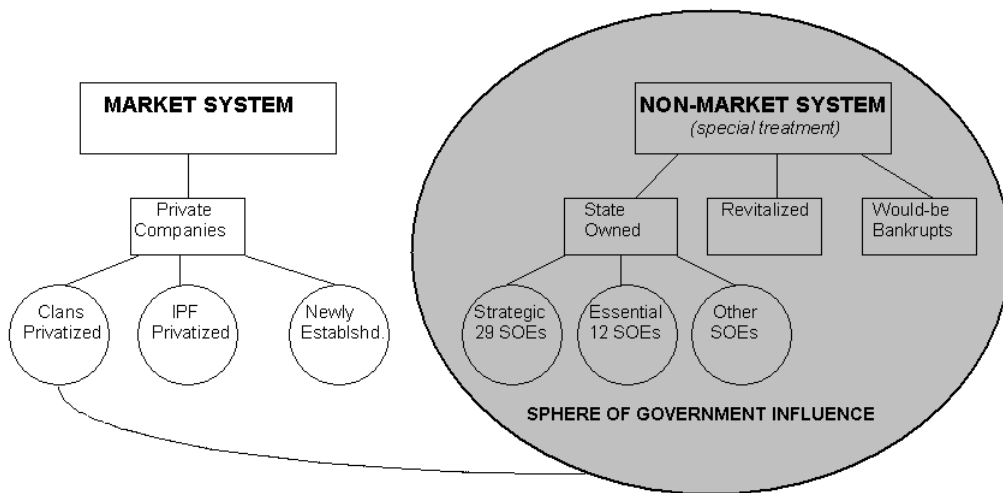
There is a significant lack of data on this measure in Slovakia. Marcincin (1997) estimates the structure of gross firm financing in the light industries to be 62% via retentions and 26% out of bank loans, which is very similar to analogous data for Germany of 76% and 24% (Sustek, 1997, p. 56). The remaining share (app. 12%) logically seems to be held by holders of tradable debt instruments (mainly bonds). Due to the high real cost of loans, Slovak bond market has developed into the largest among the Central and Eastern European countries when measured by market capitalization vis-à-vis GDP⁴³. Only 40% of the market is held by the corporate sector, which evolved from SK 0.28bn in 1993 to SK13bn in 1996. The role of bonds as financing vehicle remains marginal as on aggregate they only amount to 3.6% of loans in 1996. From the corporate governance point of view they further decline in importance as in many cases, corporate bonds have been purchased by the underwriting bank.

To summarize, the Slovak state of corporate governance seems to be rather untypical (as most of the transitional economies are), with a large share of state influence in the system acting as one of the brakes in restruc-

⁴³As of 1996, Slovak bond market capitalization was 12.6% of GDP, followed by Hungary (10.8%), Poland (7.6%), Czech Republic (7%) and Slovenia (1.7%). To compare, the same data for France is 58.3% (World Bank, 1998).

turing and thus deteriorating the corporate governance (See Figure 2, as well as the previous section on Enterprise Reform). Overall, the ‘Slovak model’ of corporate governance seems to be more efficient than the German one in the point that agency costs from manager-owner conflict are minimized, and less efficient in the sense that the virtually non-existent protection of the minority shareholders in Slovak jurisdiction further strengthens the very concentrated ownership structure and prevents any gradual ownership change or increase in a foreign capital participation. However, the owner-manager agency costs merely seem to be transferred to owner-owner conflict of interests, with shares of the top shareholders being approximately equal. So the ultimate comparative efficiency of the two systems of corporate governance is ambiguous. For a comparison of bank governance systems, see Appendix.

Figure 2: State Influence in Slovak Economy



6 Banking Sector During Socialism

The monobank system that existed in Czechoslovakia until 1989 consisted of five banks. The major role was played by the Statna banka Ceskoslovenska (The State Bank of Czechoslovakia - SBCS), which functioned as a central bank, the main corporate depositor and creditor and was operating the whole payment system of the country. In each of the republics, savings banks administered vast majority of household deposits (that were fully guaranteed by the state), provided loans for individuals and deposited the remaining funds with the SBCS. Foreign exchange transactions for individuals were administered by Zivnostnenska Banka (The Merchant Bank). For the enterprises, same was done by Ceskoslovenska Obchodna Banka (The Czechoslovak Trade Bank - CSOB), which also represented the government in international financial markets.

As I have already described above, lending activities of SBCS were solely confirmative of the decisions taken by the planning and administrative bodies. Therefore, they have merely amounted to some type of quasi-fiscal government expenditures (or transfer) which did not have to be accounted for in the budget. The misallocation of resources was complete: bad companies were in fact bailed out by the performing ones. Fresh funds were not used to support profitable investments. Therefore, the credit risk assessing skills necessary to provide a mechanism for risk sharing were poor.

7 Evolution of Banking After 1989

In 1990, the banking system underwent a considerable metamorphosis. As the classical two-tier system emerged, SBCS retained its main function of a central bank, but lost its commercial lending mandate, which has been given to three newly emerged commercial banks. Vseobecna Uverova Banka (General Credit Bank - VUB) and Komerčni Banka (Commercial Bank) assumed parts of credits and deposits of enterprises seated in Slovak and Czech Republics, respectively. Commonly for the whole Czechoslovakia Investiční Banka (Investment Bank) assumed part of the long-term investment credits, mainly those financing the housing projects. In January 1992, this bank was separated, with Investičná a Rozvojová Banka (Investment and Development Bank - IRB) emerging in Slovakia. Under the Act on Banks (passed in 1991), all of the existing banks have been granted a universal banking licences.

The fact that banks were in reality outreached government bodies not only increased the crowding out of private investment, but also caused an overall degradation of quality of bank assessment skills (due to unnecessary of their use) which declined the overall standard of skills in the banking sector. No wonder banks lent to nonviable companies long after the lift of the central credit allocation mechanism. Even worse, this led to a decrease of the quality of companies, as with the ownership structure working poorly (many were still in state hands), banks were effectively supplying the monitoring function.

As a part of the voucher privatization, state sold part of its stakes in the financial institutions (which in Slovakia only consisted of VUB, SLSP, IRB and SP - Slovak Insurance Company). After transformation into joint stock companies, percentual stake of the government remained 50.8% in VUB and 35% in IRB. Slovak Savings Bank (SLSP) was transformed into a joint stock company only in 1994 and remains fully (directly and indirectly) state owned. Slovak Insurance Company (SP) remained state owned until parts were sold out via direct sales privatization after 1994 (state still controls 50.6% of its shares).

7.1 Legal Framework in Slovakia

Following the split of the Czechoslovakia, SBCS was divided into two central banks, with the National Bank of Slovakia (NBS) assuming this position in Slovakia, set up as an independent body⁴⁴ with a double objective of main-

⁴⁴Within the limits of the Act on the NBS, the Bank should support government economic policy. This has been recently an issue of political pressure, with the government trying to change the law so as to increase the number of government-appointed officials in the NBS board from 3 to 6, move the authority to appoint the governor from the president

taining the currency and price stability. The number of banks has grown from seven in 1991 to 29 banks and 9 representations of foreign banks at the close of 1997, with an asset increase from CSK 230bn (1991) to 760bn (1996). Of the total registered capital SK 25.5bn, 40% was of foreign origin, 42% owned by the state (of that 20 by the NPF, 14 by the ministries and 8 by the state-owned businesses) and remaining 18% by domestic private sector (by March 1996). The legal framework basically consists of the Act on Banks with amendments, provisions of the NBS governing the prudential behavior of banks and the Act on Protection of Bank Deposits. The provisions manage several areas. Capital adequacy is measured by the BIS Cooke Ratio and set at minimum 8% of the risk-weighted assets. Introduced in 1994, all private banks were required to comply with this measure by the end of 1996. The Big Three (the largest state-owned banks VUB, SLSP and IRB) operate under special system. The combined capital adequacy of the banking sector was 8.7% at the end of 1997, up from 1.72% for SBCS and 4-5% for CSOB at the end of 1989. In order to contain the losses of potential default, net credit exposure towards one borrower or an economically linked group of borrowers is limited to 25% of bank's capital. The most important of the provisions for the purposes of this paper is the Provision No. 3/1995 managing the classification of bank claims into five categories according to the risk they contain and creation of reserves and provisions according to this risk (provisioning rises progressively from 0% for standard loans to 5% (special mention), 20% (substandard), 50% (doubtful) and 100% (loss) of the value of the claim under concern). As I explain below, the introduction of the this scheme has contributed to crystallization of bad debt problem.

The deposit insurance scheme in Slovakia is a typical example of limited liability scheme which temporarily observed some asymmetries⁴⁵. Only personal accounts are protected, up to a maximum of 30 times the average monthly salary⁴⁶. A fund is set up for this purpose with obligatory contributions of all banks. Depositors are eligible for payouts if the bank is declared insolvent by the NBS. Apart from the primary objective to limit the adverse information problem the scheme created a more competitive environment in deposit-taking as well as to avoid moral hazard problem on any side by spreading the risks between banks (through their regular risk-adjusted con-

to the parliament and to increase the maximum limit of government budget financing by the NBS from 5 to 10% of previous year revenues.

⁴⁵Deposits in the three largest state-owned banks were protected in full until the end of 1997 and then during the period of their restructuralization.

⁴⁶With an approximation of the net savings rate equalling 15%, and the estimated interest rate of 1% monthly an individual earning an average wage would need more than 10 years to save this amount. Hence the "limitedness" of the scheme is not that effective.

tributions), depositors (limited liability) and the state (contribution of NBS).

7.2 Privatisation of the State Owned Banks

After the sale of parts of VUB and IRB via the voucher privatization, the state holdings of financial companies remained largely unchanged, with an exception of the Slovak Insurance Company (SP) part of which was sold in 1994. Due to the unstable political situation and often voiced interests in bank ownership, all combined with the experience of overly corrupted direct privatization of enterprises, the Parliament passed a law in February 1997 prohibiting any privatization of the Savings Bank (SLSP) and the Slovak Insurance Company (SP) until the end of 2003⁴⁷.

7.3 Development of Lending

As a consequence of the credit limits imposed by the NBS in March 1993 on the five largest banks, lending volume remained under control until the end of 1994⁴⁸. In 1995, credits boomed suddenly (annual growth of 13.7%), mainly due to growth of lending in banks not subject to the limits. As it appeared later, however, this boom was in large part triggered by banks rolling over the non-performing loans together with the unpaid interest. Further still, the issuance of the Provision No. 3/95 by the NBS (On loan classification and consequent provisioning) caused a significant deterioration in the portfolio quality by making the problem explicit, towards which the first reaction was an increase in the penalty interest and further growth in accrued (uncollected) interest payments.

The development of lending and its underlying causes can be summarized into several trends. Due to the restrictive macroeconomic environment, behavior of banks was largely defensive. In order to achieve some standard degree of liquidity and to decrease the risk due to high level of bad loans, banks have been changing their asset structure by decreasing loans (from 58% in 1993 to 47% as of June 97) and increasing securities - mainly governmental (from 6.4% in 1993 to 16% in 1996). To minimize the maturity gap between long assets and short liabilities, long term loans (which compose the majority of bad loan portfolio) have been declining from 45% (1993) to 37% (June 1997) with the short term ones rising from 34% to 41%. Another

⁴⁷The Law, however, is incomplete when it forbids to privatize the *assets* of a bank but not to *sell its shares*. Therefore, according to the analyst of Symsite, Ltd., one should not worry about the impediment effect of this law as it can be renewed in the course of a few days.

⁴⁸Credit limits have been cancelled as of December 1995.

indicator of the poor loan portfolio quality is the consumption of 80% of the interest rate spread by non-interest expenses, mainly by net provisioning of the banks (68% of the margin).

Despite the gradual improvement, the banking sector in Slovakia remains very concentrated, with the share of two largest banks' assets (VUB and SLSP) in the total assets of the banking sector declining under 50% only during 1996. The share of these banks on total deposits is 61% (36% of all and 80% of household deposits is held by SLSP alone), which tends, especially in the case of the latter, create imbalances on the interbank money market. The situation on the loan market is similar, with VUB concentrating 34% of total loans (share of loans on assets is only 30% in the SLSP). The declining share of the state owned banks has been compensated for by a strong growth of private lending. The control mechanism deposits play in restructuring the asset growth was not binding in the case of new private banks, which have received large deposits from SLSP that used to provide direct loans only in a very limited amount⁴⁹. In order to prevent deterioration of the banks quality, the license-issuing process has been virtually frozen by the NBS. When compared to the developments in the Czech Republic, number of new small banks in Slovakia is lower. The reason was that in Slovakia unlike in the Czech Republic, NBS did not provide exception from the bank licensing requirements. As a result, development of the competitive environment was slower but more stable, with the only exception of IRB becoming largely insolvent and consequently taken under the forced administration of the NBS in December 1997.

⁴⁹In fact, this could have acted as a comfortable precondition of a narrow banking scheme, would the deposit insurance law not be designed in the way it is.

8 Current State of Bank Governance in Slovakia

The major features of the ownership structure of the banks in Slovakia can be seen from Figure 1. A large number of banks is indirectly controlled by the clans organized around companies, which also influence municipality shareholdings. The most successful owner of the banks is the VSZ - based group which controls large shares in IRB (until June 18, 1998: direct 15%, indirect 41%, after June 10: direct 13%), Industrial Bank (10%, 22%), Post Bank (0%, 30%), Bank Slovakia, Transportation Bank and also 20-30% in the Slovak Insurance Company (see Table 3 in the Appendix). The other major group (Trnava based) is said to indirectly control VUB and directly the AG Bank, in addition to the second largest existing VUB IPF. After eliminating clans, another large stake is held by SOEs and the National Property Fund (see Table 3 in the Appendix for more details). Bank cross-ownership structures are present but only in a limited number of cases⁵⁰. The rest of the equity is held by foreign owners, mainly of Czech origin. To summarize, banks in Slovakia are overwhelmingly directly controlled of large companies and the National Property Fund, and indirectly by clans. Exceptions are fully or at least partially foreign owned banks, which represent app. 21% of the assets of banking sector as of 1996.

Majority of the banks in Slovakia has obtained a universal banking license. Even though the licensing process led by the NBS is very strict (after the bank considered the market to be quite saturated, no licenses have been granted for over 2 years), once the bank has obtained the license, it is relatively free to pursue its own interests, as the supervisory and regulatory rights of the NBS are limited. Not only it can not effectively prevent the concentration of ownership, but even when the bank is under forced administration, NBS may not execute any changes without the consent of the shareholders.

⁵⁰E.g. VUB and Tatra Banka.

9 Bad Debt Problem

One could argue that the slump in corporate performance had to be triggered (among other factors) by the sudden decision to make all the bank-channelled transfers transparent by including them as subsidies in the government budget. As the new ones have been cut to the minimum, and the old ones (on the balance sheets of the banks) were not acknowledged as implicit subsidies and hence not removed from the balance sheets of the banks, the bad debt problem became explicit. Development of the bad loans was in part a result of the government attempting to finance some of its expenditures by quasi-fiscal operations, simply concealing and deferring the fiscal problem (Daniel, 1997).

Instead of remaining a stock problem, bad loans inevitably had to become a flow one. Firstly, the banks had virtually no skills in effective loan issuance or administration, especially not to risky borrowers, which all of the companies became due to the cumulative transitional shock. Secondly, the expectations of government action (which seemed to be justified), led to credit rollovers. As most of the companies as well as banks were fully state-owned by the end of 1992, it was impossible to force any bankruptcy procedures by bank on a company. As the private share in both sectors has been rising, rather than letting the companies under and trying to reclaim the collateral with a minimal market value, banks have been waiting and rolling over the nonperforming loans. In an effort to improve the property market, some of them have set up their own real estate agencies. Last but not least, the legal vacuum in the area of bad loans and bankruptcy procedures contributed towards locking the problem at its present stage.

The old bad debt problem has emerged as an inevitable result of the socialist economy being transformed into one without a centralized authority to make decisions (credit allocations) and take the responsibility (banks not accountable). Once the system was changed, the dependency of its mechanisms on the system became nakedly apparent. Due to its inertia, the problem has deteriorated further in the course of the transition.

In all of the transitional economies the original stake of bad debts consisted of long term loans that have been provided for the investment projects during socialism. With the change of the system, these projects had either been stopped by an administrative decision (housing construction, in Slovakia also the military production), or have ceased to exist spontaneously due to their unviability in the new system and especially in the first few years of the transition. Not surprisingly, in Slovakia the second group consisted mainly of the artificially supported sectors I have described in the first part of this paper. The price and international trade liberalization has further

aggravated the issue with the first one leading to a sudden change in relative prices which (even though strongly distorted) used to govern the production decisions; and the second one (together with the CMEA dissolution) leading to a loss of markets and rise in competition for the local firms. Faced with these shocks and a consequent liquidity shortage, the choice of firms was to stop paying: either to state authorities (tax arrears), to the enterprises they were dealing with (inter-enterprise arrears) or to the banks (new bad debts). In the case of inter-enterprise arrears, the primary insolvency developed to SK 170bn at the beginning of 1995 (44% of 1994 GDP) and then to estimated SK 220bn at the end of 1996 (38% of GDP).

In addition to the commonly cited reasons, Czechoslovakia has experienced a particular source of bad debts problem. Trying to prevent the living standards of population in 1970s from decreasing, the government budget deficit needed more ready financing sources. Hence profits of the state companies have been diverted for this purpose in exchange for very cheap revolving credits to finance their working capital. As these bore 3% to 6% interest rate, and were renewed automatically, they have presented an explicit soft budget constraint (did not have to be repaid). In 1990, banks have defensively changed the interest rates on these loans to the market level of 23%. Being in dire straits anyway, companies ceased to pay the interest, which resulted in a progressively rising amount of bad debt.

Enterprise illiquidity, which fundamentally presents another type of a bad loan developed as an unintentional by-product of the policy measures. In 1991, credit and interest rate ceilings were imposed by the government and the Central Bank as a part of a three-pillar macroeconomic policy⁵¹, mainly to curb inflationary pressures. In effect, these froze the level of real bank loans in 1991 under their 1990 level, forcing companies (non-viable as well as viable ones) illiquid as they were unable to meet their payment obligations. This adverse development was not stopped by a government attempt later that year to inject additional CSK 50bn into the economy⁵².

The contribution of the underdeveloped financial sector to the problem has been enormous. First, banks lacked personal resources (both in number and quality) to tackle the credit growth expansion. This had proved especially disastrous in combination with the lack of a corporate history of newly emerging firms and a large instability of prices, exchange rate, and unreliability of customers and suppliers, which all adversely influenced the corporate sector. Second, entry requirements and restrictions into the sector were quite

⁵¹The three pillars were: credit control (credit and interest rate ceilings), subsidy reduction and wage control (with penalty taxes on above-target wage rates).

⁵²According to Nesporova (1993), only CSK 28.5bn was channelled into economy, rest being retained by banks.

poor, allowing emergence of banks solely for the purpose of acquiring loans by their owners. Their reckless lending funded often by the deposits of the large state owned banks (mainly the SLSP) had further increased volume of the bad loans. Third, bad loans have grown also due to significant legal barriers. Legal asymmetries strengthened the position of debtors in several ways. Despite their insolvency, debtors had to give consent in order for a bank to exercise a foreclosure upon property. Only achievable in the court, this had prolonged the bankruptcy procedures to approximately 2-5 years⁵³. Even when banks could foreclose, value of the collateral was minimal in comparison with what it was accounted for. Another legal hindrance of bankruptcies was the necessity of joint action of large majority of creditors, which was very time-consuming if the company had loans with many banks⁵⁴. With respect to this point, the step which had significantly increased the transparency of the bad loans was the introduction of market-value collateral assessment in the Provision 3/95. Another step strengthening the rights of debtors was the introduction of the institute of out-of-court bargaining (Law No. 122/93), with an official purpose to enlarge the space for debtor to revive the company. Still more, the law on revitalization of companies allows selected companies to deter their tax, interest, and insurance payments⁵⁵. Last, privatization of companies in Slovakia created large number of new businesses and even larger needs for financing. At first, banks extended only a very limited amount of loans⁵⁶. Later, however, they did not resist the pressure of the society criticism for not providing loans to the acquiring companies. The large amount of loans that has been extended in a very short period of time, on average of poor quality.

⁵³Quantitatively, the poor state of bankruptcies in Slovakia can be illustrated by following: in 1995, 57 cases have been completed out of over 1000 filed, in 1996 136 out of 3000 (with only one being enforced). For the first half of 1997, 90 cases have been completed (Marcincin, 1997).

⁵⁴Here, part of the guilt is also on the banks, which, led by blind self-interest, did not share any information about their clients, supporting indirectly the dilution of creditors and making the bankruptcies yet more difficult.

⁵⁵The selection is done by a committee containing ministers, governor of the NBS and directors of the VUB, the SLSP and the Slovak Insurance Company.

⁵⁶Partly due to their inexperience and partly due to difficulties in assessing the borrowers.

9.1 What Has Been Done

The volume of inherited bad debts is very questionable⁵⁷. Even if one would have an exact number, the question really is of its importance and real value, as in most of the transition economies, the period of high inflation with its negative real interest rates had degraded the real value of all inherited loans (Szekely, 1997). In Czechoslovakia, however, this effect was minimal, with inflation rate staying above 20% for only one year and declining fast. So the country could not benefit from the spontaneous cleansing of its balance sheets as was the case of e.g. Poland.

Centralized Approach

The decision to deal with the bad debt problem has developed in an initiative to solve the problems at the enterprise level (this actually points to the priorities of the government in sequencing the reform). Unlike in Hungary or much later in Poland, Czechoslovakia used more centralized approach in dealing with the bad loans. It has, nevertheless, been a stream of non-systematic measures which have usually only been started when the situation in a particular field was critical. The intentions of the government were made clear during the period of passing a large amount of market-oriented laws, and later re-assured in the article 44(a) of Act on Banks (1995) which stated an official pledge of the government to participate at the process of portfolio restructuring in all banks that granted loans before 1990.

The first real step was undertaken by a program resulting into a general debt forgiveness when, after classifying the enterprises into three categories, companies in the middle one ('potentially viable') had their bank debts worth CSK 11bn swapped for National Property Fund bonds. Remaining CSK 4bn were used to strengthen the capital base of the banks. The next step was an establishment of a special purpose Consolidation Bank, which begun to administer the indebtedness of former military production companies restructured under a centralized conversion scheme⁵⁸ and the loans financing the revolving working capital of state companies. In March 1991, CSK 110bn worth of these loans (80%) has been transferred to Consolidation Bank, with the banks compensated CSK 50bn in government bonds, CSK 12bn for capital increase and the rest for writing off these loans. In 1992, Consolidation Bank took over another CSK 93bn worth of receivables, in exchange for issuing 8 year credit, backed in half by NPF bonds. It is estimated that the Slovak part of the bank currently has SK 16bn of bad loans in its portfolio

⁵⁷According to bankers, two thirds of bad loans have been inherited from the State Banks of Czechoslovakia.

⁵⁸These have suffered from large past due receivables from the Near East countries.

(Marcincin, 1998).

Hence, the government took full responsibility over the short-term bad debt problem. In fact, it did not have any other option, as a refusal of banks to revolve these credits would lead to a complete industrial downturn. The third attempt in the non-systematic centralized approach was the cleaning of the CSOB's balance sheet off the export companies uncollectible receivables into special Collection Companies (Slovak and Czech). Slovak Collection Company took over the claims worth SK 10.7bn and was in turn issued a loan by the CSOB maturing in 5 years⁵⁹.

Decentralized Restructuring Program

After the split-up, situation in bank restructuring in Slovakia was characterized by bold statements and lack of action. With the sequencing of reform focused on corporate sector first (mainly the completion of privatization, see above), restructuralization of banks was largely left on the shoulders of the banks themselves and the NBS. In 1993, the latter came up with a more decentralized restructuring program to be carried out in four phases: (a) Classification of Loans (Provision 3/95, see above); (b) Creation of reserves and provisions for loss coverage; (c) Preparation and approval of individual banks' restructuring projects where banks, based on the analysis, were supposed to come up with methods and options for their own revitalization⁶⁰ and (d) Implementation of the programs with a possibility for the NBS to give exemptions in justified cases from complying with prudential regulations (these were given to the 3 largest banks - VUB, SLSP and IRB). After the loans have been classified and the government still showed no intentions for any action, NBS started with a restructuring program of the three largest banks in 1996 without any direct financial assistance from the state. With a legislative support of the Parliament and a temporary exception from prudential compliance rules given by the NBS, the restructuralization was to be finished in three years, with banks maximizing their reserves⁶¹, not declaring paper profits and selling their receivables even under their accounting value. All of this was to minimize the profits and hence the transfers to the state budget. According to the government, this triggered a budget revenue loss of SK 5.4bn in 1997.

The scheme appears to be the best achievable solution in a given situ-

⁵⁹Recently, as the Slovak Collection Company failed to collect the receivables and consequently stopped repaying the debt, the issue was submitted to the International Court in Washington, D.C., USA.

⁶⁰A term used in Slovakia to cover cleaning of the loan portfolios and recapitalization.

⁶¹Which are not loan-specific, but unlike provisions are taxed only when written off, merely postponing the costs.

ation with the government playing the dead beetle strategy. Nevertheless, the program has suffered several weaknesses. Firstly, the expectations have been changing fast, in cohort with the government's voiced stance, making the scheme's future uncertain and the participants less willing to take it seriously. Secondly, the lack of co-ordination showed also in a more tangible way: probably as a result of the paper profits myopia, the government refused to initiate a legal change in order to stop taxing the unpaid accrued interest payments. These paper profits have been of a significant volume: just the VUB and the SLSP have contributed SK 2.7bn to the state budget in this manner in 1994, approximately 10% of total legal entity profits. Moreover, banks have also been motivated to maximize these paper profits to be able to create reserves and provisions⁶². Due to a poorly functioning exit system from the enterprise sector, the amount of write-offs has been minimal⁶³. Having in mind the costs of bad loans (see below), the third critical point is that this method indeed is a very slow one if one, especially if the problem is so significant in volume (see next section). The stock problem should be addressed as well. Fourthly, the incentive mechanism does not seem to put any obligations on the government, while letting it enjoy the benefits of a well functioning system in the future and temporarily higher demand for its bonds in the presence as the banks shift to less risky activities.

9.2 Size and Importance

According to the report of McKinsey and reports of NBS, the volume of doubtful and loss loans grew from SK 54bn in 1993 (20% of total loans) to SK 92bn year later (33%), with 91% of them concentrated in VUB, SLSP, IRB and the Consolidation Bank, or 76% in only the first three. The volume of pure loss loans was estimated at SK 20-30bn. In 1996, the volume of classified loans was SK 125bn (33% of total), when SK 90bn (24%) was loss. According to the latest poll by the NBS of June 30, 1997, the problems remain concentrated in VUB, SLSP, IRB and the Consolidation Bank⁶⁴. Excluding the Consolidation Bank, the capital adequacy of the banking sector was 8.4%, when the classified loans grew by 11.6% (SK 39.7bn) annually. As of the end of 1997, the loss loan volume is estimated at SK 110bn (31.4% of total loans). The adverse development was naturally reflected in worsening capitalization

⁶²These are not tax exempted, only in the case of the largest three banks which currently are in the course of their restructuring.

⁶³VUB has written off SK 142m of SK 38bn bad loans in 1994.

⁶⁴In the VUB, the situation has improved gradually: classified loans declined from 40% of total loans in 1995 to approximately 31% in 1996. The total sum of past due interest payments exceeded one third of this and represented SK 5bn annually.

of banks, with none of the three largest banks being in compliance with the capital adequacy requirement. This has dropped by 2.2 percentage points to 5.1% in 1997 in case of the VUB and by 1.8 points to 6.5% in case of the SLSP. Capital adequacy of the IRB only was 3.5% at the end of 1996 (bank is under forced administration from December 1997, see Box 1 in the Appendix). In fact, these numbers are inflated due to the exceptions from prudential rules compliance granted by the NBS to the three largest banks. Without the exception, 1997 capital adequacy of the VUB would only be 4.2%. Another way of showing the same is the volume of total uncovered anticipated loss of the banking sector⁶⁵. This has declined from SK 13.1bn in 1996 to 12.4 last year, still amounting to more than 40% of the total capital of banks. The trend was to surge in 1995 mainly due to their acknowledgement (Provision 3/95) and then decline slowly for all classified loans, with the structure changing from doubtful to loss loans, as the time element is one of those triggering the transfer between classification categories.

All in all, the volume of loss loans is among the largest in the Eastern Europe, with the only country facing larger amount of loss loans being the Czech Republic (39% in 1994). As Slovakia ranks second after the Czech Republic in the financial intermediation rate⁶⁶, and as the total assets of the banking sector equalling to 123% of GDP underscore those in developed economies (e.g. 228% in Austria and 297% in Belgium), but are highly above those of Hungary (69% in 1995), Poland (54%) and Slovenia (73%), the impact of the financial sector health on real economy is more pronounced.

9.3 Costs of Bad Loans

Bad debts, by forcing the banks into defensive positions, widen the interest rate margins thus making the services more expensive, which is suboptimal especially when there is little competition in the sector. Another observed reaction is a move by banks to less risky activities (buying securities, primarily governmental), which leads to a decrease in the quantity of loans extended. A different channel of limiting the volume of credit to private sector was mentioned by Szekely (1997): by revolving the bad loans to state companies with the unpaid interest, the volume of available funds to private sector is decreasing. Hence the bad loans contribute to *shrinking of quantity as well as a rise of price of loans to companies*, crowding-out the private long term

⁶⁵Taking into account loans as well as the off-balance sheet liabilities, the difference between provisions needed and created is decreased by available disposable reserves and reserve funds, leading to the total expected uncovered loss of the banking sector.

⁶⁶In 1995, intermediation rate (M2/GDP) was 90% in the Czech Republic, 77% in Slovakia, 43% in Slovenia, 42% in Hungary and 36% in Poland (Borish et al., 1997).

finance of heavily bank-dependant companies (especially in the Slovak and Czech Republics). On the side of banks, bad loans tend to delay their privatization, which is the only way of speeding up the learning-by-doing path they are currently taking to limit the flow problem. In effect, this *delays creation of well functioning corporate governance structure*.

The real costs depend on the role financial sector plays. From the quantitative point of view, higher rate of financial intermediation of an economy increases the marginal effects of inefficiencies in the financial sector⁶⁷. Another form of *self-sustenance* becomes apparent here: as the bad loans accumulate and hence loans are cut down, companies have nowhere to turn to with a capital market unable to satisfy their needs. Their deteriorating financial situation in an economy without an effective exit mechanism leads to a growth in the inter-enterprise arrears, which worsen the stance of previously healthy firms as well, leading to further rise in the bad loans. So we observe *two adverse self-sustaining lock-in effects, one in the banking and one in the enterprise sector*, both as result of an unsolved bad loan problem.

The costs of the bad loans should not be exaggerated, however. The argument of some authors (e.g. Blommenstein, 1997) that bad loans can trigger banking crisis seems to be overstretched, especially when applied to Slovakia. Being mostly specific to the old banks, share of the bad loans has to be decreasing with time together with the share of state owned banks. After some transitory period of their growth in these banks (largely due to the lack of experience), the problem becomes widely acknowledged due to the visibility of costs bad loans carry. Government's negligent position is sustainable only until the pressure of voters (and lobbying) forces it to act. So the problem, in my opinion, could only become widespread if one combines widespread fraud and negligence (leading to reckless lending) when banks do not behave according to the profit motive⁶⁸ with poorly functioning bank supervision. This does not seem to be the case of the Central European countries anymore.

9.4 Why restructure?

Solving the bad debt problem accomplishes two objectives: it lowers the internal risk of the banking sector by making banks stronger (by addressing the stock as well as the flow problem) and it also reduces the external risk as companies get financially more viable. When left to take care of the problem

⁶⁷Here I assume money non-neutrality, with financial sector positively influencing the real one.

⁶⁸This could happen for example if the bank owners had other superior interests, like their own companies the banks would be lending to.

themselves, banks should earn (and hence lend) more to make their way out of the problem, but due to the existent bad loans, they are forced to earn less by shifting to less risky activities. Notwithstanding the costs argument, this is what justifies the step-in of the government: *left alone, the banks would face an increasing moral hazard problem.*

The scheme aiming to solve the problem should *prevent its reoccurrence* by addressing the stock as well as flow problem. Clearly, repeated bailouts (or their expectations, even when only for small group of banks) do not introduce proper incentives for the banks and are excessively expensive. The change of incentives boils down to a change of the governance scheme, making banks responsible for everything that happens to their loans 'afterwards'. This may be done either by privatizing or at least by changing the management of the state-owned bank. As the scheme should also aim to *utilize maximum of the insider information of banks* when restructuring the bad companies, decentralized approach should be more feasible. In addition to the information utilization, decentralized workouts in Poland (Gray and Holle, 1996) have shown to have the additional positive externality of money spent on recapitalization also forcing banks to learn new skills. The disadvantage of decentralized workouts is the time period needed for loans to be worked out properly. In Poland, a two month period had shown to lead to often superficial workouts, with bad loans remaining on the bank portfolios afterwards⁶⁹. Most importantly, as the workout relies on the bank-debtor relationship, the scheme has to *address the enterprise restructuring* problem as well.

Being a process to connect the status quo with the desired state, the scheme design critically hinges on the role the banks should play in the economy. A proper assessment of the most feasible corporate governance setup for any transitional economy is surely behind the scope of this thesis. Nevertheless, following a brief description of the corporate and bank governance mechanism in Slovakia in the previous section, I would like to point to some agency cost implications for the status quo and utilize these in assessing the role of the banks in the Slovak economy.

⁶⁹Some of the privatized banks had still 25-46% of their loans bad (Gray and Holle, 1996).

10 Slovak Model of Corporate Governance

The above analysis points to some specialities in the way Slovak companies and banks are governed. The outside equity holders are in minority and when present, are only able to perform limited control function, largely due to the non-existence of minority shareholder protection. Even with their legal protection in the future, the currently high concentration of ownership and the low likelihood of the insider-owners to sell their stakes (see section 5) suggests they will not play a major role in corporate governance and enterprise restructuring. It is therefore safe to assume there are only two significant groups in governing the corporations in Slovakia, which will tend to narrow the agency conflict.

10.1 Agency Costs in Slovakia

The agency theory recognizes several relationships giving rise to the agency costs of managing the firm which are to be minimized. Jensen and Meckling (1976)⁷⁰ identified two types of conflict in the firm. One between inside equityholders (managers with ownership shares in the firm) and outside shareholders (without management position in the firm) and the other between shareholders and bondholders. In the first relationship the conflict arises from the tendency of managers to spend on non-pecuniary benefits (cars, jets) which increase their utility but decrease the value of the firm which the outside shareholders seek to maximize. In the second relationship, conflict of interests arises due to the limited liability of shareholders, which leads to their interest in the upper tail of the distribution of returns. On the contrary, bondholders care about the lower part only. Hence the former prefer more risky projects and the latter less risky ones, even when the payoff is lower in good states of the world.

In Slovakia, the relationship between insider equityholders and outside shareholders will be eliminated as a source of conflict leading to the agency costs. Nevertheless, the effect of this particular ownership setup on corporate efficiency is not clearly improving. In case the firm is purely manager-owned, the incentives of managers and owners become identical and hence the efficiency should rise, as the managers seek to maximize the value of the firm. However, in the case the firm is owned by a clan, managers are part of the clan of many and so their personal value maximization is not identical to the company value maximization (they only receive a share of the returns). Being members of the clan (in which the manager-owner relationship is based

⁷⁰For a survey of literature on agency theory see Sustek (1997).

more on trust than systematic monitoring), managers will probably not act in such a reckless way as if controlled by outside shareholders, as they have more to lose. To summarize, the agency costs of equity will be minimal in Slovakia, suggesting it could outperform other systems in this respect. The effects on efficiency of firm are less conclusive, especially in the case of clan-based management. Nevertheless, the Slovak model would outperform the Anglo-Saxon one from the agency costs of equity point of view (see the subsection on Comparative Institutional Efficiency).

The second conflict - one between shareholders and debtholders - is widely present in the Slovak economy. One can further narrow the group of shareholders to insider-owners (either manager-owners or in case of clans owners-managers). Debtholders are represented by banks, as the bond market is only marginally significant when compared to the credit market and as often bonds are owned by banks (see section 8). However, this conflict is further amplified by the ownership structure and the structure of the industry. Due to the way privatization was carried out, firms are left cash-drained, with often depreciation expenses used to cover privatization loan servicing⁷¹. Not surprisingly, then, insider-owners do not have funds needed for restructuring. With a little likelihood of outside shareholders stepping in (see above), they are turning to banks for outside financing. Banks' unwillingness to fund restructuring seems logical having in mind the large amount of bad debts they carry. This conflict has evolved into a situation when insiders have been repeatedly attempting to obtain control over the banks, which has been carried out successfully mainly in the case of the VSZ (see Table No.3 in the Appendix). The consequence of this phenomenon occurring on a large scale would be an increase in the risk preferences of the banks, as the primary incentives would be those of owners (companies) to get financing for the risky activities. This would alter the role of the banks from the corporate governance point of view significantly, as well as prevent a fast solution of bad debt problem.

10.2 Comparison with Other Models

Comparing Slovak model of corporate governance to German/Japanese (bank-oriented) or to an Anglo-Saxon (market-oriented) one is not only interesting from the point of view of comparison, but also important from the evolutionary point of view, allowing one to draw some normative conclusions

⁷¹In 1995, 27% of large manufacturing enterprises were unable to cover their depreciation expenses. In the Czech Republic, this was only 19%. Hence, not only has the manufacturing a more pronounced adverse effect in Slovakia due to its relatively larger size, it is also in a worse condition.

about the most suitable (or least costly) development of a governance system. From the evolutionary point of view, Slovak system seems to be much more biased towards the German one. The concentration of ownership in Slovakia is large⁷², resulting from the evolution of privatization and the inherited industry structure. Despite the majority of banks being universal, equity holdings by banks are insignificant, making Slovak model differ. Another difference is in banks not exercising the proxy-voting for small shareholders, reducing their role in corporate governance to only that of debtholders. This difference, however, is not systematic, it only reflects a temporary underdevelopment of capital market instruments in Slovakia. Governance boards as a tool for shareholders' control over management bear signs of a high degree of legal similarity with Germany, with the difference in smaller role of workers' councils and workers' representatives at the boards.

Composition of corporate financing is also more biased towards the German system. Evolutionary, as the former Czechoslovakia had the highest financial intermediation rate and a loan/GDP ratio from all Central and Eastern European countries, the role of loans was considerable. With very shallow capital markets, and given the imperfectly functioning legal system, increase in importance of bond financing seems to be music of a distant future. As the estimated current composition of corporate financing is almost identical to that of Germany and Japan (see the Appendix), it is clear Slovakia (equally with the Czech Republic) is very near German system in this respect.

Hence if the Czech hybrid model⁷³ of corporate governance bends more to the German than to the Anglo-Saxon, the Slovak one obviously has to do even more so. Of the significant differences one has to mention the role of banks, but this could be explained by their current condition of heavy bad debt burden hence increased risk aversion, all combined with the lack of skills in equity investments. Another difference with any of the German and the Anglo-Saxon systems is that of a significant degree of state interference in the economy, particularly in managing certain sectors. This particular point moves the Slovak system more towards the Japanese one. On the other hand, the role of clans in managing several industries puts Slovakia very near the Italian one, amplifying the family-like relationships and a higher role of trust.

⁷²Again, no exact data available with the exception of Herfindahl index mentioned above and comparisons with the Czech Republic.

⁷³For a comparison of Czech, German and Anglo-Saxon models of corporate governance, see Sustek (1997).

10.3 Comparative Institutional Efficiency

Agency Costs of Equity

As the ownership structure and the governance boards shape the size of the conflict between inside equityholders and outside shareholders, it is possible to assess the institutional efficiency of the Slovak system from the point of agency costs of equity. When compared to Germany, the Slovak model seems to be more 'equity efficient'. This is due to a similar concentration of ownership combined with virtual non-existence of outside shareholders and more significant share of manager-owners, with both of the latter decreasing the agency costs of equity due to better incentive alignment. When further combined with the fact that workers play minor role in governing the company, it is safe to say the Slovak system of corporate governance is more efficient than the German one from the agency costs of equity point of view. For the same reasons, the agency costs of equity are smaller than in the Anglo-Saxon system, with its ownership structure less concentrated, governance boards appointed mainly by the CEOs and managerial compensation being ineffective in aligning the incentives with those of shareholders.

Agency Costs of Debt

Before assessing the agency costs of debt, I will point to the role it plays in corporate governance, as this seems to be changing in Slovakia. As managers have incentives to make firms grow beyond their optimal size⁷⁴, they will always spend the free cash flow, even when debtholders would prefer it to be repaid to them. Since the default on debt repayments gives creditors a right to take over the firm, it is often understood as a disciplining device on managers, reducing the free cash flow under their discretion. Hence the agency costs of debt are mainly formed by the ownership of corporate debt. As I have mentioned above, Slovakia is very much Germany-like in this respect, at least in the aggregate view. The very important difference, as I have already mentioned, is the ownership structure of the banks, which are increasingly being controlled by clans and companies solely for the purpose of improving their financing possibilities. No matter how understandable from the evolutionary point of view, this development ultimately damages the disciplining function of debt, as the lower tail risk preferences of the banks shift upwards not only for riskier projects but also for looser terms of monitoring credits to their parent-companies. Hence, despite the similarity to the German system, the efficiency of the Slovak is probably lower. Or, to put

⁷⁴Because their power and so utility rises with more resources under their control.

it more precisely, Slovak system of corporate governance would be less debt efficient than German, would it work in a mature economy. However, the necessity of large investment outlays in transition may reduce the objective need for limiting the free cash flow of manager, and hence bend the role debt financing would play in a transitional economy. One last major difference is the very poor efficiency of the Slovak legal system in enforcing contracts and ameliorating the exit from the system further decreases the efficiency of debt as a disciplining mechanism.

The Slovak model of corporate governance seems to outperform both the German and the American from the equity point of view, due to the higher concentration of ownership, larger degree of incentive alignment between ownership and managers and a lower role of workers in managing the company. On the contrary, it seems to be less efficient than the German system from the agency cost of debt point of view, due to a possible shift in banks' risk-taking preferences. As the institutional efficiency is only comparable in systems that are similar⁷⁵, I can not fully compare efficiencies of Slovak and Anglo-Saxon system. Nevertheless, one important precaution in comparing the institutional efficiencies is the evolutionary state of an economy. The needs of transitional economy may be so different from those of a mature one that any comparison may be useless. Thus the only conclusion I make here is that once the development of the economy is more mature (including that of the legal system), the Slovak model may converge towards the German one, as its present proximity makes the transition costs look minor.

10.4 Normative Implications for the Corporate Governance

In this section, I will draw some implications of the agency theory on the corporate governance and the role of banks. In the following, I utilize a proposition from the model of Jensen and Meckling (1976), formalized by Sustek (1997):

In the world of corporate tax and fixed bankruptcy costs the firm's value is a convex function in the variance of the project's payoff⁷⁶.

The intuition can be explained easily: assume a firm facing fixed bankruptcy costs deciding among investment projects with variance range

⁷⁵Otherwise, German - Anglo-Saxon comparison would not be impossible on other than a partial scale, as it has proved to be.

⁷⁶For a formal proof, see Sustek (1997), p. 48.

from σ_{min} to σ_{max} . If we start at σ_{min} and increase the variance marginally, the firm can go bankrupt with a higher probability and at the same time can enjoy higher returns. For a marginal increase in variance, fixed bankruptcy costs will outweigh the rise in returns. But since bankruptcy costs are fixed but returns are increasing in variance, there must exist a σ_{hat} such that good prospects of higher return overcome the bad prospects of bankruptcy. For all sigma above σ_{hat} and below σ_{max} , the value of the firm is increasing in the variance of the project's payoff. (see Figure 3a)

Figure 3:

3a – Variance and the value of the firm. 3b – Value of the firm: comp. statics

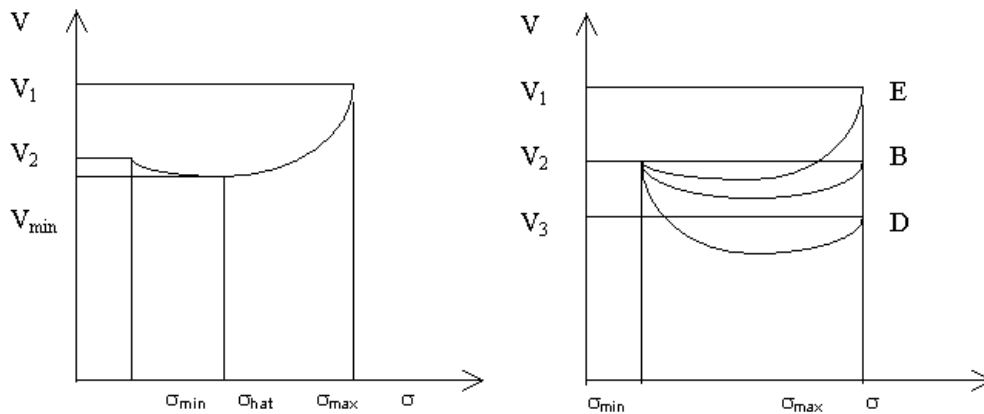


Figure 3b presents a comparative statics, when intuitively firm D is characterized by high bankruptcy costs, high leverage and low expected payoff. On the contrary, firm E is characterized by low bankruptcy costs, low leverage and high expected payoff. Hence, the proposition provides us with some implications for systems of corporate governance. In particular, if a firm is characterized by the value function D its value will be maximized at σ_{min} , which would imply that control by the risk-averse debtholders would be value-improving. On the contrary, firm characterized by value function E will benefit from control by less risk-averse shareholders. A company B will be indifferent between any of the two, nevertheless a mixed governance will lower its value.

The heavy industry and generally large corporate size in Slovakia implies high bankruptcy costs. High leverage also seems to be the case of Slovakia, at least in comparison with the other Central and Eastern European countries (here I estimate the leverage of companies by the share of loans on GDP). As majority of the Slovak industry is low value-added type (facing saturated markets with relatively high degree of competition), companies should be facing low expected returns. Hence majority of the Slovak firms should be

characterized by a value function of type D, implying that they should be controlled by debtholders in order to have their values maximized. Or, to be more precise, in an economy with healthy companies of structure similar to that in Slovakia, banks should play an important role in corporate governance. Therefore we can say the evolution towards a model located near the German one follows a value maximizing path. In other words, given the structure of the industry, the corporate governance seems to be properly evolving into the German type system, and once the transition period is over, it will be an institutionally efficient move⁷⁷.

⁷⁷Even then, one has to consider the self-sustenance of institutional equilibria, so the costs of transfer to any other system need to be taken into account. Pagano and Rowthorn (1996).

11 Restructuring the Banks and the Industry

In this section I will argue that despite the ultimate convergence towards the German model of corporate governance is desirable, the restructuring that is awaiting for industrial as well banking sector should not be performed in the way this model would suggest.

11.1 Theoretical Arguments

Let me first summarize some well known advantages of the German type bank-based model that will prove to be important in deriving my argument later on⁷⁸. A close bank-debtor relationship evolves into a long-term commitment of the bank which allows the company to survive the temporary downturns more easily than if it was financed by a market instrument. In the world of incomplete markets, this decreases the moral hazard between financiers, managers and employees. The same is achieved by debt itself as a tool for governance, when a more risk-averse debtholders overtake the company management in bad times. So the German model is very efficient in eliminating the moral hazard problem. This role suits very well to banks in particular, which can utilize the long-term relationship for gathering data about the behavior of managers to reduce the information asymmetry. Here the intermediated market will outperform the non-intermediated one of direct finance as the security holders would either free-ride on monitoring or would have to repeat it individually, both of which would seem to be inefficient.

However, Irena Grosfeld (1994) argues that the repetitive screening is important in monopolistic/oligopolistic industries or for sectors of rapid technological change. The reason is twofold. In the first case, a repetitive check-up is needed to *eliminate the deficiencies from lack of competition in the industry*. Or, if there is no competition in the industry, there should be competition in screening of the companies. In the second case (sectors of rapid technological change), repetitive screening acts as an *information and ideas-generating mechanism*. In both cases, repetitive screening achieves allocative efficiency of inputs. In both cases this role is better performed by the stock market.

11.2 Why Bank-led Restructuring Will Not Work

In Slovakia, as in some other Central and Eastern European countries, monopolies and oligopolies are usually among the most profitable companies (see footnote 32). In most cases, firms in need of restructuring are in sectors

⁷⁸This subsection is mainly based on Grosfeld (1994), Mizsei (1995) and Rostowski (1995).

that face heavy competition (domestic as well as international) and their inability to adapt to it lies in the heart of their problems. It would therefore appear that the stock market competition can not improve upon status quo, because, as it is often voiced, it is the long-term finance and temporary protection that the companies need. This naturally leads one to believe that banks are those most capable to lead the restructuring process of companies, even more so in an economy which already lies close to the German type model. The best empirical evidence on bank-led restructuring can be found in the Polish Enterprise and Bank Restructuring Program, which was by far the most incentive compatible restructuring program in Central and Eastern European countries⁷⁹. The assessment of results by Gray and Holle (1996) concludes that while the program forced the banks to confront their problems and helped them to build the capacities needed for working out bad loans, it did not fulfil its primary objective - that of promoting the restructuring of problem debtors and their successful privatization⁸⁰.

The reason for ineffectiveness of bank-led restructuring stems from the objectives of the restructuring. If we simplify the status quo, we have a number of companies which are unable to compete and only perpetuate their losses, creating a chain of problems. Most of these firms have very low net value (even negative) and should go bankrupt. No matter how pessimistic the situation seems, status quo gives us a large degree of freedom in assessing the alternatives of asset use, as the present one has proved to be unsustainable (largely due to the systemic change from planned to market type). Therefore what we need is a perhaps radical change of production technology, not a simple reorganization to improve the productive efficiency. Only when we find the best alternative use of assets of the company will the restructuring be successful. Banks may be extremely useful in providing long-term finance and alleviating moral hazard of the managers by collecting and analyzing the information, but they are unable to generate a large number of alternative uses, not to say to assess them to find the best one⁸¹. We are dealing with a situation when the *correlation of past information and potential use is very small*. This is not to say that the past information is irrelevant, the opposite is true and therefore banks have to play an important role in the whole restructuring process. Nevertheless, they should not lead it, that is

⁷⁹See, e.g., Borish et al. (1996), Gray and Holle (1996), Mizsei (1995), Moriner (1995), OECD (1997a), and Rostowski (1995).

⁸⁰In fact, two years of program's implementation saw a slowdown in the layoff rate, rise in an average real wage rate and a decline in average operating profitability and cash flow (Gray and Holle, 1996).

⁸¹How could they, when they do not yet possess the skills to assess a sole entrepreneurial project, a feature that led to the bad debt growth.

they should not generate and assess the ideas.

The other potential source of ideas is the one used in most of the centralized approaches to restructuring (including the one recently adopted in Slovakia) - the enterprise itself. Usually, managers of the firm set up an alternative plan which is based on reviving the company via additional investment to be used to improve the present production technology, which is exactly the defensive method used in 1970s by SOEs to avoid any drastic changes in the status quo. Even if we abstract from the self-defensive approach of the insiders when designing the restructuring plan (which is most probably never the case), this can not be the most effective method. The reason is the same as the previous one: despite the even better access to the insider information, this is of little correlation with the potential uses, hence the owners will probably not be in a much better position for designing the restructuring than anyone else. On the contrary, if an outsider would be given all the available information, it is likely she would come up with a more efficient suggestion for two reasons: (a) she would not be restricted in their ideas by the environment she stayed in, and (b) she would not be biased towards self-defensive proposals.

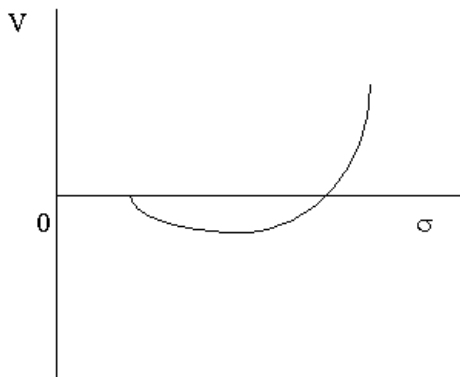
What we need for restructuring is the ideas-generating function of the open contest, its ability to generate information about the value of the residual assets. The secondary positive impact is that of consequent evaluation of these ideas, or their self-selection, by the very same mechanism. The role of banks should only be supportive⁸². The mechanism designed should allow them to participate in what they do best - collecting the insider information to alleviate the moral hazard problem - and transfer it efficiently to those participating in the open contest. In order to provide the long-term financing in the future, their bad debt problem should be dealt with in the meantime.

To illustrate the situation of a firm, I turn back to the proposition of convexity of the value function from page 37 and its graphical representation in Figure 3. As I have already argued, Slovak firms are in general characterized by a curve of type D, which I have presented as an argument for superiority of the German model in the Slovak conditions. Nevertheless, companies in need for restructuring face a different type of the value function. Given the characteristics of these firms, one can argue we are actually facing a value function of type A shifted downwards, as depicted at Figure 4 below.

The downward position is caused by the transition itself, further amplified by the hands-off approach to enterprise restructuring. Due to the negative

⁸²This is why during the transformation (or at least as long as the need for enterprise restructuring is intense) a model with close bank-company relationship with little information on value of firms available may hinder the restructuring.

Figure 4: Value function of a restructured-to-be firm



net worth, only projects with very high variance of returns have a chance to significantly improve the value of the firm. As the present production technology is unsustainable, the more conservative approach will not be effective for the restructuring purposes. The shape actually describes the ineffectiveness of the insider initiated restructuring, when due to the reasons above, insiders were unable to detach from the status quo significantly and stayed under the zero line. So if the rise in variance of returns is to describe the risk inherent in the profound restructuring of a firm (i.e. in the detachment from its present production technology), one can make the value function support the same point of ineffectiveness of bank-led restructuring and the need for open contest to generate information on alternative asset use.

11.3 Suggested Solution

To avoid as much of the information loss as possible and to create the most incentive-compatible scheme for restructuring, I strove for a decentralized solution. There are several parts to the scheme but the key characteristic is one logically flowing from what I have discussed in the last few pages. What we need for effective restructuring is: (a) to *generate diverse views of alternative asset uses*, and (b) to *select the best one, that is the one maximizing the value of the firm*. The best available method is very simple - open competition of ideas. The fact that it is open, transparent and widely known leads all interested agents to participate in it. Hence, it allows for the highest degree of diversity in the views and opinions about the potential uses of the assets which satisfies the first condition. To satisfy the second one, competition is again optimal, given some assumptions. These are, among others, an equal access to financing for those participating in the competition and an equal

access to information. Even though none of them can be fully satisfied in reality, their adverse effects may be mitigated. The former by involving a large number of participants and hence creating competition for the financing means (e.g. large amount of participants will attract large amount of banks), and the latter by establishing some vehicle for an information transfer from the banks who will in this way increase the efficiency of the scheme by alleviating the moral hazard problem. So the core of the method I present is a market similar to that of a stock exchange, where scrap assets would be traded.

Supply Side

Suppliers at the market would be those in charge of the companies at the moment - in majority of cases the creditors effectively owning the company after the bankruptcy. As their incentives to participate are more difficult to generate, an automatic trigger mechanism should be established for all companies which are insolvent⁸³ to increase the currently underscored *rights of creditors*. Simple (as to achieve high degree of controllability), easily applicable, and speedy bankruptcy process would promptly place the control into the hands of debtholders who should be obliged to list the company on the scrap asset exchange, while making public all the information available to eliminate the adverse selection problem⁸⁴. In Slovakia, most of the suppliers would be the banks and most of the companies would be those currently causing the bad debt problem. As the whole process of sales may be take longer time, the banks should be recapitalized so that they can continue with their loan-granting activities.

Recapitalization should be twofold. First, government loans amounting to some ratio of the nominal value of the bad loan should be extended to the banks, with a pre-fixed maturity date. This way government assumes partial responsibility for the problem and banks are motivated to sell the scrap assets they own as soon as possible as they can profit from the funds thus obtained until the government loans are due⁸⁵. The drawback of using solely this method is that it makes banks bear all the costs, which would most probably amount to a collapse of several large state owned banks in which the expected uncovered loss amounts to large part of their capital base. As follows from the sections above, Slovakia is very near German-type model, hence its industry would benefit from a more concentrated banking sector. Therefore, a relatively small one-off recapitalization should be performed

⁸³A precautionary note: this mechanism should be designed in such a way as to prevent an excessive bankruptcy initiation as was the case of Hungary (see, e.g. Szekely, 1997).

⁸⁴Normalization of the information requirements would probably be the best option.

⁸⁵In fact, this feature also acts as a information revealing mechanism.

after the process gets going. Relatively small to make banks incur some costs, and not immediately in order to motivate banks to participate in the market.

As the accumulation of bad debts is likely to continue as long as the banks remain unprivatized (Rostowski, 1995), the scheme should be concluded by a sale of major stakes of the remaining banks to foreigners, which would also help to stop the spread of perverse incentives of debtor-owned banks (see section 8). *Privatization* will eliminate the moral hazard of repetitive bailouts and hence of another reckless lending to scrap market participants (what has happened to a large extent after the first wave of privatization was started).

Demand Side

On the demand side, the access would be unlimited as to satisfy the needs for effective restructuring I have presented above, with the intention to maximize the number of participants. To achieve this, one has to analyze the incentives of an investor to participate. This is well beyond the scope of this paper, nevertheless I will list a few of the obvious ones. The market has to be transparent and deep, the former to generate trust in it and the latter to increase liquidity and ensure there will be as little mispriced deals as possible. *Transparency* seems to be the easier task, when all it needs is a stable, efficiently designed information system making public all the information about all participants (supply as well as demand) and all contracts made. The *depth* of the market is a harder task to overcome. Small size of Slovakia will translate into small number of scrap asset offers which surely will not facilitate their sale by attracting investors. Therefore what I suggest is a *multi-country scrap asset market*, with the participation of several Central European countries, thus increasing the number of offers and hence attracting more investors.

Anchoring this scheme on the market leads to the major *drawback* as well as to the advantage. With the advantages spelled out, now comes the time to face the drawbacks. The main one is scheme's heavy reliance on the *legal systems* of the participating countries. Firstly, the harmonization of the legislation would be not only expensive, but also very time consuming, so hindering the restructuring process. Secondly, the legal systems in these countries are overly underdeveloped, especially in the area of contracts and their enforcement, which commonly present a tool for elimination of market incompleteness in the developed economies. The inability of the marketplace to limit incomplete information problem with an effective contract enforcement legislation would have a strong deterring effect on the participants. I

came to two possible ways of dealing with this problem. The first one would be to allow for competition in the legal systems of the countries with suppliers having a choice to list the assets at any of the simultaneously working exchanges⁸⁶. Despite the fact that this solution is more market-oriented, it would probably take too long time for the needed purpose of reviving the financial systems of the countries and restructuring their industries. An alternative way would be to locate the market in a legally efficient country. Requiring the companies to register under special conditions in e.g. London, would not only eliminate the drawback of poorly functioning legal system in Central and Eastern European countries but also increase the visibility of the marketplace and due to the convenient location also its depth.

To summarize, the solution I propose is a market based decentralized scheme that would maximize the information - generating role of the market competition for the purposes of bank and corporate restructuring. The maximization on the side of suppliers would be achieved by an automatic trigger mechanism strengthening the position of creditors, a recapitalization scheme creating incentives for a speedy sale of the assets and thus creating optimal incentives for banks to transfer the maximum of accumulated information, and by consequent privatization eliminating the bail-out expectations. The maximization of the number of potential investors would be a result of making the market transparent, making available the maximum of information on the companies traded (this is also incorporated into the incentive structures of banks) and by deepening the market by including all Central European countries. To make the market as efficient as possible, contract incompleteness would be limited by listing the companies in a legally developed place (e.g. London), thus increasing the contractual efficiency.

⁸⁶In principle, this was the way the efficient legislation has evolved in the United States, when companies were given a choice to chose which state they want to incorporate in. A small state of Delaware became well known for it had the largest number of corporations in the whole United States.

12 Conclusion

In this paper I show that, in a transitional economy, banks should not be allowed to lead the restructuring of corporate sector. I start by arguing that the evolution of economy during socialism contributed to the creation of a specific system of corporate governance in Slovakia. Despite its proximity to the Czech system due to the evolutionary elements, different privatization methods shaped the Slovak model closer to the German one. By applying the agency cost theory I show that this evolution was optimal given the structure of the economy and that the Slovak model should outperform the others from the agency costs of equity point of view due to concentrated insider control of the firms. However, when one considers the implications of the clan-based intertwined ownership structure present in Slovakia, comparative institutional efficiency becomes less equivocal. I show that the way privatization was carried out contributed to this structure and that, given the legal environment, this structure has created some mechanisms of self-sustenance. Even though the difference between the German and the Slovak models seems to be non-existent in ownership of corporate debt (which leads to similar agency costs of debt), I show that the structure of ownership decreases the efficiency of the Slovak system in this respect.

The scheme aiming to solve the costly problem of bad debts hinges critically on the role the banks are to play in an economy which in turn depends on the system of corporate governance. Utilizing my previous arguments, I conclude that the role of banks in an economy of Slovakia should be similar to the role they play in the German system, to minimize the agency cost springing from the structure of the economy.

Just when one would think that the proximity of the Slovak and German systems connected with their shown optimality in respective environments should lead to banks leading the restructuring process, I argue the opposite. Despite the doubtless similarities, the German system is operating in a stable 'mature' economy while the Slovak in a transitional one. A particular feature making the transitional economy different for my purpose is the need for restructuring. I argue that the role of restructuring is twofold: (a) to generate diverse views of alternative asset uses, and (b) to select the best one, that is the one maximizing the value of the firm. In a transitional economy, we are dealing with a situation when the correlation of past information and potential use of assets to be restructured is very small. Utilizing the argument of Irena Grosfeld (1994) that banks are optimal in eliminating the moral hazard problem by collecting information while markets are better in eliminating the adverse selection problem by generating information on the value of firms, I state that banks should be restricted to information providers

and as they are unable to fulfil the above roles. The best available method for an effective enterprise restructuring is very simple - an open competition of ideas.

After elaborating upon the idea of market - led restructuring, in the last part I strive to present normative implications by drafting a comprehensive bank and corporate restructuring scheme that would be compatible with my arguments. I propose a market based decentralized scheme that would maximize the information - generating role of the market competition for the purposes of bank and corporate restructuring. The maximization on the side of suppliers would be achieved by an automatic trigger mechanism strengthening the position of creditors, a recapitalization scheme creating incentives for a speedy sale of the assets and thus implying optimal incentives for the banks to transfer the maximum of accumulated information, and by a consequent privatization eliminating the bail-out expectations. The maximization of the number of potential investors would be a result of making the market transparent, making available the maximum of information on the companies traded (this is also incorporated into the incentives structures of banks) and by deepening the market by including all Central European countries. To make the market as efficient as possible, contract incompleteness would be limited by listing the companies in a legally developed constituency, thus increasing the contractual efficiency.

Even though the scheme I develop is far from complete, it presents an interesting alternative to many of the presently suggested and implemented models for restructuring the banking and enterprise sector. Rather than in the scheme itself, I see the usefulness of this paper in showing that even if economies are characterized by almost identical structure of the industry and of corporate governance, differences in the state of an economy from the evolutionary point of view (in our case that of a transition) may lead to completely different implications for the roles of individual institutions. To generalize, institutional efficiency is not only place, but also time specific.

Appendix

Table 1: Allocation of Privatizable Property (SK mil.)

Privatizable Property	1995	%	1996	%
Shares Sold	185,200	43.3	222,300	52.0
<i>of which via following methods:</i>				
- Voucher privatization	80,000		80,000	
- Standard methods	72,000		101,000	
- Other methods*	33,200		41,000	
Shares in Possession of NPF	139,400	32.6	115,500	27.0
<i>of which:</i>				
- Temporary custody	68,800		63,800	
- Permanent custody	29,700		27,000	
- Other property**	40,900		24,700	
Shares in Possession of Founding Ministry	103,000	24.1	89,800	21.0
Total	427,600	100.0	427,600	100.0

Sources: OECD (1997b), Miklos, I. (1997).

*These include: Free of charge property transfers, Shares transferred to restitution fund, sales to insurance companies or through an intermediary.

**Reserve funds of joint stock companies and other funds, Non-executed production and price differentials

Table 2: Changes in Size Distributions of Industrial Enterprises

	1990	1991	1992	1993	1994	1995
Total number of firms	390	600	1,031	1,291	1,454	1,623
Size (workers)						
0 — 500	152	394	782	1,074	1,245	1,417
501 — 1,000	90	84	106	102	101	98
1,001 — 2,500	95	82	91	73	71	69
2,501 — 5,000	41	31	38	31	27	31
≥ 5,000	12	9	14	11	10	8
Average size (workers/firm)	1,283	751	578	419	354	319

Source: OECD (1997b) Note: The data are not completely comparable: for 1990 they cover all enterprises, for 1991 only those over 100 employees, after 1992 survey includes companies with more than 25 employees.

Table 3: Ownership Structure of Banks in Slovakia

Bank	Assets	Shareholders
Všeobecná Uverovacia Banka (VUB) <i>General Credit Bank</i>	178.8	NPF 51%, VUB Kupon (Inv. fund) 9.5% Slavia Capital 8.7%, AJKA Ltd. 5%, Tatra Banka 3.6%
Slovenská Sporiteľňa (SLSP) <i>Slovak Savings Bank</i>	172.9	<u>NPF 91%, Restitution Fund 8.7%</u> <i>Not to be privatized until 2003.</i>
CSOB <i>Czechoslovak Trade Bank</i>	51.8	<u>Czech National Bank 26.5%, MoF CR 19.6%, NPF CR 19.6%, NBS 24.1%</u>
Invest. a Rozvojová Banka (IRB) <i>Invest. and Development Bank</i>	51.0	<u>NPF 35%, VSZ 14.6%, Tatrapetrol 8.24%, Tectum Ltd. 5.8%, Slovrea 6.7%</u> NEW: <u>SP 66.6%, VSZ 13.3%, NPF 12%</u>
Tatra Banka	32.4	Raiffeisen Banking Group 52.3%, VUB 11.5% Tatra Holding 10.3%
Polnohospodárska Banka <i>Slovak Agricultural Bank</i>	29.7	<u>Slovak Insurance Company 31.9%, EBRD 20%, Finest and Unicredito (Italy) together 15%, Ministry of Agriculture 8.32%</u>
Istobanka	21.1	<u>Slovak Insurance Company 72%, City of Bratislava 18%, Giro Credit Bank AG Viena 10%</u>
PSS (Building Society)	20.0	
Priemyselná Banka <i>Industrial Bank</i>	13.8	<u>Slovak Gas Company 14.99%, Slovak Insurance Company 12.72%, VSZ 9.99%, Slovak Power Plants 9.99%, Slovak Savings Bank</u>
Prvá Komunálna Banka <i>The First Municipal Bank</i>	13.4	PT (paper) 9.98%, Vahcstav (construction) 9.98%, Povazske chemické závody (chemical plant), cities of Zilina 8.9% and Banská Bystrica 7.8%. 521 other shareholders, 405 of them municipalities
ING Bank	13.3	Dutch owner 100%
Postová Banka <i>Post Bank</i>	12.7	Slovak Telecom 34%, Slovak Post 22.7%, Trade Trans Rail Ltd 15%, Tectum 15% Kinex 5.8%
Ludová Banka	11.6	Volksbanken Group 77.5%, Italian Volksbanks 18.2%
Creditanstalt	8.2	Austrian shareholder 100%
Slovenská Kredičná Banka <i>Slovak Credit Bank</i>	6.3	<u>Slovak Gas Industry 37.7%, Slovak Energy Company Ltd. 15%, Vodohospodárska výstavba (construction) 12%, Slovak Capital and Consulting 9%, Berzinol 6.3%, MK Trade 6.3%, Slovak Shipbuilding 5.3%</u>
Bank Austria SR	5.4	100% Austrian owner
Bana Hana	5.1	
Credit Lyonnais Bank	5.1	Credit Lyonnais France 90%, VUB 10%
VUB Wustenrot (Building Society)	4.9	
AG Banka	4.4	Nafta Gbely 39%, other shareholders: SCP (paper industry), Slovakoфарма, and Biotika (pharmaceut.)
Dopravná Banka <i>Transportation Bank</i>	3.6	<u>Slovak Railways 45%, Slovak Coach Company 37.5%, IRB 15%, State Tourism Fund 2.5%</u>
Komerční Banka	3.2	100% Czech owned
Citibank	3.2	100% foreign owned
Banka Slovakia	2.5	<u>NPF 60%, Slovak Insurance Company 26.4%, SLSP 6.6%, City of Banská Bystrica 6.9%</u>
Devin Banka	2.3	MFK Russia 30%, Slovak Cooperative Union 15%, Slovak Labor Unions 15%, APIS 15%
Moravia Banka	2.0	Czech owner 100%
Hypo-bank Slovakia	1.6	
Slovak Insurance Company		<u>NPF 50.6%, VSZ 20-30%</u>

Underlined are the state-owned or state-controlled shareholders, including the NPF.

Sources: Marcincin, 1998, Synsite, 1998 and SME daily, June 11, 1998.

THE CASE OF IRB.

Being the third largest bank in Slovakia, Investicna a Rozvojova Banka (IRB) was founded in 1992 as a Slovak divide of the former Investicni Banka. The first wave of the voucher privatization significantly changed its ownership structure, when only 35% of equity remained in the ownership of NPF. Within few years, the relatively dispersed ownership structure changed so that there were approximately five companies in addition to the NPF controlling the bank. The most aggressive of them was the VSZ steel conglomerate, eager to acquire a bank to finance its expansion⁸⁷, but repeatedly hitting the NBS resistance at the maximum ownership level of 15% to be acquired without its consent. So the VSZ and its managers created several other companies and further used clan member firms to obtain what was estimated at 41% of the bank.

Notwithstanding the ownership battles, IRB was performing quite poorly, with NBS eventually agreeing to IRB's "managed loss" restructuring program⁸⁸ that was supposed to bring bank back to life within three years. There were several causes deteriorating the situation in IRB: (a) loan portfolio consisted of long-term investment projects from the socialist times, mainly the Nuclear Power Plant Mochovce (which was later reclassified from doubtful to standard when government guaranteed its repayment) and subsidised loans for housing construction; (b) loan to asset ratio which at 72% was high above the sector average of 56%⁸⁹, and (c) the liability structure heavily dependent on the interbank market⁹⁰. The costs of the bank rose due to the cut in housing construction subsidies in 1990 and the increasing amount of provision creation for its bad loans. Bank was unable to increase its revenues as the poor capital situation prevented it from investing more into government securities which became a popular risk-diversification tool for the banks after their interest rates rose above 20% (with an inflation of 7%).

This combined with a high level of exposure proved fatal after the interbank market interest rates stayed at 20-28% for most of 1996 and 1997. Bank was under continuous close monitoring of the NBS, which had, as a part of the restructuring program, lent it SK 13bn. Ending with a loss of SK 3.25bn in 1997, the net worth of the bank according to the audit by Ernest & Young was SK -9bn. Parliament's rejection to provide housing loan subsidies for 1998 worth SK 782m proved to be the ultimate trigger of the bank's collapse and a step-in of the NBS, which put the bank under forced administration in December 1997. The following run on the bank was stopped as the NBS liquidity supporting loans to the IRB rose to SK 24bn⁹¹. According to the IRB's administrator, bank's Articles as well as the law have been seriously violated.

An attempt of the NBS to increase capital by incumbent shareholders had shown unsuccessful, as did its try to enforce a further restructuring program in the bank. Here, the limited powers of enforcement of the NBS were fully exposed – despite the bank was almost brought bankrupt by its shareholders and despite the NBS providing loans worth

⁸⁷A very diversified expansion, that is. The most controversial acquisition of VSZ, apart from the media and news companies, was the football club Sparta Praha for CK 1bn (app. USD 33mil).

⁸⁸The main feature of the program was that bank was allowed to create loan loss provisions directly from the cash flow and not from the net profit as it was supposed to according to the law.

⁸⁹Here the inability to restructure the loans and the poor capital position did not allow bank to lessen its dependence on risky loans.

⁹⁰Which is more volatile than the primary deposits.

⁹¹NBS has classified these loans as loss and started with provisioning in their full amount.

57% of bank's assets, any proposals have to be agreed by the shareholders' meeting, which they were not. A search for an investor that would recapitalize the IRB intensely refocused outwards, with rumours mentioning two foreign and official news one domestic bidder.

On June 10, 1998, Slovak Insurance Company (SP), a major creditor of the IRB (SK 4bn), increased its share in the bank's equity from SK 1bn to SK 3bn and became the new majority owner (66.7%). This defensive step further increased the ownership concentration of Slovak banks, when SP already owned large stakes in 7 banks (see Table 3). Taking the SP ownership structure as given, IRB's major shareholders are: SP (66.7%), VSZ (indirect 13.3%, direct 5%) and NPF (12%). However, if one takes into account the owners of SP (NPF 50.6% and VSZ 20%;30%), the ultimate shares would be: NPF (45%) and VSZ (33%).

COMPARISON OF MODELS OF CORPORATE GOVERNANCE⁹²

The American Model

The *ownership structure* in the American (Anglo-Saxon) model is rather dispersed, when five largest shareholders control only about 25% of an average firm. The investors are legally discouraged to take larger stakes in a company, as (in addition to liquidity and antitrust regulation) the law requires anyone acquiring more than 5% of a listed firm to register with the Securities Exchange Committee (SEC), to reveal her plans and to provide the SEC with an information about its finance. Another possible explanation for this ownership structure may be her high liquidity of the equity markets, leading investors to prefer ‘exit’ to ‘voice’. From the structural view, individuals are the major investors, whereas banks play no role at all, prevented to do so by the Glass-Steagal Act of 1933. The *governance boards* play limited monitoring role of shareholders over the management, as the only board (Board of Directors) is despite the rights of shareholders to vote about its members often appointed by the CEO of the firm and hence consists largely of incumbent management. Therefore, the governance boards do not act as an efficient tool for direct control of shareholders over the firm. The *ownership of the corporate debt* is approximately equally distributed between intermediated and security financing, which is in a sharp opposition to the German and Japanese models.

Table 4: Composition of Companies’ Debt, 1985

	US	Japan	Germany
Intermediated debt	45	91	94
from banks	36	n.a.	88
Securities	55	9	6

The mechanism of shareholder control over management is not functioning effectively in the American system. Instead, the control function is executed by the market via *hostile takeovers*, whereby a group of ‘company riders’ who consider firm’s value deviating far enough from the potential, offers to buy shares of the firm for above-the-market price and after gaining control over the firm change the management and restructure the firm.

The German Model

The *ownership structure* in the German model is much more concentrated than in the US or Japan, with 5 largest shareholders controlling 41.5% of an

⁹²Largely based on Sustek (1997) and Grosfeld (1994).

average firm, when banks own 10% of equity⁹³. Naturally, this stance is supported by the legislation, which does not limit a bank to own shares of a company in any way. The power of banks in governing companies further rises as they hold in trust shares of dispersed shareholders who allow banks to execute proxy voting. As I have already mentioned, the *governance boards* are very similar to those in Slovakia, with outside shareholders (represented in large by banks) appointing Supervisory Board members (50% outside shareholders and 50% workers) which in turn elect and dismiss Management Board. This creates a direct link between the owners and the management of the firm. Hence, the relatively less developed equity market in German model and the fact that the firm control mechanism is internal seem to be complementary and self-supporting. The *ownership of the corporate debt*, as is evident from the previous table, is mainly in the hands of banks. Hence, even when their equity participation would not seem to give reason for it, banks play a major role in corporate governance in the German model.

The Japanese Model

The *ownership structure* in the Japanese model is so called Keiretsu, formed from corporations from different industries around a single ‘main’ bank. One of the ownership specialities is their cross-ownership, protecting companies against any outsider corporate rider. The second purpose for the cross-shareholdings is an attempt to internalize positive production externalities. From the concentration point of view, Japan lies between Germany and US, with financial institutions being the most important owners. Unlike in Germany, these financial institutions are still within a particular group, which allows them to circumvent the legal restrictions allowing bank to own maximum 5% of firm’s outstanding equity. There is only one *governance board* in Japan, the Board of Directors, appointed by the CEO of the firm, consisting two thirds of former top managers and one third of outsiders⁹⁴. Despite only informal, the role of the German Supervisory Board is effectively played by the President’s Club consisting of directors, large creditors and shareholders of keiretsu. Further, managers are indirectly controlled by their selection, when the main feature of Japanese personnel management is the seniority principle. Financed approximately equally by internal and external sources, the main *owner of corporate debt* is the bank, which allows it to exert a lot of additional pressure on companies.

To summarize, despite many differences, German and Japanese models

⁹³Banks rank fourth as corporate owners, after non-financial corporations, individuals and foreigners.

⁹⁴Who are, nevertheless, members of the same group, primarily the main bank.

of corporate governance are similar in their reliance on financial institutions playing the role of the shareholders and debtholders, which is in sharp difference with the Anglo-Saxon model, where these functions are separated. The higher concentration of ownership in bank-oriented models (German and Japanese) leads to significant differences in management control mechanisms, when this works from within in bank-oriented models and from outside in the market-oriented Anglo-Saxon model.

References

- [1] Abel, I., and Bonin, J., 1994, 'State Desertion and Credit Market Failure in the Transition', *Acta Oeconomica*, Vol. 46, No. 1-2.
- [2] Begg, D., and Portes, R., 1994, 'Enterprise Debt and Economic Transformation: Financial Restructuring of the State Sector in Central and Eastern Europe, Discussion Paper No. 695, Center for Economic Policy Research, London.
- [3] Blommestein, H., 1997, 'Transformation of the Banking Sector in Central and Eastern Europe - Policy Assessment and Next Steps' in *The New Banking Landscape in Central and Eastern Europe: Country Experience and Policies for the Future*, OECD, Paris.
- [4] Boot, W., and van Wijnbergen, S., 1995, 'Financial sector Design, Regulation and Deposit Insurance in Eastern Europe', in *Banking Reform in Central Europe and the Former Soviet Union*, ed. Rostowski, J., Budapest, CEU.
- [5] Borish, M., Ding, W., and Noel, M., 1996, 'On the Road to EU Accession. Financial Sector Development in Central Europe', World Bank Discussion Paper, No. 345, Washington, DC, September.
- [6] Daniel, J., 1997, 'Fiscal Aspects of Bank Restructuring', IMF Working Paper WP/97/52, Washington, DC, April.
- [7] Gray, C., and Holle, A., 1996, 'Bank-Led Restructuring in Poland. An Empirical Look at the Bank Conciliation Process', Policy Research Working Paper No. 1650, The World Bank, Washington, D.C., September.
- [8] Grosfeld, I., 1994, 'Financial Systems in Transition: Is There a Case for a Bank Based System?', Discussion Paper No. 1062, Center for Economic Policy Research, London, November.
- [9] Honohan, P., 1997, 'Banking System Failures in Developing and Transition Countries: Diagnosis and Prediction', BIS Working Paper No. 39, Bank of International Settlements, Basle, January.
- [10] International Monetary Fund, 1997, *Slovak Republic. Recent Economic Developments*, prepared by Georgiou, A., Bodart, V., Woo, D., and Schwartz, S., Washington, DC, March.

- [11] Karasek, K., 1924, 'Banking', in *Czechoslovakia. A Survey of Economic and Social Conditions*, ed. Gruger, J., New York, NY, Arno Press and The New York Times.
- [12] Lizal, L., Singer, M., and Svejnar, J., 1997, 'Enterprise Breakups and Performance During the Transition', Working Paper No. 116, CERGE-EI, Prague, October.
- [13] Makuch, J., 1996, 'Transformacia bankoveho sektora (Transformation of the Banking Sector)', Institute of Monetary and Financial Studies, National Bank of Slovakia, Bratislava.
- [14] Marcincin, A., 1997, *Restrukturalizacia slovenskych podnikov*, (Restructuring of Slovak Enterprises), Centrum pre hospodarsky rozvoj, Bratislava.
- [15] Marcincin, A., 1998, *Restrukturalizacia bank v Slovenskej Republike*, (Restructuring of Banks in the Slovak Republic), Centrum pre hospodarsky rozvoj, Bratislava, April.
- [16] Miklos, I., and Zitnansky, E., 1997, 'Ekonomika (Economy)' in *Slovensko 1996; Suhrnna sprava o stave spolocnosti a trendoch na rok 1997 (Slovakia 1996; A Summary Report on the State of the Society and the Trends in 1997)*, ed. Butora, M., Institut pre verejne otazky, Bratislava.
- [17] Miklos, I., 1997, 'Privatizacia (Privatization)' in *Slovensko 1996; Suhrnna sprava o stave spolocnosti a trendoch na rok 1997 (Slovakia 1996; A Summary Report on the State of the Society and the Trends in 1997)*, ed. Butora, M., Institut pre verejne otazky, Bratislava.
- [18] Mizsei, K., 1995, 'Lessons from Bad Loan Management in the East Central European Economic Transition for the Second Wave Reform Countries', in *Banking Reform in Central Europe and the Former Soviet Union*, ed. Rostowski, J., Budapest, CEU.
- [19] Moriner, K., 1995, 'Banking Privatisation Policy in Poland and Czechoslovakia', in *Banking Reform in Central Europe and the Former Soviet Union*, ed. Rostowski, J., Budapest, CEU.
- [20] Myant, R., 1989, *Czechoslovak Economy, 1948 - 1988*, Cambridge University Press, Cambridge.
- [21] National Bank of Slovakia, 1997, *Annual Report 1996*, Bratislava.

- [22] National Bank of Slovakia, 1996, *Provision No. 3. On evaluation of risk contained in banks' claims and off-balance sheet liabilities and creating reserves and provisions to provide against those risks*, Bratislava, March.
- [23] Nesporova, A., 1993, 'Industrial Restructuring in Czechoslovakia after 1989'.
- [24] OECD, 1997a, *The New Banking Landscape in Central and Eastern Europe: Country Experience and Policies for the Future*, OECD, Paris.
- [25] OECD, 1997b, *OECD Economic Surveys 1995-1996; Slovak Republic*, OECD, Paris.
- [26] Pagano, U. and Rowthorn, R., 1996, 'The Competitive Selection of Democratic Firms in a World of Self-sustaining Institutions' in *Democracy and the Efficiency in the Economic Enterprises*, Routledge, London.
- [27] Pohl, G., and Claessens, S., 1994, 'Banks, Capital Markets and Corporate Governance', Policy Research Working Paper No. 1326, The World Bank, Washington, DC, July.
- [28] Rostowski, J., 1995, 'The Banking System, Credit and the Real Sector in Transitional Economies', in *Banking Reform in Central Europe and the Former Soviet Union*, ed. Rostowski, J., Budapest, CEU.
- [29] Sustek, R., 1997, *Agency Costs: Theory and its Applications to Alternative Models of Corporate Governance (How Does the Czech Model Compare?)*, MA Thesis, Budapest, CEU, June.
- [30] Symsite, 1998, *Database of Slovak Companies*, Bratislava, May.
- [31] Szekely, 1997, 'Comment on Polish Enterprise and Bank Restructuring Program', in *The New Banking Landscape in Central and Eastern Europe: Country Experience and Policies for the Future*, OECD, Paris.
- [32] World Bank, 1998, *Slovak Republic; A Strategy for Growth and European Integration*, The World Bank Country Study, Washington, D.C., April.