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Abstract

Following the disintegration of the Soviet Union and subsequent Velvet Revolution in 1989, the former Czech and Slovak Federative Republic (CSFR) began the complex transition from a centrally controlled command economy to a market-based economy. The transition necessitated the removal of non-performing loans from state-owned banks' balance sheets, a task assigned by the Ministry of Finance to the newly formed Consolidation Bank (*Konsolidační Banka*, hereafter "KOB"). Established on February 25, 1991, the KOB was specifically mandated to acquire and restructure what were known as "TOZ" loans, unsecured debt with no amortization schedules and unsustainably high interest rates. The KOB used funds from the State Bank of Czechoslovakia to acquire CZK 125 billion (approximately $4.2 billion, or about 10% of GDP) in TOZ loans from four state-owned banks. The purchase was made at 80% of the loans' nominal value. In 1993, upon Czechoslovakia's split into two sovereign nations, the KOB's loan portfolio and operations were divided between the Consolidation Bank Prague (CBP) and Consolidation Bank Bratislava. Although the CBP took over the management of the bad loan portfolio, it also engaged in many other commercial banking activities. The Ministry of Finance of the Czech Republic therefore decided in 2001 to create the Czech Consolidation Agency (CCA) to handle both the TOZ loans and other bad debt that had been accumulated throughout the economic transition period. After significantly reducing its assets under management through block sales of receivables, the CCA ceased operations on December 31, 2007, transferring the CZK 17.2 billion remaining on its balance sheet to the Ministry of Finance.

Keywords: Czechoslovakia, asset management companies, asset purchase programs, KOB

[1] This case study is part of the Yale Program on Financial Stability (YPFS) selection of New Bagehot Project modules considering broad-based asset management company programs.

Cases are available from the *Journal of Financial Crises* at https://elischolar.library.yale.edu/journal-of-financial-crises/.

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Czech and Slovak Federative Republic: Consolidation Bank (KOB)

At a Glance

The economic liberalization of the former Czech and Slovak Federative Republic (CSFR) began in the early 1990s with concerted market deregulation and a comprehensive program of institutional reforms. Among these, the Ministry of Finance was tasked with the removal of non-performing "TOZ" loans (*trvale obracející se zásoby* or "permanently revolving inventories") from state-owned banks' balance sheets. The TOZ loans, which were unsecured and automatically rolled over, had been distributed by the government in the 1970s in exchange for the seizure of special pre-tax funds that companies used to pay their operational expenses. State-owned businesses would accept these loans with the understanding that they would then be compelled to re-lend them back to the government (Desai 1995; Thorne 1993). Although their creation was outlawed at the beginning of 1991, the existing TOZ loans posed a particular threat to banks' balance sheets and firms as well: inflation pushed interest rates up from 6% to an unsustainable 23% and companies were unable to negotiate replacement loans at commercial rates (Aghevli et al. 1992; Desai 1995; Rod 2014).

In response to concerns about looming budget deficits, the Ministry of Finance established the Consolidation Bank (*Konsolidační Banka*, hereafter "KOB") on February 25, 1991, in order to acquire the TOZ loans (Desai 1995; Rod 2014). The KOB was mandated to restructure the debt to have maturities of eight years and bear interest at a rate of 13% (Thorne 1993). Using funds provided by the State Bank of Czechoslovakia and additional loans from other Czech and Slovak banks, primarily Czech Savings, the KOB purchased CZK 110 billion (approximately $3.7 billion) in non-performing

Summary of Key Terms	
Purpose: To relieve state-owned banks of non-performing loans left over from the centrally planned economy and restructure them with more favorable terms (Rod 2014).	
Launch Dates	Announcement: February 25, 1991 First transfer: 1991
Wind-down Dates	December 31, 2007, under the Czech Consolidation Agency
Size and Type of NPL Problem	20% of banking system loans in 1991 (Hayri and McDermott 1995) State-directed "TOZ" loans to state-owned enterprises
Program Size	Not specified at outset
Eligible Institutions	State-owned banks that were slated for privatization by the Czechoslovakian government Open-bank only
Usage	Approximately CZK 125 billion in loans acquired from four institutions between 1991 and 1992 (Desai 1995; Rod 2014)
Outcomes	Unclear how much was realized as a result of the disposition of assets In 2007, the Czech Consolidation Agency transferred CZK 17.2 billion in remaining assets to the Ministry of Finance
Ownership Structure	Government-owned
Notable Features	KOB transferred operations to Consolidation Bank Prague upon separation of Czechoslovakia into two sovereign states

TOZ loans, which comprised almost 20% of all loans to businesses at the time (Desai 1995). In 1992, the KOB conducted its second round of acquisitions, removing CZK 15 billion in bad assets from commercial banks' balance sheets at a 20% discount (Horčicová and Payson 1997).

The KOB ceased operations upon the peaceful breakup of the CSFR into the sovereign states of Czech Republic and Slovakia in 1993. It then transferred its loan portfolio and operations to the Consolidation Bank Prague (CBP) and Consolidation Bank Bratislava. In addition to managing CZK 83.5 billion of the leftover TOZ loans, the CBP took on the responsibilities of a regular commercial bank. It ended its bad-loan operations upon the creation of the Czech Consolidation Agency (CCA) in 2001, a newly formed institution meant to resolve what remained of the portfolio. After significantly reducing its assets under management through block sales of receivables, the CCA terminated its operations on December 31, 2007, transferring the CZK 17.2 billion remaining on its balance sheet to the Czech Ministry of Finance (Rod 2014). It is unclear from secondary sources how much was realized through the disposition of the KOB portfolio.

Summary Evaluation

Academic evaluations of the KOB, when available, paint a mixed legacy of success. Its operations were considered to be "partial" in that they left banks to deal with a sizeable volume of non-performing loans (Aghevli et al. 1992). According to Bonin and Huang (2000), the transfer of bad assets was ultimately unsuccessful in contributing to a strong domestic financial sector, one that would be able to compete in a globalized market. However, Horčicová and Payson (1997) attribute this lack of success to the transitionary economic conditions under which the government was operating, rather than the design of the KOB itself.

Konsolidační Banka : Czech and Slovak Federative Republic Context	
GDP (SAAR, Nominal GDP in LCU converted to USD)	S40.5 billion in 1990 $29.7 billion in 1991
GDP per capita (SAAR, Nominal GDP in LCU converted to USD)	$3,917 in 1990 $2,879 in 1991
Sovereign credit rating (5-year senior debt)	Data for 1990: Moody's: Data unavailable S&P: Data unavailable Fitch: Data unavailable Data for 1991: Moody's: Data unavailable S&P: Data unavailable Fitch: Data unavailable
Size of banking system	Data not available for 1990 Data not available for 1991
Size of banking system as a percentage of GDP	Data not available for 1990 Data not available for 1991
Size of banking system as a percentage of financial system	Data not available for 1998 Data not available for 1999
5-bank concentration of banking system	Data not available for 1990 Data not available for 1991
Foreign involvement in banking system	Data not available for 1990 Data not available for 1991
Government ownership of banking system	100% in 1990 100% in 1991
Existence of deposit insurance	No in 1990 No in 1991
Sources: *Bloomberg; World Bank Global Financial Development Database; World Bank Deposit Insurance Dataset*	

Key Design Decisions

1. Part of a Package: The Czechoslovakian government established the Consolidation Bank (KOB) in order to remove NPLs from state-owned banks that it was recapitalizing in preparation for privatization.

Beginning in 1991, the Ministry of Finance of the Czech and Slovak Federative Republic undertook a program of restructuring efforts in order to prepare for the national transition to a market-based economy (Rod 2014). One step in the process involved recapitalizing state banks through an allocation of five-year bonds worth approximately 8% of all bank loans to state-owned enterprises. In order to determine recapitalization amounts, the government asked the state banks what portion of non-performing loans should be removed from their balance sheets (Desai 1995).

The Czechoslovakian government positioned the KOB's operations as a necessary step toward privatization. According to the Consolidation Bank Prague 1994 Annual Report, the KOB was established in order to "deal with the consequences of certain decisions from the time of the centrally planned economy, when loans failed to meet their main economic role of a mechanism for the optimal allocation of capital" (Rod 2014).

2. Legal Authority: It is unclear what legislation or legal authority was used to establish or govern the KOB.

The Ministry of Finance was responsible for the creation of the KOB by governmental decree (Desai 1995).

3. Special Powers: The KOB did not appear to have special powers to enforce collection or restructuring on delinquent borrowers.

Secondary sources consulted did not provide evidence of special powers.

4. Mandate: The KOB's mandate was to restructure non-performing loans at market rates.

The government utilized the newly formed KOB as a repository for bad loans that needed to be disposed of prior to banks' privatization. The KOB purchased TOZ loans off state banks' balance sheets and restructured them with eight-year maturities bearing interest rates of 13%, dependent on the discount rate (Desai 1995; Thorne 1993). According to leading expert on Czechoslovakian economics, Dr. Aleš Rod, the government anticipated that the old loans would be more easily refinanced within the context of the newly formed commercial banking sector.

Although the government established KOB specifically to handle bad loans, its operations were later extended in 1992 to encompass more regular banking activities (Rod 2014). According to Dr. Rod, the KOB operated with a limited banking license that enabled it to accept deposits from legal entities, provide and manage loans within the scope of the bank's business plan, and work out payments and settlements without payments with foreign countries.

5. Ownership Structure: The KOB was owned and operated by the Czechoslovakian government.

All Czechoslovakian banking institutions created between the years 1989 and 1991 were government-owned (Rod 2014).

6. Governance/Administration: Details regarding internal governance and administration are unclear from secondary sources consulted.

Although annual reports for the KOB's operations exist, they have not yet been translated or digitized.

7. Size: The Czechoslovakian government does not seem to have set a specific cap on the size of the KOB's operations.

Secondary resources consulted do not mention any cap on the size of the program.

8. Funding Sources: As a public institution, the KOB utilized funds from a number of state-owned banks in order to carry out its loan purchases.

Initially, the KOB was charged with purchasing CZK 110 billion in TOZ loans from the Czech Commercial Bank and Slovak General Credit Bank. The State Bank of Czechoslovakia, the central bank, provided funds for these purchases at a real interest rate of -3%. Other Czech and Slovak banks, notably Czech Savings, provided funds at an average interest rate of 11%, or a real interest rate of -1% (Desai 1995).

9. Eligible Institutions: Initially, the four state-owned Czechoslovakian banks that held TOZ loans were eligible for assistance from the KOB.

These four banks (Commercial Bank, Investment Bank, General Credit Bank of Slovakia, and Czechoslovak Trade Bank) held non-performing TOZ loans generated by the government in the decades leading up to privatization. In 1992, the KOB purchased CZK 14.7 billion in (non-TOZ) bad loans from Commercial Bank and Investment Bank (Rod 2014).[3]

It appears from secondary sources consulted that any state-owned Czechoslovakian bank that held non-performing loans and was slated for privatization was eligible for participation (Desai 1995; Rod 2014). As previously noted, it seems that the government compelled participation in the program as a requirement for recapitalization (Desai 1995).

[3] It is unclear from sources consulted whether the KOB purchased TOZ loans from Trade Bank.

10. Eligible Assets: In addition to the removal of TOZ loans from state banks' balance sheets, the KOB was also charged with the acquisition of other bad loans that would interfere with the transition to a market-based economy.

These non-performing loans, known as "*trvale obracející se zásoby*"—"TOZ" loans or, literally, "permanently revolving inventories"—were the result of a concerted government effort in the 1970s to seize special pre-tax reserves used by state-owned enterprises to finance their operating expenses. In their place, Czechoslovakian authorities began distributing these unsecured TOZ loans to enterprises with the expectation that they would be re-lent to the government. When interest rates on the TOZ loans increased sharply from 6% to 23% in 1989, the threat of large budget deficits pushed the government to recapitalize banks in exchange for the removal of TOZ loans from their balance sheets (Desai 1995).

The KOB also took on bad debt that accumulated during the first stage of economic transition, including non-performing loans made in relation to new foreign investment and "pioneer" loans made to new private companies (Horčicová and Payson 1997).

11. Acquisition (Mechanics): There were two rounds of purchases during which the KOB acquired assets using funds borrowed from the central bank and other state-owned banks.

The KOB purchased CZK 110 billion (approximately $3.7 billion) in non-performing TOZ loans, which comprised almost 20% of all loans to businesses at the time (Desai 1995). In 1992, the KOB conducted its second round of acquisitions, removing CZK 15 billion in bad assets from commercial banks' balance sheets at a 20% discount (Horčicová and Payson 1997). These acquisitions were considered to comprise "a large portion of loan collection from bank clients" (Desai 1995).

12. Acquisition (Pricing): It is unclear what methodology the Czechoslovakian government used to determine the pricing of the TOZ loans.

The first CZK 110 billion purchase of TOZ loans from the largest Czech and Slovak banks was carried out for 80% of their nominal value (Desai 1995).

13. Recovery and Disposal: A successor institution to the KOB, the Czech Consolidation Agency, disposed of assets under management through block sales of receivables.

The KOB was split up into two separate banks—Consolidation Bank Prague (CBP) and Consolidation Bank Bratislava—upon the breakup of Czechoslovakia in 1993. Following the split, the CBP took on the responsibilities and operations of a "normal" commercial bank (Rod 2014).

On September 1, 2001, the government of the Czech Republic created the Czech Consolidation Agency (CCA) for the express purpose of dealing with the bad loan portfolios of the CBP. Though it is unclear from sources consulted whether the CCA was created as a designated asset management company, it seemed as though the KOB continued to hold nonperforming loans without attempting to collect (Rod 2014).

After significantly reducing its assets under management through block sales of receivables,[4] the CCA ceased operations on December 31, 2007, transferring the CZK 17.2 billion remaining on its balance sheet to the Ministry of Finance (Rod 2014).

14. Timeframe: Although the KOB was initially given a temporary license to carry out loan operations for four months, its timeframe was later extended to six months.

The KOB as an institution existed from February 25, 1991, through December 31, 1992, at which point its portfolio and responsibilities were split between the newly formed Consolidation Bank Prague and Consolidation Bank Bratislava (Desai 1995; Rod 2014).

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