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# *The Czech Republic's Commercial Bank: Komerční Banka*

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Komerční Banka

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Abstract:

**Snyder, Edward A., and Kormendi, Roger C. — The Czech Republic's Komerční Banka**

Important elements of the transactional structure that created and partially privatized Komerční Banka, the Czech Republic's largest commercial bank, include antecedent actions that determined the bank's management and established its commercial loan portfolio, a decision against splitting the bank's operations into smaller organizational units, the reliance on voucher privatization, and limited post-privatization financial support. The main feature, however, is the government's decision to retain control and majority ownership of Komerční. Our analysis of the bank's subsequent credit allocations yields evidence of the government's preference for a deliberate rather than a quick move toward market-driven decision-making. The opportunity to privatize a strong bank and harden enterprise-level budget constraints quickly was foregone, or at least postponed, in favor of creating a protected bank that would deal more leniently with Komerční's politically-vested commercial clients. *J. Comp. Econom.* University of Michigan Business School, Ann Arbor, Michigan 48109.

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## I. INTRODUCTION

This study analyzes the transactional structure that created and partially privatized Komerční Banka (Komerční), the largest commercial bank in the Czech Republic and, in terms of assets, the largest bank in the region.<sup>1</sup> We explore how elements of the transactional structure influenced Komerční's market position, business strategy, and performance. Consistent with this focus on firm-level effects of bank privatization efforts, we are especially concerned with Komerční's franchise value, its corporate governance, and the government's influence on Komerční's credit allocation decisions.

The conditions for Komerční's privatization were more favorable than for any other bank in the region. First, the voucher privatization scheme used placed no burden on the nascent capital market nor did it require much institutional infrastructure. Second and related, the government was not motivated by revenue objectives and so avoided the difficult pricing issues that slowed other privatization efforts. Third, the government decided against organizational restructuring of the bank and in favor of an early plan to privatize Komerční as the Czech Republic's major commercial bank. Fourth, the privatization process was quite formal and property rights were well-defined. Fifth, with the January 1993 split of the Czech and Slovak Republics, the relative strength of the Czech economy and its extremely low unemployment rate probably relaxed the political constraints on movement toward market-based allocations of commercial credit.<sup>2</sup>

Against this backdrop, the government's decision to retain control and majority ownership of Komerční emerges as the main feature of analysis and takes on added importance for two reasons. First, the pattern of partial privatization and continued government control

applies to all major Czech banks, and is prevalent throughout the region.<sup>3</sup> Thus, Komerční's privatization is an example of the dominant outcome of the bank privatization processes in Central Europe to date. Second, because Komerční and the other large Czech banks sponsored most of the country's top investment funds, the lack of real bank privatization means that the government continues as a force in the corporate governance of "privatized" Czech enterprises.<sup>4</sup>

The contrast between the favorable conditions for privatizing Komerční and the less than satisfactory outcome indicates the existence of political constraints on bank privatization efforts and motivates an inquiry into the government's post-privatization role in the bank. Financial health and portfolio management along with the development of sound corporate governance are central, in our judgment, to minimizing the fundamental moral hazard problems that plague banking throughout the world.<sup>5</sup> For this reason, our evaluation of Komerční's strategy and performance focuses on how the government has exercised control, how the bank has dealt with its troubled clients, and the development of the bank's franchise value, i.e., its value as an on-going concern.<sup>6</sup> We recognize that the circumstances of economic transition present severe obstacles to the development of good banking, e.g., Komerční's original clientele were state-owned enterprises (SOEs). But we also believe that any bank privatization should be judged versus the standard efficiency objectives of (i) creating a bank that is capable of earning positive returns from sound banking, and (ii) focusing the government's role on bank supervision and prudential regulation.

We proceed as follows: In Section II we review Komerční's transactional structure, including, for example, antecedent actions that determined the bank's senior management and

restructured its balance sheet. Our assessment of the transactional structure follows in Section III. In Section IV, we focus on how Komerční's has managed its loan portfolio after its partial privatization. Section V contains concluding remarks.

## II. TRANSACTIONAL STRUCTURE

### A. Financial Sector Context

Compared to other communist countries, Czechoslovakia had a well-developed financial sector [for details see Kerous (1993) and Kotrba (1995)]. The most important financial institutions under communism were (a) the State Bank of Czechoslovakia (Statni Banka Ceskoslovenska), and (b) the Czechoslovak State Savings Bank (Ceskoslovenska Statni Sporitelna). The State Bank served as both the central bank and as the financial medium for channeling commercial credit and providing depository and payment services to the country's SOEs. The Savings Bank provided country-wide depository services and extended credit to individuals. In 1968 Czechoslovakia moved to a federal structure and split the Savings Bank into Česká Spořitelna (CS), operating in the Czech Republic, and its analogue in the Slovak Republic.<sup>7</sup> The State Bank's country-wide commercial banking function continued, however. Three other major banks operated during the communist era. Investiční Banka (IB) was established in 1948 to specialize in development and investments involving foreign companies. Československá Obchodní Banka (ČSOB) operated since 1965 as a foreign trade bank. Živnostenská Banka (ŽB), with the benefit of a London office, specialized in foreign currency deposits.

Legislation passed in the midst of the Velvet Revolution separated the central bank and commercial bank functions of the State Bank, with the latter divided by Republic: Komerční in the Czech Republic and Vseobecna Uverova Banka (VUB) in the Slovak Republic.<sup>8</sup> Thus, the resulting banking structure within months of the 1989 revolution can be summarized as follows: (i) a national bank for Czechoslovakia, (ii) two republic-wide commercial banks, (iii) two republic-wide savings banks, and (iv) three major specialized banks (IB, ČSOB, and ŽB). All of these banks were under firm state control during at the beginning of the post-communist era.<sup>9</sup>

The economic environment in which these banks began to operate was relatively strong. Czechoslovakia had little foreign debt and low budget deficits. Like other transition countries, Czechoslovakia experienced substantial inflation following price liberalization: Consumer prices increased about 60% over the two-year period 1990-91, but monetary policy and the staged price liberalization of regulated sectors have produced annual inflation rates of 10% or less since 1993.<sup>10</sup> The internally-convertible Czechoslovak Crown was devalued in 1991, stimulating exports and producing a positive current account balance soon after the Revolution.<sup>11</sup> The Czech Republic in particular had a strong and highly concentrated industrial base [Sujan and Sujanova (1995)]. These factors in combination with the quality of the country's SOEs meant that Czechoslovakia (a) had greater flexibility relative to other transitional economies to address its loan portfolio problems, and (b) had potentially stronger incentives to re-structure and reform its SOEs. The only major omission from the consensus reform package was that wages in the Czech Republic remained controlled until August 1995, which may have weakened the enterprise-level incentives to make labor-force adjustments.<sup>12</sup>

## B. Antecedent Actions to Komerční's Privatization

On January 1, 1990 the State Bank transferred its portfolio of loans to SOEs in the Czech Republic to Komerční, which also received liabilities in the form of commercial deposits and government debt. The value of Komerční's commercial loan portfolio, in Czech Crowns (Kc) was Kc 325 billion, or about \$US 11 billion. (The Kc - \$US exchange rate has been quite stable since late 1990, ranging from Kc 27 to Kc 30.) Komerční's commercial loan portfolio compared to Kc 450 billion in total loans of all types throughout the Czech Republic and an annual GDP of Kc 800 billion. It is noteworthy that Komerční by itself started with a higher ratio of loan assets to Czech GDP than the current levels in Hungary and Poland.<sup>13</sup>

Given that its assets mirrored the state-owned economy, Komerční's portfolio included a large proportion of non-performing assets. While these legacies are properly viewed as sunk costs, how the government and newly constituted bank would deal with its problem clients would bear on Komerční's future value. Prior to privatization, the State Bank provided favorable credit, so-called redistribution loans to Komerční, but not to other Czech banks such as CS [Kotrba (1995)]. Legislation also insured the deposits in Komerční and three other state banks without requiring the banks to pay premia.<sup>14</sup> These actions are indicative of a *quid pro quo* whereby Komerční and its senior management would benefit from various government policies and, in return, Komerční would not deal aggressively with its SOE clients. The result of such actions would be the continuation, at least to a degree, of the state's traditional role in socialist systems of guaranteeing enterprise loans and deposits.<sup>15</sup>

Four other antecedent actions are significant. First, the government took steps to cleanse Komerční's loan portfolio. Second, the government decided against any organizational



restructuring of Komerční prior to privatization. Third, the bank's future management was identified and its basic governance structures were established. Fourth, Komerční established an investment fund for voucher equity in advance of the first wave of privatization.

*Cleansing actions:* In the two years after Komerční received most of the Czech Republic's commercial loan portfolio, the bank returned a significant amount back to the state. In 1991 Komerční transferred "revolving credit loans" with a gross book value of Kc 79.3 billion to the newly created Consolidation Bank (Konsolidacni Banka); an equal amount of liabilities due to the State Bank also were transferred. The distinguishing features of these loans were low nominal interest rates, indefinite terms, and the lack of collateral. Because virtually all SOEs had received such loans as compensation for the communist government's absorption of enterprise profits, their transfer to the Consolidation Bank did not represent a systematic cleansing of Komerční's loan portfolio.<sup>16</sup>

Later in 1991 the government's National Property Fund (NPF) was established to hold all state assets and assist in privatizations. The NPF, which thus held the equity of both Komerční and its clients, made Kc 22.2 billion available to SOEs to reduce their debt burden. Komerční and other state banks were allowed to request that certain SOEs receive some of this funding, as an indirect means of reducing their bad loan problems. Komerční's share of the loans written off by the state was Kc 15.1 billion or 68% of the total.<sup>17</sup> Given that Komerční could choose which loans to write off, this put increased the bank's capital by an amount equal to the gross value of loans put, i.e., Kc 15 billion. In a separate action, the NPF allocated in 1991 Kc 7.8 billion to the capital base of state banks, of which Komerční received about 10%. The combination of these actions improved Komerční's financial status considerably. Its loan

portfolio was reduced by slightly more than one-third of its original endowment, and the 1991 recapitalization increased total bank capital by 17%.

*Decision against organizational restructuring:* A critical policy issue in transitional economy settings concerns actions to enhance bank competition and thereby increase consumer surplus. These include licensing of *de novo* banks, opening the sector to foreign competition, and carving the monobank structure into a more competitive structure. The difficulty with such actions lies in the enhanced risk of bank failures.

The Czechoslovak approach to this tradeoff was to put relatively great weight on bank solvency and relatively little weight on enhancing competition and increasing consumer surplus.<sup>18</sup> Miroslav Kerous, former Vice-Governor of the Czech National Bank, reports: "...[D]uring the decision-making on the method of restructuring and privatisation of the large state banks the method preferred was one with which no further worsening of the situation even if temporary was expected. This apprehension caused ... the rejection of all proposals directed toward the creation of a banking system with a greater number of smaller members to be created from the original state banks" [Kerous (1993)]. Additional arguments against a breakup were that (a) regaining control of sub-units of Komerční experiencing financial trouble would be difficult, and (b) a unified Komerční would advance the Czech Republic's goal of quickly developing an internationally recognized bank.<sup>19</sup>

For these reasons the government decided that Komerční would be privatized as a whole rather than broken into smaller banks. Related to decision, the government assigned to Komerční of all the assets associated with the Czech Republic's payment system infrastructure, i.e., its branches, sub-centers, and network connections to Prague.

*Management and elements of corporate governance:* As the voucher plan for privatizing Komerční was developed, it became clear that incumbent managers with strong links to the government would continue post-privatization. Dr. Richard Salzmann, a highly respected former senior executive in the Czechoslovakian State Bank, was appointed in early 1991 as Chief Executive Officer and Chairman. Dr. Salzmann was viewed as having full managerial control of Komerční. Most of Komerční's other senior executives held executive positions at the State Bank [Komerční Annual Reports, 1992, 1993].

The bank's governance structures were established early in its history, which may account for why, in contrast to other Visegrad countries, the Ministry of Finance neither assumed significant supervisory responsibilities for Komerční nor was part of the primary information flow. In 1992 the Board of Directors was established with a seven-person membership, which included Dr. Salzmann (Chairman), the Deputy Chief Executive, and individual representatives from the Czech NPF, the Slovak NPF, the Federal Ministry of Finance, and the State Bank. The Board of Directors assumed responsibility for asset and liability management, and developed the practice of having specific decisions reviewed by an asset liability committee composed of a subset of the Board of Directors and other bank managers. The Board of Directors within two years evolved into a traditional insider board, with its members coming exclusively from the senior executive ranks.

The Supervisory Board of outsiders from business and academia was also formed and assumed the responsibility of monitoring the Board of Directors. The bank's Internal Audit and Control Department was assigned to this board, which began to evaluate asset values and reserve positions as well as the bank's overall strategy. By 1994, the Supervisory Board grew

to twelve-members, including outsiders as well as central bank and Ministry of Finance representatives.

*Investment Fund sponsorship:* Komerční – as did other state sector banks – sponsored an investment fund, IPF Komerční, which received significant portions of the voucher equity distributed to citizens. Together Komerční and two other state banks (CS and IB) established five of the top six investment funds, the other being affiliated with Ceska Posjistovna, the monopoly insurance company that experienced severe financial trouble in 1996.

### C. Komerční's Privatization

With approximately Kc 4.6 billion in financial capital, Komerční was included in the first wave of voucher privatization. The government's January 1992 plan specified that up to 53% of the equity would be offered through the voucher scheme and 44% would remain with the Czechoslovak NPF, with the balance of 3% designated for the National Fund for Restitution.<sup>20</sup> Foreign bank and investor participation in the secondary equity market was restricted.<sup>21</sup> Thus, the plan determined what types of investors would be allowed to own Komerční equity, i.e., Czechoslovakian citizens, and eliminated the possibility that private ownership interests would gain control over the enterprise and its management. The government used the voucher model for the large state banks. Only ŽB, the small state bank with expertise in foreign currency transactions and no problem assets, was marketed to strategic foreign investors.

The response to the offering was positive, with 700,000 citizens trading their vouchers for Komerční shares. While the bank had developed financial statements based on International Accounting Standards, investor interest was driven principally by beliefs regarding the strength of Komerční's position in the commercial loan market and the reduced

risks associated with government ownership, and by concern that much of its loan portfolio was suspect.<sup>22</sup> No information was disclosed about the likelihood of follow-on government actions to further cleanse loan portfolios. There was relatively good information about the licensing rules, but it was unclear how much competition Komerční would face from *de novo* entrants and the other state banks then beginning to operate as universal banks.

Demand for the offering fell below the 53% of Komerční stock available under the plan due the government raising price raised the offer price seven times in the final phases of the privatization. The shortfall of actual demand relative to the 53% offered was not critical to the control issue given the diffusion of voucher equity, but revealed a tendency to err on the side of continued state control. After its privatization the bank recognized the NPF as its principal shareholder.<sup>23</sup> Given the governance structures in place, the NPF could replace the bank's management, govern its dividends, set strategic objectives, and interfere in loan portfolio decisions. In sum, Komerční was not and has not since been privatized in a meaningful sense.

Investment funds, which collected the bulk of individual citizen vouchers, featured prominently among Komerční's other shareholders, with 42% of total equity. The largest was Harvard Capital & Consulting. The other investment funds associated with state banks came to hold over a quarter of Komerční's equity. Individuals who retained their equity interests accounted for less than 7% of equity.

#### D. Post-Privatization Actions

Following its partial privatization, Komerční's financial condition was affected by two non-standard means. The first was a put of non-performing loans to the government in late

1992. Komerční was permitted to transfer Kc 9.7 billion worth of loans to the Consolidation Bank for 80% of their gross book value. As with the second cleansing action before privatization, Komerční selected the loans to be put. Given the terms, this put increased Komerční's capital by nearly Kc 8 billion, thereby almost doubling its capital.

The second action limited the extent to which Komerční took advantage of legislation allowing banks to add to reserves on a pre-tax basis in 1993. Komerční intended to allocate its Kc 3 billion of profits that year to reserves and pay no taxes. Minister of Finance Vaclav Klaus complained to Dr. Salzmann about Komerční's plan and the two reached an agreement whereby Komerční provisioned half the amount and paid taxes on the balance.<sup>24</sup>

Komerční has not received subsequent infusions of capital from the government, nor has the government taken further actions to cleanse Komerční's portfolio. Hence, the extent of post-privatization interventions directly affecting Komerční's balance sheet were limited in number and were made shortly after Komerční's privatization.

*Consequence of the 'Velvet Divorce':* With Czechoslovakia's dissolution on January 1, 1993, the government ownership interest in partially privatized Komerční was split, with two-thirds going to the Czech NPF and one-third going to the Slovak NPF.<sup>25</sup> Komerční's official publications do not disclose the Slovak NPF's equity and instead associate the Czech NPF with a 49% share. This attribution is sensible in that, as the holder of the state's equity interests in Komerční's real-sector clients, the Czech NPF has a strong interest in Komerční while the Slovak NPF is essentially a passive investor. Nevertheless, the Slovak NPF share (approximately 17%) is a potentially important barrier to further privatization efforts. In

effect, sale of the Czech NPF equity would have to be prefaced by a deal for the Slovak-held equity; otherwise, the Slovak NPF could hold a controlling stake.<sup>26</sup>

### III. Assessment of Komerční's Transactional Structure

In this section we assess Komerční's transactional structure and then discuss their implications for Komerční's business strategy and financial status. We differ until Section IV our analysis of Komerční's portfolio management.

#### A. Major Features

The major features of Komerční's transactional structure are (i) the efficiency and speed of the partial privatization effort, (ii) the lack of interest in restructuring Komerční into smaller units, (iii) continued government majority ownership and control, and (iv) the government's revealed preference for avoiding future financial interventions.<sup>27</sup>

The voucher schemes used for Komerční and other major state banks, as compared to initial public offerings, did not require much institutional infrastructure. The voucher approach also freed the government from difficult pricing problems and generated political support for the reform process. These factors allowed Czechoslovakia to develop and execute bank privatization plans quickly. An opportunity cost, however, was foregoing pursuit of a strategic foreign investor for Komerční that could have injected capital and added managerial expertise in areas such as investment banking. The voucher privatization also resulted in a diffuse ownership structure that would pose no threat to Komerční's incumbent management.

While the antecedent and post-privatization actions increased Komerční's capital and addressed to a significant degree its asset problems, Komerční was left with a large volume of

non-performing loans. Hence, the Consolidation Bank was not used to implement a 'good bank - bad bank' approach. Rather, Komerční's transactional structure represents a mixed approach of hiving off some bad loans, recapitalization, and setting the expectation that the bank would develop capabilities to address its remaining problem assets. [See Saunders and Sommariva (1993) for a discussion of alternative models for restructuring state bank assets.]

The government's decision not to further restructure the Czech Republic's commercial banking operations meant that Komerční had a dominant position in commercial lending. Of note, during the 1990-91 pre-privatization period Komerční earned exceptionally high lending margins. While these margins fell slightly in 1992, Komerční's market position allowed it to continue earning substantial rents. The decision not to restructure Komerční also enhanced the bank's long-term franchise value associated with its base of borrowers and depositors.<sup>28</sup> In general, a bank can organize a large volume of transactions efficiently as compared with individualized capital market transactions that entail higher costs. Thus, with a large deposit and loan base supported by its extensive branch network, Komerční could earn substantial income from basic bank operations. Komerční also could exploit economies of scope by differentiating its deposit and loan products and offering other banking services, e.g., foreign currency transactions.

As indicated, the main feature of Komerční's transactional structure is the government's majority ownership and control, which has continued to the present. As of mid 1996, the Czech NPF controlled 53.1% of Komerční's equity (the combination of the 48.7% share retained by the Czech and Slovak NPFs and its proxy for the Restitution Investment Fund's 4.4% share). Given the significant amount of German-style cross-ownership among other state



sector banks and investment funds, the 53.1% stake understates the government's total ownership interest. Further details about Komerční's ownership structure are reported Table 1.<sup>29</sup>

Insert T1

It is noteworthy that the observed pattern of government majority ownership and control extends to other major Czech banks, including (i) CS (the former State Savings Bank), (ii) ČSOB (the former foreign trade bank), and (iii) IPB (created in 1994 via the merger of the postal bank and IB, the former investment bank). While 58 banks had licenses and 56 conducted operations in the Czech Republic as of 1995, the four major state banks still dominate the industry. Indeed, according to Table 2, these and the Consolidation Bank account for 76% of industry assets, 83% of deposits, and 80% of non-government loans.<sup>30</sup> ŽB, the only state bank to be effectively privatized, accounts for a mere 2% of industry assets.

Insert T2

The wisdom of the government's continued control of the banking industry is open to debate. While we do not offer a final judgment about its policies and its emphasis on bank stability, we believe that if Komerční were offered as a candidate for real privatization in 1992, it would have been attractive to private investors for a combination of bank- and country-specific factors: Komerční's dominant position in commercial loans, its payment system infrastructure, the antecedent actions to reduce and cleanse its portfolio, the favorable macroeconomic environment, and the extent of pro-reform support. A provisional reason for the government's decision against bank privatization, therefore, is that it sought a more deliberate adjustment in credit allocation policies to Komerční's politically-vested clients.

If correct, the government's decision not to restructure Komerční into smaller units may have been a mistake: From a political perspective, as the Czech Republic's most important commercial bank, Komerční became too significant to be privatized. The public policy implication is that a government may be better able to move forward on real bank privatization when the state-banking structure is less concentrated and no individual bank privatization would implicate so many important commercial clients. Komerční's dominance might also be viewed as a complement to on-going government ownership. Given the decisions not to privatize other actual competitors and the limits on bank competition generally, Komerční could support politically important clients with the monopoly rents earned rather than more explicit, and hence more problematic, forms of government subsidy.

#### B. Firm-Level Effects of Komerční's Transactional Structure

We stated at the outset that elements of the Komerční's transactional structure have influenced to a great extent Komerční's operations, business strategy, and performance. At this point we offer support for this contention, summarizing the firm-level consequences of the transactional structure in the context of Komerční's early history.

*Bank Management and Governance:* Komerční has had a stable senior management. In principal, the diffusely held voucher equity and passive investment funds are contributing factors. However, the government's control of Komerční along with the continuity of the Czech political leadership are sufficient to explain this phenomenon. Even if the voucher equity could be concentrated in one or two active investment funds, such institutions could not overcome the effects of majority government ownership.

The combination of Komerční's ownership structure and governance mechanisms means that the Czech NPF represents the government at shareholder meetings and so exerts the most direct control over Komerční's senior management. For example, at such meetings nominations of Komerční's senior executives to the Board of Directors are accepted and voted upon. The NPF is itself is governed by a "presidium" with nine members, eight of which are members of parliament, and the ninth is the Minister of Privatisation.<sup>31</sup> Hence, it would be surprising if political interests were absent from discussions between Komerční's senior management and NPF officials about bank policies and practice.

Significantly, the Czech government has been circumspect in exercising its control rights. Its most clear-cut intervention was countering the management's recommendation to increase dividends at the 1995 Annual General Shareholders Meeting.<sup>32</sup> As to overt interventions *outside* of the formal governance structure, only two are known: The 1993 compromise with respect to pre-tax provisioning and the recent insurance crisis intervention.

Government ownership and control are expected to make the bank's selected management less attentive to profit opportunities and operational improvements than would be the case if the bank were controlled by private investors. However, conditional on Komerční's status as a government bank, the senior managers appear committed to increasing Komerční's franchise value. In general, the senior executives have sought to shed the image of a government bank, signal Komerční's credibility to the West, and establish Komerční as the leading financial institution in Central Europe.<sup>33</sup> Of course none of these objectives is inconsistent with the government's interests, and certainly earning profits would reduce the need for explicit subsidization of Komerční's operations and give the bank the means by which

it could assist some commercial clients. Therefore, the bank's objective function might be characterized as a mix of engendering political support for the government as well as exploiting profit opportunities and developing the bank's franchise value.

*Bank strategy:* Komerční's status as the largest and one of the region's most prominent banks derives directly from its launch as the dominant commercial bank in the Czech Republic. Komerční's original asset endowment has been a determining factor in the bank's quite straightforward business strategy. Czech SOEs and newly privatized enterprises are the bank's most important sources of deposits and loan demand. The net interest income from this core business currently generates about 70% of Komerční's income. The second largest source of income are fees from foreign exchange transactions, most of which involve these same clients. The income data in Table 3 indicate that Komerční earned 86.3% of its net income over the period 1992-1995 from these two sources.

Insert T3

The decision to assign the Czech Republic's payment system to Komerční further secured Komerční's commercial clientele, and positioned Komerční to market a broad array of banking services to its commercial clients.<sup>34</sup> Komerční led all banks in the region in the development of an on-line ATM network, developed an extensive branch network for deposit services, and along with other Czech banks began participating in international credit card systems.<sup>35</sup> Komerční is now viewed as the preferred counter-party for transactions involving foreign firms and major Czech enterprises. Related services of these types account for most of the balance of Komerční's income.

Also consistent with its original asset endowment and, in particular, the government's decision not to fully cleanse its problem assets, Komerční has developed a formidable workout division for delinquent commercial clients. Komerční has not, however, progressed in developing an investment banking capability even though it is further along than other Czech banks.<sup>36</sup> Non-interest income from its Investment Banking Division in 1992-95 averaged Kc 0.4 billion against annual net income totals ranging from Kc 18.6 to 23.3 billion. Partly this reflects the lack of demand among its clientele: The country's major bond offerings in 1994 totaled only Kc 16 billion [Komerční GDR Prospectus, 1996]. Komerční's failure to utilize its universal license is also consistent with the government's approach to Komerční's privatization, which excluded strategic foreign investors who might have added investment banking expertise.

*Financial status:* Two aspects of the transactional structure have contributed to Komerční's status as a financially sound bank. First, the antecedent actions cleansed and reduced its loan portfolio to a significant degree. Second, its market dominance has allowed it to earn, at the expense of its customers and clients, high interest rate margins on an on-going basis. These margins have dropped from exceptionally levels in 1991 to the 5% range in the 1994-95 period; but the average interest rate spreads in the first half of 1996 have increased, indicating a bottoming or reversal of trend. The persistence of Komerční's healthy interest rate margins reflects Komerční's market position, the government's restrictive licensing policy, and the lack of strong private competitors. Komerční identifies its principal competitors as the three other major state banks — CS, ČSOB, and IPB. None of these is a major threat to Komerční's core business of about Kc 200 billion in loans to medium and large commercial

Czech companies. From this, Komerční can expect to earn Kc 10 billion annually (about \$310 million).

With its protected position Komerční has succeeded in strengthening its balance sheet and has met the capital requirements, which were increased from 1.25% in 1992 to 6.25% at the end of 1994, and to the current 8% level that anticipates European Union standards [Komerční Annual Reports]. Of course, the bank's true financial status depends on the extent of non-performing and problem loans. Komerční enjoys a reputation for early recognition and accurate reporting of bad loans.<sup>37</sup> It also has provisioned fairly aggressively against all categories of loans.<sup>38</sup>

Consistent with its status as a government bank and the Czech Republic's low debt, Komerční has secured good sources of credit, e.g., borrowing nearly Kc 2 billion at low rates over LIBOR in 1994. Also consistent with the minority status of private investors, Komerční's stock price performance has been mixed: After trading began in the third quarter of 1993, Komerční's stock was around 1900, and then fell into the 700s in mid 1995, when it started to rally. The December 1996 trading range centered around 2180.

*Internal organization and employment:* The bank has been re-organized into seven major divisions including the Finance Division where its core activities are managed and new functional areas such as the Mortgage Division. Komerční has also invested in new information system capabilities. Employment at the bank has, however, actually increased since partial privatization; end-of-year employment was 16,086 in 1992, 16,644 in 1993, 16,979 in 1994, and 16,638 in 1995.

*Investment Fund:* As a result of the first wave of privatization, Komerční's investment fund became the second largest (non-government) equity-holder in Czech enterprises.<sup>39</sup> In addition, Komerční and other state banks circumvented the prohibition that bank-sponsored investment funds could not buy equity in other banks by creating subsidiaries to take such positions. The pattern of continued government control of major Czech banks and cross-ownership among them thereby accentuated the interdependence among the banks, the newly privatized enterprises, and the government (which continued to hold significant shares of many real sector enterprises).

#### IV. KOMERČNÍ'S LOAN PORTFOLIO MANAGEMENT

As suggested above, the available evidence indicates that the government has not meddled in Komerční's loan operations and instead appears to defer to Komerční's strong and competent management.<sup>40</sup> But it must be recognized that the management is likely to internalize government objectives, eliminating the need for heavy-handed interventions. Especially in a complex environment where scores of credit allocation decisions are made each quarter, an implicit contract between the government and Komerční's senior management would focus on broad objectives.

A transitional economy government might favor softening the bank's approach in dealing with politically important SOEs and new private sector [NPS] enterprises. But, because of its interest in enterprise restructuring, the government might favor hardening budget constraints in some cases and providing additional credit if the enterprise is capable of making needed improvements. The Czechoslovak government is known, for example, to have encouraged

Komerční to lend to new, relatively risky enterprises in 1991.<sup>41</sup> Komerční responded, increasing its loans to private entrepreneurs from 8% of loans in 1991 to 23% of loans in 1992 [Komerční Annual Report, 1992].

In the balance of this section we focus on how Komerční has managed its loan portfolio, where we see indications of government influence.

#### A. Komerční's Loan Portfolio Since Privatization

A striking feature of Komerční's commercial loan portfolio is the lack of growth. Even netting out the effects of the government's cleansing actions, the balance sheet data reported in Table 4 show that loans to customers grew in nominal terms from Kc 163 billion level in 1992 to Kc 200 billion in 1995 — a 6% decline in real terms. The only component of financial asset growth is in government lending. The book value of the bank's government bonds increased from Kc 23.6 billion in 1994 to Kc 45.3 billion in 1995. Most of the increase is accounted for by Komerční's willingness to purchase treasury bills issued by the Czech National Bank to reduce the money supply. [Rf. Komerční GDR Prospectus, 1996; Komerční Annual Reports].

Insert T4

According to data provided by the bank and reported in Table 5, more than 60% of its commercial loan portfolio as of 1994 is a carryover from its original portfolio of medium and large SOEs. The increased lending to NPS enterprises in 1992 yielded bad loss experience and so reinforced Komerční's strategic focus on its original clientele. [Jan wants one more sentence of detail about the NPS experience.] As indicated by Table 6, significant proportions of Komerční's loan portfolio are in the Sub-standard or below categories, which means that payments are overdue by more than 90 days.<sup>42</sup>

Insert T5



## B. Indications of Government Influence

We have received data from the bank that allow us to make inferences about Komerční's loan-granting decisions. Specifically, Table 7 tracks the bank's ten largest clients over the period 1992 to 1995. For the years 1993-95, the table shows the current-year top ten clients, their original position in the 1992 portfolio, how each loan was classified.

Insert T7

The data indicate, first, that while Komerční's top ten client list changed substantially, no client ranked twentieth or below in the 1992 portfolio has assumed a top-ten position subsequently. Several of the new entries to the top ten list are consistent with good lending practices. Specifically, five of the new entries in the top ten lists for 1994 and 1995 had loans classified as Standard. In a similar vein, four of the original clients who remain among the top ten clients in 1994 are classified as Standard, and three who appear in 1995 are classified as Standard. In other words, several of the firms continuing as top creditors have been timely in their payments. We suspect that SPT Telecom was the bank's largest debtor in 1992 and is one of those who continued as a sound credit risk.

The data in Table 7 also indicate, however, inconsistencies with sound credit allocation decisions. There are two types of evidence. First, several original clients remain on the top ten list despite poorly classified loans. For example, the third largest client in 1992, whom we suspect is Tatra, a.s. Koprivnice, the truck manufacturer, remains a top-ten creditor even though it was classified as Sub-standard in 1993 and 1994, and as Loss in 1995. Any decision to continue to extend credit to this client does not appear to be based on the merits.<sup>43</sup> Second, of the new entries on the 1994 and 1995 lists, four have Sub-standard or lower rated loans. The top client in 1995, which was ranked fourteen originally, moved up despite being rated as

Watch in 1994. Thus, the evidence is consistent with the notion that the bank does not consistently pursue sound credit practices and is influenced by political considerations. Also of note, despite the deterioration of loan quality among the top ten, they account for a slightly higher percentage of the total loan portfolio in 1995 than originally.

### C. Approaches to Troubled Loans

The appearance of new, poorly classified loans on the top ten list suggests that Komerční is rolling over troubled loans. This view is supported by the data in Table 8 summarizing the means used by Komerční to resolve its troubled assets. The reliance on debt restructuring and workouts as compared to the frequency of foreclosures, bankruptcies, and asset sales indicates that Komerční's approach to troubled clients is not to force radical change and resource redeployment. Certain features of the operating environment for banks in the Czech Republic probably discourage banks from dealing aggressively with problem clients. Lenders in the Czech Republic have not had a credible bankruptcy threat until recently.<sup>44</sup> The table also indicates that the bank now has collateral against much of its loan portfolio, but Komerční and other Czech banks do not typically take collateral when enterprises are in default.<sup>45</sup>

Insert T8

Komerční's workout unit (the Financial Restructuring Department within the Loan Administration Division) manages about 100 client cases and is actively involved in developing business and financial plans for about half the companies. Primarily because of the client's management, the bank has made a judgment that such efforts in the other cases will not be fruitful.<sup>46</sup> For both groups Komerční is fairly aggressive in provisioning against suspect loans and writing off bad loans. Table 9 indicates, for example, that Komerční has increased the

ratio of reserves to gross non-performing loans and decreased the ratio of non-performing loans to the total portfolio.

Insert T9

### C. Assessment of Komerční's Loan Portfolio Management

The main points that we draw from Komerční's loan portfolio management are that the bank takes into account the government's interests in softening the effects of the transition on the former SOEs, that the bank has not become an important channel of new credit, and that Komerční's real sector clients are probably overly dependent on bank credit.

*Politicized decision-making:* The government's objective was not to fully cleanse Komerční's assets and launch a bank that would take a clean-slate approach to lending, but rather to increase Komerční's financial health such that, given its protected position in the market, it could (a) continue to serve its traditional clientele, (b) develop a workout capability to deal with remaining problems, and (c) deal carefully with politically-vested clients. The nature of this implicit contract means that the broad set of consumers of Komerční's clients and the stronger commercial clients would, in effect, be taxed in order to subsidize certain key constituencies and thereby neutralize opposition to the only transitional economy government to remain in power since 1989.

The contract thus produces the type of political equilibrium analyzed by Peltzman (1976) involving a government, a regulated firm (in this case owned and controlled), and multiple political constituencies. The underlying logic is that gains are shared, the costs associated with the economic transition are spread, and concentrated political opposition is minimized.

The implicit contract appears to have the following features: (i) the government agrees not to interfere directly in the bank's management, (ii) the government encourages the

development of managerial expertise and efforts to increase the bank's market value, (iii) the bank accepts a hard budget constraint, and (iv) the bank pursues an objective function that is consistent with the government's interests subject to the budget constraint. The NPF, which holds the state's equity interest in Komerční, SOEs, and partially privatized enterprises and also controls Komerční's management, is central to the contract.

No evidence of overt influence need be found since enforcement depends on commitment and reputation [Hart and Holmstrom (1987)]. But the circumstantial evidence we have reviewed indicates that the contract was operative for at least some of Komerční's history. The bank's high interest margins allow it to deal cautiously with its clients and, in some cases, deviate from profit maximization. Indeed, if the government were satisfied with a profit-maximizing approach to lending, then it would not have resisted full privatization nor continued its control of Komerční seven years into the transition.

Of course implicit contracts are not necessarily stable. One obvious insight from this analysis is that cream-skimming of good credit risks by competitors such as Western banks diminishes Komerční's ability to use the monopoly rents earned for extension of commercial credit to less-than-worthy clients. Another insight is that if the Czech government interferes with Komerční's decisions in an overt and significant way, the bank's management might either require additional subsidies, reduce their efforts to increase the bank's market value, or be less attentive to the government's political interests.<sup>47</sup>

A combination of three events in 1996 may have signaled a fundamental change along these lines in the implicit contract between Komerční and the government. The three events are (i) the government-orchestrated bailout of Kreditni Banka, (ii) the financial collapse of

Ceska Pojistovna, the state's monopoly insurance company and majority owner of Kreditni, and (iii) the government's decision to take administrative control of Agrobanka, the fifth largest Czech bank. Negotiations between the government and the major state banks about bailing out Kreditni Banka, with losses between Kc 6 billion and Kc 12 billion, were first revealed in June 1996.<sup>48</sup> Within two months of Kreditni's failure the government also faced huge losses from the failure of Ceska Pojistovna, whose majority-owner is the NPF and whose principal minority owners are the four major state banks.

Despite their public opposition, the government forced Komerční and the others to formally contract to shore up the insurance company and also discouraged them from selling their equity in the company. The third event in the sequence is the most intriguing. In September 1996 the government took administrative control of Agrobanka, which holds a large percentage of Ceska Pojistovna's deposits and is linked to Motovest, a maverick group of investors known for their aggressive approach to corporate governance. Motovest had accumulated 13% of Agrobanka's equity and then succeeded in forcing IPB to give up its 17.5% stake in the country's largest private bank.

While it is difficult to ascertain the truth, one interpretation is that the major state banks triggered Agrobanka's liquidity crisis because Motovest had gained corporate control.<sup>49</sup> So rather than let a form of corporate control emerge in a banking sector characterized by extensive cross-ownership, the major banks refused to let Agrobanka borrow on the interbank market, with government acquiescence, as a means removing Motovest from Agrobanka's ownership structure.<sup>50</sup>

The timing of the government intervention is consistent with the fact that the May 1996 elections shortened, from the government's point of view, the political time horizon and thereby weakened the implicit contract. [See Rosen (1985) for analysis of how expected future rents govern behavior]. If our speculation is right, the nearly immediate pay-back to the banks, i.e., the government administration of Agrobanka, is also consistent with a shortened time horizon from Komerční's point of view. These events underscore the point that if ideology favoring market outcomes is the only barrier to the exercise of political rather than business judgment, political considerations eventually will dominate ideology. Thus, the extent to which the government has avoided interference in Komerční's operations in the past should be viewed more as the outcome of a cobbled solution rather than a sustainable framework.

*Limited loan portfolio growth and development:* The limited lending to the NPS and the lack of growth in Komerční's commercial loan portfolio raise the criticism that Komerční is not channeling capital to the companies that will lead the country's economic transition. That judgment, however, depends on a comparative analysis of the alternative means by which NPS firms can raise capital and the reasons for the lack of growth in Komerční's total commercial portfolio. The following considerations are potentially relevant. First, the Czech Republic began the transition period with a high ratio of commercial debt to GDP. As a result, Komerční would not be expected to increase commercial debt. Second, to meet the increased capital requirements Komerční, like other banks facing higher capital requirements, both increased its capital and held its total assets in check. Third, with respect to the NPS, lending to new enterprises involves fundamental information asymmetries and so is not necessarily

value-maximizing for the bank.<sup>51</sup> Fourth, because of its status as a government bank obligated to tend to former and current SOEs, Komerční's objectives do not include such lending.

We are not in a position to completely rule in or rule out these potential factors. In general, credit can be extended whenever there is a sufficient and observable infusion of outside equity (as distinct from internal financing). Therefore, Komerční could find opportunities for NPS lending if it were committed to doing so. Because there are no indications that Komerční is a less effective competitor than other Czech banks in this regard, we suspect that the performance to date reflects the priorities of the government and so reveals the importance attached to Komerční's financial health and the relative unimportance attached to supplying large amounts of additional commercial credit to the Czech economy. Komerční is not, therefore, performing one of the roles that some expect in a transitional economy setting, and the capital needs of companies must be met through alternative means such as retained earnings, inter-enterprise lending, and equity investments.

*Reliance on short term financing:* The case can be made that major Czech banks have used investment funds to obtain credit business. Our analysis indicated that Komerční emphasizes loan restructuring in dealing with troubled loans and in several cases has extended greater amounts of credit to clients who are known bad risks (cf. Tables 7 and 8). The implication, which is consistent with the data showing a high ratio of commercial credit to GDP and a low level of equity financing in Czech enterprises, is that there is an over-reliance on short term credit.<sup>52</sup> The origins of this problem lie in the combination of voucher privatization and the establishment of investment funds controlled by major state banks.

## V. CONCLUDING REMARKS

Two of the disturbing findings from our study are (a) that Komerční and the other large banks that emerged from the state banking system remain under government control, and (b) that these banks continue to dominate the Czech banking industry. What makes these facts particularly troubling is that, as posited, the conditions for a successful privatization of Komerční were better than elsewhere in the region. Thus, this study of Komerční underscores the difficulty of bank privatization efforts and the strength of the political constraints on the process. In light of these political constraints, it is important in our view to look at Komerční's status as partially privatized both in the context of transitional economy and as an example of broader political/economic phenomenon. Our long run concern is that government ownership will impair the development of Komerční's franchise value from good banking and cause classic moral hazard problems.

One policy question specific to economic transitions raised by our study concerns licensing of *de novo* and foreign banks. Such licensing can be viewed as a complement to bank privatizations, especially if the industry structure resulting from privatizing the state banks is not competitive. But in light of actual experience, i.e., the lack of actual privatizations, licensing with the development of appropriate supervisory capabilities should be viewed as a substitute means of developing an efficient banking sector.

We have argued that the lack of much overt government interference in Komerční's business decision-making during in the period 1992-95 is deceptive and may instead reflect the existence of an implicit contract with respect to fundamental government objectives. Even though our evidence on portfolio management requires *ex post* judgments, we do not believe that Komerční's credit allocation decisions are premised on profit maximization. The



consequences for the real sector are the needed enterprise restructuring is delayed, there is a lack of equity financing, and an over-reliance on short-term credit.

This prospect of introducing European Union rules suggests that some of the shortfalls of the Czech approach, i.e, the lack of meaningful privatization of major banks and the weakness of product market competition, will be remedied. Already banks are preparing for the prospect of competition from Western banks that have achieved greater efficiencies. Nevertheless, we are convinced that the Czech government should resume its privatization efforts. Doing so will improve corporate governance and reduce the likelihood of future government interventions. In turn, this will encourage the development of banks with sustainable franchise value, which is the basis for a sound banking system.

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**TABLE 1**  
**KB OWNERSHIP STRUCTURE**  
**APRIL 1996**

Owner	Ownership Share (%)
Government	53.1
<i>National Property Funds (CR and SR)</i>	48.7
<i>Restitution Investment Fund</i>	4.4
The Bank of New York, ADR Dept. (GDR holdings)	5.8
All In Real Estate Leasing (an indirect, wholly-owned subsidiary of KB)	3.4
Investicni privatizacni fond Komerčni banky (KB's investment fund)	3.4
VUB Kupon (Investment fund of the Slovak Republic's largest commercial bank)	2.7
Ceska sporitelna (Czech Savings Bank)	2.6
State Street Bank and Trust Co.	1.5
Investicni a postovni banka (IPB, a government-owned commercial bank)	1.3
Others	26.2

Source: KB Prospectus, May 7, 1996.

**TABLE 2**  
**THE ROLE OF STATE SECTOR BANKS IN CZECH BANKING**  
**DECEMBER 1995**  
**(Kc Millions)**

	Assets (Kc B)	%	Deposits (Kc B)	%	Non-Gov't Loans (Kc B)	%
<b>State Banks</b>						
KB	384	22.8	190	24	212	28
CS (Czech State Savings Bank)	349	23	289	36	119	16
IPB (Czech Commercial Bank)	209	10	96	12	104	14
CSOB (Foreign Trade Bank)	190	10	64	8	82	11
Consolidation Bank	112	7	12	1	78	10
ZB (Privatized Bank)	32	2	16	2	4	1
Subtotal	1,276	76.0	667	83	599	80
<b>Other Banks</b>						
Subtotal (N=50)*	404	26	132	17	146	20
<b>TOTAL</b>	<b>1,680</b>	<b>100%</b>	<b>799</b>	<b>100%</b>	<b>745</b>	<b>100%</b>

Sources: GDR p. 64; Association of Banks 1995 Annual Report; "Czech Republic Banking System Report," Bankwatch.

\*\* CNB Annual Report, 1994, p 59. Two other banks with licenses were not operating – Bohemi Bank and Kreditni and Prumyslov Bank.

**TABLE 3**  
**KOMERCNI BANKA INCOME: 1992-1995**  
**(Kc Millions)**

	1992	1993	1994	1995
Net Interest Income	14,814	17,140	13,857	13,065
Income from foreign exchange transaction	2,687	2,778	1,538	1,899
<i>Sub-total</i>	17,501	19,918	15,395	14,964
Other non-interest income	2,709	3416	3237	3609
<b>Total Net Income</b>	20,210	23,334	18,632	18,573

**TABLE 4**  
**KOMERCNI BANKA BALANCE SHEET: 1992-1995**  
**(Kc Millions)**

	1992	1993	1994	1995
<b>Assets</b>				
Loans to customers	163,485	178,103	202,793	198,393
Treasury Bills	4,740	13,067	12,128	10,894
Loans to credit institutions	34,293	32,197	32,625	31,119
<i>Subtotal of interest bearing assets</i>	<i>202,518</i>	<i>223,367</i>	<i>247,546</i>	<i>240,406</i>
Cash, balances with central banks and post offices	31,135	24,617	25,494	22,641
Due from banks	4,862	1,332	342	1,018
Fixed & Other Assets	39,012	25,865	36,333	44,780
<b>Total</b>	<b>277,527</b>	<b>275,181</b>	<b>309,715</b>	<b>308,845</b>
<b>Liabilities</b>				
Owed to credit institutions	78,803	64,626	51,875	55,667
Owed to customers	157,184	181,438	206,795	195,319
Certificated debts	5,761	5,146	19,102	21,473
Other liabilities	24,995	2,709	2,755	5,166
Provisions, accruals, deferred income	632	4,628	1,535	2,097
<b>Total Liabilities</b>	<b>267,335</b>	<b>258,547</b>	<b>282,062</b>	<b>279,722</b>
<b>Shareholder Equity</b>				
Share Capital	5,002	7,502	9,502	9,502
Reserves	5,190	9,132	18,151	19,621
<b>Total Equity</b>	<b>10,192</b>	<b>16,634</b>	<b>27,653</b>	<b>29,123</b>
<b>Total Liabilities and Equity</b>	<b>277,527</b>	<b>275,181</b>	<b>309,715</b>	<b>308,845</b>

Sources: GDR Offering, Selected Balance Sheet Data; KB Prospectus, May 7, 1996.



**TABLE 5**  
**COMPOSITION OF KB'S LOAN PORTFOLIO**

Type of borrower	1991		1995	
	Percent of loan portfolio in currency	Number of loans	Percent of loan portfolio in currency	Number of loans
Former SOEs that are now private	5.2%	1100	34.9%	16333
SOEs	80.4%	17043	26.8%	12540
Majority domestic-owned private companies (not former SOEs)	3.4%	717	31.3%	15021
Majority foreign-owned private companies	—	—	1.6%	729
Government bodies	0.4%	170	0.6%	280
Banks	—	—	1.0%	2
Other	10.6%	2249	3.8%	1796

**TABLE 6**  
**CREDIT QUALITY CLASSIFICATIONS: 1992-1994**  
(Kc Millions)

Rating	1992		1993		1994	
	Gross Amount	Reserve	Gross Amount	Reserve	Gross Amount	Reserve
Standard*	39,910	512	43,844	532	130,844	0
Watch*	66,923	1,560	80,063	1,530	28,515	490
Total Standard and Watch	106,833	2,072	123,907	2,062	159,359	490
Sub-standard*	25,582	2,506	31,636	2,285	14,869	924
Doubtful	23,694	2,377	15,636	2,712	13,138	2,591
Loss	29,376	9,545	31,616	12,386	43,523	19,213

**TABLE 6**  
**(CONTINUED)**

Rating	1992		1993		1994	
	Gross Amount	Reserve	Gross Amount	Reserve	Gross Amount	Reserve
Total Customer Loans	185,485	19,500	202,795	19,445	230,889	23,218
General Reserves	—	2,500	—	3,757	—	3,757
Credit Institutions	—	—	—	308	—	308
Balance Sheet	185,485	22,000	202,795	23,510	230,889	27,283
Total	5		5		9	
Guarantees	17,703	—	18,781	1490	14,970	1121
Total Risk	203,188	22,000	221,576	25,000	245,859	28,404

\* Significant change in the bank's loan classifications based on borrowers' debt servicing histories occurred in early 1994, resulting in material reclassification of Sub-standard to Watch loans and Watch loans to Standard loans.

**TABLE 7**  
**CREDIT EXPOSURE TO TOP TEN BIGGEST CLIENTS 1992-95**  
**(Original Size Rank in 1992 Portfolio Indicated)**

1992		1993		1994		1995	
Rank	Book Value Kc (millions)	1992 Rank	Book Value Kc (millions)	1992 Rank	Book Value Kc (millions)	1992 Rank	Book Value Kc (millions)
1	5,167	1	4,757	1	4,343	14	4,765
2	3,883	8	2,638	11	3,204	16	4,145
3	2,948	3	2,587	13	3,145	2	4,064
4	2,613	11	2,493	3	2,921	1	3,431
5	2,594	12	2,450	12	2,724	10	3,410
6	2,332	2	2,435	5	2,721	17	3,132
7	2,268	4	2,427	14	2,716	3	2,857
8	2,202	10	2,160	15	2,395	18	2,800
9	2,287	6	2,119	4	2,378	4	2,113
10	2,025	5	2,100	10	2,359	19	1,982
<b>Total</b>	<b>28,319</b>		<b>25,979</b>		<b>28,906</b>		<b>32,180</b>

Source: KB.

Note:

1. Loan classifications are defined as follows: *Standard* - less than one month overdue; *Watch* - one to three months overdue; *Substandard* - three to six months overdue; *Doubtful* - six to twelve months overdue or rescheduled within the last six months; and *Loss* - twelve or more months overdue or a bankrupt debtor.

**TABLE 8**  
**MEANS USED BY KB TO RESOLVE TROUBLED ASSETS**

Method of resolving troubled loans:	1995
Restructuring - bank agrees to change terms of the debt instrument or trades debt for equity or rewrites the loan in a substantive way.	Frequently (33-67% of cases)
Discounted Payoffs - Bank accepts lower payments than those required by loan contract.	Seldom (0-5% of cases)
Company Workout - banks works with borrower to improve its operations and generate cash flow.	Frequently (33-67% of cases)
Foreclosure - bank gains ownership of specific assets through judicial process.	Occasionally (5-33% of cases)
Bankruptcy - borrower is placed in the hands of a liquidator and assets are sold to meet obligations of bank and other creditors.	Occasionally (5-33% of cases)
Selling off Assets - borrower sells assets to meet its bank obligations.	Occasionally (5-33% of cases)
Write-off/Forgiveness - bank removes loans from its books and charges loss to income.	Seldom (0-5% of cases)
Collateralization - bank accepts assets to secure the loan.	Frequently (33-67% of cases)

Source: KB.

**TABLE 9**  
**LOAN RESERVES VERSUS NON-PERFORMING LOANS: 1992-1994**

	199 2	199 3	199 4
Reserve for customer loan losses / total gross customer loans	10. 5	9.6	10. 1
Reserve for customer loan losses / gross non-performing customer loans	24. 8	24. 75	32. 5
Gross non-performing customer loans / total gross customer loans	42. 4	38. 9	31. 0
Total provision for customer loan losses / gross non-performing customer loans	28. 0	29. 4	37. 7

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<sup>1</sup> "Top 100 Central Europeans" Banker, September 1996.

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<sup>2</sup> In the face of large officially measured declines in GDP (output dropped by 21% in the 1990-92 period), unemployment remained modest: about 4% during that period and recently in the 2-3% range. For a discussion of the factors supporting the Czech reform process and its stability, see Svejnar, "Introduction and Overview, in *The Czech Republic and Economic Transition in Eastern Europe*, ed. Jan Svejnar (San Diego: Academic Press, 1995), pp. 119-120.

<sup>3</sup> See Rf. For evidence on this point, see Anderson et al. (1996), Meyendorff and Snyder (1996).

<sup>4</sup> The linkages are as follows: The government controls the major banks; the banks dominate the investment funds; these funds hold the voucher equity in major Czech enterprises; and the funds and banks in turn are the major stakeholders in Czech enterprises.

<sup>5</sup> The classic moral hazard problems in banking concern incentives to take on too much risk or simply manage the bank's assets carelessly, with the result that depositors are at risk. These incentives arise because of either deposit insurance or an implied guarantee that the state will bail out failed banks. These incentives are especially strong when the bank has little of its own capital at risk.

<sup>6</sup> For a discussion of bank franchise value, see Kormendi, Bernard, Pirrong, and Snyder, *Crisis Resolution in the Thrift Industry*, (Boston, MA: Kluwer Academic Press, 1989), pp.28-29.

<sup>7</sup> While the federal Ministry of Finance was retained, each republic established its own Ministry of Finance.

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<sup>8</sup> State Bank of Czechoslovakia Law No. 130/1989, passed November 15, 1989.

<sup>9</sup> This is consistent with Czechoslovakian communism, which was characterized by “the extreme degree of central control and virtually complete government ownership of the economy.” Svejnar, “Introduction and Overview, in The Czech Republic and Economic Transition in Eastern Europe, ed. Jan Svejnar (San Diego: Academic Press, 1995), p. 4.

<sup>10</sup> “Emerging-Market Indicators” sections, Economist, various issues.

<sup>11</sup> The Czech Republic is currently running, however, a trade deficit that is expected to be nearly 6% of GDP [rf. Economist Intelligence Unit].

<sup>12</sup> Labor productivity improvements in the Czech Republic lagged Hungary and Poland in the period 1991-94 [rf. ING Barrings Report].

<sup>13</sup> The Czech Republic’s current levels of loans to bank customers is about 75% of GDP compared to 27% in Hungary and 20% in Poland. Rf. Banker, various issues.

<sup>14</sup> Legislation effective July 29, 1994 ended this preferential arrangement and required that all banks offer insurance on 80% of deposits up to Kc 100,000 (almost \$4,000). Rf. Act No. 156/1994.

<sup>15</sup> For a discussion of the credit guarantor role under socialism see Calvo (1990).

<sup>16</sup> The amount of enterprise-specific debt of this type might have been positively related to enterprise profitability. The Consolidation Bank (presumably by virtue of Minister of Finance authority) restructured these loans into regular assets with seven-year maturities and market interest rates. The subsequent performance of the restructured loans has been favorable.

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<sup>17</sup> In return for the write off, Komerční received NPF debentures with principal of the same amount. *Rf. Komerční's Global Depository Receipt Offering (GDR)*, p. 33.

<sup>18</sup> For arguments encouraging greater tolerance of bank failures, see Gorton and Winton (1996). For a discussion of Poland's efforts to orchestrate re-structuring of the market, see Bonin and Leven (1996).

<sup>19</sup> Interviews of Mr. Pavel Kysilka, Board of Governors, July 17, 1995, and Mr. Ladislav Petrasek, Komerční, July 16, 1995.

<sup>20</sup> Komerční Annual Report, 1992

<sup>21</sup> Foreign investors could own a maximum of 25% of banks and need government approval before investing. *GDR*, pp. 17-18.

<sup>22</sup> While investors knew that Komerční was in a dominant position in commercial banking, a reasonably complete valuation of Komerční would depend on (a) expected government actions to fill the "financial hole," about which no information was given, (b) interest rate regulation that could increase or decrease Komerční's franchise value, (c) implementation of licensing rules, (d) government assistance to troubled companies in Komerční's loan portfolio, (e) tax policy toward loan loss provisions, (f) government interference in Komerční's loan policies, (g) government influence on dividend policy, (h) the value of shareholder rights in a government controlled bank, and (i) the possibility that the government would sell additional shares, and (j) expectations about to whom the government might sell its shares. Not surprisingly, "cheap talk" and uncertainty dominated the investment environment.



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<sup>23</sup> Komerční Annual Report, 1992

<sup>24</sup> Interview of Dr. Richard Salzmänn, July 18, 1995.

<sup>25</sup> Given how the banking system evolved – with banks specialized by function and geography, the split did not have major effects. The Czech Republic established its own central bank. The country-wide development bank (IB) split its operations. The foreign trade bank (ČSOB) remained as a Czech-registered bank, yet was jointly owned by the two republics and continued with operations in each republic.

<sup>26</sup> Interview of Dr. Richard Salzmänn, May 30, 1996.

<sup>27</sup> See Dittus (1994) for an analysis of how bank reforms have affected their behavior.

<sup>28</sup> Here we distinguish, on a conceptual basis, a bank's franchise value from its ability to exercise market power. In practice, it is difficult to decompose measures of firm value into rents attributable to monopoly power and rents from firm-specific efficiencies. See Smirlock, Gilligan, and Marshall (1984) for an empirical inquiry into the firm values using Tobin's Q.

<sup>29</sup> The only major changes in ownership since privatization are (a) the decrease in reported ownership by Harvard Consulting & Capital, which started with a 16.1% share after the partial privatization, and (b) the 1995 sale of 3.2% of non-voting equity, "Global Depository Receipts," to U.S. and Western European investors.

<sup>30</sup> These figures are conservative in that the balance of the banking industry is not free of government control. Many of the newly established domestic banks are in fact controlled by the state sector banks. In particular, the large state sector banks control twelve of the

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domestic “de novo” banks, which account for an additional 197 Kc Billion in assets equaling about 13% of the industry assets [Czech Republic Association of Banks, Annual Almanacs, 1993-1994]. Thus, a more accurate statement is that the government controls 83% of the Czech banking assets.

<sup>31</sup> Komerční GDR Offering, June 29, 1995, pp. 19.

<sup>32</sup> The government voted against a management recommendation to increase the dividend at the 1995 Annual General Meeting.

<sup>33</sup> Two examples include the selection of external auditors in 1991 and the marketing of non-voting equity (Global Depository Receipts) in 1995 to Western European and U.S. investors.

<sup>34</sup> Interview of Dr. Richard Salzmann, Komerční’s CEO, July 13, 1995.

<sup>35</sup> Komerční and other Czech banks achieved greater operating efficiency than other banking systems in Eastern and Central Europe. As of January 1996, Komerční had 79 branches, 246 sub-branches, and five offices outside the Czech Republic. The Czechs developed a modern payment system focused on Komerční’s infrastructure, allowing completion of inter-bank transactions within one to three days. A computerized clearing system, probably the best in the region, began in March 1992. For details, see “Czech Republic: Banking Infrastructure Report” and “Komerční Banka”, various issues, Bankwatch Report, BREE Consulting Services Ltd; and Komerční’s GDR Offering, p. 17.

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<sup>36</sup> Interview with Dr. Ivan Angelis and Dr. Jiří Černý, senior officers of the Czech Republic's Bank Association, July 18, 1995. Of note, Komerční's annual reports list investment banking as seventh on a seven item list of its lines of business.

<sup>37</sup> BREE BankWatch, Komerční Report, September 1995, p.8.

<sup>38</sup> Legislation in December 1991 established the independence of the Central Bank and gave it the authority for bank supervision and licensing. The laws on banks also established the general framework for regulation including capital adequacy rules, liquidity rules (i.e., reserve requirements), provision for credit risk, classifications of loans, provisioning).

<sup>39</sup> The value of the fund's broadly diversified portfolio of Czech enterprises has fluctuated around Kc 12 billion (\$433 million). Rf. Patria Equity Research, various issues.

<sup>40</sup> If state ownership is to continue, a strong management can counter a new government's interest in more overt political interference in the bank. As a result, in some circumstances Dr. Salzmann's role as a strong CEO can be beneficial. But to the extent that the management has become politically powerful, it may block the transfer of corporate control to private investors and be uninterested in acquiring new managerial expertise. In sum, while strong management is a negative factor with respect to ownership dynamics, it may be a positive factor conditional on continued state control.

<sup>41</sup> Interview with Dr. Ivan Angelis and Dr. Jiří Černý, July 18, 1995.

<sup>42</sup> Asset quality is indicated as follows: *Standard* - less than one month overdue; *Watch* - one to three months overdue; *Substandard* - three to six months overdue; *Doubtful* - six

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to twelve months overdue or rescheduled within the last six months; and *Loss* - twelve or more months overdue or a bankrupt debtor.

<sup>43</sup> The Davidson Institute is knowledgeable about Tatra's business prospects, having included Tatra as a partner in the management education programs.

<sup>44</sup> Komerční as of September 1995 had filed 150 petitions. Rf. BREE Bankwatch Report, Komerční, September 1995, p.8. But the Czech courts typically do not offer attractive terms to creditors. A typical settlement is for less than 50% settlement over two years.

<sup>45</sup> The collateralization may reflect the incentive effects of the Czech regulations. The requirement that banks hold reserves (equal to 5, 20, 50, and 100% of loans classified, respectively, as Watch, Substandard, Doubtful, and Loss respectively) is net of collateral. Thus, for example, of Komerční's total 1994 customer loan portfolio, Kc 71.5 billion (31.0%) were in the categories of Substandard, Doubtful, and Loss. Because Komerční had collateral of Kc 42.5 billion, its obligation to provision was reduced by that amount. [Komerční GDR].

<sup>46</sup> Rf. Komerční's 1994 Bulletin; Interviews with the unit's manager, Mr. Josef Snopek, July 16, 1995 and October 14, 1996.

<sup>47</sup> A related prediction is that an appropriate cross-sectional analysis of the relationship among ownership, control, and bank performance would indicate that government control of banks reduces their profitability (as compared to private banks), but does not eliminate profitability.

<sup>48</sup> Source: Lidove Noviny, August 15, 1996.

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<sup>49</sup> The most explicit statement of this view is in Central European Business Weekly, September 20, 1996.

<sup>50</sup> For details see the Economist, September 21, 1996.

<sup>51</sup> Expectations about lending to NPS companies should be low for three reasons: First, value-maximizing banks in transitional will face information difficulties in assessing NPS lending risks given (a) NPS enterprises have short histories, (b) the lack of reliable accounting data, (c) the fast pace of market-oriented change, and (d) the limited expertise of newly privatized banks in assessing credit risks. See Haggard and Lee (1995). Second, many of the most successful NPS companies will not want to accept loans from licensed banks because that action will force them into the formal sector and expose them to high tax liabilities. Third, privatized banks carry a large volume of loans that were extended to SOEs. It is natural for the banks to continue to allocate a large share of their available capital to these companies both because of the client relationships and the incentive to continue to extend credit, even if doing so is risky, in the hopes of improving the chances that the firm will be able to repay its other debts. For a discussion of barriers to NPS lending, see Perotti (1993).

<sup>52</sup> The Financial Times "Survey: The Czech Republic", December 1996, summarizes the available evidence.