

## COMMERCIAL BANKS IN RECOVERING AND SELLING ECONOMICALLY INSOLVENT ENTERPRISES: EVIDENCE FROM THE ECONOMY OF UZBEKISTAN

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### **Abstract**

One of the measures of financial and economic anti-crisis program of Uzbekistan was to transfer economically insolvent enterprises to the balance of commercial banks with the aim of recovering their activity due to the banks' funds and profitable selling to strategic investors in future. This article is devoted to the analysis of this untraditional practice for Uzbek economy. It studies external benefits from the recovery of economically insolvent enterprises on the economy and principles of implementing this mechanism. Moreover, we tried to reveal obstacles existing in selling these enterprises for strategic investors and represented practical recommendations to eliminate these barriers. We used descriptive statistics techniques.

**Key words:** economically insolvent enterprise (EIE), strategic investor, commercial banks, Uzbekistan, balance-sheet of commercial bank, modernization.

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## 1. Introduction

One of the main areas envisaged in anti-crisis program of Uzbekistan was to establish the expansion of the resource base in real sector of economy and to undertake measures to ensure the growth of investment activity. Because, it is assumed that key factors of high economic growth rates in Uzbekistan (at least 8% growth of GDP per year for the last 11 years) lies in active investment policy, based on modernization, technical and technological re-equipment of factories, creation of modern and high-tech new production.

Commercial banks actively involved in injecting their own funds in the financing restructuring of enterprises of the real sector of the economy, into the modernization of production and to the creation of new jobs. There was developed an unique mechanism in Uzbekistan as transferring economically insolvent enterprises (EIEs) to the balance of commercial banks and applying approaches of their recovering for the funds of banks to sell them in future to strategic investors. This practice has justified itself and today showing its effectiveness.

In this research we tried to analyze current tasks of commercial banks in dealing with unordinary investment activity and further development of it. Also, we developed some academic proposals and evidence-based recommendations related to more efficient organization of sales to strategic investors of the firms, created from assets of economically insolvent enterprises, which were transferred to the balance sheet of commercial banks. So, research project of this paper is the activity of commercial banks in managing the assets of EIEs and process of selling them to strategic investors.

Because mechanism of realization of subsidiaries created on the basis of assets of EIEs by commercial banks of Uzbekistan has unspecific features, in many foreign and local economist researcher's theoretical works current topic was studied as sale of nonperforming loans. Among foreign researchers we can find Thonabauer and Nosslinger (2004), Martini et. al. (2009), Barton and Wilson (2010), Flechtner (2012), Jahn, Memmel and Pflingsten (2013) who mainly studied the role PLS's in banks, the ways to clear them and to control those loans in European Union countries and USA. Whereas among Uzbek economists Vahabov, Jumaev and Khoshimov (2009), Azimov (2013), Sattarov(2013), Akramov (2013) devoted their attention to issues such as enhancing the role of real sector of economy in the period of financial and economic crisis,

promoting banking system, modernization of the production, technological renovation of enterprises and measures taken to recover the activity of EIEs. Even though above mentioned scientists covered only one side of the process of the realization of subsidiaries created on the basis of assets of EIEs. Hence, there is urgent need in carrying out deep studies in selling already restored production by commercial banks and provide relevant recommendations.

In research we used widely available research methods. We transferred the available data into a cross-sectional dataset. Descriptive statistics have been generated for all relevant variables under consideration.

## **2. Economics of recovering EIEs by commercial banks**

In the period of financial and economic crisis, the support of real sector plays a crucial role. The real sector of economy is the part of the economy that is concerned with actually producing goods and services (Financial Times 2015). Key issues in boosting the real sector of the economy are the modernization of production, establish strong cooperation and promote internal demand to the goods produced within the republic. Moreover, one of other ways of assisting the enterprises of real sector is restructuring the debts which originated because of different reasons and negatively affect the financial and business activity of the company. Taking into account every firm's uniqueness, its role in the sector, production and financial relations with other enterprises, these debt redemption periods can be prolonged, different kinds of sanctions can be cancelled and measures as even totally these debts can be excluded from the list. In 2014 Uzbek Government in order to promote the real sector, reconsidered due payments of current liabilities and payments to budgetary and extra-budgetary funds for 50 enterprises. As a result, it created the opportunity to leave 350 billion UZS at the disposal of the enterprises and to develop their manufacturing activity (Khodiev et. al. 2009).

But another practice, the unique system created in Uzbekistan to my best knowledge and observations has no analogues in other foreign bank practices. The mechanism combining set of incentives and intended to transfer EIE to the balance of the commercial banks, recovering them for the funds of these banks and further selling to potential investors has economic benefits for the society. In order to fulfill the tasks outlined in President Degree #4053 dated from the 18<sup>th</sup>

November, 2008 and Resolution #4010 dated from the 19<sup>th</sup> November, 2008 local commercial banks as on the 1<sup>st</sup> January, received to their balance sheets 173 EIEs (see table 1).

**Table 1**

**Quantity of EIEs transferred to the balance sheet of commercial banks**

#	Name of the bank	Quantity of EIEs transferred	Quantity of EIEs sold	Investments of banks (in million UZS)	by % sold
1	National Bank (NBU)	68	40	253 767	58.8%
2	Asaka bank	47	46	59 759	97.9%
3	UzPSB Bank	15	13	56 376	86.7%
4	Agro bank	14	14	36 221	100%
5	Ipoteka bank	12	10	26 862	83.3%
6	Turon bank	5	5	45 653	100%
7	Kapital bank	2	1	85 653	50%
8	Aloqa bank	3	3	27 844	100%
9	Xalq bank	3	3	383	100%
10	Infinbank	1	1	18 486	100%
11	Mikrokredit bank	1	1	48	100%
12	Qishloqqurilish bank	1	1	2 176	100%
13	Hamkor bank	1	1	71	100%
	<b>TOTAL</b>	<b>173</b>	<b>139</b>	<b>613 298</b>	<b>80.3%</b>

Source: Statistics of Central bank of Uzbekistan (CBU 2015).

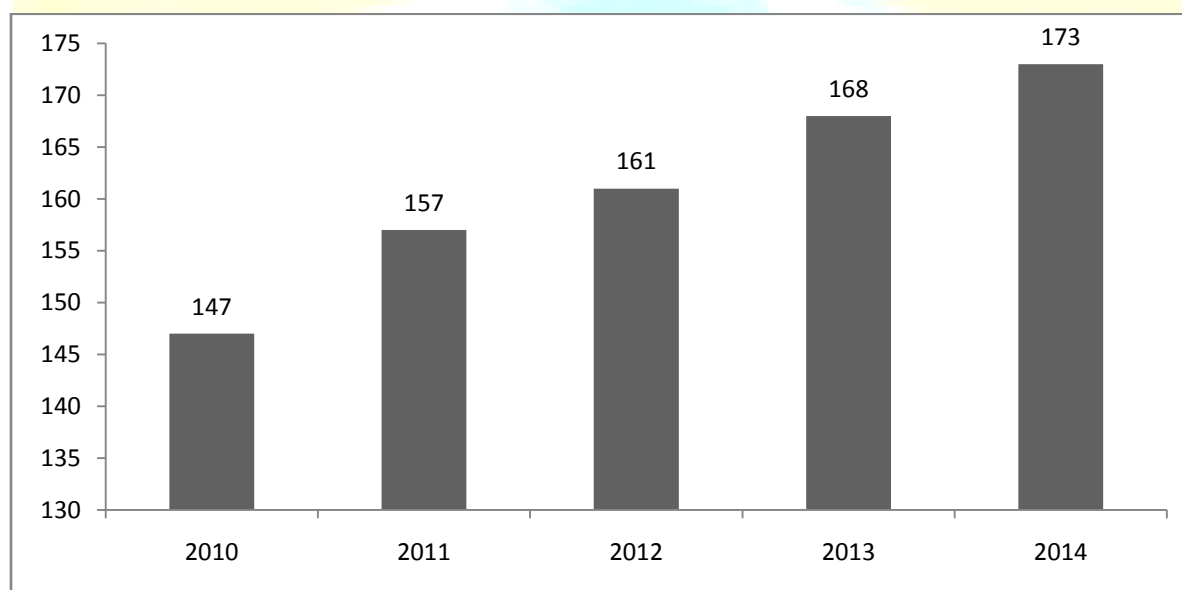
As can be seen from the table above, with the purpose to organize the production activity of EIEs local commercial banks invested 613.3 billion UZS or 253.2 million USD as per official exchange rate of Central Bank. By those recovered enterprises which were created on the basis of assets of EIEs, produced goods equaling 3 115.5 billion UZS including exports 821.6 million USD. As on the 1<sup>st</sup> January of 2014 as a result of undertaken modernization measures more than 9000 new working places were created (Karimov 2014). 139 EIEs or more than 80% of total transferred quantity were sold to strategic investors.

According to the statistics of the Central bank (CBU 2015) total price of sold 139 enterprises compromises 1 234.2 billion UZS out of which 452.2 billion UZS or 36.3% is being redeemed by investors; payment for 44 EIEs in the amount of 110 billion UZS is totally redeemed; left 95 EIEs SPA agreements amount of 793 billion UZS will be paid in equal portions periodically.

Below we depict the EIEs taken to the ownership of the commercial banks during the period from 2010 to 2014, in quantitative means.

**Graph 1**

**EIEs taken on the balance sheet of commercial banks of Uzbekistan**



Source: Statistics of Central bank of Uzbekistan (CBU 2015).

According to the graph above, we can see the stable upward trend in the quantity of transferred to banks EIEs. In this situation the attraction of particularly the financial resources of banks plays the crucial role, since any other financial institution could not handle the terms of their capital and qualification levels. Coming to the end of 2014, growth of the quantity of EIEs compared to year 2010 amounted to 117%.

IF we imagine that, process of selling EIEs to strategic investors being as a small branch of the tree, even though it is a crucial part of it since it can be considered as a trust of general public (and investors) to the banking sector. In the case of fully selling those bank-owned EIEs it

creates chance for further lending, since all these measures is from the rational banker view is economics of the financial institution, liquidity, correspondence to capital adequacy requirements which are getting very strict with the time in compliance with Basel committee recommendations and also for positive P&L account provision. Thinking broadly, in terms of macroeconomics, what is more important than already mentioned factors, that is a base for further GDP growth, also stability of financial sector, positive economic reforms leading to low levels of inflation since production exists, new working places diminishing the unemployment rate, huge exports in positive correlation with stable currency and other key macroeconomic indicators are being stabilized.

So the government understanding the full responsibility beyond the society's prosperity stepped forward and created operating, nowadays proven itself mechanism. We remember that in 2008-2009 the USA, Ireland, Great Britain and other EU countries by using different kinds of schemes – bought risky assets of banks, created special government sponsored asset management companies, purchased NPL's, injected huge amounts of capital or applied other bad bank concepts (Khodiev 2009, Martini et. al. 2009).

### **3. Organization and development of EIE sales by commercial banks**

Eventually question arises, how commercial banks organized selling of EIEs and from which period they started selling them. Currently, investment activity in banks is carried out by the Department of Monitoring and Coordination of banks investment activity (DMCBIA).

Along with this, according to article 4 of the “Law on Banks and Banking” of the Republic of Uzbekistan dated from 25<sup>th</sup> April, 1996 #216-I “banks are not allowed to operate directly in production, commerce and insurance businesses, except as required by law”. The sentence “except as required by law” not just like that since investment made in the real sector is starting the production but banks are not allowed to participate in the production process directly. That's why in the process of recovering EIEs banks establish special asset management investment companies with 100% share of bank in their charter capital as well as new subsidiaries organized on the basis of assets of EIEs. In turn, it coordinates the activity of banks with the effective law.

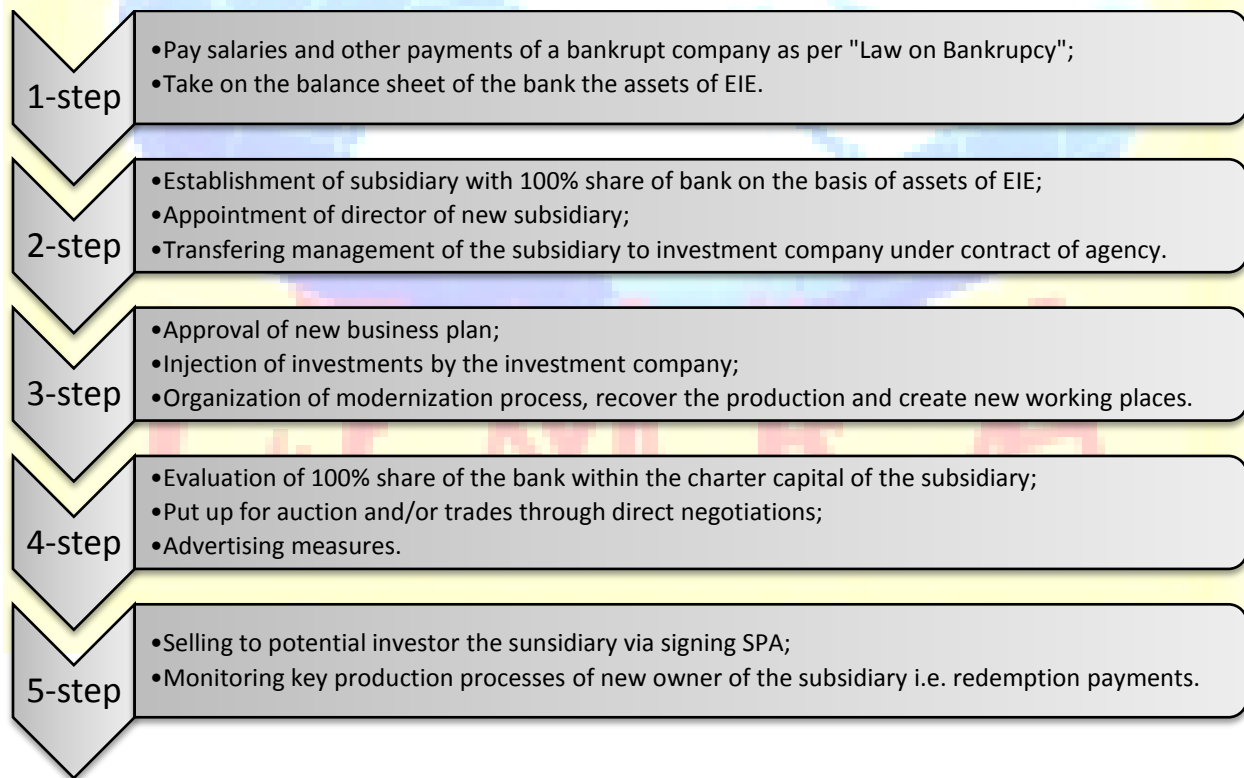
Any sort of investment activity is formed from attracted and/or own funds of the banks, and the risk of default on investment relies on the bank management. Compared to foreign experience in

Uzbekistan “bad loans” are transferred to the investment portfolio whereas in foreign banks practice they are still in credit portfolio as NPL’s. One moment should be noted its previous loans and kept out of the balance sheet of the bank until redemption payment of sold subsidiary is fully covered by the investor, afterwards claims will be satisfied according to President Order #4010 dated from 19<sup>th</sup> November, 2008.

Before the stage of selling EIEs banks pass a long road. First of all it establishes new subsidiaries on the basis of assets of EIE and before that, banks pay salaries and extraordinary expenses of bankrupt company according to existing Law. Current step can be considered as initial step in 5 stages process of selling EIEs to new owner.

**Graph 2**

**Major 5 steps in selling EIEs to new potential investors by the commercial banks**



As per appropriate resolution of the court, special commission formed by the employees of the bank and bankrupted company transfer and takes the assets of EIE after conducting inventory, via signing acceptance transmission.

New enterprise is considered as subsidiary of the bank and organized as limited liability company legal form, and bank transfers the assets of EIE in order to form the statutory fund and this is regarded as 100% share of the bank within the charter capital of the subsidiary. Particular new subsidiary has no obligation to pay previous debts of the bankrupt company, since these claims will be paid according to its turn in register of creditors, as per article 57 of the President Order #4010 dated from 19<sup>th</sup> November, 2009 after selling a subsidiary to investor.

Second sub step of second stage includes appointment of highly qualified, experienced in production and management areas, responsible manager (director) via general shareholders meeting of the LLC after prior approval by the Chairman of the bank.

Bank in order to effectively manage the assets, run the production, inject investments and create new jobs in ex-EIE taken on the balance sheet established special investment companies. Management is carried out through signing tripartite Agreement of Agency signing among the Bank, Investment Company and the Director of the subsidiary, usually for the period of three years. As per particular agreement the rights, obligations, and influences are exactly determined of each party, also payment for the investment company's management is mentioned.

For example, there are two investment companies, namely "NBU Invest Group" LLC and "NBU Investment" LLC established by National bank of Uzbekistan, which were initially organized in joint stock organizational and legal form but in 2014 they were reorganized into limited liability company form in order to improve the process of decision making and to minimize costs related with securities market. In turn on the 1<sup>st</sup> January, 2015 under Agency contracts "NBU Investment Group" LLC manages 9 subsidiaries of bank and "NBU Investment" LLC 18 subsidiaries (NBU 2015).

At the third level, after getting the management under control, Investment Company carries out precise technical audit of the EIE through which it will help to reveal the real conditions of tangible and intangible assets, after critical evaluation, business plan will be prepared and investments will be injected. Usually investments are of a two type. The first one is modernization of the enterprise often with low interest rates and the second one is for working



capital obviously with higher bearing interest payment. Investment companies accounting is based on accrual method as one at banks. After recovering, production is started and most importantly, export-oriented goods are being produced. Taken measures lead to the development of country's economy.

At the fourth step special commission organized from the bank staff carries out a tender in order to select licensed independent evaluation company to determine the market value of 100% share of bank within the charter capital of the subsidiary. Due to this, bank announces the object to be evaluated and receives proposals from evaluation companies until preannounced date and time. Commission will make its choice, depending on the rational cost, time and experience of the evaluation company. Time of the evaluation is correlated with the size of the assets, the role of the subsidiary in particular sector and other criteria's. Evaluation company conducts evaluation in accordance with national standards of evaluation of Uzbekistan in current case it evaluates the business, since depending the object various evaluating standard are applied.

After evaluation report is presented to the bank, in order to secure itself and according to the recommendation of State property committee, bank signs contract to expertise the evaluation report so that exclude the bias. After getting the positive expertise about the report according to internal Regulation about the selling the EIEs, DMCIAB presents its official opinion and gets the approval of Board of Director's and/or Council of the Bank.

At the final stage as a result of bidding, protocol of auction commission is being signed participants as director of the Real Estate Company, Deputy Chairman of the bank, Head of Investment Banking Company, Chairman of the Investment Company and other. Minutes of the auction commission's meeting includes proposals and made decision and signed on the date of the auction or trades through direct negotiations are held. Signed minutes is presented to the Risk management Division of the bank for identifying possible risks resulting from the auction and is submitted to the investment committee of the bank. The latter confirms the results of the auction and submits to the Board of Directors and/or to the Council of the Bank. The copies of the minutes are presented to every side which is the basis for signing the contract – the Sale & Purchase Agreement (SPA). If winner rejects to sign after winning the bid the prepayment is not

transferred back to the participant. Otherwise, within 20 days after announcing the winner, the SPA is signed between investor, Bank and the Organizer.

All these procedures outlined in the chronology of selling is deeply outlined in internal “Order of selling enterprises on the balance sheet of the bank, shares in the charter capital of the enterprises, and other assets collected from the obligations of the debtor” of the bank. The obligation of the new owner continues until the last redemption payment is made, in other words, bank monitors the duly payment of the redemption amount and other terms of the SPA. Such obligations may also include: hold the assets transferred safe and secure, insure it from possible external risk, allow bank to inspect to enterprises in periodic time, to report about volumes of the production, investment and working places to the bank. After signing the SPA, property right is transferred to the investor and in order to prevent from credit risk the assets of the sold enterprise are subject to mortgage and collateral contract. These assets should be insured by the new owner via signing appropriate contract among bank, Investor and the insurance company.

#### **4. Barriers in selling subsidiaries created on the basis of bank-owned EIEs**

Along with some success, there are other tasks that need to be solved and which slow down the sale of the subsidiaries:

- Most of the investors purchasing the share of bank in the subsidiaries are local investors rather than foreign ones. In other words, foreign investors are less interested in buying bank-owned enterprises. As in the case of National bank, approximately 25% of all sold EIEs are bought by foreign investors (NBU 2015).

- The information about selling subsidiaries advertised publicly is limited with the 2000 copies of newspapers and only in web-sites of banks, investment companies. It means that we need to work in spheres as marketing and advertisement, participate in international exhibitions. To present bank-owned enterprises widely, banks should fine optimal expenses and benefits from advertising.

There are particular steps before selling to the investors such as modernization, organization of the trades and others; so, bank need to pay considerable amount of money to Evaluation Company and it takes certain long time to evaluate the business; furthermore, now bank is practicing and bearing re-evaluation costs. There are examples when evaluation company with the intention to sign more contracts with bank offering less fee for their services. But, sometimes they are not fulfilling their promises and as a result it negatively influencing the pre-assigned time limit of evaluation. Overall, evaluation and re-evaluation in order to determine the market price is troublesome and leading to the contracting the dates to announcing the trades, to boost the selling process.

Preparation of qualified and experienced specialists in investment management sphere is also one of the important issues in selling EIEs. We know that there are a lot of specialists in loans, project management, leasing sectors. However, particular sphere, the sphere of asset or investment management, working with 'bad assets', especially in unique mechanism is comparatively new for commercial banks. So, we need to concentrate our attention to the development of qualified staff, possibly exchanging experience with foreign banks' professionals.

Inflation degree is the type of financial risk and leads to the loss of capital's real value. Moderate depreciation of national currency and declined refinancing rate set by Central bank makes it possible to purchase bank-owned subsidiary for less foreign currency. However, the cost of imported raw materials can be expensive.

Undeveloped production infrastructure. In the period of modernization, government is paying great attention to the development of communication, road and transportation and other infrastructures. Investors are more liable to purchase production capacities in more developed infrastructure locations as Tashkent city and Tashkent region. In other cases, it could lead to substantial increase in cost of production, tax burden, wear out of technology and machines installed in enterprises, production of substandard goods.

Information asymmetry. Commerce sphere can face bureaucracy issues and influence investment activity of the investor.

### **5. Ways to develop the sale of subsidiaries**

Indeed we have to note that further development of subsidiaries sale is a key issue not only for commercial bank but for Central bank also, since overall banking system will be financially stable, banks will clear their balance sheets from bad assets, ensure that bank's will not deal with non-standard work and others. We propose several scientific and practical recommendations:

- In order to economize the time spending to the evaluation and reevaluation of 100% shares of bank within charter capital of enterprises, commercial banks in close cooperation with State property committee (since this government agency provides licenses to evaluation company) may create special web-site, where all the information about the objects of the bank and acceptance of online applications to evaluate the particular enterprise by evaluation company should be available. Along with this, State committee for privatization, demonopolization and development of competition of Uzbekistan could have cancelled the practice of re-evaluation for the evaluation of shares of bank within subsidiaries organized on the basis of EIEs and thoughen providing the license for evaluation companies. In order to accomplish current measure, if necessary, legal document should be adopted in the governmental level.

Unique consideration of each business proposal on purchase of subsidiary, if required, to provide extra incentives in the governmental level in terms of tax benefits.

To increase the responsibility of directors of the subsidiaries and investment companies in further seeking of potential investors interested in buying subsidiaries, increase their attractiveness in terms of profitability, to make well-known brand name of the product.

Looking forward, government should act in close cooperation with regulators and Central bank to minimize the risk of any further external shocks in real sector. Before that they ought to increase the efficiency and transparency of plans and measures for the public in particular case, potential investors, who will be buying the EIEs.

Commercial banks should closely cooperate with special Republic commission on selling EIEs to commercial banks and consider in periodic meetings of the Commission new ways of increasing the attractiveness of firms which are offered in auctions (trades through direct negotiations) and possible problems facing the firm. It could be any obstacle such of funds into hard currency to import new technologies, electricity issues, bureaucracy or any other problems. Indeed, currently there are online application systems working in banks, tax committees and government agencies to consider the complaints of citizens and help to solve efficiently.

Along with further development of selling EIEs, we, talking from the side of the bank, have to support investors who already bought new subsidiaries so that them to 'stay afloat'. These measures may include organizing special seminars familiarizing with new legal documents, introducing new changes in taxation sector for investors and other related topics with close cooperation of Tax committee, Ministry of Justice, Chamber of Commerce and Industry of Uzbekistan or any other interested government agency.

Banks need to further develop their own 'signaling reports' provided by new owners of the subsidiaries to the bank, signaling the possible risks faced by enterprise, observe the unfavorable changes in balance sheet of the enterprise in order to minimize the exposure to credit risk and to determine the solvency of subsidiary. As long as, bank don't prefer to start the process of recovering allover and to be part of the big fraud designed by not good investors.

Above mentioned proposals regarding the development of EIEs sale more or less from the practical side, thus, can be applied in real conditions.

## 6. Conclusion

In our research we identified the practice applied in national commercial banks on the topic of dealing with bad assets. We found that there is huge difference in working-out with bad assets i.e. local banks apply the practice of changing 'bad assets' into 'good assets' and then sell them which takes longer time period and substantial costs. Analyzing the overall picture in Uzbekistan, we got familiar with the fact that as a result of undertaken measures 139 EIEs or more than 80% of total transferred EIEs to the balance-sheet of commercial banks were sold to

strategic investors, and compared to year 2013 particular ration increased by 8,9%. Then we deeply described organizational process of selling EIEs to potential investors and its further monitoring from practical side which constitutes out of five major steps. We found out persisting and possible obstacles in selling subsidiaries created on the basis of bank-owned economically insolvent enterprises assets', namely, foreign investors are rather less interested in buying bank-owned enterprises, banks will still need to work in marketing and advertisement spheres, long time to evaluate the business, preparation of qualified and experienced specialist in investment management sphere, increase the operativeness of decision making by bank management, political instability, inflation degree, undeveloped production infrastructure, informational asymmetry.

The practical results of current study is that provided recommendations are applied in the activity of investment banking units of commercial banks, they can be widely used in making precautionary plans that can increase the efficiency of investment projects of commercial banks.

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