BANKING SECTOR DEVELOPMENT
IN THE CZECH REPUBLIC

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I. Introduction

At present, the financial sector of the Czech Republic finds itself in the final stage of its reform. Now that the privatisation of large banks has been completed, the banking sector is dominated by foreign strategic owners, most of them EU-based banks. These owners are expected to bring much-needed modern banking expertise, improve the efficiency of domestic banks and prepare them for the challenges of EU and EMU accession. After extensive clean-ups of portfolios, the banks’ prudential indicators have improved significantly. The regulation of the banking sector has been largely standardised, and the remaining challenges are broadly similar to those faced by financial regulators in advanced countries, too.

The path from the beginning of transition to this promising stage has been no easy one, though. There have been substantial costs associated with it, both in terms of macroeconomic inefficiencies in the allocation of resources and in terms of public expenditures. The aim of this paper is to describe these reform processes, focusing in particular on the current situation and future prospects.

The paper is organised as follows. In section II, I give a short overview of the starting conditions and the early years of transition. Section III presents the major developments and reform steps in 1994–2001, including the public and macroeconomic costs. Section IV describes the current situation of the Czech banking system and its outlook. Section V summarises and concludes with some general observations for the transition economies.

II. Starting conditions and the early years of transition

At the beginning of the transition period, all the post-communist countries faced similar challenges concerning banking sector reform. They had to create a two-tier banking system, with the central bank ensuring macroeconomic stability (and in most cases supervising commercial banks, too) and commercial banks contributing to efficient credit allocation. They also faced similar constraints that made this task quite difficult: (i) no managerial and supervisory know-how; (ii) no market history of potential lenders; (iii) greater uncertainty regarding the outcome of entrepreneurial projects; (iv) inherited bad loans; and (v) no adequate legal framework and regulation, including a general framework for creditor protection, such as functioning bankruptcy laws and enforceability of collateral. These problems aggravated the information asymmetries that are inherently present in the financial sector. The lack of entrepreneurial history and heightened uncertainty during the transition made the information asymmetries greater, while the lack of know-how, problems with the use of collateral and insufficient public regulation reduced the effectiveness of their standard solutions.

In terms of size, there were significant differences between the banking sectors of the individual countries at the beginning of the transition period. Credits to the domestic non-governmental sector ranged from 10% to 50% of GDP, the Czech Republic and Slovakia being at the upper end of this interval and some Eastern and Southern European countries being at the lower end. The relatively high figure for the Czech Republic reflected its historically high reliance on bank intermediation, as well as the fact that the Czech Republic—unlike many other transition countries—did not go
through a period of high inflation, which would have eroded the real value of banks’ assets and liabilities. Some of the above differences have reduced over recent years (e.g. a decline in private bank credits in the Czech Republic to 36% of GDP in 2001, versus growth in Hungary and Poland), making Central and Eastern Europe much more homogenous in this area, but significant differentiation still exists. Similarly, there are large differences between the monetisation of the individual countries, ranging from roughly 75% of GDP in the Czech Republic down to about 20% or less in some other economies (e.g. Latvia and Lithuania). The issue of size is often exaggerated in the discussions, though. What matters most is the quality of market institutions, corporate governance and efficiency in the allocation of resources.

After the formation of the two-tier banking system in 1990, the large Czech banks were transformed into joint-stock companies in 1992 and partially privatised within the first wave of “voucher privatisation”. The state, nevertheless, kept controlling stakes in these banks (over 50% in Česká spořitelna and Československá obchodní banka, 47.4% in Investiční a poštovní banka and 44% in Komerční banka). The large banks thus remained under state control until the late 1990s (with the exception of IPB, in which the state lost its control in the mid-1990s). In the early 1990s, licences were granted quite freely to newly created banks, and the market was opened to foreign bank branches in 1992. This led to a fast increase in the number of banks during the early 1990s. The liberal licensing policy was primarily motivated by a desire to increase competition in the banking sector quickly.

In order to reduce the inherited bad loan problem and to create the basic conditions for the viability of the commercial banks after their split-off from the State Bank of Czechoslovakia (SBCS), a project called Consolidation Programme I was undertaken in early 1990s. This included operations associated with the clean-up of the balance sheets of Komerční banka (KB), Česká spořitelna (ČS), Investiční banka (IB) and the State Bank of Czechoslovakia (SBCS) of the bad loans extended before 1990, operations to strengthen the capital of the state-owned banks (KB, ČS and IB), and the clean-up of the balance sheets of other banks in the periods both before and after the division of Czechoslovakia. These operations were: (i) transfer of assets to Konsolidáční banka (KoB); (ii) write-off of loss loans from the National Property Fund’s (NPF) resources; (iii) increases in the capital of the banks split off from the SBCS and of ČSOB; and (iv) transfer of credits and guarantees from ČSOB to Česká inkasní (ČI). The net cost of this programme has been estimated at about CZK 100 billion.

A supervisory department was established at the former SBCS in 1991, with only eight employees and an inadequate legal framework for its operation (at that time, the regulation of banks was primarily the responsibility of the Ministry of Finance—unlike at present). Banking supervisory operations were started in this department in the course of 1991, but much of its capacity was then taken up with the creation and implementation of new laws and central bank regulations. The controls that were carried out were aimed primarily at obtaining experience with this activity. The actual supervision of banks started to become more effective only during 1993, which can be considered the end of the early stage of bank regulation in the Czech Republic. It was during this early stage, however, that a massive expansion in the number of banks took place (see Figure 1). The progress in bank regulation thus lagged behind the progress in the banking sector itself. The banking sector had been in essence formed at a time when
banking supervision was defined and conceived but when no supervisory activities had been developed. This contributed to some of the problems in the sector later on.

**Figure 1: Number of banks by ownership**

![Number of banks by ownership](image)

Source: Czech National Bank

**III. Problems in 1994–2001 and policy responses**

The period of 1994–96 was marked by rather sharp credit growth, reaching almost 20% in nominal terms and 8–16% in real terms. This was fostered, inter alia, by inflow of foreign short-term capital. The Czech banks played an important and active role in channelling foreign debt finance into the economy, borrowing abroad to increase their disposable funds and to profit from the lower foreign interest rates compared to the domestic ones. The foreign borrowing of Czech banks peaked at 6% of GDP at the end of 1995 (before falling back to zero by the end of 1996).

As a result of the capital inflows, money supply growth substantially exceeded the CNB’s targets every year between 1993 and 1995. The fast growth of the money supply, combined with quickly growing wages and consumer spending, boosted domestic demand. Moreover, fiscal policy was not very supportive of macroeconomic balance and the exchange rate, either, as the structural budget deficit (adjusted for privatisation revenues and transition-related transfers) increased by roughly 2.5% of GDP in 1994–96. Fiscal policy was thus pro-cyclical in this period. As a result, the period of 1994–96 was characterised by rather fast economic growth (see Figure 2). Given the supply-side and institutional weaknesses of the Czech economy, the actual growth rate exceeded potential, leading to an economic overheating by 1996.

**Figure 2: Economic growth during transition**
Already during this period of economic boom, serious problems started to emerge in the sector of small banks, which had been established in the previous period with little own capital or experience in banking business.\(^1\) The CNB thus developed a comprehensive programme for consolidating small banks (“Consolidation Programme II”) at the end of 1995, with implementation commencing at the beginning of 1996. Banks whose capital adequacy fell under 8% were instructed to produce consolidation programmes to ensure that the target of 8% would be met by 31 December 1996. The measures adopted in the individual banks can be divided into four basic groups: (i) reduction in capital and introduction of conservatorship in cases where there was a chance of revitalising the bank, but where the management and main shareholders were not able to deliver this process; (ii) termination of the bank’s activities; (iii) sale of the bank with the expectation of a future merger; and (iv) capital increase by existing shareholders or a new investor. Of the total of 18 small banks, 15 were included in Consolidation Programme II, with radical solutions (revocation of licences, introduction of conservatorship or take-over by another bank) adopted in 9 of them. The gross amount of funds issued by the CNB under Consolidation Programme II, i.e. without taking repayments and other revenues into account, was CZK 32.9 billion.

The situation in Agrobanka Praha was resolved outside the consolidation programme for the small banks sub-sector, although within the same time frame. This was the sixth-largest bank in the Czech Republic at that time. To ensure the stability of the banking sector, it was therefore decided to preserve the bank’s operations in full during conservatorship and to promote clients’ confidence by issuing a guarantee for their deposits. At the end of 1995, however, the bank ceased to comply with the agreed programme and found itself in an insupportable liquidity situation, which climaxed in a need for the introduction of conservatorship. In the end, the bank’s situation was resolved by the sale of part of the company to a strategic investor, who took over all of the bank’s commitments to its clients and part of its assets. The CNB supported the

\(^{1}\) In fact, the CNB had observed signs of negative developments in certain banks since 1993.
strategic investor by compensating it for its losses from taking over the part of the bank with negative value. In addition, the CNB contributed towards increasing the bank’s capital and provided it with bridging loans. The total cost of these operations was about CZK 50 billion.

The consolidation of the small banks sub-sector in 1996 led to a fundamental change in its structure. Banks which were insolvent were removed from the banking sector. The consolidation process did not take place without a decline in the public’s confidence in the banking sector, though. Small banks were threatened with a gradual outflow of deposits, which they would not have been able to withstand. The Czech Government thus adopted a programme to enhance the stability of the banking sector (the “Stabilisation Programme”) as a systemic solution in October 1996. The essence of the Stabilisation Programme was the purchase of insolvent receivables from banks at their nominal value by Česká finanční, up to a maximum of 110% of the banks’ capital and on the basis of returnability. Under the Stabilisation Programme, the drawing of a total of CZK 14.9 billion was approved.

In the meantime, the economic overheating which resulted in a current account deficit of almost 8% of GDP in 1996, forced the CNB to introduce restrictive monetary policy measures in the second half of 1996 (after having widened the exchange rate’s fluctuation band to ±7.5% in February 1996). These restrictions included, among other things, raising the minimum reserve requirements by 3 percentage points and increasing all the CNB’s major interest rates by about 1 percentage point. These measures in themselves put some strain on the banking sector’s financial situation. They also proved to be insufficient in terms of quickly stabilising the current account deficit. In May 1997, the Czech Republic thus experienced a period of currency turmoil, during which both nominal and real interest rates rose sharply and remained relatively high even after the exchange rate was floated (until the second half of 1998). This currency turmoil and the subsequent economic recession had a clear negative impact on the banks’ financial position.

Unlike in many other recent emerging-market crises, though, the banks’ problems were not directly linked to the exchange rate and interest rate risks taken by the banking sector. The short foreign-exchange balance-sheet position of the Czech banking sector did not exceed CZK 15 billion at the time the currency turmoil broke out in spring 1997, as the Czech banks passed on much of their foreign borrowing to domestic companies as foreign exchange loans. Moreover, the balance-sheet position was hedged by off-balance-sheet operations, meaning that the overall FX position of the banking sector was close to balance. This prudential approach to managing foreign exchange risk in the banking sector, partly thanks to the appropriate regulations being in place, was thus an important element that had a positive impact on the Czech situation. As a result, the currency turmoil did not directly undermine either solvency or confidence in the Czech banking sector. This probably helped to reduce the scope of the crisis.

That is not to say, however, that the Czech banks were completely immune to the consequences of the macroeconomic adjustment. The economic recession in 1997-98 hit the performance of domestic firms and thus exacerbated the excessive credit risks and other balance-sheet weaknesses that the Czech banks had taken on owing to their poor corporate governance. The impact of the macroeconomic adjustment on Czech banks was thus not a direct and rapid one, but rather an indirect one working through the credit-risk channel with a lag of about one or two years.
A worsening in the quality of loans in connection with the economic decline in 1998 and 1999, combined with stricter bank regulations by the CNB, resulted in additional provisioning needs by banks. In a number of cases, this led to failure by the small banks covered by the Stabilisation Programme (see above) to meet the prescribed limits. The CNB was forced to respond in 1998 with remedial measures for the banks in question. Eventually, most of the banks participating in the programme either had to be closed down or had to be merged with a strategic partner. This time, however, the problems were not limited to small and medium-sized banks only, but hit strongly the sector of large, mostly state-controlled banks, too. At the end of 1999, more than 40% of the loans granted by the large banks were classified, while the same indicator for small Czech-owned banks even exceeded 50%. For the banking sector as a whole, the ratio of classified loans to total bank credit increased by more than 5 percentage points and exceeded 32%. In risk-weighted terms, classified loans accounted for almost 17% of the total in 1999 (see Table 1 in section IV below).

The above bad loan problem, coupled with substantially increased caution on the part of banks in granting new credits and a lack of creditworthy projects during the economic recession, contributed to a substantial slowdown in credit growth in mid-1998. In fact, the credit growth became strongly negative in real terms during 1999–2001, even after adjusting for the effect of credit portfolio clean-ups (see Figure 3). As the banking sector has traditionally been an extremely important channel of financial intermediation, and because the capital market, which in a standard market economy provides an alternative source of financing, is not sufficiently developed, the banks’ problems inevitably had a significant impact on the economy as a whole.

**Figure 3: Bank credit growth** (adjusted for clean-up operations)

![Figure 3: Bank credit growth](image)

Source: Czech National Bank

Eventually, the Czech economy found an alternative way to substitute for domestic credit in terms of generating liquidity sufficient for an economic recovery. The inflow of foreign direct investment has reached massive proportions since 1998. Foreign investors with experience in relevant businesses have the ability to assess the viability
of domestic companies and, by obtaining controlling stakes in them, avoid the problem of poor enforcement of credit contracts. They can thus overcome the major factors which were “blocking” the domestic credit channel. The Czech banks, on the other hand, invested substantial resources abroad either by providing credits to foreign investors, by buying foreign securities or by depositing money with foreign banks. This outflow of bank money in turn helped to reduce the exchange rate impacts of the accelerated FDI inflows in 1998–2000. Nevertheless, the problems of domestic banks must have had important structural effects on the economy, as foreign finance is typically available to larger companies only, or in the form of foreign green-field investments, while domestic smaller and medium-sized companies are dependent on domestic credit.

In the end, the bad loan problem forced the government to engage in extensive clean-ups of the balance sheets of the remaining state-owned banks before their privatisation. The costs amounted to CZK 33.4 billion in the case of Česká spořitelna (privatised to Erste Bank in March 2000) and CZK 51.4 billion in the case of Komercní banka (sold to Société Générale in October 2001). A specific case was the bail-out of Investiční a poštovní banka (IPB). On top of the general transition problems faced by all large banks, the extent of mismanagement in this bank proved to be extraordinary. This happened in spite of the fact that the remaining minority stake in the IPB had been sold by the state already in February 1998, illustrating that a bank privatisation into foreign hands is not a panacea per se, if the incentive structure of the particular deal is not appropriate. Eventually, this bank ran into unsustainable solvency and liquidity problems, had to be taken under conservatorship in June 2000 and its banking activities re-sold with extensive state guarantees. The cost of this operation is not known yet, but is estimated to be in the order of CZK 100 billion.

To sum up, the reform period of the Czech banking sector has been costly both in macroeconomic and fiscal terms, its direct cost to the state being equivalent to roughly 10-20% of yearly GDP (see Table 1; the exact figure is hard to determine, though, as it depends heavily on the methodology of calculation). The international experience confirms that no efficient allocation of capital can be achieved in an economy without a sound banking system, both in intermediating the domestic savings and foreign capital inflows. Many of the emerging market crises during the 1990s (including the Czech case) were accompanied by weaknesses in the banking sector. Such weaknesses were one of the factors that initiated the crises, but were at the same time themselves considerably aggravated by the crises. To avoid this, the banking sector needs to be healthy in terms of its exchange rate risk management, general financial situation, corporate governance, credit allocation procedures, etc., which was not fully the Czech case.

Table 1: Public costs of the bank reform
<table>
<thead>
<tr>
<th></th>
<th>Net costs</th>
<th>Expected net yields</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidation programme I (1991-94)</td>
<td>104,8</td>
<td>-5,5</td>
</tr>
<tr>
<td>Consolidation programme II (1995-96)</td>
<td>103,5</td>
<td>5,2</td>
</tr>
<tr>
<td>Stabilisation programme (1996)</td>
<td>~13,5</td>
<td>~7,6</td>
</tr>
<tr>
<td>Preparation of privatisation (1998-2001)</td>
<td>84,8</td>
<td>9,8</td>
</tr>
<tr>
<td>IPB case (2000 - )</td>
<td>-</td>
<td>~(-95,0)</td>
</tr>
<tr>
<td><strong>Total I</strong></td>
<td><strong>306,6</strong></td>
<td><strong>-77,9</strong></td>
</tr>
<tr>
<td>Yields on bank stocks</td>
<td>-106,8</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total II</strong></td>
<td><strong>199,8</strong></td>
<td><strong>-77,9</strong></td>
</tr>
</tbody>
</table>

Note: Net costs = The costs net of revenues incurred before 30 June 2001; Expected net yields = Expected costs minus yields after 30 June 2001.

Source: Czech National Bank

The Czech experience also illustrates that with a malfunctioning legal and regulatory system no satisfactory results can be achieved either in macroeconomic performance or in reform of the financial system. In recent years, however, substantial progress has been made in this field. The protection of creditor rights has been strengthened through amendments to the key commercial laws, and the same is true for the protection of investors in the capital markets. As early as 1994–95, bank regulation started to respond to the knowledge acquired from supervisory activity by drafting and modifying prudential rules, for example stricter rules on banks’ transactions with related counterparties. An anti-money-laundering act came into force in 1996. Since 1998, the major aim has been to harmonise the regulatory framework with international best practices and EU legislation. This effort has been based on a medium-term blueprint for the CNB’s banking supervision drawn up in January 1998. The CNB has been making a continuous effort to incorporate the latest banking supervision trends into the system. Consolidated supervision of financial groups incorporating a commercial bank has been established, and a regulation on capital adequacy on a consolidated basis has entered into force. In April 2000, a CNB regulation on the capital adequacy of banks incorporating credit and market risks took effect, which meant a further qualitative step forward in measuring and managing bank risks. The existing rules on capital adequacy, credit exposure and open foreign exchange positions have been modified and merged into a single document in this regulation. The new capital adequacy provision also enables banks to use their own models to calculate the individual risks from which the capital requirements are derived, provided they meet certain minimum requirements defined in this provision. This has been one of the first steps towards a more qualitative approach to banking supervision in the Czech Republic. The actual oversight of banks has become more effective, too. Since 1998, an increasing emphasis has been put on on-site examinations. The aim of these is to determine the quality of the bank’s management systems, internal audit systems, information systems and the risk management in general.
IV. Current situation

As of 30 June 2002, the Czech banking sector was made up of 37 banks and foreign bank branches, down from the peak of 55 in 1994–95 (see Figure 1 in section II). The largest decrease occurred in 1997–99, when several banks closed down as a result of their poor financial condition (see above). In 2000 and 2001, the decline was primarily due to bank mergers, mainly between foreign-owned banks, reflecting changes affecting parent banks abroad. Moreover, Konsolidační banka, the state clean-up institution, was converted into Česká konsolidační agentura (Czech Consolidation Agency) on 31 August 2001. The reduction in the number of banks has been an important aspect of the Czech banking sector’s consolidation.

During 2001, the share of foreign owners in the equity capital of the banks in the Czech banking sector continued to grow sharply. The main factor underlying the changes in the ownership structure of the banking sector in 2001 was the completion of Komerční banka’s privatisation through the sale of the state’s controlling interest to Société Générale of France. The new shareholders of the large banks are foreign banks based in Belgium, France and Austria. Foreign capital also plays a major role in the equity capital of the other groups of banks. As of the end of the year, foreign capital predominated in seven medium-sized banks, four small banks and two building societies. Foreign entities held a 70.0% stake in the total equity capital of the Czech banking sector as of 31 December 2001, an increase of 15.5 percentage points on a year earlier. An increasingly large share of the foreign capital is concentrated in European Union member states; at the end of 2001 this share surpassed the 50% mark for the first time. The state is currently involved in only two banks, which specialise in government programmes in the areas of export promotion and support for small businesses.

The growing predominance of foreign capital in the activities of the Czech banking sector is also apparent when one looks at its share in total assets. As of 31 December 2001, foreign shareholders (i.e. those owning more than 50% of the equity capital, including all foreign bank branches operating in the Czech Republic) controlled 90% of the total assets of the sector, which is 24 percentage points more than a year earlier. Taking into account banks owned indirectly by foreign entities through subsidiaries operating in the Czech Republic, the figure increases to 94.2% (see Figure 4).

Figure 4: Structure of bank assets by owner (as of 31 December 2001)

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2 Of this total, there were 6 building societies and 9 foreign bank branches.
The foreign owners are expected to financially stabilise the banks, improve their efficiency and, perhaps most importantly, to supply much-needed expertise in modern banking. It is interesting to note that at least in Central Europe, all the transition countries have converged to a similar outcome concerning foreign ownership. This reflects the fact that the state generally proved to be a bad owner of banks during transition, often because of a conflict between economic and political motivations, and that there has been a lack of solvent and trustworthy domestic investors in the banking sector. The entry of foreign owners was thus almost unavoidable if the bank reform process was to be successful. It is important to stress, however, that according to the Czech experience (in particular the IPB case) privatisation to foreign owners must be designed in an appropriate way that gives the buyer sufficient motivation to restructure the bank and follow a strategy of long-run stabilisation and development.

The prudential indicators of the Czech banking sector have improved considerably over the last two years (see Table 1). Even though credit portfolio quality remains one of the fundamental problems of the Czech banking sector, the share of classified credits in total credits had fallen to 18% in mid-2002 from 32% at the end of 1999. This was due to the clean-up operations before the privatisation of the large banks (and the clean-up operations related to the IPB case) and the growing prudence of banks when providing new credits.\(^3\) The remaining still rather high volume of classified credits is, to a large extent, due to a low level of write-offs of these receivables against provisions. This is linked with difficulties in recovering written-off receivables through the courts and in deriving tax-deductible provisions from the volume of classified credits, and with the low recovery rate of collateral on classified credits.

### Table 2: Prudential indicators of the banking sector

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>02:H1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign capital</td>
<td>94.2%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State and municipalities</td>
<td>3.8%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czech private</td>
<td>2.0%</td>
<td></td>
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<td></td>
<td></td>
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</tbody>
</table>

\(^3\) The ratio was also influenced by the rise in total credits resulting from the inclusion of the former bank loans provided to Konsolidační banka into credits to non-bank clientele. But even in absolute terms, the volume of classified credits has declined substantially, to CZK 168 billion in June 2002 from CZK 291 billion in December 1999, which represents a fall of more than 40%.
Non-performing credits, i.e. classified credits minus watch credits (which, owing to their minimal degree of risk, are not considered classified credits in many countries), amounted to 10.6% of total credits in mid-2002. The weighted classification indicator, which reflects the differential degrees of risk in the individual loan categories, amounted to 7.4% of total credits, down from 16.9% in 1999. The reduction was caused primarily by an overall decline in classified credits, reinforced by a positive change in their structure towards watch credits, which have the lowest risk weight.

Banks cover their potential losses from the credit portfolio chiefly by setting aside reserves and provisions. In mid-2002, this coverage exceeded 100% of the weighted classification for the first time. In addition, there was collateral against loan losses amounting to CZK 19.3 billion in June 2002.

The capital adequacy of Czech banks has improved as well. In June 2002 it reached 15.4%, compared to 12.1% in 1998, which reflects both absolute growth in the amount of banks’ capital and investment primarily in assets bearing a lower risk weighting. It should be also noted that since April 2000, banks are required to include market risks when calculating capital adequacy. This has brought the capital adequacy calculation in the Czech banking sector into line with the recent best practices and standards.

The increased pressure for efficiency has resulted in declining bank employment and a falling number of bank units (see Figure 6). In June 2002, the number of bank employees was 40,000, down from 51,000 at the end of 1998. The ratio of total bank assets per employee thus increased from CZK 43 million in 1998 to CZK 63 million in mid-2002, which is a substantial rise even after accounting for inflation. The number of banking units is also declining. In June 2002, it stood at 1,755, compared with 2,204 in December 1998. Moreover, it is important to stress that this cost-saving took place in a period of rapid development in retail banking, which naturally puts higher demands on numbers of employees and branches. It was partly enabled by re-directing banking services towards alternative distribution channels of direct banking. Rationalisation, and related improvements in efficiency, at the head offices of the largest banks will presumably continue. One of the significant reasons for this is the concentration of certain—mainly strategic—activities in parent banks abroad. The reduction in the

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4 The consumer price index rose by approximately 12.5% between December 1998 and June 2002, which means that bank assets per employee rose by 30% in real terms over the same period.
The number of employees at head offices has not affected the range and quality of the services and products offered by the banks concerned.

As a result of the above savings, the ratio of banks’ administrative expenses to total assets was 1.9% in mid-2002, down from 2.0% in 1998 (see Table 2). In spite of that, their operating profits as a percentage of total bank assets were down to 3.9%, from 4.6% in 1998, which reflects falling interest rate spreads (2.3%, vs. 3.2% in 1998), which are being only partly offset by other factors. Compared with 2000, however, the profit from banking activities has slightly increased. The most important factor is profits from securities and derivatives transactions, which in 2000 had been loss-making for the banking sector as a whole. An increase in profit from fees and commissions and a slight improvement in total net interest income have also had a positive effect on profit from banking activities since 2000.

**Figure 5: Bank employment and number of bank units**

![Figure 5: Bank employment and number of bank units](image)

Source: Czech National Bank

Perhaps even more importantly, the net profitability of banks has improved considerably over the last two and a half years. In 2001, the return on equity reached 14.4%, compared with -5.2% in 1998 (see Table 3). Only two banks were loss-making in that year, compared with eight in 2000. This is primarily due to sharply reduced creation of reserves and provisions after the clean up of banks’ loan portfolios.
Table 3: Banks’ profitability indicators

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>02:H1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit from banking activities/average assets in %</td>
<td>4.62</td>
<td>4.15</td>
<td>3.59</td>
<td>3.77</td>
<td>3.90</td>
</tr>
<tr>
<td>Net profit/average assets in %</td>
<td>-0.36</td>
<td>-0.26</td>
<td>0.67</td>
<td>0.72</td>
<td>1.33</td>
</tr>
<tr>
<td>Net profit/capital (Tier 1) in %</td>
<td>-5.22</td>
<td>-4.32</td>
<td>13.08</td>
<td>14.41</td>
<td>25.42</td>
</tr>
<tr>
<td>Total interest income/interest earning assets in %</td>
<td>11.45</td>
<td>7.76</td>
<td>6.35</td>
<td>6.23</td>
<td>5.29</td>
</tr>
<tr>
<td>Total interest expenses/interest bearing liabilities in %</td>
<td>8.24</td>
<td>5.34</td>
<td>4.08</td>
<td>3.87</td>
<td>3.02</td>
</tr>
<tr>
<td>Interest rate spread in %</td>
<td>3.21</td>
<td>2.43</td>
<td>2.26</td>
<td>2.37</td>
<td>2.28</td>
</tr>
<tr>
<td>Administrative expenses/average assets in %</td>
<td>2.01</td>
<td>2.02</td>
<td>1.94</td>
<td>2.02</td>
<td>1.91</td>
</tr>
</tbody>
</table>

Source: Czech National Bank

It can thus be summarised that the Czech banking sector is steadily becoming more stable and efficient, thanks in particular to the completion of the privatisation process accompanied by the clean-up of the loan portfolios of the large banks. It is expected that the presence of major foreign banks in the key Czech banks will contribute to a further strengthening of the sector. At the same time, though, it is important to keep in mind that foreign owners are not a panacea per se, and much homework still needs to be done in terms of corporate governance framework. The primary banking risk in the Czech Republic is still credit risk, owing to the banks’ persisting orientation towards classic banking products. This risk is gradually decreasing, though, thanks not only to improvements to the lending process in individual banks, but also to the improved state of the Czech economy.

In the capital markets, important qualitative progress has also been achieved over the last years. But the Czech economy is traditionally strongly dependent on the bank intermediation, and the role of the capital markets in financing the private sector is still much smaller. It is almost exclusively limited to issues of bonds, but even these are limited to the financial institutions and larger non-financial companies, while smaller and medium-size Czech firms remain dependent on banks. Issues of new shares are very limited, and involve increases in the equity of existing companies; no initial public offering has taken place so far. The banking sector thus remains by far the largest channel of financial intermediation (see Figure 6).

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5 In 1999, issues of private bonds totalled CZK 52.0 billion in the Czech Republic, of which only CZK 25.3 billion were bonds issued by the non-financial private sector. In 2000, the corresponding figures were CZK 45.1 billion for total private bond issues and CZK 17.7 billion for the non-financial sector’s issues. In 2001, the figures were CZK 10 billion (plus EUR 21 million) and zero respectively.

Concerning the role of banking supervision in the ongoing positive developments, emphasis is being put on further harmonisation of the Czech regulations with European Community law. Two key legislative changes were the amendments to the Act on the Czech National Bank, which should ensure full compatibility of the CNB’s legislative status with the requirements of Community law, and the “harmonisation amendment” to the Act on Banks, which took effect on 1 May 2002. Among other things, this latter amendment provides for tighter and more transparent licensing proceedings and proceedings to grant prior consent to the acquisition or increasing of a qualifying holding in a bank; it places greater emphasis than the previous legislation on the quality and transparency of the relations between a bank, its major shareholders and related entities; and it introduces consolidated supervision not only of bank holding companies, but also of financial and mixed-activity holding companies that include a domestic bank. It also allows the Central Register of Credits administered by the CNB to be put into operation.

The Czech Republic’s expected and approaching accession to the European Union is not only placing heavy demands on compliance with EC directives, but is also putting increasing emphasis on the practical conduct of supervision and on the need to improve its efficiency and effectiveness. These aspects are increasingly being assessed by EU authorities and other international institutions. In 2001, this issue was addressed in particular by an IMF/World Bank mission as part of the Financial Sector Assessment Programme and by an EC mission as part of the Peer Review project. Both assessments praised the significant progress made by CNB Banking Supervision in the past period. Their recommendations and comments chiefly concerned consolidated banking supervision, expanding the co-operation between domestic and foreign regulators, and focusing banking supervision on qualitative assessment of banks, and in particular on the inspection of risk management systems and internal control systems. CNB Banking

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7 Save for a number of harmonisation provisions, which will take effect when the Treaty of Accession of the Czech Republic to the European Union enters into force.
Supervision is devoting attention to all these areas in order to achieve the fastest possible harmonisation with practices in advanced economies. Efforts are also being made to intensify the co-operation of the CNB with the regulators of other segments of the financial markets in order to improve the effectiveness of financial regulation.

V. Summary and conclusions

If we compare the Czech experience, which I have just described, with the process of reform in other transition countries, we can arrive at a few general conclusions:

- In terms of size, there were significant differences between the banking sectors of the individual countries at the beginning of the transition period. Credits to the domestic non-governmental sector ranged from 10% to 50% of GDP, the Czech Republic and Slovakia being at the upper end of this interval and some Eastern and Southern European countries being at the lower end. Some of these differences have reduced over recent years (e.g. a decline in private bank credits in the Czech Republic to 36% of GDP in 2001, versus growth in Hungary and Poland), making Central and Eastern Europe much more homogenous in this area, but significant differentiation still exists.

- The transition countries differed in their reform strategies aimed at creating functioning financial markets and, in particular, functioning banking systems. The Czech Republic chose a relatively slow pace of bank reform, while some other countries proceeded much faster (e.g. Hungary). At least in Central Europe, though, the eventual outcome is fairly similar across countries. Foreign owners now dominate the banking sectors of Central European countries, their share in equity typically ranging between 55% and 75% (70% in the Czech case in 2001). The share of bank assets controlled by foreign owners is typically even greater (in some cases, including the Czech Republic, exceeding 90%). The foreign owners are expected to financially stabilise the banks and, perhaps most importantly, to supply much-needed expertise in modern banking.

- An important issue for success with bank reform has been the development of a functioning general institutional framework that supports efficient corporate governance and gives sufficient protection to creditors. With a weak institutional framework, even bank privatisation and good state supervision need not suffice to achieve satisfactory results. But even in this area, the CEECs have been converging toward similar results. A key constraint on domestic policies is the EU accession process.

- The capital markets have generally faced the same kind of problems as the banking sector during transition (lack of experience, insufficient regulation, a weak general legal framework, etc.). But their stage of development still lags far behind the banking sector, as the capital markets had to start from scratch. The role of capital markets in financing the private sector is thus typically much smaller than that of bank intermediation and is limited almost exclusively to bonds, with IPOs of shares being either completely absent (as in the Czech Republic) or relatively negligible.
• In most countries, bank reform was associated with substantial costs. These included, first of all, direct fiscal costs, estimated at 5–20% of GDP in the different countries (in the upper half of this interval in the Czech Republic). The direct costs were partly related to the banking sector’s size, and partly to the strategy of reform. Second, there were also indirect macroeconomic costs in terms of higher unemployment and lower output, inefficiencies in the allocation of capital, sectoral impacts, etc. Intuition tells us, and experience tends to support this, that slower reform leads to higher direct bail-out costs and higher costs in terms of capital allocation inefficiencies, but temporarily lower costs in terms of unemployment and output.

• In the bank regulation sphere, the process of transformation can be characterised as experience-building through a trial-and-error process. This naturally contributed to the high costs of bank reform (but was not the main cause). At present, though, bank regulation is close to international standards in most Central European countries. The remaining challenges are to fully implement consolidated supervision of banks, prepare for new international standards (Basel II), strengthen crisis prevention as opposed to crisis resolution, and so on. An important aspect is again future EU membership for the accession countries.

• An oft-discussed issue is the synchronisation of bank reform with liberalisation of the financial account, which is another key element of transition. It is interesting to note that some of the countries that were relatively fast with bank reform were at the same time gradualist with financial account liberalisation (Hungary, for instance). On the other hand, some early liberalising countries in terms of the financial account were relatively slow with bank reform (such as the Czech Republic). The capital inflows into transition and emerging markets are often largely intermediated through the domestic banks, as was the Czech case in 1994–96. This means that this sector of the economy must be fundamentally sound to reap all the benefits of capital flows, otherwise serious problems may emerge. In fact, many of the emerging market crises during the 1990s were accompanied by weaknesses in the banking sector. Such weaknesses were one of the factors that initiated the crises, but were at the same time themselves considerably aggravated by the crises. A minimum requirement is that the banking sector must not take on excessive exchange rate and maturity-transformation risks. This was indeed the case in the Czech Republic, both in the banking sector and, by and large, in the economy as a whole. The experience of Asian and Latin American countries, though, shows that large foreign exchange exposures in the economy can be truly devastating. In addition to avoiding excessive exchange rate risk, however, the banking sector also needs to be healthy in terms of its general financial situation, corporate governance, credit allocation procedures, etc.

References


