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THE CZECH BANKING SYSTEM IN THE LIGHT OF REGULATION AND SUPERVISION: SELECTED ISSUES

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Abstract

This paper focuses on the current issues linked to the goals of banking regulation and supervision. The banking supervision policy carried out in transition countries – Central and Eastern Europe – takes into account a range of specific phenomena. The key distinctive factor of banking supervision and regulation in these economies was until recent the absence of a market-oriented banking system. This meant that banking supervisors actually had to establish "the rules of the game" and ensure "a level playing field" for all participants in a given financial market. In the Czech Republic, this period in banking supervision could be labelled as a "learning by doing" process.

The CNB has amended the legislative framework regarding commercial banks, with the primary goal of implementing the EU Directives. Although the present situation in transitional economies is far from that of standard economies, we argue that remarkable progress has been made in creating a legislative framework regarding the prudential operation of commercial banks since the beginning of the 1990s.

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Contents

1 Introduction 7

2 The role and place of banking regulation and supervision 9

2.1 Banking regulation and supervision - legislative framework 11

2.2 The Czech National Bank in the process of implementing the EU regulatory standards 12

2.2.1 Prudential rules imposed by the CNB 15

2.2.2 The implemented rules for prudential behaviour of commercial banks 16

3 The condition of entry into and exit from the Czech banking sector 25

3.1 Licensing policy 25

3.2 Exit from the banking system 30

4 Failures of commercial banks and deposit insurance schemes 37

5 Conclusion 41

References 45

1 Introduction

When banking sectors in transition countries grow (not only in the Czech Republic but also in other Central and Eastern European countries (CEECs)), difficulties arise in finding the appropriate way of controlling commercial bank activities, (to set up rules eliminating or limiting an imprudent behaviour). This discussion asks what sort of policy and targets should be adopted and applied. A further question might be what makes banking supervision and regulation in the Czech Republic different from similar activities in EU countries.

The banking supervision policy carried out in emerging markets – CEECs – takes into account a range of specific phenomena. Indeed, the key distinctive factor of banking supervision and regulation in these economies was the until recent absence of a market-oriented banking system. This meant that banking supervisors actually had to establish "the rules of the game" and ensure "a level playing field" for all participants in a given financial market. In the Czech Republic, this period in banking supervision could be labelled as a "learning by doing" process. A further condition for a sound and efficient banking sector is the creation of a macro and micro economic environment which will go hand in hand with the widening financial activities of commercial banks. Therefore, the main priorities lay in developing an institutional

framework including: bankruptcy law, corporate law, laws protecting creditors instead of debtors, accounting standards, etc.

Banking supervision and regulation is adopted as a set of measures preventing banks from operating in an imprudent way, and, at the same time, ensuring the stability of the system as a whole. In our analysis, banking regulation and supervision is a system consisting of several related elements that have a direct impact on the efficiency and stability of the banking system. The principal problem is which type of bank regulation is optimal, in terms of the degree of intervention and finding a level of a regulation that is not counter-productive. These points are closely related to the question of the amount and method desirable achieving the final objective, i.e. efficiency and stability. The results of this analysis should focus on the design of systems of banking regulation and supervision that will be appropriate for the emerging single European financial market.

The crucial factors that will be discussed in the course of our analysis are the following: legislative framework for bank prudential regulation, barriers to entry, exit and forced exit from the banking sector, deposit insurance schemes. All these aspects of banking regulation and supervision in transition economies must reflect the EU banking directives since the most of the Central European countries are at the threshold of a negotiation process regarding future membership. Therefore, in creating banking sectors, the gradual harmonization with the EU directives is essential.

2 The Role and Place of Banking Regulation and Supervision

As for the role of banking regulation in Central and East European Countries, the issues faced by policy makers, at the beginning of banking reforms was: what could be and should be the pace of reforms to liberalise and restructure the financial and banking system (enhancing their functional efficiency). How can the objective of functional efficiency be reconciled with that of stability and soundness? What degree of intervention is admissible in the banking system?

A regulatory body must first decide what the main objectives of banking supervision are. The principal objective of regulation might be seen as the mitigation of the potential instability of the banking system – in the limitation of systemic risk. The growth in the number of commercial banks, the share within a market the complexity of the applied technology, new products contribute to the increase in hostility in the environment in this sector; competition pressures and inexorably rising costs jeopardise a banks' success.

As to what the potential causes of systemic risk are, we can classify them as follows (see Hviding, 1995):

- The vulnerability of banks to depositor runs,

- The risk in the payment system, as when a large participant fails to meet clearing obligations destabilising trading practices arising from "pro-cyclical" trading practises.

In order for efficient banking regulation and supervision to be performed, the regulator has to clearly state the objectives of and accountability for its activities. The failure of several small-sized commercial banks in the Czech Republic demonstrates the importance of this principle. The CNB – banking supervisory body – faced criticism of its accountability for the current stage of banking in the Czech Republic. Furthermore, criticisms have been that interventions and rescue activities come too late and their impact, if any, is uncertain.

In fact, this situation could be prevented by the CNB setting a clear and transparent policy for the banking system. Certainly, those, who have advocated that there is no room for discussion, whether or not the goals of banking supervision are clear and transparent, have argued that in the framework of the Czech National Bank Act the role and accountability of the CNB is clearly defined. One can agree with this explanation, i.e., that the CNB is responsible for the stability of the banking system, but this definition is too general. We assert that if the banking supervisory body (CNB) had declared its main aims, the CNB would not be blamed for that.[1] Therefore, in order to avoid a repetition of this situation the regulator must make clear its policy as far as the banking sector is concerned. In other words, one should point out the priority, i.e., stability, and soundness of banking system and the protection of retail clients. These priorities can be listed as follows:

- The regulator has to prevent failures and systemic externalities of a banking system. This measure can be achieved, for example, *via* a financial support, which is, of course, accompanied by a significant cost but in many case less expensive that the cost of systemic failures within the sector.

[1] In 1996, the credibility of the CNB declined when a number of small and medium sized banks faced financial crises.

- Meeting the objectives of optimal resource allocation. This means above all to apply such a licensing policy, which will eliminate so-called capture banks. These banks are characterised by providing credits to their shareholders.
- Providing instruments of control and conducting monetary policy. If the regulatory body is a part of the Central Bank, monetary department can better set up their policy target, since the stability of banks is essential for sound and efficient monetary policy.
- Protecting depositors *via* setting prudential rules and deposit insurance schemes (see chapter 4).

2.1 Banking Regulation and Supervision – Legislative Framework

The legislative framework of the Czech National Bank – banking supervision – has undergone substantial changes since 1990 when the two-tier banking system was introduced. The CNB has gradually amended the legislative framework for commercial bank activities in order to meet the EU regulatory standards (EU directives) and recommendations of the Basle Committee on Banking Supervision. The focus has been on incorporating the EU directives into the Czech banking law.

The main directives that have a substantial impact on the banking industry might be list as follows (Mulineux, 1996):

- **The Second Banking Co-ordination Directive** (effective 1 January 1993). This directive, in conjunction with the Own Funds and Solvency Ratio Directives enables EU banks to branch into, or provide services to, any other member state.
- **The Own Funds Directive** (effective 1 January 1993). This directive defines the bank's capital.[2]
- **The Solvency Ratio Directive** (effective 1 January 1993), defining the amount of capital that must be held for regulatory purposes.

[2] The directive is indentical with the capital definition set by BIS.

- **The Consolidated Supervision Directive** (effective 1 January 1993). In accordance with supervisors are required to regulate banking groups on a consolidated basis, rather than undertaking solo supervision.
- **The Deposit Insurance Directive** (effective 1 January 1993), which imposes a minimum level of deposit insurance of 20 000 ECU for EU members states.
- **The Money Laundering Directive** (effective 1 January 1993) listing the obligation of credit and financial institutions to prevent money laundering from drugs organised crime, etc.
- **The Large Exposure Directive** (effective 1 January 1994), limiting bank ownership in companies or groups.
- **The Investment Services Directive** (effective 1 January 1996). This directive gives the same passport to the EU non-bank investment service firms as the Second Banking Directive for banks.
- **The Capital Adequacy Directive** (effective 1 January 1996). This directive requires that risk-based capital be applied to non-bank investment firms and introduces consolidated supervision for these firms.

2.2 The Czech National Bank in the process of implementing the EU regulatory standards

The principal task of the Czech National Bank is the implementation of the White Paper (Stage I and Stage II) for the associated countries. The Czech National Bank has adopted, up to now, into the Czech banking law the First Banking Directive (77/780/EEC), The own funds Directive (89/299/EEC), Directive (89/647/EEC) on a solvency ratio, Directive on Providing of banking services (89/646/EEC) and Directive on deposit guarantee schemes (94/19/EC). However, there are still certain technical differences that should be removed in the following period. The measures of Stage II have been implemented only partly. Directive (86/635/EEC) on consolidated accounts and Directive (92/30/EEC) on a consolidated supervision have not been incorporated in the Czech law yet. The same applies for Directive (93/6/EEC) on capital adequacy. These directives should be imposed by the Czech National Bank not later than 2000.

A common feature of the implementation of these directives is the different approach and criteria imposed on banks when performing the banking supervision function. A proposed time schedule for implementing all measures of the White Paper is time scheduled over four to five years. The Czech National Bank has recently enhanced its efforts to meet "The Core Principles for Effective Banking Supervision" issued by Basle Committee on Banking Supervision. The "Core Principles" have become an integral part of the banking regulation policy and they are perceived as a bridge leading to the successful implementation of the set of the EU Directives.

In order to meet the EU Directives, the CNB revised in the Banking Act of 1992 in two stages. The so-called "small amendment" (Banking Act No. 16/1998) was approved by Parliament in January 1998 and "the large amendment" Banking Act (No. 165/1998) took effect in September 1998.

The small amendment addressed the following problems: the interconnection of banks with the corporate sector, the separation of investment and commercial banking, and the increase in the amount of deposit insurance scheme. The main changes brought about this amendment can be listed as follows:

- The prohibition of banks from acquiring direct or indirect majority control over non-financial institutions. A bank's qualified interest must not exceed in one legal entity 15 per cent of a bank's capital and 60 per cent in total,
- The prohibition of a bank board members' and bank employees' placement on the statutory body or supervisory board of another legal entity,
- The prohibition of insider trading related to credit and investment operations and trading on customers' accounts and on one's own account,
- The implementation of measures ensuring the separation of credit and investment transactions,
- An increase in insurance limit for deposits CZK 100,000 to CZK 300,000 per depositor.[3]

The fulfilment of these new rules and obligations for banks has been phased in. The rules dealing with ownership participation have been phased in over three years

[3] From September 1998 this amount is CZK 400,000.

and changes regarding participation in statutory and supervisory boards over six months.

A fundamental change seems to be the separation between commercial and investment banking. However, the Czech banking system was deliberately built up as a universal one resembling the German banking model. Therefore such a radical change, after eight years, brings up a principal question about the optimal banking system. Undoubtedly, the German-banking model has contributed to the so-called closed triangle: commercial banks – investment funds – firms. In addition, the suggested changes or restrictions will have a direct impact on the business strategy of these banks, although opponents argue that only a few banks do not already meet these limits.

The second amendment involved further substantial changes in the legislative framework for commercial banks. The revision of the Banking Act above all enhanced the general confidence in the banking sector. The amendment includes measures which:

- improve the accountability of a bank's management and board by requiring that a bank's board of directors is composed of the top management of the bank and that the board of trustees must be chosen by a general meeting rather than by the employees of the bank,
- allow the CNB flexibility in dealing with problem banks, through the authorisation of an administrator to liquidate a bank, and the provision for mandatory removal of a bank's licence if its capital falls below one-third of the required rate,
- broaden the banks' obligation to inform the public - disclosure,
- provide further improvements to the deposit insurance system, with an extension and specification of the groups of persons who are not eligible for compensation, i.e., those with a special relationship to a bank,
- allow the CNB control over the shareholders of a bank via the requirement that voting stock can be issued only in registered form,
- require the acquisition of voting rights exceeding 10 per cent be approved by the CNB.[4]

[4] The same requirements is imposed when voting rights exceeding 20, 33 and 50 per cent.

The deteriorating situation in the Czech-banking sector was a driving force for these changes. The failures and irregularities among small and medium sized banks showed the absence of internal effective controls. At the same time, the former Banking Act did not enable to the CNB to effectively deal with problem banks. Although, the amendments go hand in hand with the EU Directives there are still shortcomings in the Czech legislative framework. For example, in the amended Banking Act there is a conflict between discretionary policy (decisions) and rules. Since the CNB is responsible for the stability of the banking sector, clear rules on dealing with problem banks should be drafted.

2.2.1 Prudential rules imposed by the CNB

If the role of banking supervision is to reduce systemic risk, then this can be achieved in part by setting up appropriate rules for the prudential behaviour of commercial banks. These rules would include the control of bank solvency, liquidity, the imposition of a minimal capital requirement, the limitation of risk exposures to individual borrowers; limits on credit exposure; etc. One could argue however that these restrictions might bring about a decline in bank efficiency. Indeed, the restrictions prevent commercial banks from providing credit to highly performing clients whose influence often has a direct impact on a bank's financial position, but this sort of banking regulation fortunately does not entail a moral hazard problem.

Since the start of the transition to a market economy, deregulation and the introduction of new regulatory rules have taken place in the banking sphere simultaneously. While departing from the totally regulated system of a centrally planned economy, the former Czechoslovak monetary authorities installed credit volumes and interest rate ceilings to assist the implementation of their monetary and credit policies, given the constraints and imperfections of the existing environment. However, the more competitive and liberalised the environment, the more banks and their financial institutions are exposed to risk and, consequently, the more crucial prudential rules and guidelines for their behaviour become. The policies of deregulation, aiming at increasing the functional efficiency of the banking institutions, phased in forms of intervention which could be considered as "anti-competitive", for example, credit volume and interest rate ceilings. Given the existing non-competitive

environment at the beginning of banking reform, the Central Bank imposed obligatory interest rate ceilings on commercial bank credit to avoid interest rates surging "unduly". These ceilings, introduced in October 1990, were gradually modified and phased out entirely on April 1, 1992.

The extent and speed of interest rate deregulation was remarkable, even compared with the post-war experience of developed economies, and represented a clear signal of the determination of the monetary authorities to move to a market environment. Though the phasing out of interest rate regulation seemed to be to some extent replaced by "window guidance" by the Central Bank, commercial banks in principle have been free to set their lending and borrowing rates since then. This has given them the leeway to develop their own interest rate policies, to react to market conditions and to reflect the differences in creditworthiness and riskiness of their clients and projects.

Deregulation and the introduction of rules for prudential regulation were related to the various dimensions of banking activities. Deregulation together with the introduction of new regulatory measures was thus not contradictory, but rather complementary.

2.2.2 The implemented rules for prudential behaviour of commercial banks

As elsewhere, the introduced rules of prudential regulation followed the EU standards and the recommendations of the Basle Committee for Banking Supervision and Practises. However, in their targeting and in setting the time profile, the Central Bank had to allow for certain constraining factors, and for the legacy of the past in particular some adjustments. Consequently, a stepwise approach was adopted for the most part.

In addition to the Banking Act, which provides the essential legislative framework governing the activities of commercial banks, the CNB issued so-called “provisions”. The provisions are an integral part of the Banking Act. The advantage of these provisions is that they react flexibly on the situation within the Czech-

Table 1

Comparison of the legal system in the Czech with the EU banking directives

Area of regulation	EU directives	Czech Republic
Access to market	Directive 77/780/EEC (First Banking Directive)	Harmonized
Providing of banking services	Directive 89/646/EEC (Second Banking Directive)	Principle rules for providing banking services are harmonized
Pursuit of business	Directive 89/299/EEC on the own funds	Remaining discrepancies are of the technical nature
Minimum Capital	ECU 5 mn (6US$ 6 mn)	CZK 500 mn (ECU 14 mn)
CARs a	>8% risk-adjusted and Directive 93/6/EEC on capital adequacy market risk	Only >8% risk-adjusted
Investments in non Financial Firms	<15% core capital in one firm; <60% core capital in aggregate	<15% core capital in one firm; <60% core capital in aggregate
Large Exposure	<25% core capital	<25% core capital
Connected Exposure	<20% core capital	<20% core capital
Aggregate Large Exposure	<800% core capital	<230% core capital
Deposit Insurance	<ECU 20,000 (US$ 25,000)	CZK 400 000 (ECU 11 500)
Bank Supervision	Directive 92/30/EEC on consolidated supervision	In the process of harmonisation
Licensing	Open	Open
Loan Loss Provisions	Tax-deductible	Total annual tax deductible provisions may not exceed 2 per cent of the average level of credits during the tax period.

Source: World Bank, CNB.

banking sector. For example, the Hungarian Banking Act includes all “provisions” in the Act and therefore any amendment requires to approval by Parliament. In other words, this hampered prompt reaction to new circumstances within the sector. It would be misunderstanding that these provisions are misused by the CNB.

Nevertheless, there has been some discussion among lawyers of the legitimacy of the provisions.

Capital adequacy

In CEECs, there was a broad discussion about capital adequacy ratios. Most of these countries accepted the BIS recommendation to keep the required minimum risk weighted capital/assets ratio to 8 per cent, with the exception of Estonia, where a ratio of 10 per cent was maintained. The rationale for higher capital adequacy, at least at the start of the two-tier banking system, is to ensure a sufficient “buffer” which would prevent from running into financial distress. In addition, banking supervision has not yet been performed on a consolidated basis. In the Czech Republic the imposition of the supervision on a consolidated basis is currently under consideration.[5] We foresee banks being forced to increase their capital once banking supervision is performed on a consolidated basis. The same is valid for supervision including market risk, which will come into effect by the end of 1999. Therefore it would be more appropriate to install higher barriers to entry for banks when the system was unfolding than now.

The Czech National Bank requires that the minimum capital for banks must amount to CZK 500 mil. This amount is almost three times higher than the directive 89/646/EEC requires (ECU 5mil.). In implementing the standard capital/assets ratio, the required minimum risk weighted 8 per cent was made obligatory only for new entrants, i.e., for those starting banking activities after January 1, 1991. The "old" banks were granted a transitional adjustment period with the following interim minima: 4.5 per cent by the end of 1991; 6.25 per cent by the end of 1993; and the final target of 8 per cent not later than the end of 1996.

Parallel to this, the banks' liquidity ratios, rules for credit exposures and for open foreign exchange positions also provided for gradual stages of adjustment. Since June 1, 1993, the banks have incorporated in the Czech Republic that net credit exposure may not exceed:

[5] The CNB has prepared provisions for supervision on a consolidated basis, but only for financial institutions.

- to one client (or an integrated group) the limit of 40 % of a bank's capital by the end of 1993, and 25 percent by the end of 1995;
- to a bank in the Czech Republic and in the OECD countries (or an integrated group of these banks) a limit of 80 percent of the bank's capital by the end of 1995[6];
- to legal persons, equity capital of which the bank owns to an amount of 10 percent or more, or controls it, a limit of 20 percent of a bank's capital by the end of 1993;
- the cumulative volume of credit to the ten largest debtors must have a limit of 230 percent of the bank's capital by the end of 1995.

According to Directive 93/6/EEC on capital adequacy, in the EU countries banks will include market risk in their model for capital adequacy. However, in the Czech banking system bank capital adequacy is still calculated according to standard the Basle accord from 1988 - "Cook ratio". The Basle accord requires capital to be equal at least 8 per cent of the total risk-weighted assets of the bank. Capital consists of two components: Tier 1 capital - core capital - and Tier 2 capital - supplementary capital (Jorion, 1997).

The new provisions regarding supervision on a consolidated basis and capital adequacy including credit and market risk are in the process of implementation. The question remains what impact these measures will have on capital requirements for banks. At least for the Czech–banking system one might envisage the increase of capital. This will influence above all small and medium sized banks suffering from a lack of external financial sources but also partly for state owned banks. The new concept of the regulator relying on banks' own systems to measure the risk of potential loss is still in the process of implementation not only in CEECs but also in EU countries. In addition, there are disputes among economists about the impact of this way of calculating capital adequacy.

Liquidity

[6] This rule was changed and the net credit risk exposure towards a bank in the Czech Republic and OECD countries or towards a group of connected debtors made up solely of such banks must not exceed 125% of a bank’s capital.

Within Czech banking there is a significant number of money market and interbank dependencies for many banks. With the exception of *Česká spořitelna Investiční a Poštovní banka (IPB)* and *Komerční banka*, banks tend to possess a low level of retail banking. At the outset of the transition newly established commercial banks were completely dependent on the inter-bank market. Liquidity regulations set no explicit quantitative obligation affecting bank's liquidity positions. The regulation of liquidity is focused primarily on two objectives: the method of liquidity management and organisational requirements for liquidity management. The former objective contains instructions as to the separation of assets, liabilities and off-balance sheet items according to their residual maturity, estimated development of fixed-term liabilities, experience with the behaviour of depositor, the liquidity grade of assets, etc. The later objective contains organisational prerequisites for liquidity management. The banks have to follow the criteria in order to finance firstly from stable resources, the diversification of funds from the viewpoint of maturity, the establishment of organisational measures leading to effective liquidity management, regular contingency plans containing the main directions of activities and measures of the bank in cases of critical situations endangering its liquidity.

Table 2

Liquidity

	1994	1995	1996	1997	30.9.98
Quick assets* in % of total asset volume	12.14	20.69	16.05	17.15	20.85
Quick assets in % of total primary resource	n.a.	39.06	30.28	32.73	39.58

*Quick assets are defined as cash value, deposits and credits with the CNB, current accounts with banks and treasury and other bills.
Source: CNB.

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Credit risk and bad loans

The current regulatory framework requires provisions against credit risk only. Other risks are to be covered by general reserves. The banking sector is exposed to interest rate risk and owing to the reliance of several banks on short-term interbank borrowing exacerbates the maturity mismatch.[7] Exposure to market and exchange rate risks has been limited. This is evident from the fact that the share of marketable securities in banks' portfolio is relatively small and the imposed prudential limits on open foreign exchange positions. However, the vulnerability of banks to interest and market risk became evident in May 1997.

A poor portfolio adversely affects the soundness of the banking system. The identification of the extent of problem loans in the Czech Republic and in other transition economies as well, is not straightforward. In the discussion of transition economies the term "bad loans" has often been used with two different interpretations, which causes some confusion. In a wider sense it comprises all types of qualified credits, for which the Czech banking statistics used the term "risk credits" and later on "classified credits". In a narrow interpretation it is confined only to the "worst" sub-category of problem loans, i.e., to non-performing loans. The second qualification refers to the amendments in classification that were implemented several times in the course of the transition years, the most recent one becoming effective in the second half of 1994. As a result, the identification of problem loans (classified credits) as well as their division into individual sub-categories has been changing. The third constraining factor is related to the available data themselves. Their quality and coverage have also undergone considerable changes. While at the start of transition only big banks were scrutinised by external auditors, over time all banking institutions have become subject to auditing procedures and to increasingly more in-depth and more sophisticated supervision both on-site and off-site.

Table 3

Loan classification

	Delay in servicing	Required total provisions (%)	Annual tax-deductible provisions/reserves* (%)
Standard	Up to 30 days	0	1

[7]The Czech banks have kept their medium-and long-term credits at 25 per cent of short-term deposits and liabilities with a residual maturity of up to one week exceeded 30 per cent of total liabilities in 1997.

Watch	31 to 90 days	5	1
Substandard	91 to 180 days	20	5
Doubtful	181 to 360 days	50	10
Loss	More than 360 days	100	20

*Total annual tax deductible provisions may not exceed 2 per cent of the average level of credits during the tax period.
Source: CNB.

The Data in Table 4 provide the identification of trends in the classified client credits of commercial banks in the Czech Republic in the period 1994-1997. These banks are also confronted with the corresponding trends in reserves and loan loss provisions. One might observe a gradual decline of total classified loans to total credits. However, this decline should be explained by the fact that the CNB did not include banks under conservatorship.

Parallel to the volume of classified credits; there was also a corresponding decrease in the amount of risk-weighted classified credits, i.e., in the amount of reserve requirements. The data indicate that despite the growing volume of reserves and loan-loss provisions, the ratio of actual to required reserves continued to diminish in the covered period.

The trends in both of these ratios suggest those problem loans and the resulting vulnerability of commercial banks is the highest burden for banks. This conclusion must, however be qualified by at least three arguments:

- As discussed above, the interpretation of data in time series must allow for the institutional changes which materialised over time;
- According to the legal regulations in force up to mid -1995, the possibilities of writing-off non-performing loans were severely restricted. As a result, commercial banks stockpiled classified credits on the one hand and non-used reserves and loan loss provisions on the other;
- The ratios of classified credits and of accumulated reserves and loan-loss provisions varied widely across groups of banks.

Table 4

Classified loans
(% of total credits)

	1994	1995	1996	1997	30.09.98

Total classified loans	36.53	33.04	29.33	26.98	27.10
Weighted Classification	21.52	20.26	18.82	17.42	17.19
Classified credits adjusted for collateral	n.a.	17.01	14.72	14.55	16.90
Reserve and provisions surplus (+) or shortage (-)	n.a.	-0.28	0.10	-0.03	n.a.

Excluding *Konsolidační banka* and banks under conservatorship.
Source: CNB.

In the Czech banking system real estate is used as collateral for a great volume of loans. However, the liquidity of that collateral is very doubtful and also its price is, in many cases, overestimated. Therefore the CNB in July 1998 imposed a new measure that changes the rules for creating reserves and provisions for loss loans collateralized by real estate and overdue more than one year. This measure will be phased in over three years. Commercial banks have to create reserves and provisions, which fully cover the value of collateralized real estate. This measure will have a direct impact above all on *Komerční banka*, the biggest bank in the Czech Republic, with the highest volume of non-performing loans.[8] Another bank, *Investiční a Poštovní banka* (IPB), which was overtaken by Nomura also displayed a relatively high ratio of non performing loans backed by real estate but most of them are fully covered by reserves and provisions due to the capital injection provided by Nomura.

[8] *Komerční banka* announced an accounting loss of CZK 9 billion for the first half of 1998. The bank increased reserves and provision to cover non-performing loans.

3 The Condition of Entry into and Exit from the Czech Banking Sector

3.1 Licensing policy

When the Czech Republic began to establish a two-tier banking system, it was widely accepted that the more banks operating within the financial market, the better; as this would result in the system as a whole being more competitive and efficient.[9,10]

The Czech Republic (among other countries) had a unique opportunity to start building a banking system almost from scratch. As of 1st January 1990 the mono-banking system was replaced by the two-tier banking system. Two commercial banks were carved out from the former Czechoslovak State Bank - *Komerční banka* in the Czech Republic and *Všeobecná úverová banka* in the Slovak Republic). In addition, the following banks have already operated *Česká spořitelna* (Savings Bank), *Živnostenská banka*, *Československá obchodní banka* (Czechoslovak Trade Bank) and *Investiční a Poštovní banka* (former *Investiční banka*).

The rapid growth of new commercial banks in the period 1991-1992 brought a certain degree of competition into the financial market but later the financial position

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[9] However, it cannot be said that providing new banking licences was not under control. The ratio of banking applicants to those granted a licence was approximately ten to one.

[10] The argument widely used by the private sector was based on the false idea that foreign banks could strengthen competitive pressures within the banking sector. There has been no

of these banks was considerably impaired. From Table 5, one observes the growth of commercial banks in the period 1990- 1994 and since then their gradual decline.

Table 5

Number of Banks in the Czech Republic
(As of the end of year)

	1990	1991	1992	1993	1994	1995	1996	1997	30.9.98
Total Banks	**9**	**24**	**37**	**52**	**55**	**54**	**53**	**50**	**47**
Big Banks	5	6	6	6	6	6	5	5	5
Small Banks	4	14	19	22	21	18	12	9	4
Foreign Banks	x	4	8	11	12	12	13	14	14
Foreign Bank Branch Offices	x	x	3	7	8	10	9	9	10
Specialised Banks	x	x	1	5	7	8	9	9	9
Banks under forced administration	x	x	x	1	1	0	5	4	0
Banks without Licences	x	x	x	x	1	4	6	10	5

Source: CNB.

Developing banking sector requires simultaneously liberalization and prudentially regulated entry. The licensing policy applied by the Czech National Bank that evolved from a lax to tough one was inappropriate. At the onset of banking reforms the minimum amount of capital was CZK 50mil. This amount was later increased by the CNB up to CZK 300 mil. Since 1994 the capital has been CZK 500 mil. A relatively low required limit on the bank capital, in the early stage, has undeniably caused the growth of so-called "capture banks" or "zero banks".[11]

There are several questions regarding the expansion and openness of the banking system. Firstly, commercial banks were carved out of the former Czechoslovak State Bank (Central Bank). This step was identical for most of the former communist countries undergoing the transformation of domestic banking sectors. But if one looks at the current situation within the segment of the biggest commercial banks it is possible to see different shortcomings in the applied

evidence in EU countries that foreign banks have substantially influenced competitive pressures on domestic banks.

[11] These banks are characterized by providing credits to their shareholders above all.

measures.[12] In Poland, nine state-owned regional banks were established instead of one or two large banks. The advantage of such a policy is, at least for the first stage of development, to avoid creating “capture banks”. Decentralization led to covering all major regions in the country and the allocation of credits was better monitored. This might be explained by better knowledge of debtors and regional conditions. On the other hand, experience shows that a regional break-up limits the competitiveness within a given market since banks play dominant position. EBRD, for example, suggests that the break-up of state banks should be organized on the basis of sectoral than geographical terms.

However, this way of building up the banking sector also asks questions. Such an organization reduces the advantages of portfolio diversification and increases the probability of a default risk. Secondly, this almost "free entry" of the small and medium sized commercial banks into the banking sector, which was mainly adopted because of the perceived benefits of competition, has in fact been detrimental. Partly unrestrained access has induced a situation where too many banks serve a limited market. In addition, these newly operating banks were mostly poorly capitalized and managed. At present the growth of operating banks is almost zero – the banking supervision stopped giving new banking licenses in September 1993 in order to create breathing space for established banks to consolidate their positions.[13] Thirdly, as for foreign entry the situation is quite different. There is a general consensus that the activities of foreign banks are in the first stage of transition neutral in terms of their impact on the banking sector in question. This might be explained by their specific role when these banks provide above all services to their home country clients who start establishing within the unfolding market economy. Later these banks expand and provide services not only for their home country clients but also for domestic firms and individual clients see Table 6.

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[12] We do not discuss other important issues as the privatisation process.

[13] Recently three foreign banks obtained licences from the CNB–Midland Bank, Westdeutsche Landesbank and GE Capital Bank (the banking licence of West Deutsche Landesbank was revoked since the bank did not start operations).

Table 6

Share of Banks in total Assets (%)

	1993	1994	1995	1996	1997	1998*
Large banks	82.3	77.18	71.72	68.87	65.67	68.04
Small banks	8.9	4.44	4.92	5.21	4.72	3.52
Foreign banks incl.	7.2	11.67	16.46	18.84	22.28	21.35
Specialised banks	n.a.	1.47	2.11	3.09	4.29	4.04
Banks under	n.a.	5.24	4.78	4.00	3.04	3.03
Total	100	100	100	100	100	100

Source: CNB.
* estimation

An unsustainable situation when a number of newly established banks find themselves in difficulties is to be sorted out by authorities through restrictive license policy, for example, the Czech Republic, Poland, Russia etc.

One argument that has justified ceasing to provide banking licenses, in the Czech Republic, was grounded by the fact that the banking system has displayed symptoms of over-banking and that there are elements of instability at several small and medium sized commercial banks. However this measure was also imposed on the foreign banks although these banks have been playing quite different role within the sector. The situation when the "first class" foreign commercial banks applied for banking licenses and either having their applications rejected or being asked to acquire banks already operating is another extreme. We do not assert that foreign banks can necessarily increase the competitiveness of the banking sector, but they can provide stability within the financial system, unlike "zero banks", which is discussed below.

Experience has shown when establishing a banking system, one should adopt thorough criteria for granting banking licenses for domestic banks or banks which do not have a sufficiently long track record. In addition, the biggest commercial banks play a crucial role in the Czech financial market, extending their activities over the entire Czech Republic. As a result of these activities, a number of small-sized banks, including "zero banks", are finding themselves in difficulty. It is far more difficult for small banks to find a place in the market. One of the possible ways to remedy this situation is for these banks to become so-called *niche players*. Meaning their attention should be focused on special activities and banking services, which are not (or only marginally) performed, by the bigger banks. A minor comfort, though hardly a

practical consolation for the bank regulation authority, is the fact that some EU countries have also struggled with a similar phenomenon.

The problem remains as to how to proceed with the banking license policy in the future. Let us find some lessons for the Czech-banking sector. Clearly, the present situation is no longer sustainable. The CNB, which has advocated a restricted policy, has argued that it is necessary to sort out current problems connected largely with the unfavourable position of small banks – the situation has lasted for more than two years and must be resolved. A currently running consolidation and restructuring program is one of important steps improving the situation within the sector. Nevertheless, there is a need to speed up the process of restructuring and consolidating of the banking sector in order to be in accordance with the Association Agreement between the Czech Republic (including other countries in CEE) and the European Community, which came into effect in February 1995. The policy decisions of the CNB regarding entry into the banking sector need to continue in the spirit of the "Second Directive". Providing new banking licenses to the Czech banks must be scrutinised by the CNB very carefully, and banking licences should only be provided to domestic banks if there is "more" than a 100 percent guarantee that the bank will be able to meet the criteria of the EU Directives.

Concerning banks from EU countries applying for a banking license to operate within the Czech system, The CNB should apply slightly different rules. We admit that it is necessary to adopt a strictly selective policy in order to avoid a negative impact on the banking sector from newcomers. But, as noted, the entry of foreign banks has had a positive effect on the domestic banking system for the most part. Hence, if there are some highly regarded foreign banks wishing to operate in the Czech Republic, no obstacles should be imposed by the Czech National Bank. Furthermore, if the CNB continues to apply the restriction policy on foreign banks, this is undoubtedly a negative signal to the European Commission, when subjects wishing to obtain licences do not know what criteria to meet. In other words, this situation can cause doubts as to whether this country will be able to meet one of the essential criteria involved in the "Second Directive", i.e., to enable a non-domestic credit institution to operate in any member country. Providing banking licenses to foreign banks is appropriately expressed by Bonin et.al (1996, page 10):

> *There should be no special restrictions on the entry of foreign banks or the purchase of existing banks by foreigners. Foreign entrants should be subject to the same capital adequacy and examination standards that would apply to any domestic entrant or purchaser.*

To sum up this part of the analysis we can conclude that the regulator authority should provide a banking licence only if it is completely convinced that the applicant will meet all requests imposed by law.

3.2 Exit from the Banking System

If a bank fails to comply with the regulatory requirements or becomes involved in criminal activities, the authority responsible for regulation and supervision must make a decision about the future of that institution. The outcome of this decision is constrained above all by the legislative framework – the range of supervisory instruments.

Broadly speaking, there are a number of measures that can be employed. In the case, normal prudential regulations fail to prevent banks from imprudent behaviour, remedial measures are required to avoid the further financial deterioration of the bank in question. By remedial measures we mean the effort of the bank management and the regulatory body to improve a given situation. However, in many cases there is no consensus between management and the regulator about taken measures leading to restore financial stability. In this situation there must be a legal framework and available instruments enabling a regulator to impose mandatory measures. And finally, when all else fails, the regulator should revoke the banking licence.[14]

According to the IMF, the key factors in assessing the viability of banks are:

i) the integrity and probity shareholders, directors, and/or officers of the bank;

[14] In many cases, it is suggested to conduct early regulatory intervention and closure when serious under-capitalisation appears, i.e., closure before technical insolvency (Lastra, 1996).

ii) the actual objectives pursued by the major shareholders of the proposed bank relative to its safety and soundness;
iii) the qualifications, experience, and judgement of all or some of the directors, members of the supervisory board, and other high-ranking officials of the proposed bank relative to the nature, size and sophistication of the proposed business;
iv) a financial buffer to absorb losses that may surface in operation as the bank's business is conducted which depends on the nature and scale of the proposed bank relative to the nature and scale of the proposed business and the risk attached to the same;
v) the quality of the corporate governance and the distribution and segregation of duties and responsibilities in the bank;
vi) the quality of the policies, management systems, internal controls, and procedures in the bank, in particular with regard to risk management, pricing, provisioning and internal audit.

It should be underscored that the most of these factors are applied by the CNB in process of assessing banks in question. According to the Banking Act (No. 21/1992), banking regulation and supervision had a limited array of instruments to cope with banks having financial difficulties. These legislative limitations were recognised during the turbulence in the Czech-banking sector in 1995-1996. Therefore, the current Banking Act (No. 21/1992) was revised and the legal instruments were strengthened and widened. Mainly, the range of operating instruments for so-called forced administration of the bank in question was limited. At the same time, the new Banking Act also redefined criteria for suspension of the banking licence.[15]

The failures of small and medium sized banks

Since 1994 we have witnessed the failure of several commercial banks. These banks had obtained their financial resources largely via the interbank market, and the

[15] The CNB can take off the banking licence when capital falls below one-third of the required rate. And a time period to take off a banking licence became shorter in the case that a bank does not take deposits or start operations from 18 months to 12 months.

biggest banks in the Czech Republic are (were) the main creditors of these small-and medium-sized banks in the market. It is not surprising that the big banks were involved in rescue activities when these events occurred. A particularly prominent role was played by *Česká spořitelna* (Savings Bank) and Československá o*bchodní banka* (Czechoslovak Trade Bank). Although *Česká spořitelna* allegedly lost a huge amount of credits, especially to *AB banka* and *Bohemia banka*, we cannot trace any sign of systemic risk or rather systemic crises in the banking sector as a whole.[16]

The likelihood of failure of some commercial banks in the Czech Republic is still possible, we would not envisage that the decline of small banks could lead to an epidemic in the banking system as a whole. Even if this is a matter of *ad hoc* judgement, the reason for this assumption lies in the "too big to fail", or rather, "too important to fail” doctrine. These "big" banks are too important in the Czech banking system; we presume that they have such a strong footholds they are able to deal with whatever disturbances there may be within the banking system. In fact, the state is a shareholder in these banks and thus the government will support these big banks if a solvency problem arises, e.g. *Česká spořitelna.*

There cannot be traced any deterioration as for a direct impact on the Czech-banking system. Since the total assets of these banks amount to 5 per cent of total assets within the banking sector. Nevertheless, the decline of small-sized banks cannot be neglected, since it could cause not only systemic risk (crisis) in this segment of the banking sector, but also the decline of confidence in the banking sector.

The main weaknesses of the small- and medium-sized banks can be identified as follows:

- Insufficient capital;
- The lack of primary deposits;
- Inappropriate assets-liabilities mismatch;
- No transparency of shareholders;
- A problem of adverse selection due to relatively high interest rates;
- Inadequate management in many cases.

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[16] In the inter-bank market, the largest lender is particularly *Česká spořitelna*.

A glance at the above mentioned problems supports the idea that one of the possible ways of resolving these problems would be a merger of these small banks with bigger, healthier banks. However, we argue that this solution has not been widely adopted in the Czech-banking sector. Reasons to be sceptical also can found in the experience in other economies. First of all, it is desirable to analyse the benefits of mergers among banks. As key factors leading to mergers the following are very often quoted:

- An effort by banks to become a member of a core bank group;
- To secure unrealised economies of scale;
- To carry out the rationalisation of branch networks;
- To enable the demands of large customers to be met;
- To match the size of other banks in international banking;
- To meet foreign bank competition in their home country.

Applying these factors to the Czech-banking sector, there is minimal incentive for mergers or take-overs by domestic banks. The same situation can be seen in mergers of foreign commercial banks. We observe that there is absolutely no incentive to be active in these operations. One possible explanation is that the advantages are not significant, at most marginal. The small banks mentioned have a few or no branches and their clients are mainly small private companies, which are not good performers. The process of mergers and acquisition in the Czech Republic can be seen from Table 7.

Table 7

Small Banks under Liquidation, Conservatorship and Prepared for Merges (As of October 1998)

Name of bank	Start of operating	CNB administrat.	Liquidation	Method
Agrobanka	01-07-90	17-09-96	08-10-98	Take-over by GE
AB banka	01-04-91	-	05-03-96	Licence revocation (15-12-96)
Banka Bohemia	29-01-91*	31-03-94	18-07-94	Licence revocation (18-07-94)
Bankovní dům Skala	13-12-90	-	10-12-97 to	Take-over by Union banka,

			30-04-98	licence revocation (31-03-97)
COOP banka	24-2-92	23-04-96	-	Take-over by Foresbanka Licence revocation
Česká banka	15-01-92	-	19-03-96 to 27-06-96	Licence revocation (15-12-95), Bankruptcy (28-06-1996)
Ekoagrobanka	01-11-90	16-01-96	01-01-98	Take-over by Union banka, licence revocation (31-05-97)
Evrobanka	01-10-91	-	-	Take-over by Union banka, licence revocation (30-06-97)
Kreditní a průmyslová banka	01-10-91	30-09-93 to 31-08-95	-	Licence revocation, (02-10-95), Bankruptcy (02-10-95)
Kreditní banka Plzeň	01-01-90	-	01-10-96	Licence revocation (08-08-96),
Podnikatelská banka	18-12-92	06-06-96	-	n.a.
První slezská banka	12-01-93	-	24-07-96	Licence revocation (13-05-96) Bankruptcy (20-11-97)
Realitbanka	01-11-91	10-07-96	-	Licence revocation (17-04-97), Bankruptcy (24-03-97)
Velkomoravská	03-11-92	10-07-96	-	Licence revocation 24-10-98 Bankruptcy 02-07-96
Pragobanka ,	01-10-90			Licence revocation 24-10-98 Bankruptcy 19-11-98

Source: CNB, Hospodářské noviny.

Nevertheless, one way of how to proceed might be to eliminate undesirable banks by increasing the minimum capital requirement for banks – a measure, which would have a relatively fast and positive impact on the banking structure. Above all, it is desirable to emphasise the measure prior to taking this step; there is a need to make clear which size banks, in terms of capital levels, should be "eliminated". Unfortunately, the secondary consequence of this step is that a few of the small banks which do not have any difficulties at present would also have to either increase their capital or merge with a larger bank.

An indirect way of increasing capital was applied in the Czech banking system. Since a number of small-sized banks have a great volume of bad loans, the CNB decided, in the framework of a consolidation programme, to oblige these banks to increase their capital in order to cover their bad loans. If they are not able to do so, the CNB will put these banks under forced (special) administration and look for a strategic partner. If no other investor can be found relatively quickly, Konsolidační banka – a state-owned bank formed to consolidate debts left over from the previous regime – will temporarily take over the bank. It is worth noting, that the above mentioned method, i.e., forced administration, is an operation often used as a temporary solution for failed banks. During this period the authority seeks bridge banks, new banks or other institutions which will ensure the stability of the bank in question. These operations have a positive effect, in the sense of avoiding a further deterioration in the financial position of the bank in question. Such a method was, for example, applied when Barings failed in 1995. The bank was under the administration of the Bank of England and then sold to ING, the Dutch banking and insurance group (see Lastra, 1996).

The last, but not necessarily least, way of dealing with failed institutions is to revoke the banking licence of the bank in question. Such a step avoids the further deterioration of this situation. On the other hand, it should be said that this step could have negative consequences as far as the credibility of the banking sector is concerned. In addition this solution can be costly. Therefore, any hasty decision on the part of the banking supervisory body or other authorities could be very harmful. But when a bank has failed owing to fraud, liquidation is the appropriate response.

4 Failures of Commercial Banks and Deposit Insurance Schemes

If banking markets were complete, information would be perfect, symmetric there would be no need to protect their users. In other words, intervention by the authorities, as shown in the course of this paper (law, regulations, supervisor's etc.), would be unnecessary. However, the real financial world (and not exclusively the financial one) is far from perfect and its users must be protected.

The existence of asymmetric information is far more perceptible in a retail market than in a wholesale market. One can argue that its moderation can be carried out via a fuller disclosure by the banks in question, which would undoubtedly lead to a reduction in costs and in the extent of banking regulation,[17] but this may cause unreasonable costs for small depositors. Nevertheless, by no means do we say that the information disclosure within the Czech banking system has been sufficient. Annual reports issued by the Czech commercial banks did not provide relevant information as far as their financial position is concerned; (especially small and medium sized banks).

Regarding retail customers, there are a number of legitimate questions as to whether protection should be provided. The reasons for protection are based on the following:

[17] Advocates of fuller disclosure are in New Zealand, where no protection of depositors exists.

- The absence of repeat orders, which does not enable learning by experience,
- The suppliers and demanders are less equal in a retail mark7et than in wholesale one,
- Individuals are limited to monitoring the behaviour of the supplier of financial contracts.

As indicated above, the need for banking protection appears reasonable but is closely linked to a moral hazard problem because any protection, for clients or bankers, is likely to lead to riskier decisions. A further negative consequence of protection is that it incurs costs. Therefore, an optimal scheme of deposit protection must be established, one that is neither too generous protection nor too limited and that favours the stability of the banking sectors. Broadly speaking, generous protection discourages the prudent behaviour of bankers and depositors, although, only partial compensation has a negative impact as well. It follows that the best solution would be to set up a fairly priced deposit insurance scheme. But such a scheme is very difficult to establish and therefore most countries have deposit schemes based on fixed rates.[18]

As for deposit insurance we can trace different types of their frameworks. The main distinguishing feature is whether the insurance scheme works on a legal basis or an informal arrangement. Further classifications are whether these schemes work on a voluntary basis or through compulsory membership, and whether the schemes are administered officially or privately.

For example, in France, Austria, the Netherlands, Italy and Switzerland deposit insurance is compulsory and operates on an *ad hoc* levy. The system does not require annual contributions from member banks, but the realised losses of declining banks are divided ex post among participants. Countries like Norway, Germany, Spain, Belgium and Finland have a deposit insurance system which is financed through periodic premium payments. The representatives of the banks themselves manage these funds. Japan, Canada and the United States apply a deposit insurance system based on collecting periodic insurance premia from banks through a deposit insurance corporation.

[18]The United States and Finland have tried to adopt fair deposit schemes.

According to the Deposit Insurance Directive, the minimum level of deposit insurance for all EU countries is ECU 20,000. The task of this deposit insurance scheme is not only to protect deposits but also to discourage bank runs. In addition, the home member country protects branch depositors, but branches have the option of joining the host country scheme. The compensation amounts in the EU countries are as follows: Belgian coverage is Fr 500,000. The UK scheme covers only 75 per cent of the eligible deposit and maximum compensation is limited to GBP 20,000. In France the limits is FFR 400,000. A further important point to note is that, for example, the UK scheme covers only sterling deposits in the United Kingdom, whereas the German scheme covers deposits in any currency.

In the Czech Republic a question linked to depositor protection was raised after the first failure of the above mentioned banks. The amount of compensation is well below average in comparison with the EU, countries but is quite sufficient for ensuring a certain degree of confidence in the banking sector. The "Deposit Insurance Fund" was set up, in the Czech Republic, to ensure the compensation of depositors. Compensation amounts to 80 per cent of an account; however, the maximum amount of any compensation, is CZK 100,000 per depositor per bank. The contribution paid by the bank amounts to 0.5 per cent of the volume of insured deposits as of 31 December of the previous year.

In the second amendment of banking law the compensation increased to 90 per cent of an account but not more than CZK 400,000. A further significant change is that this compensation scheme includes all accounts and not only household savings – accounts. However, this deposit scheme does not cover accounts in foreign currencies, i.e., it covers only Czech crown accounts.

However, even if there is a deposit insurance fund in the Czech Republic, it must be said that depositor were compensated only once through the above mentioned schemes (in the case of Česká banka). In the other cases, retail deposits were compensated, not through the fund but through the authority support. The compensation was CZK 4 million per depositor. These measures could not only be understood as an effort to avoid social tension before parliamentary elections in 1996, and also to mitigate potential runs on small- and medium-sized commercial banks. However, this measure can cause the already mentioned "moral hazard problem" and, moreover, any discretionary policy in banking can be harmful. This is

because users and management of commercial banks may rely on repeat orders of such rescue activities from the authorities in future.

5 Conclusion

This paper focused on the current issues linked to the goals of banking regulation and supervision. Although we are aware that the present situation in emerging markets is far from that of standard economies, we argue that remarkable progress has been made in creating a legislative framework regarding the prudential operation of commercial banks since the beginning of the 1990s.

The CNB has amended the legislative framework regarding commercial banks, with the primary goal of implementing the EU Directives. Even if there is still a gap between the EU standards and the Czech banking law we can trace more than a gradual shift. The following directives have got to be implemented: Directive (86/635/EEC) on consolidated accounts, Directive (92/30/EEC) on a consolidated supervision and Directives (93/6/EEC) on capital adequacy. Nevertheless, the CNB has begun the process of incorporation this Directive into the Czech-banking law.

The role and objectives of banking supervisors must be clearly spelled out; otherwise they can have a negative impact on the authority performing these activities in particular cases. Such a situation occurred in August - September (1996), when the CNB was made accountable for the situation in the banking sector. However, it would be naive to believe that supervisors are better at identifying the weakness banks in comparison with the incumbent bank management. In fact, sophisticated and efficient internal control (audit) mechanisms protect banks from

financial distress more effectively than intervention. At the same time the Czech National Bank must perform and adopt such policies (regulation) that do not allow moral hazard problems to be created. In other words the shareholders and bank management have to bear the costs linked to the financial distress of the bank in question. Taxpayers should be involved only if there is a danger of systemic risk in the system.

As to the entry of new commercial banks into the Czech-banking sector, it seems convenient to adopt a strictly selective policy. However, the decision to restrict the entry of foreign banks does not appear to be particularly rational. Empirical studies have proven that foreign banks have only had a marginal effect on the domestic banking system for the most part. Hence, if there has been a "queue" of highly regarded foreign banks wishing to operate in the Czech Republic, no obstacles should be constructed for them by the banking supervisory body—the Czech National Bank. In other words, these banks will not worsen the situation within the banking system. In addition, these tough restrictions on foreign banks give a negative signal to the European Commission as to whether the Czech Republic will be able to meet one of the essential criteria involved in the Second Directive.

The former Banking Act (No. 21/1992) had a limited array of instruments enabling to supervisors to deal with problem banks. In particularly, the range of operating instruments for so-called forced administration of the bank in question was limited. In the course of our analysis we have suggested options which might be adopted by banking supervision to eliminate "undesirable" banks. One acceptable way would be to increase the minimum capital requirement. As was shown in the course of our discussion, such a measure would have a relatively speedy and positive impact on the banking structure. Unfortunately, this measure is not selective and thus could affect banks performing well. The Czech National Bank has applied this measure in a slightly different way, by deciding in the framework of a consolidation program that these banks have to increase their capital in order to cover bad loans. If they are not able to do so the CNB will put these banks under forced administration and look for a strategic partner. The necessity of such measures was brought about by problems the small- and medium-sized banking sector.

As for the protection of depositors, our discussion shows that without guarantees the banking sector could face liquidity problems. By no means do we

argue that deposit insurance schemes can completely avoid runs, but they can contribute to an increase in the confidence within the banking system. As for the volume of compensation, experience has shown that it is crucial to avoid a moral hazard problem. It must be emphasised that insurance deposit schemes work until the banking sector no longer faces systemic risk. In these cases, authorities usually provide financial support (e.g., Scandinavian banking crisis). As for the compensation amount the CNB increased this volume from CZK 100,000 to CZK 400,000.

Finally, although the legislative framework for efficient conducting banking regulation and supervision has not been fully harmonised with the EU Directives, we can see that there has been made substantial progress since 1990.

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