4 THE FINANCIAL SECTOR

The improvement in the performance and stability of the financial sector continued in 2003 and on into 2004. This trend built on previous changes in the financial field caused by long-term systemic factors. Such factors included the process of privatising large banks and clearing their balance sheets of bad debts by transfer and sale to transformation institutions, which took several years. They also included the transformation of investment funds, linked to the establishment and development of new open-ended mutual funds and the entry of foreign funds into the domestic market. Stability was further enhanced by re-registration and reduction of the number of investment companies, funds and securities dealers. In individual segments of the financial market, activities were concentrated, mergers occurred and some businesses exited the sector due to liquidation. Supervision of the financial markets was bolstered and unified accounting policies were introduced for financial institutions (banks, credit unions, pension funds, investment companies and investment funds and securities dealers, although not insurance companies).

In recent quarters, the stability of the financial sector has been favourably affected by the continuing recovery and improving financial position of the corporate sector. In this environment a turnaround has occurred in lending to corporations and the rapid growth in loans to households has continued. Foreign investors' interest in individual segments of the financial market has been associated with expectations of further growth in household and corporate financing, as well as in financial services related to the growth in government debt. A new impetus to the development of financial market activities was the Czech Republic's accession to the EU, which introduced the application of the single licence principle and hence free access to the financial market.

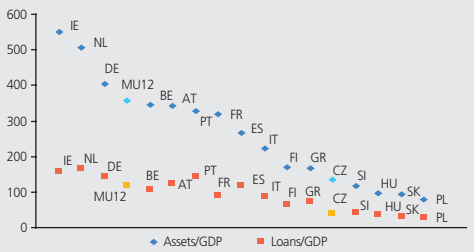
The above trends also entail certain potential risks. Increased loan expansion in a period of economic growth may result in a resurgence of the problem of bad loans in the event of a future economic slowdown or recession. An increase in interest rates and revenues in a situation of a closing output gap may affect the asset markets, including the property market, and result in an increased interest burden on debts incurred rapidly in the period of low interest rates. Although the ever-increasing international integration of the Czech financial sector entails a strengthening and bringing in of the required financial know-how, it is also opening up new potential channels for the transmission of elements of international instability.

4.1 INTERNATIONAL COMPARISON

The financial sector in the Czech Republic as measured by assets in relation to GDP is half the size of the European average and, for instance, that of Austria and Portugal. The depth of financial intermediation in the Czech Republic is close to the Greek and the Finnish financial systems. By comparison with other Central European EU member states, the Czech Republic's financial sector is the largest, in spite of the fact that its assets relative to GDP have gradually decreased to 135%.

As for the banking sector itself, which constitutes the core of the financial sector, the Czech Republic's ratio of total banking sector assets to GDP is – at 99.8% (2003) – also very high by comparison with other new CEE member states of the EU. This is a sign of a relatively developed banking sector, although this ratio for the Czech Republic is also decreasing.

CHART IV.1
Financial sector assets and loans in 2003
(% of GDP)



Note: High figures for LU not included.
Source: CNB, CZSO, ECB

A more detailed examination reveals that the Czech Republic lags behind advanced EU countries in terms of lending. By comparison with these countries the volume of loans in relative terms (including the government sector) is up to three times lower. This is chiefly due to a still considerably lower level of household debt in the Czech Republic (the share of loans to households in total loans is approximately half the EU figure), to a still relatively low – although rapidly increasing – level of government debt, and also to a lower relative volume of loans provided to the corporate sector. As far as the corporate sector is concerned, some role may be played by alternative methods of financing, including financing from abroad, which does not show up in the domestic lending figures, and, for instance, intercompany debt, which remains significant.

Banking assets account for 74% of the Czech Republic's financial structure, compared to 76% in Poland, 82% in Hungary and 83% in Slovenia. The structure of the Czech financial sector is similar to that in other European countries. In the euro area countries (for instance in Austria), around three-quarters of financial sector assets are likewise banking assets.

The above information indicates that there are certain differences in the weight of the financial sector in the Czech Republic compared to developed EU countries, and, conversely, that there is some similarity in terms of structure. From the viewpoint of the theory of optimal currency areas, cross-country differences in the position and functioning of the financial sector could lead to differences in financial intermediation and monetary policy transmission and hence create conditions for asymmetric shocks. Despite its smaller weight, however, an efficient and flexible financial sector can efficiently absorb various adverse economic shocks and eliminate their impacts on the economy.

The international comparison, however, should not be overestimated and might gradually lose significance somewhat over time. The new environment, in which European financial institutions can now offer their services under the single licence principle, by cross-border provision of services or by applying European Company status, will reduce the information value of national financial sector indicators. As stated above, many firms are already financing their operations from foreign sources. Thus, information on the size of a national financial sector may gradually become indicative of the attractiveness of a particular country and its legislative and institutional environment from the perspective of a financial institution's headquarters, rather than of its economic significance within the relevant territory.[23]

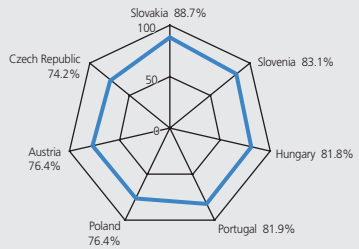
4.2 STRUCTURE OF THE FINANCIAL SECTOR

The basic segments of the current financial structure of the Czech Republic (banks, credit unions, insurance companies, pension funds, investment companies and funds, leasing companies and other financial institutions) have been in place since the mid-1990s. However, there have been some structural changes within this architecture. Although banking assets have risen in absolute terms in the last several years, their share in the financial sector has decreased owing to an expansion of non-bank entities and products. Banks have also lost out to their competitors as a result of clean-up operations. By international comparison, the weight of banks within the financial system is the lowest among

CHART IV.2
Banking sector assets in 2003
(% of GDP)

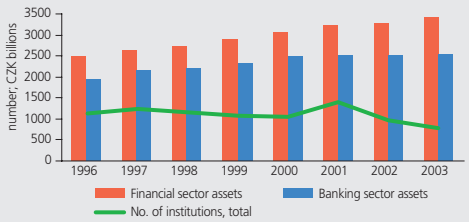
Note: High figures for LU not included.
Source: ČNB, CZSO, ECB

CHART IV.3
Share of the banking sector in financial sector assets in 2003



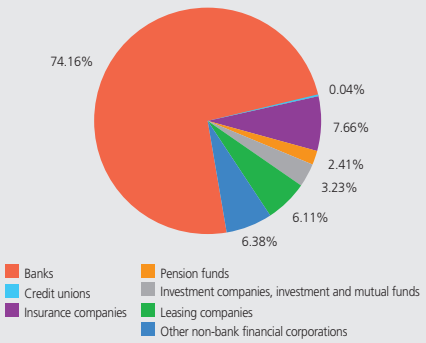
Note: Slovakia excluding pension funds.
Source: ČNB, CZSO, ECB

CHART IV.4
Number of institutions and volume of assets in the financial and banking sector
(CZK billions)



Source: ČNB, CZSO, ÚDDZ

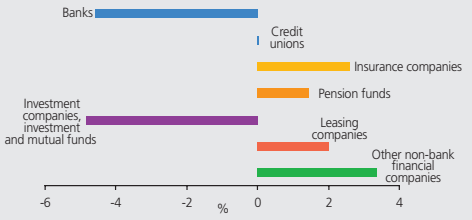
CHART IV.5
Shares in financial sector assets as of 31 December 2003



Source: ČNB, CZSO, MF ČR, ÚDDZ, ALS

23 The ratio of total banking sector assets to GDP need not always be merely an indicator of a highly developed local banking sector. For instance, for tax and regulatory reasons some banks choose to locate their head offices in some other country. An example is Luxembourg with a ratio of 32, which is more than ten times the level in the euro area (3.1).

CHART IV.6
Rise/fall in share in financial sector assets, 1996-2003
(%)



Source: CNB, CZSO, MF CR, ÚDDZ, ALS

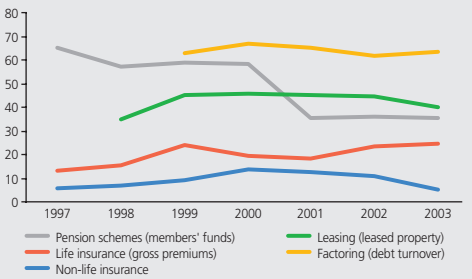
the new EU member states from Central and Eastern Europe. The weight of investment institutions and closed-end investment funds in the shallow capital market has dropped as well. On the other hand, the weight of other financial institutions has grown.

Differentiation and increasing competition in the loan and deposit market have resulted in a more diverse supply of products. Thanks to state contributions, insurance companies active in the life and annuity insurance market and pension funds have offered people an attractive opportunity for medium-term and long-term investment, and open-ended mutual funds likewise for short-term investment. As far as loans are concerned, leasing companies have taken advantage of the existing opportunities to lend to small and medium-sized enterprises and households. Consumer loans and hire-purchase plans offered by non-bank financial and commercial institutions are competing with the products and services offered by banks.

A diversification process has also been going on within banks, which, in a number of cases, head consolidated financial groups and through their subsidiaries exercise significant control over segments of the financial market. In addition to activities in the insurance and private pension scheme fields, they are involved in capital market trading, financial leasing, factoring and property trading. Many of these services, especially in the deposit market, but also in the loan market, are targeted at households.

4.3 MARKET STRUCTURE

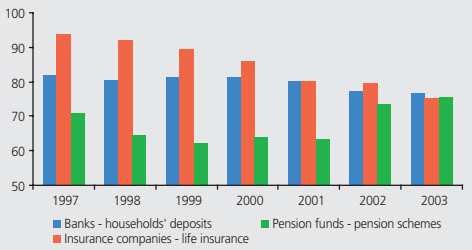
CHART IV.7
Market shares of banking financial groups
(%)



Source: APF ČR, ČAP, ALS, AFS.

Changes in market structure are a factor influencing the competitive situation in the sector and hence the efficiency and stability of financial institutions. Several aspects are important in this respect. Thanks to their capital strength and their ability to manage risks effectively and diversify their business, large strong financial institutions should be better able to withstand adverse pressures from the external environment. The concentration of financial activities into several large institutions is a positive development in this respect. However, their very size means that major financial institutions may also present a higher systemic risk than small companies. This also gives the state a greater incentive to intervene and bail out large companies when problems arise. Besides the fact that state assistance means intervention in the market and distorts competition, it also incurs fiscal expenses and generates a significant risk of moral hazard, tempting large companies to get involved in higher-risk activities. Consequently, in this context, a more competitive – i.e. less concentrated – market structure is the priority. Competition should foster better quality services and lower prices of products and hence motivate firms to be more efficient.

CHART IV.8
Market shares of the five largest companies on the relevant market
(%)

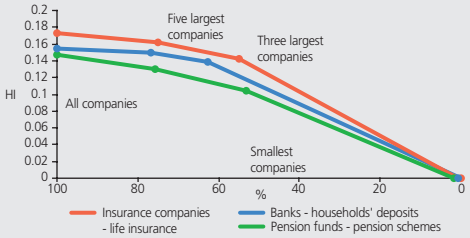


Source: CNB, ČAP

Rather mixed developments have been recorded across the individual segments of the financial sector in recent years. For instance, the number of organisations operating in the banking sector decreased from 40 in 2000 to 35 at the end of 2003 and the number in the pension scheme industry from 19 to 12 in the same period, whereas the number of insurance businesses has been flat at 40 since 1997. At the same time, there has been a gradual moderate decrease in concentration in the banking and insurance industries (which are currently the main segments of the financial sector), as measured by the share of the five largest financial institutions in the market. The pension fund sector has moved in the opposite direction, recording a rise in concentration. In spite of these mixed trends in the number of entities operating in the market, a similar market structure with a similar level of concentration has gradually emerged in these industries, with the five largest companies controlling around 75% of the market.

However, each financial industry has its specific features. In banking, for instance, many banks are currently trying to win new clients for loan transactions, and competition in this market segment is on the rise, whereas the deposit market remains controlled more conservatively by a smaller number of banks. This is also apparent in a way from the Herfindahl index, which measures the level of concentration. In the banking sector in mid-2004, the indices were 0.12 for assets, 0.11 for client receivables and 0.14 for primary deposits. In the household deposit market, the position of the three dominant banks is only slowly being challenged by competition from building societies (the large banks have maintained their positions through their subsidiary building societies) and from mergers and acquisitions implemented by some foreign banks operating in the Czech Republic.

CHART IV.9
Herfindahl index (HI) and market shares (%) of the three and five largest companies on the relevant market in 2003



Source: CNB

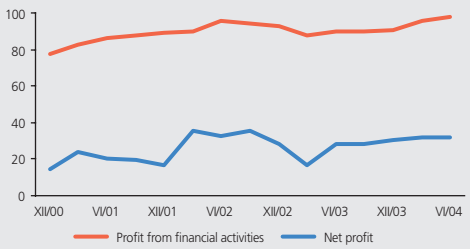
The main domestic insurance company has long had a privileged standing on the life insurance market. Today, its competition consists mainly of insurance companies operating within financial groups headed by banks. Foreign competitors specialising in the insurance market have bolstered their position by taking over a number of troubled pension funds. A strong position has also been maintained by subsidiaries of domestic banks. In 2003, large domestic banks controlled almost 36% of the private pension market and 24% of the life insurance market, but only 5% of the non-life insurance market. On the capital market, banks (the largest investment intermediaries) managed domestic investment funds and most of the assets of domestic open-ended mutual funds through their subsidiary investment companies.

4.4 THE BANKING SECTOR

4.4.1 Profitability and Efficiency

The stability of the banking sector has been positively influenced by the profitability in the last several years. Sufficient profit generation has improved banks' ability to absorb even higher business risks and has fostered a favourable environment for growth in lending.

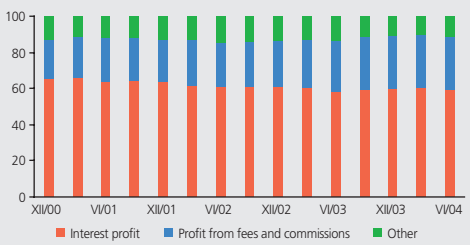
CHART IV.10
Profit from financial activities and net profit
(CZK billions, excluding Konsolidační banka and banks under conservatorship)



Source: CNB

The banking sector closed 2003 with a net profit of CZK 30.2 billion, after having made a profit in each of the previous three years. Net profit amounted to CZK 16.1 billion as of 30 June 2004, up by CZK 2.1 billion on the same period a year earlier, thus increasing the financial stability of the sector as a whole (of 35 banks, only 3 were loss-making). The half-year result indicates that the total net profit for 2004 might be around CZK 2–4 billion higher than in the previous year, provided that the current trend continues. The main reason for the net profit growth is higher growth of profit from financial activities than administrative expenses. Another factor that has considerably affected net profit has been a repeatedly falling level of net creation of provisions.

CHART IV.11
Profit from financial activities
(%; excluding Konsolidační banka and banks under conservatorship)

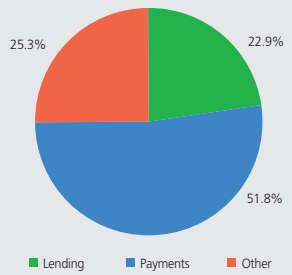


Source: CNB

Profit from financial activities, which is the basis of the resulting profit, has ranged around CZK 90 billion over the last three years. At 59% of total profit from financial activities for the first six months of 2004, interest income remains the largest component.

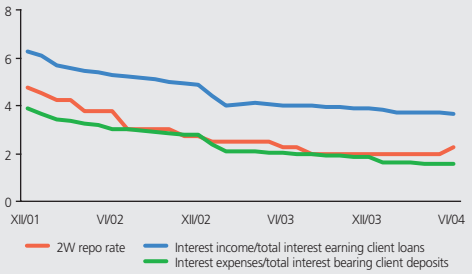
In summer 2004, banks responded to an increase in the CNB's key rates by increasing commercial interest rates on loans and partly also on deposits. This, together with continuing growth in lending, should result in a further increase in interest profit. Some banks, however, have for competitive reasons opted to make selected types of loans cheaper or have kept their interest rates unchanged and have not so far reflected the new market conditions in their margins.

CHART IV.12
Profit from fees and commissions as of 30 June 2004



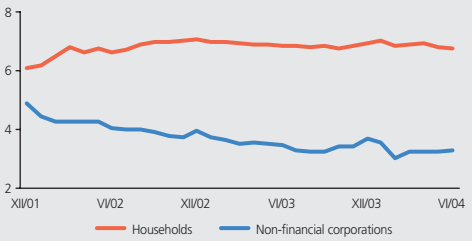
Source: CNB

CHART IV.13
Client and reference rates
(%; excluding banks under conservatorship)



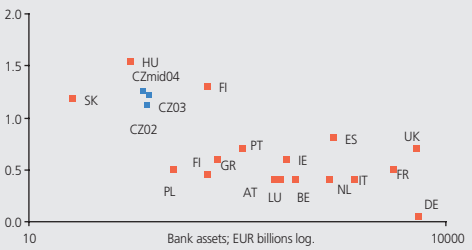
Source: CNB

CHART IV.14
Interest rate spread
(p.p.; total loans)



Source: CNB

CHART IV.15
Return on assets in 2003
(%)



Source: CNB, ECB

Profit from fees and commissions have recorded a rising share. The growth in this profit item is due to various effects. There is a rising volume of banking services associated with fees and commissions, such as cashless payments (e.g. salaries transferred to employees' current accounts replacing payments in cash, or direct debits from current accounts replacing payments by post) and the use of payment cards. There is also a huge expansion in consumer credit and mortgage loans. Such loans generate interest profit over the course of their repayment, but a fee is also charged for loan applications at the outset of the entire process. The provision of a mortgage loan, and in certain cases also of a consumer loan, is moreover tied to the opening of accounts on which fees are paid. Through their fee policies, banks are, among other things, trying to steer their clients towards cheaper forms of account maintenance (for instance Internet or mobile phone banking) which do not require the direct personal involvement of a bank employee. Banks make almost three-quarters of their fee and commission profit from payment and lending activities. The cost of advisory services and the fees attached to various service packages are also quite high.

Banks have in many cases decided to increase their fees for banking services. In this connection, the competitive market structure forming in the banking sector should play an important role in reducing the risk of an excessive increase in prices. At 29% in 2003, the share of profit from fees and commissions in total profit from financial activities in the Czech Republic was 3 percentage points higher than the average in the new EU member states.

The interest profit generated by banks in individual sectors of the economy depends on the volume of loans and deposits and on interest rates, which are conditional on the amount of loan (deposit) and the debtor's risk profile. In 2004 H1, transactions with the government sector accounted for 6.9% of banks' total interest profit, transactions with clients for 39.5%, transactions with banks, including the central bank, for 19.4%, debt securities (primarily government ones) for 30% and hedging interest derivatives for 4.2%. Profit from client transactions, which are the highest-risk component, thus has the largest share.

In June 2004, the interest rate spread on transactions with households was 6.76 points, compared to just 3.31 points in the non-financial corporations sector. Non-financial corporations have the advantage of lower interest on loans. The corporate sector is also more perceptive than households to loan rates and more often chooses floating rates in preference to fixed rates. Many households still view the latter positively as an element of security. In 2004 H1, households chose floating (or fixation of up to one year) for 12.2% of all house purchase loans, whereas 59.2% of such loans had a rate fixed for over five years. The corporate sector, on the other hand, opted for floating or fixation of up to one year for 89.2% of all newly drawn loans, while only 4.2% of such loans had a rate fixed for over five years. However, the type of rate also depends to a large extent on what the bank is offering, and not only on what the depositor or loan recipient is interested in. Rate fixation creates a risk arising from future unexpected movements in rates. In theory, banks, given information asymmetry and their better ability than clients to predict future developments, should be in a more advantageous position. However, even banks can lose on fixed rates. In building societies over the past few years, rate fixation has led to an insufficient interest spread and hence to a decline in interest profit. These institutions have had to seek other ways of offsetting this decline in order to protect their financial stability.

Households accept relatively high loan rates. Household loans have thus become a major source of profit for the banking sector at a time when interest rates have been at a low. The higher interest charged on loans to households also reflects the high transaction costs associated with a large number of loans of relatively low amounts.

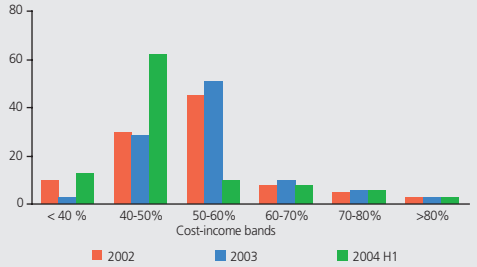
The profitability of the banking sector expressed as the ratio of net profit to assets has gradually risen in the last several years and is now relatively high. At 1.25% in mid-2004, it was almost double the year 2000 figure. Similarly good results have also been achieved by some other new EU member states from Central Europe. This contrasts with lower profitability in Western European countries, the banking sectors of which are still feeling the effects of the past economic downturn.

Return on equity – expressed as the ratio of net profit to Tier 1 capital – has been relatively high in the past four years. The figure for the first six months of 2004 was 23%. The domestic banking sector owes its generally high ROE values in the recent period primarily to the large banks category, which has been extraordinarily successful.

Beside profitability, costs are another indicator of banks' performance and efficiency. Administrative expenses – and especially staff costs (constituting almost 50% of administrative expenses as of 30 June 2004) – are relevant. Cost-effectiveness expressed as the ratio of administrative expenses to profit from financial activities (the cost-income ratio) ranged between 51% and 54% in 2000–2003. The development in 2004 so far indicates a slight fall in this ratio, i.e. a positive development, confirming the trend of a strengthening of the financial sector as a whole. As of 30 June 2004, those banks with ratios between 40% and 50% controlled almost 62% of total assets (three large banks are in this category).

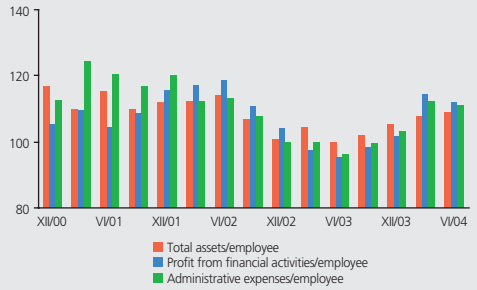
After recording a slight decline in 2002, growth in labour productivity, as measured by total assets per employee, has been rising since mid-2003 and was 9% year on year as of 30 June 2004. In absolute terms, the productivity achieved amounts to CZK 64.8 million per employee. Labour productivity expressed as profit from financial activities per employee grew by almost 12% year on year.

CHART IV.16
Cost-income ratio distribution
(% on bank assets)



Source: CNB

CHART IV.17
Labour productivity
(%; year-on-year changes)



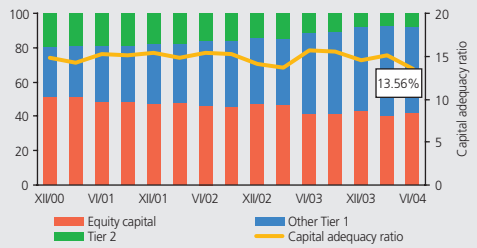
Source: CNB

4.4.2 Capital

In recent years, net profit has become an important source of capital for banks, thanks to which the banking sector as a whole has adequate capitalisation at present. This reduces the potential financial vulnerability of banks. Profit enters banks' capital in the form of retained earnings and funds created from profit.

In previous years banks set aside the bulk of their profits in the form of retained earnings, which became part of their total capital. In 2004, however, banks decided to disburse a significant portion of their year-2003 profits in the form of dividends. This applies especially to the category of large banks, where in some cases part of the retained earnings from previous years was also paid out as dividends. Banks decided to do this chiefly because of the high level of capital adequacy, which significantly exceeds the regulatory minimum. Dividends paid to shareholders for the year 2003 accounted for almost 90% of the total distributed profit and 79% of the net profit in 2003. The share of the banking sector in the total outflow of profit from the Czech Republic abroad is around 40%. The current high level of profit generation and repatriation to investor countries is linked with the objective stage of maturity of the FDI channelled into the banking sector in past years. The outflow of dividends is significantly increasing the income deficit and hence increasing the current account deficit in the balance of payments. The ability to finance this outflow presents a risk of external imbalance.

CHART IV.18
Capital structure and capital adequacy
(%; excluding Konsolidační banka and banks under conservatorship)



Source: CNB

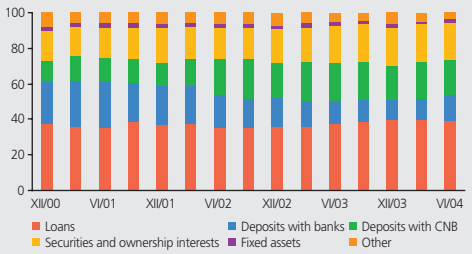
The capital adequacy ratio of the sector as a whole has long exceeded the required 8% minimum. It stood at 13.56% in June 2004, but has been gradually

falling since 2001 (from 15.4% at the end of 2001). This is due to higher growth in risk-weighted assets (which are subsequently reflected in the capital requirement)[24] than in total capital. This trend reflects the increased attention being paid by banks to the issue of capital efficiency in a situation where the risks of bad loans have decreased and the banking sector has stabilised.

The capital adequacy ratio of banks in the Czech Republic and its evolution corresponds to the ratios and evolution in other new EU member states. The ten new EU members reported an average capital adequacy ratio of 13.6% in 2003. The ratio had declined year on year, chiefly as a result of dynamic growth in risk-weighted assets (just as in the Czech Republic).

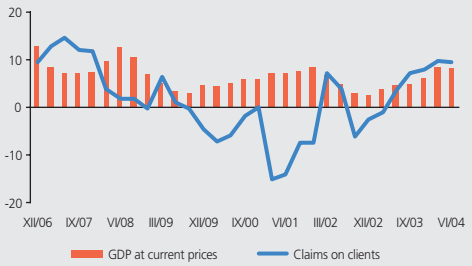
The banking sector's current capitalisation is so high that it would be able to maintain an 8% capital adequacy level even in the event of serious unexpected shocks. In a stress testing model, the banking sector proved its resilience to hypothetical changes in macroeconomic variables in two shock scenarios representing combinations of moderate and relatively large negative changes in interest rates, the exchange rate and loan quality.[25]

Chart IV.19
Asset structure
(%)



Source: CNB

Chart IV.20
Claims on clients and GDP
(%; year-on-year changes)



Source: CNB, CZSO

4.4.3 Asset Structure

The structure of assets and liabilities reveals banks' greatest potential risks. Loans and quick assets – accounting for 38.8% and 37.6% of total assets respectively in June 2004 – are the most important asset components. Loans are the more risky component of total assets. Quick assets, on the other hand, are liquid instruments with guaranteed, albeit none too high, yields.

The evolution of the asset structure reflects the cyclical development of the economy and also some longer-term trends. In the course of the past three years of economic recovery, the declining share of claims on clients recorded in 1999–2001 has turned into modest growth. Relatively low interest rates have also played a role in stimulating demand for loans. Many banks have recently been focusing increasingly on retail clients. Over the last three years, banks have considerably expanded their range of housing loans and consumer credit. The focus of banks on households was further supported in 2004 H1 by the passing of legislation permitting "American" mortgages.[26]

The rising lending could considerably help increase the total assets of the sector. In an environment of rising interest rates, banks could at the same time continue to increase their profitability. The development of government debt will also play a role in the years ahead, giving banks risk-free investment opportunities. However, if the economy unexpectedly slows or the balance sheets of corporations and households deteriorate for any other reason, banks would face a rise in credit risk.

4.4.4 Loans and Credit Risk

Receivables from clients amounted to CZK 1,029.6 billion as of 30 June 2004. Growth in lending exceeded 10% in 2003 and was 3.4% in the first six months of 2004. Since the end of 2001 there has been a pronounced upward trend in

24 The main reason is the overall growth in lending, represented primarily by growth in assets with a higher risk weight.

25 The stress test parameters and results are given in Annex 1.

26 A mortgage loan may thus be used for any purpose, provided that it is covered by pledged property. Further information is given in section 4.4.7 *Developments in the Area of Regulation.*

loans to households, which continued into the first six months of 2004 (growth of 14% compared to the end of 2003). Growth in bank loans to the corporate sector was considerably lower (3% in 2004 H1). Loans to the trades sector also increased slightly. These trends are reflected in the structure of lending.

Loans to the corporate sector form the largest component of total bank lending (43% at the end of 2004 H1). The decline in these loans (just like the decrease in their share of total loans) stopped in 2003 H2, and in the period that followed moderate growth was recorded. Bank loans to the non-financial sector amounted to CZK 441.6 billion as of 30 June 2004. The expected evolution of total bank lending is optimistic. It can be expected essentially to copy developments in the corporate sector, which in 2004 showed a continuing high rate of growth of industrial production and an improving business confidence indicator. The evolution of lending is consistent with the pick-up in investment growth powering the recent GDP growth. The largest increase in loans in the first six months of 2004 was recorded by construction firms, which enjoyed lending growth of almost one-quarter. The development of lending to non-financial corporations can be set in the broader context of their performance. Section 3.1 *Non-Financial Corporations* deals with the complex issues of this sector.

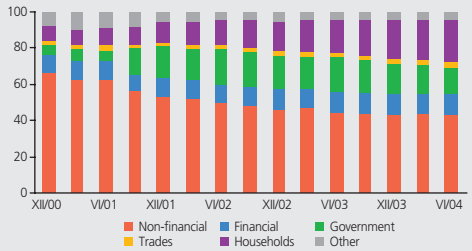
Most bank loans to the corporate sector are provided in Czech koruna. The koruna component has long been around 80%. In terms of maturity, short-term loans predominate in the corporate sector (41.6% of total loans as of 30 June 2004). However, their share of the total dropped year on year in favour of medium-term and long-term loans. The change in the maturity structure indicates their increased use for investment rather than short-term operational needs. Also in this respect, the evolution of the loan structure is consistent with the current stage of the business cycle. Bank loans are an important, but not the only, form of external financing for the corporate sector. Bank loans accounted for less than 30% of the external funds of the corporate sector at the end of 2003. Alternative corporate financing methods are given in section 3 *The Corporate and Household Sectors*.

Growth in loans to households continued into 2004. The total loans provided by banks to this sector amounted to CZK 240 billion as of 30 June 2004, representing a year-on-year increase in the debt of this sector of 36%. By international comparison, the current rate of growth of loans to households is high. However, it is based on a low initial level of these loans. Banks in the Czech Republic have started to focus more on the household sector only since the end of the 1990s. The growth in loans to retail clients is linked with changes in the saving and consumption behaviour of households and with low interest rates (even though, as stated above, rates for households are higher than those for corporate clients) and also with the fact that large loans to households can be secured by a system of guarantors, insurance and pledging of assets. The evolution of loans to households in relation to their total balance sheets is outlined in section 3.2 *Households*.

The rise in loans to households in the past several years has outpaced growth in wages and salaries. The indebtedness of households has thus increased. The quarterly volumes of wages and salaries increased by almost 6% in 2003, but total loans to households grew by 34%. This large difference between growth rates continued into 2004 H1.

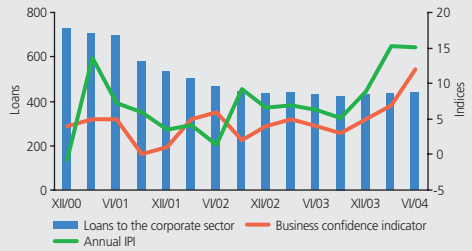
Within loans to households, housing loans (i.e. mortgage loans and building society loans) have recorded particularly strong growth in the last several years. The rate of growth of bank consumer loans has slowed somewhat. The existence of other forms of debt outside the banking sector might adversely affect the level of debt of this sector. Debt purchases, hire-purchasing, leasing and credit card borrowing are further increasing the overall indebtedness of the domestic population.

CHART IV.21
Loan structure by sector
(%)



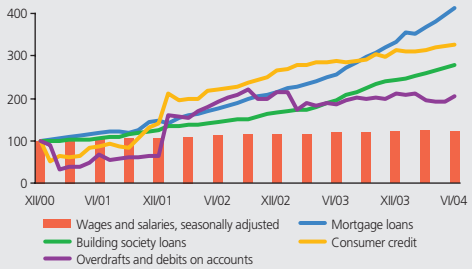
Source: CNB, CZSO

CHART IV.22
Loans to the corporate sector, business confidence indicator and industrial production index
(CZK billions)



Source: CNB, CZSO

CHART IV.23
Wages and salaries and loans to households in the Czech Republic
(%; 100% = XII/2000)



Source: CNB, CZSO

With their 41% share (almost CZK 98 billion) as of 30 June 2004, mortgage loans play the decisive role in the structure of total retail bank loans. Currently, mortgage loans can be drawn in the amount of the full price of the pledged property. This is fostering rising household indebtedness, as is the intensive construction of new apartments.

The credit risk in the case of mortgage loans is associated with several factors. Besides the continuing growth in the volume of these loans,[27] these factors include interest rate movements, which can change the debtor's instalment burden, developments on the property market, and the short history of these loans, which has so far prevented banks from gaining practical experience with long-term repayment. Section 3.2 *Households* and section 3.3 *Property Prices* deal with this issue in more detail.

Both banks and clients are continuing to focus on consumer credit. In January–June 2004, the stock of consumer loans to households grew by 4.5% to CZK 63 billion to account for 26% of total loans in the sector. The average amount of the loans being offered is on the rise, and at the same time the amount of loans provided without any evidence of income is increasing. As with other types of loans to households, the enormous growth in consumer loans is due primarily to their low initial level. The trend for these loans currently differs from most of the original EU member states. The year-on-year rate of growth has slowed (from 30.5% in mid-2003 to 12.7% in mid-2004), whereas in the euro area the original slowdown in growth in 2003 has turned into an absolute decline of more than 3%.

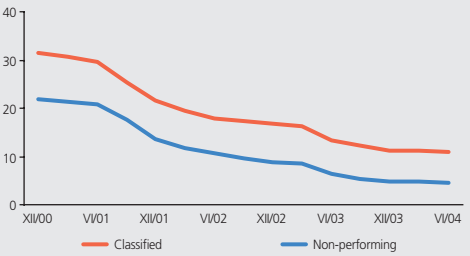
In aggregate, the quality of all types of loans has risen considerably over the past few years. In mid-2004, the share of classified loans in total loans was 10.8% and the share of non-performing loans in total loans was 4.5%, i.e. 24.7 percentage points and 23.5 percentage points lower, respectively, than in mid-1995, when the figures peaked.

The quality of the loans provided by banks in the Czech Republic is comparable to that of bank loans in the other new EU member states, where problem loans stood at 10.7% on average at the end of 2003.

The situation is improving in the case of corporate clients. In June 2004 classified loans to corporations amounted to 43% of the December 2000 figure and the share of classified loans in total loans fell just below 20% for the first time. Nevertheless, loans to corporations remain the poorer quality component of the loan portfolio.

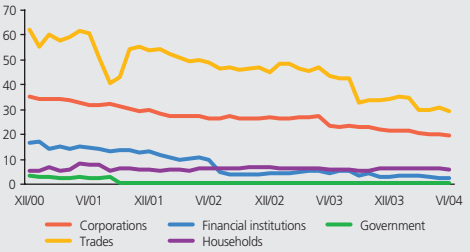
Loans to households are still among the least problematic ones in the Czech Republic. The share of classified loans in total loans has been fluctuating around 6% for some time. However, a future deterioration in quality cannot be ruled out in the medium term due to their dynamic growth. The quality of these loans differs considerably depending on their purpose. The share of classified mortgage loans in total mortgage loans has been in the range of 2%–3.5% since the end of 2000. Moreover, a large part of these loans are watch loans. The lower risk associated with housing loans is linked with banks' increased emphasis on assessing clients' solvency and with the existence of pledged property. The high

CHART IV.24
Watch and non-performing loans
(% of total loans; excluding Konsolidační banka and banks under conservatorship)



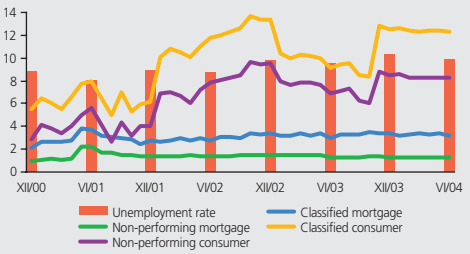
Note: Classified loans = watch and non-performing loans.
Source: CNB

CHART IV.25
Watch and non-performing loans by economic sector
(% of total loans of given sector; excluding Konsolidační banka)



Note: Classified loans = watch and non-performing loans.
Source: CNB

CHART IV.26
Watch and non-performing mortgage and consumer loans to households
(% of total loans of given purpose; excluding Konsolidační banka)



Note: Classified loans = watch and non-performing loans.
Source: CNB, CZSO

27 The sharp growth in mortgage loans, as with building society loans, in the Czech Republic is also due to a low initial base, as these types of loans only started to be provided in the mid-1990s. Comparing client housing loans between the Czech Republic and the euro area, one can see different trends in recent years. Loans in the Czech Republic grew by 46% in 2003 and by 19% in the first six months of 2004, whereas in the euro area the rate of growth slowed from 10% in 2000 to 8% in 2003.

quality of this component is also linked with debtors' motivation to hold on to their own housing for which the loan was acquired. The risk level of mortgage loans will probably rise in line with growth in the interest charged on newly provided loans and when rates fixed for shorter periods are revised.

In the case of consumer credit, households' discipline as regards repaying loans on time and in full is significantly worse. These loans are also usually far more poorly secured by banks. Their quality has steadily deteriorated, and the share of classified consumer loans in total consumer loans exceeded 12% in mid-2004. One factor indicating a possible improvement in this respect is the slowing rate of growth of consumer credit. The risk associated with consumer loans is reflected by banks in their interest rates, which are the highest for this type of credit.

The highest quality loans, i.e. those with the lowest ratio of classified to total loans, are loans to the government sector (around 0.5% in the long-term), followed by loans to non-bank financial institutions, whose share of classified loans in total loans dropped from 3.5% to 2.7% in 2004. The sector posing the highest risk to banks is trades, where almost one-third of loans are classified.

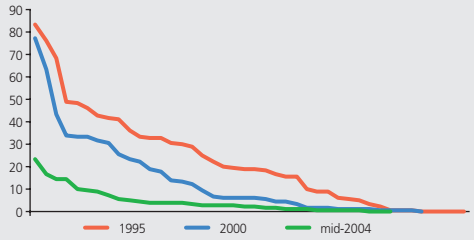
The distribution of the shares of non-performing loans in total loans also differs from bank to bank. However, this distribution has recorded a large shift in the period under review. At the end of 1995 the bank with the poorest loan quality had to include 83.5% of its loans among its non-performing loans, whereas five years later the highest reported figure was 77.2%. As of 30 June 2004, the least successful bank in terms of asset quality had 23% non-performing loans in its loan portfolio.

The banks' high degree of caution in providing new loans is playing a key role as far as asset quality is concerned. Another reason for the increasing loan quality was the transfer of low quality loans outside the banking sector, which was linked with the pre-privatisation clean-ups of the portfolios of large state-owned banks. Between the beginning of 2000 and mid-2004, banks sold loans valued at CZK 151 billion to non-banks, most notably the CCA (the Czech Consolidation Agency). The most frequently used forms of elimination of watch and non-performing loans were standard repayment and reclassification into the standard loans category.

Potential losses from the loan portfolio at the level of the banking system as a whole are fully covered by provisions, reserves and collateral. The degree of coverage by all of these forms exceeded 150% of the potential losses in June 2004. The absolute volume of reserves and provisions is falling in direct response to the rising quality of assets. Also, the use of information from registers of debtors may also be playing a role in the process of improving the quality of loans.[28]

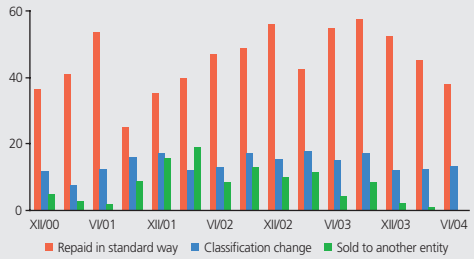
Despite the aforementioned favourable trend in loan portfolio quality, credit risk remains the primary risk for most banks. In this context, a shock affecting loan quality was simulated in a model. The results of the stress test showed that even quite a large increase in bad loans would not cause the capital adequacy ratio of the banking sector as a whole to fall below the regulatory minimum.

CHART IV.27
Share of non-performing loans in total loans according to individual banks
(%)



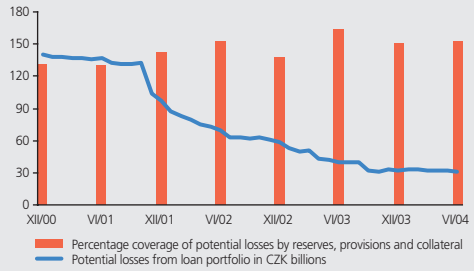
Source: CNB

CHART IV.28
Forms of decreases in watch and non-performing loans
(CZK billions; excluding Konsolidační banka and banks under conservatorship; excluding overdrafts)



Source: CNB

CHART IV.29
Coverage of potential losses from the loan portfolio



Source: CNB

28 There are three credit registers in the Czech Republic. The CNB operates the Central Register of Credits, containing information on legal entities and sole traders. The Czech Banking Credit Bureau is a commercial credit register with information on repayment of loans by citizens and sole traders. The information contained in the third register, Solus (Association for the Protection of Leasing and Loans to Consumers), may only be used by those banking institutions which helped to set it up.

4.4.5 Sources of Asset Financing

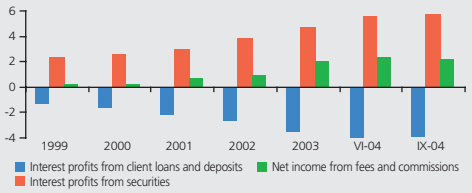
Risks also arise in banking business from maturity and currency mismatches between assets and liabilities and from mismatches between various sources of financing and the way they are used.

The surplus of primary funds over lending was 76% in June 2004 for the banking sector as a whole. The situation in terms of funds that can be used to finance bank assets differs from bank group to bank group and from bank to bank. Branches of foreign banks, with an interbank ratio (receivables from the interbank market/liabilities from the interbank market) of less than 1, use the interbank market as a source of financing. Conversely, large banks (ratio of 2.1 in mid-2004) allocate in this market the primary client deposits for which they cannot find any better allocation from their viewpoint.

A discrepancy between the forms of the individual sources of financing and the way in which they are used could put the building societies in particular at risk. In building societies, client deposits currently exceed loans provided by almost twofold. A balancing of the volume of deposits and loans is expected sometime in 2008–2010. Owing to a large decline in new contracts in 2004 following an amendment to the relevant law decreasing the state subsidy for savers, however, we cannot entirely rule out the scenario where building societies will seek other sources to finance loans. Financing on the interbank market may cause difficulties in the financial management of these banks, especially if there is a pronounced increase in interest rates.

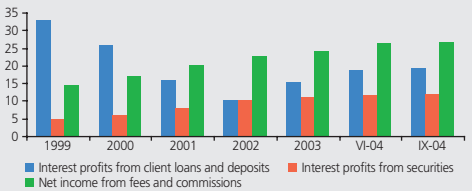
A shock affecting interest rates was modelled in a stress test, which showed a greater strain for building societies. For the banking sector as a whole, the stress test did not indicate any significant interest rate risk.

CHART IV.1.BOX
Interest profits and fees in building societies
(CZK billions)



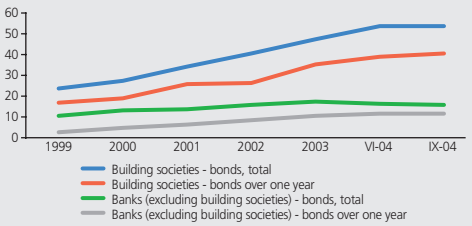
Source: CNB

CHART IV.2.BOX
Interest profits and fees in banks (excluding building societies)
(CZK billions)



Source: CNB

CHART IV.3.BOX
Bond portfolios as a percentage of total assets
(%)



Source: CNB

Box
Building Societies and Interest Rate Risk

Business in the building savings market has specific features which are reflected in the structure of building societies' balance sheets. On the liabilities side, deposits of building savings scheme participants dominate. These deposits accounted for 93% of total assets at the end of 2004 Q3. Interest is paid on these deposits at a fixed rate.

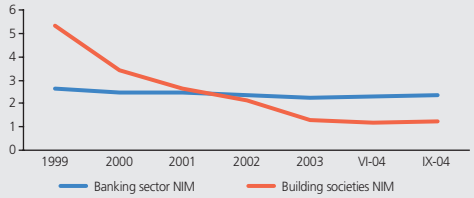
The situation on the asset side is different, since interest rates and income are much more variable there. Investments in money market and capital market instruments which meet the safety requirements make up a large part of the asset side. The proportion of bonds is significant. In mid-2004 bonds accounted for 54% of building societies' assets, compared to 16% for other banks (bonds with a maturity over one year accounted for 39% and 11% respectively). Loans granted by building societies represented 27% of their client deposits and 25% of their total assets as of the same date. In 2002–2003 there was a considerable fall in rates and yields on the money and capital market, leading to a sizeable decline in building societies' net interest margin. This contrasts with the relatively stable margin of other banks. Despite this, building societies have in recent years paid relatively high dividends to their shareholders, ranging from 10% to 15% of their capital.

The sensitivity of building societies' balance sheets to interest rate movements is amplified by the longer duration of their bond portfolio compared to other banks. The average duration of bonds with maturity over

one year held by building societies in mid-2004 was 3.4 years, compared to 2.2 years for other banks.

The aforementioned structure of building societies' balance sheets has significance in the assessment of market risks in the sector. Owing to the nature of their business, building societies are not exposed to direct exchange rate risk. However, the interest rate risk is higher than in the case of banks and could be reflected in capital adequacy.

CHART IV.4.BOX
Net interest margin (NIM)
(%)

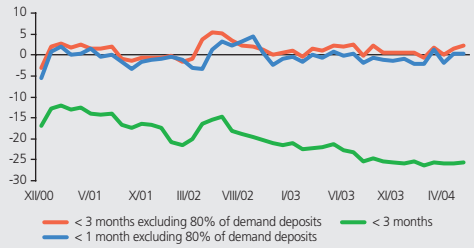


Source: CNB

The low interest rates in the last several years have stimulated borrowing rather than saving, which has resulted in a deterioration of matching in the case of long-term maturities. With the exception of building savings schemes tied to the achieving of a premium, clients have shunned time deposits, especially long-term ones. As for asset side transactions, there has been a clear effort to take advantage of the low interest rates and the best-ever supply of mortgage loans.

Given the rise in interest rates, growth in the volume of long-term bank liabilities can be expected going forward. The expected moderate growth in long-term client deposits will most probably be supplemented by a generally rising volume of mortgage bonds, new issues of which have been supported by several legislative measures (see section 4.4.7).

CHART IV.30
Cumulative net balance sheet position
(% of total assets, including off-balance sheet)



Source: CNB

In the case of short-term maturities, liabilities exceed assets. However, if the usual liquidity of demand deposits is taken into account, the matching of assets and liabilities with short maturities has been very good over the past two years.

The risks arising from currency mismatches of assets and liabilities in the balance sheets of banks in the Czech Republic is minimised by means of limits on open currency positions. Currently, such limits are not fully utilised by most banks. The issue of exchange rate risk is discussed further in the following section.

4.4.6 International Aspects

The continuing process of international integration of the Czech banking sector is introducing new aspects. This integration is taking several forms, the most important of which being the recent privatisation of state-owned stakes in banks to foreign investors and the various forms of operation of foreign banks in the Czech Republic. It also entails certain risks.

The Czech banking sector is almost fully controlled by foreign owners. As of 30 June 2004, foreign shareholders held 85.1% of the registered capital of banks, and 96% of the total assets of the sector were under foreign control (directly or indirectly) as of the same date. A high share of foreign capital in the banking sector is also typical for some other new EU member states.[29]

TABLE IV.1
Ratings of the Czech Republic and home countries of foreign parent banks
as of August 2004

	Fitch		
	LT Foreign Currency	ST Foreign Currency	LT Local Currency
Czech Rep.	A-	F2	A
Belgium	AA	F1+	AA
France	AAA	F1+	AAA
Austria	AAA	F1+	AAA
	Moody's		
	LT Bonds & Notes	ST Bonds & Notes	LT Bank Deposits
Czech Rep.	A1	P-1	A1
Belgium	Aaa	P-1	Aaa
France	Aaa	P-1	Aaa
Austria	Aaa	P-1	Aaa
	Standard & Poor's		
	LT Foreign Currency	ST Foreign Currency	LT Local Currency
Czech Rep.	A-	A-2	A
Belgium	AA+	A-1+	AA+
France	AAA	A-1+	AAA
Austria	AAA	A-1+	AAA

Source: CNB

Parent foreign banking institutions have facilitated the transfer of management know-how and new technologies, expanded the range of banking products and services on offer, introduced modern distribution channels and changed the approach to the client. An improvement in the quality of risk management and an emphasis on internal control systems have bolstered the banks' stability. All

29 At the end of 2003 the share of assets controlled by foreign capital was highest in Estonia (97%). In Slovakia it was the same as in the Czech Republic, at 96%. The share is also very high in Latvia (91%), Hungary (83%) and Poland and Malta (both 68%). Local capital predominates in Lithuania, Slovenia and Cyprus. Foreign investors, primarily banks from the EU15, controlled around 70% of the assets in the banking sectors of the new EU member states.

these factors have fostered relatively high and repeated profitability of the sector and satisfactory asset quality and capital formation.

On the other hand, the prevailing foreign ownership is a potential source of risks with regard to the transmission of economic problems from the home countries of parent banks or from parent banks themselves. Some Western European banks operate in several new member states simultaneously. The risk of international contagion might thus increase further. However, it should be noted that judging from the ratings of the home countries of foreign parent banks, the scenario of transmission of economic problems to the Czech Republic is not very likely. According to studies performed, however, a curtailment of subsidiary banks' lending activity cannot be ruled out in the event of a recession or financial shock in the parent's home country.

Another potential risk is the aforementioned outflow of profits in the form of dividends paid abroad. The decision on the amount of profit repatriated to the home country depends on the stage of the life cycle of the subsidiary bank, the economic and political situation in the country and the performance of the subsidiary itself. Much higher dividend payments abroad thus were registered in 2004 than in previous years.

As regards the stability of the Czech financial sector, the lower weight of subsidiaries and branches of foreign banks in the Czech Republic for their "large" parent banks and home supervisors by comparison with their significant, almost decisive importance in the Czech banking sector and financial sector as a whole, should not be underestimated.

The four largest foreign-owned Czech banks are, in terms of total assets, far less significant than their parent companies and have somewhat worse ratings if assessed by rating agencies (although they do have investment ratings). However, when one compares ratios, subsidiaries outperform their foreign owners in some cases. Indicators derived from profit show subsidiaries to be better performers, whereas indicators of loan portfolio quality only started to approach those of foreign parent companies in 2003.

As indicated above, foreign ownership has helped to open up the Czech banking sector to foreign economies. The overall position of the banking sector vis-à-vis non-residents – showing an excess of claims over liabilities since 1998 – recorded an increase as of 30 June 2004 due to contrary movements in non-resident assets and liabilities. With respect to non-residents, the overall position of the banking sector as a creditor was considerably strengthened, which might pose some risk to the recovery of claims if the bulk of them were linked to more risky regions. Currently, though, Czech banks' main business partners are banking institutions and non-banks in EU countries. The potential risk of contagion through the banking sectors of EU countries is insignificant, thanks to the diversified geographical orientation of the strategic owners of domestic banks and other foreign banks operating on the domestic market. Transactions with non-residents show considerable volatility. The bulk of them are linked to transactions on the interbank market (about one-half of non-resident assets) in which domestic banks try to take advantage of conditions in foreign markets in order to utilise their resources efficiently.

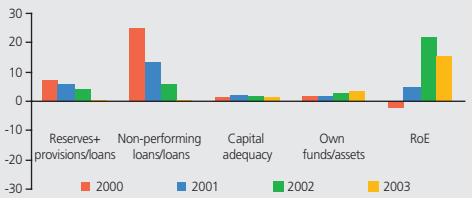
Particularly important are non-resident interbank transactions with partners based in Belgium, France, Italy, Austria and Germany, i.e. the home countries of the owners of the key Czech banks. These transactions chiefly relate to links between parent banks and their subsidiaries. The significance of bonds issued by banks in

TABLE IV.2
Ratings of Czech banks and their foreign parent banks
as of August 2004

	Fitch		
	LT	ST	Individual
ČSOB/KBC	A+/AA-	F1/F1+	C/B-C
KB/SG	A/AA-	F1/F1+	C-D/B
ČS/Erste Bank	A-/A	F2/F1	C/B-C
	Moody's		
	LT Bank Deposits	ST Bank Deposits	Fin. Strength
ČSOB/KBC	A1/Aa3	P-1/P-1	C-/B
KB/SG	A1/Aa3	P-1/P-1	C-/B
ČS/Erste Bank	A2/A1	P-1/P-1	D+/B-
	Standard & Poor's		
	LT Foreign Currency	ST Foreign Currency	LT Local Currency
ČSOB/KBC	BBB+/A	A-2/A-1	BBB+/A
KB/SG	BBB+/AA-	A-2/A-1+	BBB+/AA-
ČS/Erste Bank	BBB+/ -	A-2/A-2	BBB+/ -

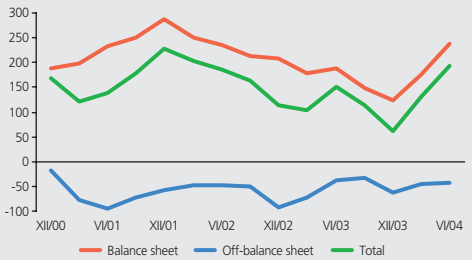
Source: CNB

CHART IV.31
Differences in selected indicators for the four largest Czech banks and their foreign parents
(p.p.)



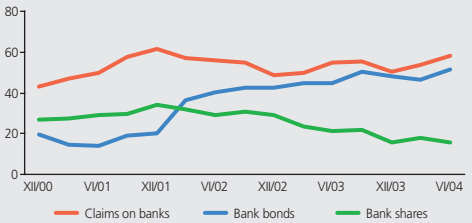
Source: CNB, BankScope

CHART IV.32
Position of the banking sector vis-à-vis non-residents
(CZK billions)



Source: CNB

CHART IV.33
Non-resident transactions vis-à-vis banks in EU member states
(% of total transactions of given type)



Source: CNB

the EU has recently become close to that of interbank transactions with foreign banks. The potential risk of contagion associated with the interbank market as measured by exposure vis-à-vis banks in the USA and Asia is significantly less than the potential risk vis-à-vis EU countries. Claims on banks from these regions individually account for less than 3% of the whole. The share of classified loans vis-à-vis foreign banks is practically zero.

With the exception of Slovakia, Czech banks rarely have exposure to foreign non-bank clients.[30]

The banking sector executes most of its business in the domestic currency (more than 83% of assets in June 2004), and the openness of the foreign exchange position is relatively low. The long foreign exchange position fell continuously until mid-2002, when it changed into a short foreign exchange position. This accounted for less than 1% of assets as of 30 June 2004. Direct exchange rate risk is insignificant.

In all, 86% of claims on clients are currently denominated in koruna. Euro-denominated claims have grown in recent years. This growth trend is logically consistent with the increasing volume of transactions between clients of domestic banks and their partners from the euro area, and it can be expected to continue. As for client deposits, the koruna share is even higher than for claims, being close to 90% of the total. The euro component of primary deposits has been flat for the last four years at 6%–7%. The overall position for euro-denominated client deposits and loans is almost balanced. The foreign exchange position in the dollar-denominated client loans and deposits market shows a slight predominance of liabilities.

The banking sector was exposed in a stress test to a model shock to the exchange rate. The results of the test confirm that exchange rate risk for the banking sector as a whole is insignificant.

Another aspect of the links between the Czech economy and the banking sectors in EU member states is the provision of banking services in the Czech Republic by foreign banks. These issues are discussed in the following section.

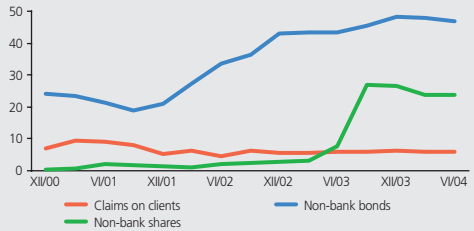
4.4.7 Developments in the Area of Regulation

The current changes in the area of regulation and legislation often form part of the continuing harmonisation efforts aimed at giving banks a level playing field for business in the enlarged European Union. The planned new regulations and amendments to existing documents also respond to the requirements of the new capital framework (Basel II) and the further development of the rapidly changing domestic and international financial market environment.

The new capital framework – Basel II

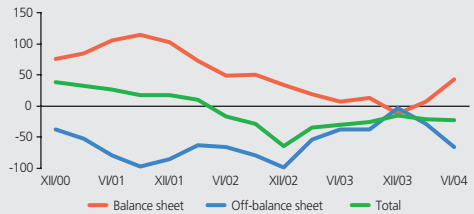
The objective of the new capital framework is to increase the safety and soundness of financial systems, to introduce more accurate and sensitive rules for risk management and the calculation of regulatory capital, and to engender more extensive disclosure of information directly from banks so as to enhance the disciplining role of the market. These objectives are reflected in a more sensitive

CHART IV.34
Non-resident transactions vis-à-vis clients in EU member states
(% of total transactions of given type)



Source: CNB

CHART IV.35
Foreign exchange position of the banking sector
(CZK billions)



Source: CNB

30 The high proportion of client loans, ownership interests and fixed interest securities is related to ČSOB's strong historical ties to Slovakia. As of 30 June 2004, this bank had more than 200 branches in Slovakia.

approach to measuring risks in relation to the particular risk profile of a bank, and in more exact procedures for quantifying the regulatory capital of each individual bank.

Banks have been preparing themselves for the implementation of the required changes on a continuous basis since 2002. The changes arising from Basel II have thus already been influencing banks' behaviour prior to their introduction and require significant external investment (in information systems, development of models) and internal investment (in training, conversion to new processes) relating to the implementation of the new framework.

An important element in terms of financial stability is the banks' regulatory uncertainty arising from the fact that the relevant EU Directive implementing the Basel II principles is not yet in its final form, so changes having a more significant impact cannot be ruled out. Another element introducing uncertainty into the banking environment is the partial downgrading of the role of national regulators on the one hand and the emphasising of the role of consolidated regulators at EU level on the other. The rights of the banking supervisory authority in the Czech Republic may thus be constrained, owing to a shift in powers by comparison with the current situation. The scope and division of powers under the current proposal does not coincide with the specific responsibility for decisions made and is subject to debate within the EU. The establishment of the function of consolidated regulator at the European level will probably require some changes to the current version of the Czech Act on Banks.

The banks operating in the Czech Republic regard the uncertainties relating to the planned regulatory changes as a potential source of risks. A survey conducted among Czech banks in the first half of 2004 revealed that the risk arising from the expected regulatory changes is deemed medium to high by 87% of the banks questioned.

Apart from bringing a major change in risk management, the new capital framework will significantly change the calculation of the capital requirement. Large foreign banks expect to make capital savings as a result of the changes. However, the conclusions of the survey conducted among Czech banks are less optimistic. The capital requirement for operational risk may significantly increase the overall capital requirement.

Fair value accounting

Fair value accounting (FVA) principles are gradually being implemented into domestic banks' bookkeeping. The different accounting principles used in different countries prevent full comparability of national banking sectors and also make life difficult for entities owned by foreign investors, who have to keep accounts in dual format and hence incur higher costs.

The direct impact of FVA on profit/loss is positive, as it facilitates the identification of potential and hidden weaknesses (or irregularities) using the current accounting system. FVA enables more timely detection of deteriorations in asset quality than historical cost accounting and thus allows appropriate measures to be adopted more quickly. This should ultimately lead to a strengthening of the confidence and stability of individual institutions and the sector as a whole.

In terms of financial stability it is vital that investors and analysts have a proper understanding of the principles of fair valuation. The FVA approach may lead to over-optimism in a period of boom when market prices of assets are simultaneously peaking, and conversely to excessive caution in the event of recession.

FVA will significantly affect the monitoring of lending and loan quality. With the use of fair valuation, the potential volatility of loan data has two components, namely actual changes in the volume of financing of the economy and changes in the valuation of these loans. The introduction of FVA will thus reduce the information value of the balance sheet for some analytical purposes.

Single banking licence and free provision of services within the EU

Foreign banks have long been present in the Czech Republic through their subsidiaries and branches. Since the Czech Republic's accession to the EU in May 2004, all nine existing branches of foreign banks have been enjoying the benefits arising from the EU single licence directive. Under the same principles, other branches of foreign banks from EU countries may operate in the Czech Republic. Following accession, some other banks have taken advantage of the possibility of offering their services and products in the form of cross-border banking.

Since May 2004, branches of foreign banks do not fall fully within the competence of the CNB as the domestic supervisory body. In the case of branches of foreign banks which are supervised by their head offices' home supervisory authorities, the CNB currently supervises compliance with the liquidity rules and the area of money laundering. By contrast, the role of co-operation between supervisory authorities and the tasks arising from memoranda of understanding are being strengthened. Branches of foreign banks, both existing and newly established, continue to provide the CNB with all information on their activities in regular reports. These reports are currently used solely for statistical purposes.

Cross-border banking undoubtedly has some positive features, first among them being greater competition. Banks that start doing business in the Czech Republic (after making the required notification) help to foster a broader supply of services and products. This might, in turn, lead to growth in the quality of services and to a correction of prices. However, this new banking institution segment also brings with it potential risks. Relations with clients need not be, and, given the condition of non-systematic provision of services, should not be as stable as in the case of subsidiaries and branches of foreign banks. Thus, the risk may arise of more volatile cross-border cash flows responding sensitively to changes in economic, political or institutional conditions. Free provision of cross-border banking services is not supervised by the CNB in any respect, nor are statistical data provided. In the position of host country regulator, the CNB will not have at its disposal relevant data on cross-border financial activities, despite the fact that these activities, should they expand, might affect financial stability in the country.

The issue of non-uniform insurance of bank deposits in individual European countries is another problem area. Mandatory deposit insurance in the home country of the bank's head office does not absolve the host regulator – and in particular the central bank – of its responsibility for the financial stability of its country. Given the current structure of the Czech banking sector it cannot be ruled out that large subsidiaries (the former state-owned banks) of systemic relevance to the Czech banking sector will be transformed into branches.

Other legislative changes

In January 2004, an amendment to the Act on Building Savings Schemes and State Support for Building Savings Schemes entered into force. The main thrust of this amendment was to change the parameters of the state support provided for building savings schemes. In the area of deposits, building societies had in the recent past acquired a large market share, thanks chiefly to advantageous saving

conditions up to the end of 2003. However, in 2004 the number of new contracts dropped in year-on-year comparison. Should this trend intensify further, it could – in the longer term – affect the financing of loans extended. Their share in total assets (25%) is still low, but their growth is fairly buoyant and their quality is above average. The share of classified loans in total loans is approximately one-third of the average.

Besides the amendment to the Building Savings Schemes Act, the stability of the sector may be affected by a fine. The Office for the Protection of Competition is currently deciding in appeal proceedings on a fine imposed for a cartel agreement and an increase in fees on the building savings scheme market. The building societies decided to increase their fees or introduce new fees primarily in response to a sharp drop in their interest profit (resulting from a fall in interest rates). An alternative means of increasing profit is expansion of business and growth in lending. In 2004, building societies licences' were extended to include distribution of financial products such as insurance, mortgage loans and pension and investment fund products in the context of financial brokerage. In connection with the ongoing proceedings of the Office for the Protection of Competition, preparatory work also started on potential legislative bills to revise the Building Savings Schemes Act. The considerations focused on defining rules for determining and changing fees for building society clients. Also considered was the option of allowing client migration between individual building societies in order to increase competition and reduce fees. Such a change, however, would motivate building societies to improve the conditions for savers at the expense of borrowers. As regards the functioning of the building savings scheme system, the benefits of migration are dubious, since they would be exclusively on the side of clients interested in saving rather than in taking out a special-purpose loan, which is the main reason for the existence of the state support for building savings schemes.

The issue of real estate has also been affected by an amendment to the Act on Banks (which entered into force in May 2004), which repealed the obligation of banks to ask the regulator for a permit to issue mortgage bonds. Mortgage bonds may now be issued by all banks headquartered in the Czech Republic. The new Act on Bonds changes the definition of mortgage loans. Newly, a mortgage loan may be any loan secured by property, and mortgage bonds can now be issued against this broader scale of loans. This revision should foster growth in the overall issuance of mortgage loans and hence of mortgage bonds as well. The incorporation of American mortgages into the domestic legislation – allowing the drawdown and long-term repayment of large, non-specific loans – is an addition, rather than alternative, to consumer loans, which are generally smaller and have shorter maturity. For the client, one advantage of American mortgages over consumer loans is the lower interest charged on them. One potential disadvantage is the situation where the value of the property exceeds the amount of the loan requested. For the bank, conversely, collateral in the form of property represents a significant improvement of its position vis-à-vis the debtor compared to the situation for consumer credit. Thanks to a limit on the amount of the loan to 60%–70% of the value of the property, the bank also eliminates to some extent the risks associated with movements in property prices.

A positive effect on the stability of the entire financial system can be expected from the planned Act on Financial Conglomerates. This will regulate the performance of complementary supervision of regulated entities operating in financial conglomerates, relations between the supervisors of individual sectors of the financial market, and the obligations of entities operating in a financial conglomerate. The primary objective of the new Act is to define requirements for capital at financial conglomerate level so as to prevent multiple use of capital.

A new draft amendment to the Bankruptcy and Composition Act should strengthen the position of banks as creditors and newly regulate the position of banks in bankruptcy or composition.

In 2003 and 2004, the central bank also drafted new provisions and decrees (and amended the existing ones) regulating and changing the regulatory framework for bank business. These measures reflected the need for stronger internal control systems in banks, disclosure of information, prevention of money laundering and further development of mortgage lending.

An important condition for efficiently functioning financial markets is a strong system of co-operation between individual regulators. In a government-approved plan to integrate supervision of the financial markets (published in May 2004), the aim is to create a single integrated supervisory authority.[31] The integration of supervision into a single institution (as of the date of introduction of the euro in the Czech Republic) should eliminate the overlapping of activities of the current supervisory bodies, reduce administrative costs, strengthen and streamline the supervisory system and thereby promote efficient operation of the financial markets.

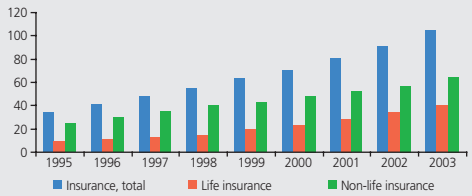
4.5 INSURANCE COMPANIES

The insurance market can be divided conceptually and in terms of the risks involved into two independently monitored and, as a rule, institutionally separate parts: life insurance and non-life insurance. Besides specialised insurance companies, universal insurance companies with separate accounts for life insurance and non-life insurance operate on the current domestic insurance market. Of the total number of 42 insurance companies in 2003, 23 non-life insurance companies, 3 life insurance companies and 16 universal companies operated on the market.

The insurance market is enjoying buoyant growth (16.9% in 2003). The high rate of growth will be maintained in 2004 thanks to life insurance, tax relief and the demographic structure of the population. However, the utilised potential of the market based on premiums written is still low: 4.2% of GDP, compared to a euro area average of around 50% of GDP.

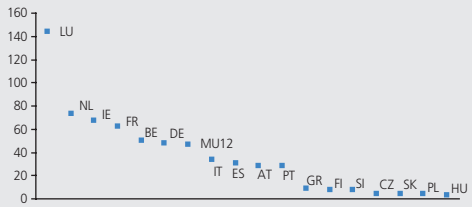
Insurers are required by law to set aside adequate technical reserves to cover the risks arising from insurance activities, doing so separately from their other liabilities. In conditions of market growth and prudent business activity, technical reserves are showing a rising trend. Technical reserves are the main source for financial investment in assets, which are subject to restrictions by law and whose structure should comply with the principles of safety, profitability, liquidity and diversification. In 2003, insurance companies invested 63% of their technical reserves in risk-free bonds and almost 10% in deposits in banks. Other investments are made in publicly tradable domestic and foreign bonds, mortgage bonds, property in the Czech Republic and only a negligible proportion in hedging derivatives.

CHART IV.36
Life and non-life insurance (premiums written)
(CZK billions)



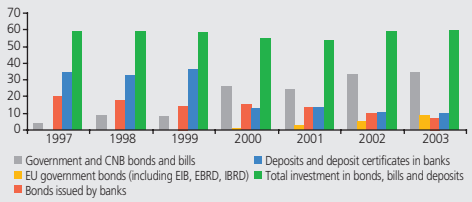
Source: MF CR

CHART IV.37
Life and non-life insurance (premiums written)
(% of GDP)



Source: MF CR, IAIS, ECB (figures for 2002)

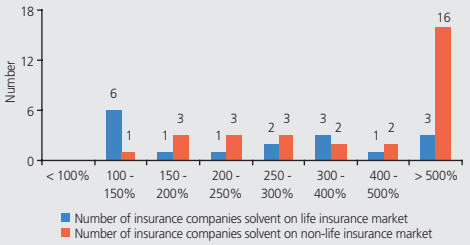
CHART IV.38
Financial investment in safe assets
(% of financial investments)



Note: Technical reserves are the main source for financial investment.
Source: MF CR

31 Supervision of the financial markets is currently performed by CNB Banking Supervision, the Office for Supervision of Credit Unions, the Czech Securities Commission and the Finance Ministry's Office of State Supervision of Insurance Companies and Private Pension Schemes. Initially, supervision of banks will be integrated with supervision of credit unions within the CNB (as of 30 June 2005) and state supervision of the capital market will be integrated with state supervision of insurance companies and pension schemes within the Czech Securities Commission (by 31 December 2005). The second stage, which is expected to be implemented on the date of introduction of the euro in the Czech Republic, will involve integrating the supervisory activities of the CNB and the Securities Commission.

CHART IV.39
Number of insurance companies satisfying the disposable to required (minimum) solvency ratio (%) in 2003



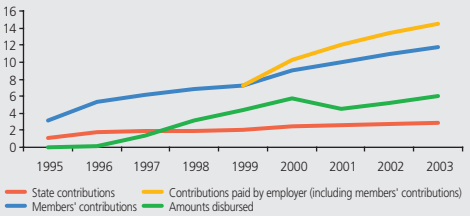
Source: MF CR

As regards compliance with the solvency criterion (prescribed in a decree), disposable (actual) own funds should be greater than, or at least equal to, the required minimum solvency.[32] In 2003, all insurance companies operating on the market were compliant with this criterion. Aggregated disposable solvency was 3.9 times required solvency in the non-life insurance market and 2.7 times required solvency in the life insurance market. Most insurance companies have sizeable own funds available for future expansion. The stability of insurance companies was also fostered by higher profitability (ROA), which stood at 2.2%.

Activities in the insurance industry are regulated by law for domestic insurance companies and reinsurance companies, for insurance companies with a single licence, and for third-country insurance companies. Newly, an insurance company cannot be granted a licence to carry on life insurance and non-life insurance activities simultaneously. The Finance Ministry is responsible for supervising insurance companies and for supervising an insurance company's activities within a group.

4.6 PENSION FUNDS

CHART IV.40
Pension fund sources and amounts disbursed in the given year
(CZK billions)

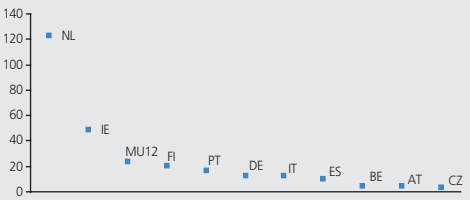


Source: MF CR

From the emergence of private pension schemes, until the end of 2003 a total of CZK 90.3 billion in contributions was invested in the system. Of this, CZK 19.7 billion came from the state. The stock of liabilities of the twelve active pension funds after collections and payments vis-à-vis members totalled CZK 77.2 billion. State contributions are rising in absolute terms in line with the number of pension scheme members requesting a state contribution, but their weight is falling relative to the overall volume of funds. The growth in funds is being motivated by the state contribution and by tax deductibility. Funds from employers, to which the state contribution does not apply, receive preferential treatment either in terms of taxation or by cost formation from the social insurance assessment base up to a prescribed level.

The ratio of private pension insurance to GDP was 3.1% in 2003. The growth potential of pension schemes by comparison with the euro area average (23% of GDP) is thus considerable. Due to demographic trends and the planned reform of the pension system, further growth of the private pension system is expected, as a supplementary pillar to the state pension system.

CHART IV.41
Pension scheme members' funds in 2003
(% of GDP)



Source: MF CR, ECB, CZSO

Pension funds invest the funds they receive from their members in safe assets: 46.4% in government and CNB bonds and bills, 19.4% in bank deposits and bonds and 12.3% in bonds issued by OECD countries. They located 21.8% in other investments in 2003.

Pension funds have achieved a sustained high return on average assets, which stood at 3.15% at the end of 2003 and was higher than that of banks and insurance companies. The profits have helped to increase the value of investors' contributions.

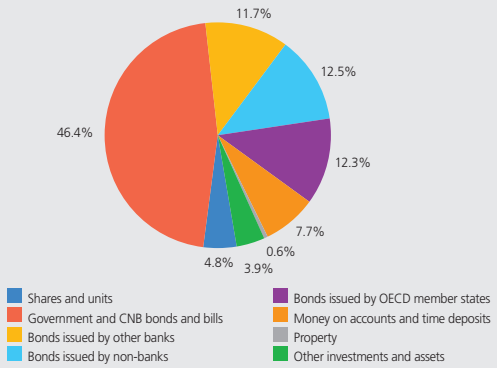
The Private Pension Insurance Act allows pension funds to be established by domestic and foreign legal entities or natural persons. This option has been used by employers and trade unions as well as financial companies. Employers have gradually been selling off their pension funds to foreign financial corporations, and the influence of well-capitalised shareholders simultaneously operating in banking and insurance is on the rise.

32 Solvency is the required amount of own funds sufficient to cover such (extraordinary) insurance claim payments that are not covered by the technical reserves of the insurance company.

Supervision involves inspecting the internal operations of pension funds, contractual relations and compliance with members' statutory entitlements. The state supervisory authority performs inspections in the area of claims for state contributions and the number of eligible members, the size of their assets, and compliance with the statutory limits on investments in financial assets, in line with the principles of safety, quality, liquidity and profitability of the structure of such investments. An amendment to the Accounting Act clearly segregates members' funds from the other liabilities of pension funds.

The activity of a pension fund and the activity of a depositary are subject to state supervision performed by the Ministry of Finance and the Czech Securities Commission (investment in capital market instruments). The pension plan and any changes thereto have to be approved by the Ministry of Finance.

CHART IV.42
Structure of pension fund investments in 2003



Source: MF CR

4.7 OTHER CAPITAL MARKET PARTICIPANTS

Apart from banks, insurance companies and pension funds, there are collective investment undertakings (i.e. investment funds converted into open-ended mutual funds, and investment companies administering shareholders' assets pooled in funds) which are involved in capital market transactions. Other organised market participants include securities dealers, brokers and investment intermediaries.

There was a further fall in the number of such entities in 2001–2004, as a result, for instance, of the withdrawal of licences from investment funds (which did not have depositaries), the investment company liquidation decisions of the Czech Securities Commission, the decisions of administrator investment companies to merge open-ended mutual funds, and a review of licences in the case of securities dealers. These steps fostered consolidation on the capital market, where institutions and persons now operate who satisfy prudential requirements and standards in compliance with the European law and are subject to state supervision.

4.7.1 Investment Companies and Investment Funds

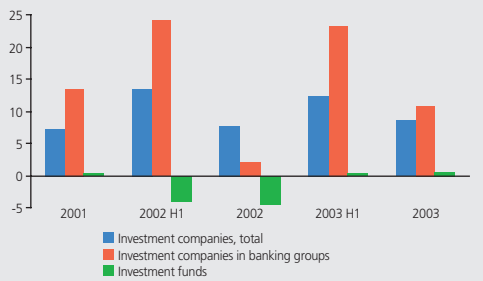
As of the end of 2003, a total of 15 investment companies were operating on the capital market, of which 3 were foreign owned and 5 were controlled by resident (mainly large) banks. Investment companies had assets of almost CZK 4 billion. They had 20% of their investments allocated in non-government bonds and 80% in shares, units and other securities. The companies maintained an overall ROE of 10.8% and ROA of 8.7%. The importance of investment companies consists in rational, prudent management of domestic funds (usually open-ended mutual funds or investment funds).

The size of the assets in investment funds dating from the privatisation period dropped considerably (to CZK 2 billion), owing to conversions to open-ended mutual funds. Bank subsidiaries administered the four last investment funds active in the market.

Investment funds within banking financial groups were profitable. However, banking financial funds' profitability was low, partly because of limited investment opportunities linked with their expected conversion to open-ended mutual funds (shareholder lawsuits regarding the validity of the conversion).

Investment companies and investment funds are required by law to have in place administrative and accounting procedures, internal control system requirements and policies to prevent conflicts of interest during the provision of services. Under

CHART IV.43
ROAs of investment companies and investment funds
(%)

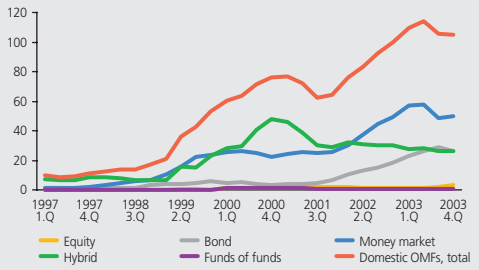


Source: KCP

the Collective Investment Act and other standards, an investment company or investment fund may not use administered assets for its own account. State supervision of investment companies and funds is performed by the Czech Securities Commission.

4.7.2 Open-Ended Mutual Funds (Domestic and Foreign)

Chart IV.44
Assets of domestic open-ended mutual funds
(CZK billions)

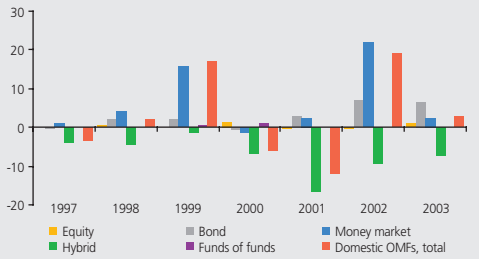


Source: UNIS

Domestic open-ended mutual funds are a developed form of collective investment in the Czech Republic. At the end of 2003, a total of 66 funds were active, with assets totalling CZK 106 billion. Of this number, 38 funds, with assets of CZK 99 billion, were administered through domestic subsidiary banks. Open-ended mutual funds invested mainly in bonds: 38% in government bonds and 48% in other bonds.

In addition to these domestic funds, foreign mutual funds offer products through registered investment intermediaries and securities dealers (including banks), although the actual investing is carried out by an investment company (fund) headquartered abroad. To publicly offer foreign special funds in the Czech Republic, a permit is needed from the Czech Securities Commission. To publicly offer foreign standard funds (UCITS) in the Czech Republic, the single licence principle applies, i.e. there is a duty to notify the Commission. According to the Capital Market Association, 730 foreign funds operate in the domestic market, and the total value of the investments of these funds in the Czech Republic was CZK 46 billion at the end of 2003.[33]

Chart IV.45
Net sales of domestic open-ended mutual fund units
(CZK billions)



Source: UNIS

Net sales of CZK 10.4 billion in foreign funds' units and CZK 2.6 billion in domestic funds' units in 2003 proved that there was strong interest in investing. Money market funds prevail over bond and hybrid funds in Czech households' financial investment structure. Interest in secured funds is also growing (these funds offer a contractual guarantee of return of principal and a minimum yield). These are funds that were offered primarily from abroad in the period under review.

The activity of registered funds based in the Czech Republic is regulated by the Collective Investment Act, which took effect on 1 May 2004, although the activities of investment companies and mutual funds, and also the depositary, are gradually being adjusted up to 30 June 2005.[34] This Act regulates the business of standard open-ended mutual funds (in accordance with the law of the European Communities) and the business of special mutual or investment funds (national legislation). Assets in a mutual fund are administered by an investment company on the shareholders' account. The investment company issues the open-ended mutual fund's units and is obliged to repurchase them. The investment company keeps accounts on the assets of the mutual fund separately from its own accounts and from other mutual funds. The depositary of the fund keeps records on the assets of the collective investment fund and checks that the fund handles the assets in accordance with the law.

The stability of collective investing is reinforced by diversification and limitation of the risks of investing in securities. There are limits with respect to single issuers and limits on investing in financial derivatives. An investment company that

33 Hedge funds, venture capital funds and private equity funds offer high risk investments on the domestic market. These funds are not a traditional form of collective investment and are intended primarily for institutional investors. They invest in risky instruments and many of them are registered in tax havens. The funds would like to see a change in the Czech legislation enabling easier access to the domestic resources of pension funds and insurance companies.

34 The Act on Investment Companies and Investment Funds has been repealed.

wishes to provide a service in another EU member state through an organisational unit or without establishing an organisational unit under the principle of free movement of services has to notify the Czech Securities Commission of this fact. The single licence principle applies in this case. Likewise, a foreign investment company headquartered in an EU member state can provide services in the Czech Republic through an organisational unit or without establishing an organisational unit. The terms and conditions for foreign entities' activities in the Czech Republic under the single licence system are set forth in the Collective Investment Act. State supervision of compliance with the Collective Investment Act is performed by the Czech Securities Commission.

4.7.3 Securities Dealers

There were 60 securities dealers active in the capital market at the end of 2003, of which 15 were banks. The total volume of non-bank dealers' assets was CZK 9.5 billion and their equity capital was CZK 2.5 billion. Non-bank dealers had an ROA of 2.3%.

The capital adequacy ratio of the dealers is high (average 105%, median 83%), but is much more volatile than that of banks, the values being spread over a wide range (from 8% to around 400%). This is mainly due to the fact that only some dealers trade actively on their own account and have positions in their trading portfolios for which capital requirements are calculated. The volatility is due to the nature of their activities, which entails frequent changes in the trading portfolio positions held.

A securities dealer licence may only be issued to a joint-stock company. A licensed securities dealer must comply with the capital adequacy requirements on an individual basis as laid down in a special legal rule, unless it is a bank. The capital adequacy calculation under EC law includes a procedure and a capital adequacy limit for dealers of 8% in respect of the capital requirements for credit risk and market risks on an individual basis. Compliance with the limit and calculation procedures and other prudential legal provisions is overseen by the Czech Securities Commission.

CHART IV.46
Distribution of securities dealers by capital adequacy ratio in 2003

Source: KCP