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The Czech Republic's banking sector: Emerging from turbulent times



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1. Introduction

In contrast to many other accession countries of Central and Eastern Europe (CEECs), the Czech Republic experienced a shorter and less severe transition recession in the first half of the 1990s. The decline in output lasted two years and by 1995, real GDP had returned to its 1989 level. Unemployment was surprisingly low, averaging less than 3 percent in 1990-95. In addition, stabilisation policies (the fixing and devaluation of the exchange rate, tight fiscal and monetary policies, and initial wage discipline) led to a fast reduction in inflation to single-digit levels and, thus, to internal as well as external stability. The liberalisation of prices, wages and trade, along with the fast launching of mass privatisation of state property were seen as major achievements in getting the country on a path to prosperity.

A number of observers have noted that what appeared like a smooth transition from socialism to capitalism was in fact a sign that a fundamental reorientation of the Czech economy was yet to come. We agree with this assessment. What is more, one of our main hypothesis is that the country's apparent success at output and macroeconomic stabilisation in the early phase of transition distracted from addressing fundamental problems of the banking sector and corporate governance. That these problems were real became evident with the massive accumulation of non-performing loans on banks' balance sheets, bank failures, and the economic recession in the second half of the 1990s.

Against this background, we analyse in Section 2 the transition of the Czech banking sector. Section 3 builds on this and examines the main forces that have shaped sector developments. The long-postponed privatisation of banks to foreign strategic investors is one of these factors. With this in mind, Section 4 turns to the impact of foreign-owned banks and off-shore financing on the Czech banking sector. Finally, Section 5 concludes.

2. The transition of the banking sector in the Czech Republic

2.1 Privatisation and foreign ownership

The transformation from a one-tier banking system to a two-tier banking system in former Czechoslovakia had already begun in 1989, when a new law separated central banking activities from commercial banking ones. In January 1990, the SBCS (the former monobank) transferred its commercial banking activities to three newly established banks: Komerční banka (KB), Všeobecná úvěrová banka (VUB) and Investiční banka (IP, which merged with post-office banks in 1993, forming IPB, i.e. Investiční a poštovní banka). Together with Česká spořitelna (CS) and Slovenská sporiteľňa (in operation since 1969), these banks dominated the newly developing banking markets. The two other incumbents on the market were Československá obchodní banka (ČSOB) and Živnostenská banka, which, however, specialised in international trade financing and large private clients.

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The rapid growth in the number of private, Czech-owned banks in the first half of the 1990s was followed by an equally rapid market exit in the second half.

The number of banks operating in the market grew most rapidly from 1990 to 1995, when many small banks and branches and subsidiaries of foreign banks were established. In early 1990, the Czech Republic had a central bank plus seven banks licensed for universal banking. By the end of 1995, the number of banks had reached 55 (see Table 1). These newly established banks were typically small, with Agrobanka being the one significant exception.

Table 1. Number of active banks in the Czech Republic, by ownership

	Total	Czech controlled					Foreign controlled			
		Total	State financial institutions	State-owned banks	Czech-controlled, private banks	Banks under administration	Total	Foreign-controlled banks	Foreign bank branches	Unlicensed banks
1990	5	5	4	1	0	0	0	0	0	x
1991	9	9	4	1	4	0	0	0	0	x
1992	24	20	4	1	15	0	4	4	0	x
1993	37	26	1	4	21	0	11	9	2	x
1994	52	34	1	4	28	1	18	12	6	x
1995	55	34	1	4	28	1	21	13	8	2
1996	55	32	1	6	25	0	23	13	10	5
1997	53	30	1	6	18	5	23	14	9	7
1998	50	26	1	6	15	4	24	15	9	11
1999	45	20	1	5	14	0	25	15	10	18
2000	40	14	1	4	8	1	26	16	10	20
2001	40	14	1	4	8	1	26	16	10	23

Source: CNB, www.cnb.cz, current information about banking sector.

After some time in operation, many of the smaller newly established banks, especially those with private Czech capital, were unable to cope with the risky transition environment and were forced to terminate their activities. Table 2 summarises the restructuring efforts with regard small and medium-sized banks. Large state banks were also affected by the same problems and had to be bailed out (this took place between 1998 and 2000). Out of 63 banking licenses granted since 1989, 23 licenses were ended. Of these, 17 licences were terminated because of bad management and a lack of prudence, five ended as a result of sales or mergers, and one bank never started operations. At the end of 2000, the banking sector consisted of 40 banks (both domestic banks and subsidiaries, and branches of foreign banks).

The first Czech bank to be privatised (1) was Živnostenská banka. Already in 1992, 52 percent of its shares were sold to foreign investors, with the rest being sold under voucher privatisation. However, after this transaction, the transfer of state ownership of banks to private hands came to a halt for a number of years (under various governments) and in 1996 the state still held major stakes in the four big commercial banks (KB, CS, IPB, and ČSOB), representing over 30 percent of equity in the sector.

1) And also the first bank in Central and Eastern Europe privatised to foreign investors.

Table 2. Restructuring small and medium-sized banks in the Czech Republic

Pre-1993	Consolidation programme I: bad loans from the pre-1990 period shifted to Konsolidační banka, capital injections to state owned banks
1993	Forced administration in Kreditni a prumyslova banka
1994	Forced administration in Banka Bohemia (fraudulent activities; the bank ceased operation; due to insufficient deposit insurance, funds were taken over by ČSOB) License revocation to AB banka stopped (taken over by Česká spořitelna) The state and the CNB committed themselves to cover losses that had emerged in two problematic banks: Bohemia Banka, and AB Banka
1995	Licenses revoked to AB banka and Ceska banka.
1996	Consolidation programme II: on the basis of external audits, potential losses from active operations of banks were provisioned; capital adequacy in the sector significantly decreased; 15 banks participated and nine banks were put under forced administration or had their banking license taken away. Stabilisation programme: designed for 13 small banks; six banks participated. Bad assets up to 110 percent of equity should be carved out temporarily (seven years) from balance sheets. The programme was conditioned on the banks following a set of very strict rules. The banking supervision body took legal actions on 16 occasions due to criminal activities in some banks. Six forced administrations (Ekoagrobanka, COOP banka, Podnikatelska banka, Realitbanka, Velkomoravská banka, and Agrobanka) and two licenses taken away (První slezská banka and Kreditni banka)
1997	Licenses of Bankovní dum Skala, Ekoagrobanka, Evrobanka and Realitbanka revoked.
1998	Licenses of COOP banka, Velkomoravská banka, Agrobanka, and Pragobanka revoked.
1999	Licenses of Universal banka and Moravia banka revoked. Privatisation of ČSOB
2000	Forced administration of IPB (business sold to ČSOB) Bail-out and privatisation of Česká spořitelna
2001	Privatisation process of former state banks finished Bail-out and privatisation of Komerční banka

Source: CNB, www.cnb.cz, banking sector development.

Bank privatisation got off to a very slow start and gained momentum only towards the end of the 1990s.

Privatisation was re-launched in 1997 and the state's divestiture from large banks commenced in February 1998 with the sale of the state's 36 percent minority stake in IPB to Nomura International. This was the first time that foreign investors got the opportunity to acquire a substantial or majority interest in a large Czech bank. Privatisation continued in June 1998, when General Electric Capital Services (GE Capital) acquired a substantial part of Agrobanka assets, which had been under forced administration since 1996. And then, in mid-1999, KBC of Belgium bought a 66 percent

stake in ČSOB, the fourth largest Czech bank (2). In March 2000, Erste Bank of Austria acquired 52 percent of CS. This came after the Czech government had carved-out a good part of the bad debt and protected the new owner against the remaining credit risk on CS's loan portfolio through a ring-fencing agreement. Finally, in mid-2001, the process of bank privatisation was essentially completed - again after carving-out bad assets - by the sale of KB to Société Générale.

The last state financial institution, Konsolidační banka (3), terminated its activities in August 2001, when its assets were transferred to the Konsolidační agentura. The state will retain its stakes only in a number of specialised banks specifically oriented towards financing government programmes in the areas of export, support for small businesses, and administration of poor quality assets.

As elsewhere in the region, foreign-owned banks now dominate the banking sector.

As a result of the privatisation, the share of foreign capital in the equity of the banking sector increased markedly between 1995 and 2000. At the end of 2000, foreigners held about 55 percent of total equity of the Czech banking sector (see Table 3). At the same time, the share of banking sector assets under direct control of foreigners (i.e. subsidiaries of foreign banks and majority foreign shareholdings in Czech banks) was almost 72 percent. This share increases to about 75 percent when banks under indirect foreign ownership (i.e. banks that are controlled by a domestic legal entity which, in turn, is majority-owned by foreigners) are included. EU investors account for the largest proportion, with about 80 percent total foreign equity capital.

The development of medium-sized banks, which are mainly foreign banks and foreign bank branches, has gradually eroded the dominance of the large banks. Between 1998 and 2000, the share of large banks in total banking sector credit declined from 74 percent to 64 percent. In the more competitive derivatives market, the share of large banks fell from 42 percent to 33 percent. Even on the deposit side, large banks have lost ground, with their market share falling from 75 percent to 70 percent (4).

Table 3. Ownership structure of Czech banks by share of equity, in %

	1995	1996	1997	1998	1999	2000
State, municipalities	31.5	31	20.3	25.1	27	23.6
Czech capital	45.7	44.9	50.2	36.2	24.7	21.9
Foreign	22.8	24.1	29.5	38.7	48.3	54.5
- EU	13.3	15.1	22.1	28.6	37.3	43.5
- USA	.	.	.	4.6	7.5	7.7
other foreign	.	.	.	5.5	3.5	3.3

Source: Own calculation (Banking supervision 1997, p. 21, and 2000, p.19).

Notes: Including foreign bank branches. The sale of the state share in KB to Société Générale in 2001 implies a decline (increase) in state ownership (foreign ownership) by about 15 percentage points.

2) In June 2000, ČSOB bought the assets and liabilities of IPB, which had been put into forced administration after its majority owner, Nomura, failed to address liquidity problems and the undercapitalisation of IPB.

3) Konsolidační banka concentrated on the administration of poor quality assets transferred to it from other banks as part of the consolidation of the banking sector.

4) The level of competition in the banking sector measured by the Czech National Bank using Herfindahl indices (taking value in the range of 0 to 1, where 1 represents a non-competitive, monopoly-controlled environment and a value near 0 denotes a competitive market) shows that at present, the strongest competition is in the area of assets (0.10) and on the credit market (0.09). In spite of growth in competition in the area of deposits, the competitive environment continues to be weakest in this area (0.12).

To summarise, after an initial burst, the number of banks operating in the Czech Republic has declined, but remains relatively high for the size of the Czech economy. Bank privatisation got off to a slow start and only gained momentum towards the end of the 1990s. As in all other CEECs, except Slovenia, foreign-owned banks now dominate the market both in terms of bank capital and banking sector assets.

2.2 Profitability, assets and liabilities

The aggregate net income from banking activities grew between 1995 and 1998 to CZK 97 billion, but declined to CZK 80 billion in 2000. Net profits of the banking sector in the late 1990s were affected by massive reserve creation, and the sector recorded aggregate losses (Table 4). Only in 2000 did the sector announce an aggregate profit.

Client transactions, those activities connected with accepting deposits and granting credits, have remained the primary source of profit from banking activities. The most important source of revenues has been interest profit, followed by the profit from fees and charges. Despite the significant decline in interest rate spreads, the share of interest profit in total profit from banking activities rose from 46 percent in 1997 to 67 percent in 2000.

The share of profit from fees and charges also increased during the same period from 13 percent to 22 percent. At the end of the 1990s, the Czech banks sharply increased fees and charges on over-the-counter services to induce clients to use the lower-cost services. Thanks to a strong increase in the volume of transactions (retail payments, card transactions), large retail banks are best positioned to increase fee income by repricing charges on retail services.

Due to a sizeable bad loan problem, banks have been making losses for a long time, but lately there are signs of improvements.

Table 4. Profitability and efficiency of the Czech banking sector

	1997	1998	1999	2000
Key indicators, in %				
Profit from banking activities/assets	4.5	4.6	3.9	3.3
Net profit/assets	-0.2	-0.3	-0.2	0.6
Net profit/tier 1 capital	-3.5	-5.2	-4.3	12.0
Interest income/interest earning assets	11.9	11.7	7.8	6.7
Interest expenses/interest bearing liabilities	8.1	8.2	5.2	4.2
Interest rate spread	3.8	3.5	2.6	2.6
Net interest margin	2.9	3.4	2.6	2.4
Interest profit/profit from banking activities	45.8	67.8	62.8	66.6
Profit from fees and charges/profit from banking activities	13.3	13.3	16.2	21.5
General operating expenses/assets	n.a.	2.2	2.2	2.2
Key indicators, in thousands of CZK				
Assets per employee	40 692	43 231	47 369	55 822
Profit from banking activities per employee	1 708	1 889	1 845	1 783
Net profit per employee	-66	-142	-114	332
Operating expenses per employee	831	930	1 044	1 171
Personnel expenses per employee	238	255	297	333
Number of banking sector employees	51 170	51 079	48 924	44 932

Sources: CNB, Banking Supervision 1999, 2000.

Notes: Data for 1998-2000 are for banks with licences as of 31 December 2000, excluding Konsolidační banka. Data for 1997 are for banks with licences as of 31 December 1999, again excluding Konsolidační banka.

Specialised banks, building societies in particular, have so far achieved the highest interest rate spreads. Large banks have also realised wide interest rate spreads. By contrast, foreign banks and branches have maintained very narrow spreads. Furthermore, interest rate spreads of small banks decreased radically in the second half of the 1990s. This was mainly because they faced funding problems and, thus, had to offer higher deposit rates to attract more deposits.

The share of total assets in GDP was 131 percent in 1995 and 138 percent in 2000 (5). By this measure, the Czech Republic exhibits the highest degree of bank intermediation among all CEECs and, in fact, has attained a level that is comparable to those of many Western European countries. Here it has to be kept in mind that large bad debts inflate and thus distort Czech data. Still, the ratio of deposits to GDP suggests that the size of the banking sector in the Czech Republic is larger than in countries such as Poland and Hungary; in fact, the Czech deposit to GDP ratio compares favourably with EU countries like Spain and Italy.

The importance of lending to the enterprise sector has fallen significantly in the second half of the 1990s.

Between 1995 and 2000, the composition of banks' assets developed more towards "safer" assets such as deposits with the Czech National Bank (CNB), i.e. the central bank, and other banks, T-bills and CNB-bills. This can be seen as a cautious response of domestic banks to the severe bad loan problem that emerged during this period. The share of such "safer" assets increased between 1996 and 1999 from 32 percent to 45 percent of total assets, with T-bills and CNB-bills accounting for much of the increase (see Table 5). At the same time, the share of credits to clients decreased from 46 percent to 36 percent of assets.

Classified credits accounted for up to 30 percent of total credits in 2000. However, there has been an improvement in the quality of the balance sheet of the surviving banks as low-quality credits have been taken off banks' balance sheets and passed on to Konsolidační banka or sold at a discount to other banks. It should also be emphasised that according to CNB methodology, "watch" credits are included in the category of classified credits. This is not common in many countries (6). The sum of the three high-risk categories (i.e. "sub-standard", "doubtful" and "loss" credits) accounted for 19 percent of the total amount of credit in 2000, which compares to about 15 percent and 7 percent in Poland and Hungary, respectively. In sum, notwithstanding improvements in recent years, the poor quality of assets still represents a substantial financial burden for the Czech banking sector, which is evident from high provisioning costs of large Czech banks, amounting to over 3 percent of customer loans in 2000. This is significantly higher than the CEECs average of around 2 percent and the Western European average of 0.4 percent.

5) At end-2000, total assets of the banking sector stood at CZK 2 719 billion (including the bad assets managed by Konsolidační banka). CNB's annual publication provides aggregate data for banks with valid licenses at the end of the year and re-computes the previous two years on this basis. This results in an underestimation of the aggregate data of earlier years.

6) Loan classification and the required creation of reserves depend on the quality of the client (financial and income performance of borrower), his/her credit history, and the overdue period of interest and principal. Banks are permitted to deduct the value of collateral before calculating specific provisions. Each credit exposure must be classified under one of the following categories: "watch" (overdue 30-90 days); "sub-standard" (91-180 days); "doubtful" (181-361 days); and "loss" (overdue more than 361 days). Required reserves in percent of the outstanding loan not covered by collateral are as follows: "watch" 5 percent; "sub-standard" 20 percent; "doubtful" 50 percent; and "loss" 100 percent.

Table 5. Structure of assets of the Czech banking sector, in %

	1995	1996	1997	1998	1999
Cash	1.3	1.4	1.2	1.1	1.5
Deposits and credits with CNB	8.9	7.0	8.6	11.1	10.8
of which: required reserves	(4.1)	(5.6)	(3.9)	(3.6)	(1.1)
Deposits and credits with banks	17.1	19.2	21.7	20.5	22.6
CNB bills and T-bills	8.4	5.6	5.8	8.9	11.2
Credits granted (net)	45.9	46.2	44.9	41.4	37.3
of which: to clients	(45.6)	(45.9)	(44.0)	(40.3)	(35.9)
to state and local authorities	(0.3)	(0.2)	(0.9)	(1.1)	(1.3)
Securities	8.0	8.7	4.4	4.0	3.0
of which: bonds	(6.6)	(6.5)	(4.0)	(3.8)	(2.9)
equity	(1.3)	(1.9)	(0.4)	(0.2)	(0.1)
Long-term financial investments	1.2	1.1	4.1	3.8	4.8
Tangible and intangible assets	3.1	3.2	2.8	2.6	2.5
Other assets	6.0	7.7	6.5	6.6	6.4
Memo item: share of "safe" assets	34.4	31.8	36.1	40.5	44.6

Sources: CNB, Banking Supervision 1996 and 1999.

Notes: Data for 1995 and 1996 for banks with valid license as of the end of 1996, data for 1997-1999 for banks with valid license as of the end of 1999. "Safe" assets comprise deposits with CNB, deposits with other banks, T-bills and CNB bills.

As can be seen from Table 6, the structure of liabilities of Czech banks remained very much unchanged during the late 1990s, with slightly more than half of the balance sheet formed by client deposits.

Table 6. Structure of liabilities of the Czech banking sector, in %

	1995	1996	1997	1998	1999
Funds from CNB	4.0	3.9	3.3	2.2	1.3
Deposits and credits from banks	20.8	23.1	22.9	20.8	19.4
Non-banks deposits	50.8	49.7	50.2	50.3	51.9
of which: state and local authorities	(2.4)	(2.0)	(2.3)	(2.3)	(2.2)
Bond issues	2.6	3.1	4.2	3.8	3.9
Equity, capital, and reserves	10.5	10.5	9.4	9.7	9.0
Other liabilities	11.3	9.7	10.0	13.2	14.5

Sources: CNB, Banking Supervision 1996 and 1999.

Notes: Data for 1995 and 1996 for banks with valid license as of end 1996, data for 1997-99 for banks with valid license as of end 1999.

The term structure of assets and liabilities developed as follows. In the second half of the 1990s, the maturity of assets lengthened, with long-term credit gaining in importance. In 1995, 29 percent of total CZK and foreign currency credits were long-term. By 2000, this share had increased to 43

percent. On the liability side, a shift towards less liquid instruments was also visible. The share of demand deposits decreased between 1995 and 1999 from 41 percent to 33 percent, which is a sign of improving money management of the population.

Business of Czech banks with non-resident banks have increased, in particular on the asset side.

Operations of Czech banks with non-residents have been increasing, especially on the asset side of the balance sheet. As a result, in 1999, Czech banks developed a net external creditor position. In that year, the assets vis-à-vis non-residents increased by 40 percent, reaching around CZK 500 billion (equivalent to 19 percent of assets). Within the category of non-resident assets, deposits of Czech banks with non-resident banks dominate, accounting for 60 percent of total non-resident assets. It is also worth noting that deposits with non-resident banks accounted for more than half of total assets held with other banks. The growth in deposits with non-resident banks has been due to reduced lending activity in the Czech Republic. Liabilities to non-residents made up about 14 percent of total liabilities in 1999. Deposits of non-resident banks with Czech banks accounted for the majority of non-resident liabilities (62 percent), but they have been falling steadily.

Large banks, foreign-owned banks, and branches of foreign banks have the largest share of operations with non-residents whereas small banks and specialised banks are virtually absent. Interestingly enough, large banks hold most of non-resident assets while foreign-owned banks and foreign bank branches account for the majority of non-resident liabilities.

In sum, the performance of the Czech banking sector has been poor. Banks accumulated large amounts of bad debt and incurred substantial losses, which continue to be a burden on the government budget. Although the situation is getting brighter - banks became profitable in 2000 - the challenge in the period ahead will be to accelerate lending again while maintaining profitability.

3. Explaining the Czech experience

Following a period of optimism and large credit expansion, the Czech banking sector experienced a period of insufficient capital adequacy, non-transparent ownership structure, related lending, asset stripping and a huge bad loan problem. As a result, domestic banks suffered losses and large state banks had to be bailed out, while small and medium-sized domestic banks had to be paid special attention in restructuring programmes. At the same time, banks under foreign control behaved prudently and were profitable. The Czech case may serve as a handbook of banking sector problems caused, paradoxically, by a lack of binding constraints (7). A number of factors caused these adverse developments. We will concentrate on the most important.

Inherited debt and voucher privatisation

Large state banks were burdened by low-profit or loss assets from the time before 1990. Voucher privatisation harmed the banking sector by dividing the assets and liabilities of companies to be privatised. Apart from a direct damage through the shift of the productive assets from some companies with substantial bank debt to new companies earmarked for privatisation, voucher privatisation created very dispersed ownership of the privatised companies and this led to poor performance. Widespread ownership structures with no strong shareholder(s) effectively left control

7) Slovakia suffered similar problems, but later, and the problems were less pronounced.

The voucher privatisation has hindered the development of a sound and efficient banking sector.

over the company in the hands of the existing management. As this management had no motivation or ability to formulate promising business strategies, the financial situation of such companies gradually deteriorated. Incumbent banks were thus often left financing companies with no prospects. Because of the immense size of such loans on banks' balance sheets, these banks were locked-in and maintained credit links to these companies despite their obvious inefficiency.

Lack of expertise in banking

Banks with domestic capital showed a characteristically low level of expertise in bank management and entrepreneurship, and lacked a sound methodology for assessing credit risk. Moreover, banks were viewed publicly as an automatic source of financing for the take-off of the domestic economy. When granting credits, the prospects of the economy were often overvalued, while staff was incapable of using appropriate tools to assess risks, be it industry risk or overexposure to financially connected groups. However, following an increased stringency and rigorousness of banking auditors, the quality standards for submitted projects rose in the late 1990s.

The problem of poor risk assessment concerned both large and small domestic banks, while foreign banks - in addition to possessing the know-how - attracted the top-tier clientele. The ranking of bank groups obviously reflected an adverse selection problem; foreign banks served the best customers - their home-country clients and the top local clients - because they were able to supply the demanded product. Large state banks captured projects with poorer, but still of a more-or-less standard quality while small banks often financed very doubtful projects. The deposit interest rates offered by particular banks could serve as a reliable indicator of the bank's loan portfolio. The deposit interest rates offered by some small banks, for instance, exceeded any rates of return on the market. Loan interest rates that had to be charged to recoup excessive deposit rates were so high that the debt service on these loans could hardly be expected. Indeed some debtors that accepted such conditions probably did not even plan to pay such interest rates.

Shortcomings in the legal, regulatory and supervisory environment

The banking sector and banking regulation in Czechoslovakia emerged at the same time in the beginning of the 1990s, and thus regulation and supervision developed through a learning-by-doing process. In practice, the regulatory body was unable to prevent adverse developments and avoid emerging problems. Part of the problems of the Czech (and Slovak) banking sector, then, dates back to their co-existence in one state.

Conditions for obtaining banking licenses in the beginning of the 1990s, prior to the split of Czechoslovakia were quite soft, requiring a minimum subscribed equity capital of only CZK 50 million (8). This low requirement was gradually increased later on, reaching CZK 500 million in 1994. Moreover, the Law on Foreign Exchange protected the local market against foreign competition by preventing firms from directly acquiring capital abroad. Such a protectionist policy was schizophrenic: The state desired to create a competitive environment for the incumbent banks to force them to behave efficiently, yet it was clear that direct competition from foreign banks would soon ruin the domestic banks. The entry of foreign banks was effectively limited and the emerging banking market remained dominated by state banks.

8) At that time, it was - strictly speaking - the Czechoslovak rather than the Czech koruna.

Soft licensing policies, shortcomings in bank regulation and supervision, and weak creditor rights have all contributed to problems in the banking sector.

Due to soft licensing procedures and the insufficient screening of license candidates, many newly formed banks (9) lacked a sufficient capital base, and hired employees without proper managerial skills and business ethics. With too little capital, all small and medium-sized banks were subject to moral hazard behaviour: They had little to lose but a lot to gain when extending loans to risky borrowers. And then, by charging the highest lending rates in the market, they fell victim to the adverse selection problem: The preponderance of their clients became those carrying out the riskiest projects that other banks refused to finance.

In addition, several new banks began using deposits to extend credit to other activities of the bank's owners, or simply tunnelling the deposited money out of the bank. Whether the main reason was incompetence or theft, the overall effect on the cash flow and balance sheets of these banks was damaging (10). Several bank failures, which began in December 1993, jeopardised public trust in the banking sector and had a strong influence on the stability of small and medium-sized banks.

For a long time a characteristic feature of the Czech banking legislation was that appropriate changes in banking laws typically followed problems that had emerged. It was not that changes were implemented in a proactive way to avoid the emergence of such problems. And then, the social and political encouragement of credit activities and the strong influence of politicians on lending decisions also contributed to the adverse developments. Moreover, there was little political will to prevent or punish risky and illegal behaviour of some bankers. Although the first bank collapse occurred in 1993, it was not until 1998 that effective changes were incorporated into the Act on Banks.

Reactive rather than proactive measures also applied to CNB regulations, which have been amended almost annually from 1992. The regulations only responded to the developments in the banking sector, although more flexibly than the legislation. However, some types of undesirable behaviour flourished for quite some time. For example, banks circumvented capital adequacy regulation by transferring their risky assets to other entities of their financial group or by misreporting them. More generally, bank regulators and supervisors failed in several cases to identify and take timely steps against banks or bankers that did not follow the regulation.

Finally, the poor protection of creditors' rights significantly harmed the effectiveness and profitability of banking. Banks were not able to get rid of bad loans accumulated before and during the transition period. Bankruptcy procedures were inordinately long and debtors were given enough time to strip the assets of the indebted companies. Creditors could not effectively take over ownership. Thus, banks often realised only a fraction of such assets and at a huge cost. Imperfect definitions and weak enforcement of particular laws caused banks to knowingly continue financing de facto ruined enterprises because they were not able to satisfy their overdue claims guaranteed by collateral. This led to a significant reduction in bank lending activities.

9) A majority (in the Czech Republic, all) of banks with private domestic capital were granted licenses in the initial period (1991-1993).

10) To quote The Economist magazine (September 1996): "Each of these bank failures stemmed from a deadly cocktail of mismanagement, orgiastic lending (often to bank's own stockholders), and more often than not, fraud".

Lack of competition from financial markets

In the 1990s, banking products dominated financial markets. Banks faced no competition in selling their products (i.e. providing credit) from capital markets. What is more, banks had a dominant position in particular with regard to competing for savings. Capital markets were in their infancy, and pension and investment funds played only a marginal role in the intermediation of savings to productive investment. The pay-as-you-go pension system relieved the population from the need to save for retirement, and investments into pension funds have become popular only lately. The redirection of funds from saving accounts - practically the only means for the population to accumulate financial wealth during the past forty years - towards other places in the financial market such as investment and mutual funds has been gradual. Overall, banks did not have to fear competition for resources with other types of financial institutions. As a result, bank owners and managers were often not forced to achieve efficiency and to innovate with a view to attracting customers

State influence

Considerable state influence is probably the most important factor that explains adverse developments in the Czech (and Slovak) banking sector. Indeed, there is little doubt that without the state's dominant ownership position in the banking sector, some of the developments we have described would have been completely avoided and the effects of institutional imperfections would have been less severe.

Unlike in Poland and Hungary, the state in the Czech (and Slovak) Republic was a majority owner of the incumbent banks for too long - well into the late 1990s. The state played three roles that were pitted against each other - the role of regulator, owner (seller) and policy maker. As an owner, the Czech Republic failed. The government was neither able to behave efficiently in allocating assets and in running the banks, nor to maintain their ownership stake and decision power.

In contrast to other CEECs, the Czech government had many degrees of freedom in creating strategies for restructuring the banking sector. The state was not in financial trouble at the beginning of the 1990s and did not have to sell the banks for fiscal reasons. And then, a comfortable fiscal position did not necessitate bank privatisation when banks had to be bailed-out in the mid-1990s. Paradoxically, the lack of binding constraints left the governments with so much freedom that they could postpone an optimal strategy, involving timely privatisation to foreign investors. Due to poor corporate governance the value of the banks over time deteriorated and the opportunities to sell them for a decent price shrank. At the end of the 1990s, however, the cost of the banking sector restructuring and recapitalisation surmounted an acceptable level, the state sold one bank after another, and the circle closed. Although banks were finally sold for a positive price, the total cost of this sale greatly exceeded its revenues. Table 7 shows the interim account of this detour.

Considerable state influence is probably the most important factor that explains the difficulties in creating a functioning banking sector.

Table 7. Costs and revenues of bank privatisation in the Czech Republic, CZK billion

		Revenues	Costs
Bank	Komerční banka	40	98
	ČSOB	40	57
	Česká spořitelna	19	47
	IPB	3	16
Total		102	218

Notes: The IPB cost estimate excludes the expected loss of CZK 40-100 billion that the state guaranteed to pay to ČSOB after taking over the IPB business in mid-2000.

Source: CNB, www.cnb.cz

The three state-owned banks, KB, CS and IPB, along with the group of small banks, were most violently hit by the problem of bad loans as a consequence of the inadequate investment appraisal. At the same time, cost management was very poor and labour productivity low. The weak competition in banking that sustained in the second half of the 1990s allowed these banks to maintain large spreads and did not force them to cut costs. Provision and reserve requirements that followed the worsening of the banks' balance sheets led to huge losses that undermined their capital.

What can we conclude from our short review of the Czech experience? On the one hand, in creating a functioning banking sector the country faced challenges that were very similar to those of other CEECs, including inherited bad debts, a lack of banking sector expertise, and the task to swiftly establish and implement an appropriate regulatory and supervisory framework. On the other hand, there are features that clearly distinguish the Czech Republic from most other CEECs. Two of them are worth repeating. First, voucher privatisation resulted in corporate governance structures that fostered an inefficient - if not fraudulent - use of bank loans. The resulting accumulation of new bad debt was not addressed for many years. On the contrary, there was a tendency to roll over doubtful outstanding loans, in particular to well-connected companies and those firms that banks owned - directly or indirectly. Second, the largest banks remained under government control for much longer than in other countries. What is more, privatisation to strategic foreign investors began in earnest only towards the end of the 1990s. With this in mind, we now take a look at the impact of financial sector integration on the Czech banking sector.

4. The impact of financial integration

Foreign investment and off-shore financing are the key factors that are driving the integration of the Czech banking sector with that of the EU.

The activities of foreign banks in the Czech banking market got off to a slow start. While more than two thirds of the 26 foreign banks currently operating in the country entered in 1993-94, the scope of their activities was restricted in the early years of their development. When expanding to the Czech Republic, the vast majority of foreign banks followed the standard way of entry by focusing first on serving their home country customers. As these banks gained more experience with the local market, they started to market the top-tier local corporates. And as the foreign banks offered better services and newer products, they successfully entered this market segment.

Until very recently, foreign-owned banks served a narrow market segment and their activities broadened only after strategic foreign investors became majority owners of formerly state-owned banks.

While prior to 1998 all foreign banks had to build their franchises through greenfield investments, the acquisitions of stakes in large Czech banks diversified the playing field and strategies of main market players. Banks acquiring control over the largest Czech banks (Erste Bank over CS and Société Générale over KB) have naturally focused more on developing retail strategies for their acquisitions and risk management procedures for their lending businesses. On the other hand, banks traditionally strong in corporate banking (ČSOB/KBC, franchises of foreign banks) continued in their traditional activities and have only gradually entered the retail market. Also, some of these banks identified the SMEs market as being relatively unexplored and developed specific product and service offers for this market segment (e.g. Citibank and GE Capital).

The retail market entry has often focused on a specific product (e.g. credit and debit cards of Bank Austria-Creditanstalt/HypoVereinsbank (BA-CA/HVB), consumer finance focus of GE Capital) or a specific target market (middle to high-income individuals, which is the focus of Citibank). In this way, new entrants have been able to limit the need for building extensive physical networks and distribute their products through alternative channels such as sales representatives and electronic banking.

Foreign banks operating in the Czech Republic can be grouped according to their business mix as (i) universal banks with regional networks (e.g., Erste Bank and BA-CA/HVB), (ii) large international banks (ABN Amro, Commerzbank, Crédit Lyonnais, Société Générale), (iii) investment banks (Deutsche Bank, Dresdner Bank), and (iv) "bancassurers" (ING Group, KBC Holding). Banks may also be classified according to how they have entered new markets. Some banks achieved growth by extending their business model to new customer bases or new markets, i.e. functioning as universal banks. Other banks achieved growth and returns through specialisation and developing strengths in selected product lines.

As a result of the relatively recent privatisation of large Czech banks and the slower entry of foreign banks compared to countries such as Hungary and Poland the impact of financial integration and structural changes on banks' activities is still emerging in the Czech Republic. Czech banks are less active in the most dynamically developing market segments. This is clearly illustrated by the share of retail loans in total loans, which accounted for about 9 percent of total loans. This compares to some 13 percent and 25 percent for Hungary and Poland, respectively. Although the Czech figure is influenced by the role of corporate loans in the economy, the retail loans segment certainly represents a significant growth potential in the Czech banking market. To illustrate this it is worth noting that in Western Europe the share of retail loans in total lending amounts to about 40-50 percent.

Given the international experience of foreign banks, their entry into the Czech banking sector also has indirect positive effects on the availability and costs of financing entrepreneurial projects. Foreign banks can introduce strong companies with viable development projects to international investors who do not necessarily have on-ground presence or knowledge of the local environment, but would consider investing in these projects. In this respect, product expertise, structuring capabilities and a broader investor base help foreign banks match the available cross-border funds with the financing needs of Czech based companies. This financing can and does take a number of forms, from loans in foreign currencies syndicated on international markets, to bonds and other fixed income instruments, to GDR issues for blue chip companies. Increasing competition among financial institutions in serving the top market segments then translates into lower financing costs for Czech companies.

Box 1. Size and structure of off-shore financing in the Czech Republic

Off-shore sources certainly played an important role in financing the activities of local businesses during the 1990s. Once the Czech koruna became fully convertible in 1995, Czech nationals were able to tap international financial markets. Table 1.1 shows external debt trends for the Czech Republic. In 1993-2000, convertible currency debt increased from USD 8.5 billion to USD 21.2 billion. A major part of this increase can be attributed to increased lending by foreign banks (USD 9.4 billion) but also to growing credit from suppliers and direct investors (some USD 3.4 billion) (11).

Concerning the structure of convertible currency debt it is worth noting that funds directly channelled to non-financial sectors (labelled "other sectors" in Table 1.1) increased from USD 3.1 billion (equivalent to 37 percent of the total) in 1993 to USD 11.8 billion (56 percent) at the end of 2000. In addition, the term structure of external debt owed by Czech entities has shortened, with the share of short-term debt rising from 24 percent in 1993 to 42 percent by end 2000.

Table 1.1 Czech Republic - external debt, in USD billion

	1993	1994	1995	1996	1997	1998	1999	2000
Convertible currency	8.5	10.7	16.5	20.8	21.4	24.0	22.6	21.2
Long term	6.5	7.8	11.5	14.8	14.3	15.0	13.8	12.3
Government and CNB	4.0	3.0	2.8	2.1	1.6	1.5	1.2	0.8
Commercial banks	0.5	1.0	3.6	5.5	4.6	4.5	3.6	2.5
Other sectors	2.0	3.8	5.1	7.2	8.1	9.0	9.0	9.0
Short term	2.0	2.9	5.0	6.0	7.1	9.1	8.8	8.8
Government and CNB	0.2	0.3	0.6	0.1	0.2	0.0	0.0	0.1
Commercial banks	0.7	1.2	2.7	3.9	4.9	6.5	6.4	6.0
Other sectors	1.1	1.4	1.8	2.0	1.9	2.6	2.4	2.8
Non-convertible currency	1.1	1.5	0.6	0.3	0.3	0.3	0.2	0.2
Total	9.6	12.2	17.2	21.2	21.6	24.3	22.9	21.4
Memorandum items:								
Debt owed to foreign banks	3.5	5.4	10.3	14.0	14.4	15.5	14.0	12.9
Long term	2.8	4.4	8.1	10.9	10.3	9.6	8.4	7.5
Short term	0.7	1.0	2.2	3.1	4.1	5.9	5.6	5.4
Debt owed to suppliers & foreign investors	1.9	2.4	1.7	2.7	3.0	4.7	2.4	5.3
Long term	0.9	1.2	0.1	1.0	1.3	2.4	2.1	2.7
Short term	1.0	1.2	1.6	1.7	1.7	2.3	2.3	2.6

Source: CNB; numbers may not add up due to rounding.

The increase in external debt was particularly strong in 1993-96, when external debt in convertible currencies increased by USD 12.3 billion, of which around two thirds reflected long-term debt. Commercial banks and borrowers other than the government and the CNB accounted for an increase of USD 8.2 billion and USD 6.1 billion, respectively. In essence, these inflows financed the credit expansion of foreign-owned banks in the Czech Republic or went directly to the non-financial sector of the Czech economy. Overall, cross-border lending clearly complemented domestic financial resources available to resident borrowers.

11) Note that the change in external debt owed to these creditors exceeds the change in total convertible debt. This is because the external debt of the Czech Republic to other creditors, notably official bilateral and multilateral lenders, declined during the period.

The situation changed significantly during the 1997-98 period. The economy was in recession and growing credit problems with their existing loan portfolios forced the large Czech banks, in particular, to reconsider their lending strategies and to contract domestic credit. While foreign banks reacted to the increased uncertainty by shortening the tenure of their loans (the amount of long-term loans decreased by USD 1.3 billion), their net exposure to the Czech economy increased by USD 1.5 billion thanks to an increase of USD 2.8 billion in short-term debt. The fall in long-term financing available from domestic and foreign credit institutions forced manufacturing and other non-financial Czech businesses to seek alternative financing sources from their suppliers or other direct investors. In the event, debt owed to foreign suppliers and other investors increased by USD 2.0 billion, with some 70 percent of the rise reflecting long-term finance. Overall, the level of external debt in convertible currencies increased by USD 3.2 billion in 1997-98, substituting for the reduced pool of domestic credit available to resident borrowers.

Foreign-owned banks offered better service and more innovative products than locally-owned banks. Additional competition arose from off-shore financing, comprising non-resident bank lending and intercompany loans (Box 1 sheds some light on the size and structure of off-shore financing in the Czech Republic). This led to a significant loss of market share of local banks in the priority segment of top-tier local firms, forcing them - primarily the large ones - to seek alternative business opportunities with smaller or financially weaker companies. Given the deficiencies in risk management systems of local banks, this contributed to the increase in classified credits of local banks.

Czech banks face strong competition from off-shore sources of finance.

And then, competition from foreign-owned banks and cross-border lending has made it more difficult for incumbent banks to cross-subsidise various activities and has increased the role of proper risk assessment and pricing. As most local banks still lack experience, the role of foreign-owned banks is crucial for providing the know-how and technology for further developing the banking sector.

A comparison of performance indicators for banks with different ownership structure suggests that foreign-owned banks operating in the Czech Republic are generally more efficient than both state-owned and local private banks (12). Unlike local banks, foreign-owned banks were able to generate, on average, a positive return on assets in 1994-99 despite the economic recession of the late 1990s. This was mainly due to significantly lower operating costs.

Looking ahead, the diversification from pure traditional banking to modern financial products certainly represents an important opportunity for Czech banks. For example, CS has already successfully marketed its money market funds to its large retail client base and currently enjoys a large market share in this business, with assets under management amounting to USD 866 million at the end of 2000 (compared with USD 458 million for KB, USD 930 million for Hungarian OTP Fund Management, or USD 279 million for the largest Polish fund, Skarbiec).

While these are promising developments, it is clear that in the absence of well-defined corporate governance and risk management mechanisms, this diversification also poses potential conflicts of

12) Hawkins and Mihajlek (2001), Table A4, p.39.

interest and may influence the credit decisions of the banks. The dual role of owner and lender proved especially damaging to the stability of the Czech banking sector during the economic recession between 1997 and 1999. In this respect, the financial strength, risk management know-how, and ability to formulate and pursue clear strategies of foreign-owned banks are expected to continue to have positive effects on the stability of the Czech banking sector.

While coming late, the increasing role of foreign-owned banks is expected to bolster the development of the Czech banking sector.

More generally, the future efficiency and stability of the Czech banking sector will be determined by the ability of individual banks to cope with the changing competitive landscape of increasing competition in the traditional banking products from both bank and non-bank institutions. In this respect, evidence from the European banking industry in the 1990s is illustrative. In continental Europe, the contribution of non-interest income to banks' total income has increased while the importance of (net) interest income, i.e. traditionally the mainstay of banks, has declined. In essence, because of a limited growth potential of traditional bank intermediation, European banks are increasingly providing services with more scope for growth, notably investment banking and asset management services. Given the direct influence that European banks have wielded by acquiring a large market share and the indirect influence of the EU convergence, the trends and market structures observed in Europe provide a useful comparison benchmark.

The possible lack of finance for small and medium-sized enterprises is often a particular concern of policy makers - and not only in accession countries of Central and Eastern Europe. Contrary to concerns that market segments such as lending to SMEs and households will not be served as foreign-owned banks will focus on different business segments, foreign-owned banks in the other CEECs have increased lending to these clients as a result of growing penetration and competition in other market segments. This trend can also be expected in the Czech Republic.

5. Conclusions

The development of the Czech banking sector in its post-transition period has been erratic. It has been marked with problems and large economic losses. These materialised most visibly in the second half of the 1990s. First, the crisis of small banks in 1996 revealed several problems in the Czech banking sector. Second, the experience in 1997-98 clearly confirmed the need for change. The economy was in recession, and growing credit problems of banks with their existing loan portfolios forced the large Czech banks, in particular, to reconsider their lending strategies and to contract domestic credit. Observers often refer to this period as a "credit crunch" since it has been characterised by a lack of capital. We would instead consider this period a healthy adjustment of previous soft lending behaviour. Perhaps the period should be renamed "lack of projects". Overall, it is fair to conclude that it was more an undefined strategy, lack of proper risk management systems, and related-party lending that caused most of the failures of Czech banks, rather than excessive competition.

Soft lending procedures or even soft budget constraint behaviour of the Czech banks make us wonder whether policy makers did not allow them on purpose. There was a smooth transition from shrinking "old sectors" to growing "new sectors" that went along with social peace, i.e. low unemployment. A comparison of the Czech Republic excessive banking costs (mostly bailouts) to those of other CEECs certainly raises the question of whether the price for such a smooth transition was not too high.

Privatisation of the banking sector is expected to result in greater efficiency, and mostly in higher stability. It is clear that the new market players do not lack either sufficient capital or know-how. There is no reason, therefore, for any of the banks to be exposed to a higher risk than others. In other words, the adverse selection problem disappears.

After a lengthy period of restructuring, the Czech banking sector now appears to be on a promising growth trajectory.

Despite a slowdown of the economy during 1996-99, it seems that the problems and crisis in the Czech banking sector did not interfere with economic growth. We attribute this phenomenon to the significant role of cross-border capital flows - comprising foreign direct investment, intercompany loans, and direct lending of non-resident banks - which dominate the allocation of resources to fast growing enterprises.

The key conclusion is that after an excessively lengthy period of restructuring - and many false starts and haphazard measures - the Czech banking sector has now been put on a firm footing for future growth.

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