Bank consolidation in the Czech Republic

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1. General features

The domestic banking sector is the core of domestic financial intermediation. For historical and legal reasons it enjoys a role which goes far beyond that of securitised markets or of other financial institutions.

Private banking structures have only developed since the early 1990s, when the state banking monopoly was dismantled and the entry of foreign institutions permitted. The banking system follows the principle of universal banking; thus banks are allowed to carry out a vast range of financial services beyond the core deposit and loan business. In particular, banks are major participants in the capital markets and, via subsidiaries, providers of insurance services.

The domestic banks suffered from a number of weaknesses: undercapitalisation, a shortage of the long-term funds necessary to support their development plans, inexperienced staff, non-existent risk management, and underdeveloped information systems. The risks were heightened by shortcomings in professional skills and by a number of legal loopholes that could be exploited through fraudulent behaviour. Thus, the political pressure to satisfy the enormous financial needs, combined with the credit expansion and high rates of growth in the banking business as a whole, led inevitably to the generation of losses. In addition, the large banks (which are the backbone of the Czech financial sector) were faced with the difficulty of low capital adequacy coupled with an inherited burden of bad loans.

In this way, the potential arose for destabilisation of the banking sector. Since the banking sector was unable to address this problem on its own, state financial injections became inevitable.

2. Consolidation process

Major rounds of cleaning up banks' balance sheets were undertaken in order to establish a healthy banking industry. Konsolidacní banka (KOB) was established in order to take on bad loans, accumulated before 1991, from the banking sector. In a first step, starting in 1991, larger banks were freed from bad loans.

As of 1994 emphasis shifted to smaller banks. In particular, the failure of Kreditní banka in August 1996, and a subsequent partial run on Agrobanka, caused some strain on the Czech banking system. The programmes concerned led only to a temporary increase of state ownership in banking in 1995, and again in 1998, due to the revocation of the license of Agrobanka. Overall, the government share in banking rose to 32% at the end of 1995 from 29% at the end of the preceding year.

Moreover, to support the small banks, another programme - the Stabilisation Programme - was approved in 1997. This essentially consisted of replacing poor-quality assets with liquidity of up to 110% of each participating bank's capital through the purchase of poor-quality assets from the bank by a special company called Ceska financni, with subsequent repurchase of the residual amount of these assets within a five- to seven-year horizon. Six banks joined the programme. However, five of these were excluded after failing to comply with its criteria and subsequently went out of business. Thus, the Stabilisation Programme has not been successful. The macroeconomic deterioration together with the inability of banks to cope with the existing situation led to participation in the programme being halted. Most participating small banks were closed and liquidated.

The main impact of these programmes has been a marked decrease in the number of banks, because of the licence revocations, mergers, acquisitions, liquidations and bankruptcy proceedings involved. The total cost of the efforts made by the Czech National Bank and the government to support the stability of the banking sector is estimated at roughly CZK 200 billion (including preparations for the privatisation of banks).

By the end of 1998, 63 banking licences had been granted (60 of these before the end of 1994). As of 30 September 2000, 41 banks and branches of foreign banks remained in business, 16 were under extraordinary regimes (in other words, out of business - eight in liquidation and eight involved in bankruptcy proceedings), four had merged with other banks, and the licence of one foreign bank had been revoked because it had failed to start its operations. Out of the 41 remaining institutions (including KOB) 15 were domestically controlled banks and 27 foreign-controlled banks, including foreign subsidiaries and foreign branches. Of the total of nine special banks, one is a mortgage bank. In addition, seven institutions are authorised to issue mortgage bonds.

Table 1

Number of banks (July 2000)

Class of banks	Number
State financial institutions	1
Banks with domestic majority ownership	5
Special banks with domestic majority ownership	7
Banks with foreign majority ownership	9
Subsidiaries of foreign banks	6
Foreign-owned special banks	2
Branches of foreign banks	10
Banks under conservatorship	1

The number of banking institutions actively operating on the Czech market has been slowly declining since 1994. That year marked the turning point between the first phase after the economic liberalisation, with a considerable number of small and medium-sized domestic start-ups, and the subsequent phase of ongoing consolidation of the Czech market, in particular among the smaller domestically controlled institutions.

The large number of banks that went out of business contrasts with their low share in the total assets of the banking sector. This peaked at around 5% in 1994 and then steadily decreased to about 3% at the end of 1997. Consequently, the loss-making business of these small banks presented no systemic risk in itself. Nevertheless, the possibility of a negative impact on the public could not be ignored and costly preventive measures were necessary. Customers were indemnified up to a limit of CZK 4 million, although a Deposit Insurance Fund was in place with a maximum indemnity of CZK 300,000.

3. Share of foreign banks

Foreign banks, including branches of foreign banks, had by the end of 1999 attained a market share of 39% of assets. Foreign banks have gradually strengthened their position in the Czech banking sector. Their typical business profile, however, is more wholesale business oriented, as in securities business and lending to large industrial customers and foreign-owned enterprises, than the average of the banking sector as a whole. Therefore, at the end of 1999, the share of foreign banks in lending (23%) and deposit-taking (18%) was considerably lower than the respective figure for the total balance sheet. Of the larger foreign-controlled banks and branches, most have a German, Dutch, French or US parent company. Austrian companies are also in the market, with one large institution, and a number of very small ones established primarily on the Austrian-Czech border. The number of foreign banks continued to increase until the end of 1995, but has remained stable in recent years.

The banking sector in the Czech Republic comprises:

(i) banks and branches of foreign banks which, given the scope of their activities, can be characterised as universal banks;

(ii) banks with a special products and services profile, namely:

- KOB (Consolidation Bank, a state credit institution), the only wholly state-owned Czech bank, administering long-term state claims;
- Ceskomoravska zarucni a rozvojova banka a.s. (Czech-Moravian Credit and Development Bank Ltd), supporting small and medium-sized private businesses;
- Ceska exportni banka (Czech Export Bank Ltd), established for export support;
- building savings banks: the core business of the six building societies consists in collecting long-term deposits from the public and granting long-term housing loans. Their banking activities are regulated by the Act on Building Savings Banks. Personal deposits with these banks are subsidised by a state contribution up to a limit set by the law;
- mortgage banks: at present, there is only one specialised mortgage bank in the Czech Republic. Seven other banks are also authorised to issue mortgage bonds. These banks are, in addition, entitled to provide state-supported housing mortgage loans to natural persons.
- credit unions, established pursuant to a special legislative act. In the Czech Republic these are not classified as banks: they do not have direct access to the money market and are allowed to offer their products and services only to their members, not to the general public. Compared to the banking sector, their share in financial intermediation is very low.

4. Banking supervision

The CNB is the supervisory authority responsible for the licensing as well as for the prudential supervision of all banking institutions. The Banking Supervision Department, which was established at the beginning of the 1990s, has created its supervisory system according to the standards and rules set by the Basel Committee on Banking Supervision.

Banking supervision activities proceeded in 1999 in harmony with the medium-term concept of the further development of banking supervision approved by the CNB board in January 1998. This comprehensive document expresses the basic objectives of banking supervision and the measures required for their accomplishment. It was based on the organisational changes in the bank that took place at the end of 1997. Its primary aim was to create the preconditions for intensive development of on-site supervisory activity - one of the principal methods of banking supervision in the Czech Republic - by establishing separate supervisory teams. In the methodological area (as discussed later) activity was focused on preparing new regulations implementing capital adequacy, incorporating market risk and consolidated banking supervision in line with EC directives and the Basle Core Principles for Effective Banking Supervision. Laws and regulations under preparation were thoroughly reviewed by experts with regard to their compliance with EC directives.

5. Banking sector trends

The development of the Czech banking sector is closely connected with that of the domestic economy. Since 1997 the economy has been in recession. Household income in 1999 grew only very modestly and banks did not have enough sources of deposits.

On the assets side, the nascent recovery, the first signs of which appeared in the second quarter of 1999 when GDP growth resumed, still remained too weak to change main trends in the structure of banking sector assets;

- first, the “flight to quality” represented by a decline in the share of credits to below 50% and a rising share of liquid assets. However, behind this overall trend lie differences between the big banks, whose volume of credits decreased, and foreign banks and branches of foreign banks, which recorded growth;
- second, since 1999, banks have exported capital in amounts exceeding their (balance sheet) liabilities vis-à-vis non-residents.

These trends were not only banks’ reaction to the decline in economic activity itself but also to the structural and institutional weaknesses that the recession fully revealed on the microeconomic level. The biggest risk in banking remains credit risk. The worsening financial situation of a significant section of businesses, together with the difficulty of recovering credits and seizure of collateral, placed credit risk at a level no longer acceptable to banks. Banks increased their prudence in granting credits and tightened their criteria for customer evaluation. On the other hand, the same factors that curtailed the supply of credit restricted the room for an increase in the efficiency and creditworthiness of troubled enterprises. Thus, the demand for credit remained strong, but only partly met the creditworthiness criteria set by the banks.

6. Classified credits

The Czech banking sector’s main problem is its heavy burden of classified credits and its limited ability to deal effectively with them. During 1999 the share of classified credits in overall credits rose to 32%. This increase seems to reflect, in particular, the cooling-down of the economy and the slow growth in the volume of newly granted loans.

The overall nominal volume of classified loans rose, too. However, the “weighted classification”, which represents potential losses, dropped. Underlying this relatively favourable development was the high volume of write-offs against loan loss provisions and the transfer of bad loans to KOB.

At the end of July 2000 the total volume of classified credits had fallen by 16% from the end of 1999, and their share in the overall loan volume fell by 4 percentage points to 29%. However, this decline was all due to the transfer of part of the loan portfolio from Komercni banka to KOB. The volume of reserves and provisions set aside to cover potential losses from the loan portfolio stood at CZK 92 billion as of 31 March 2000. These reserves and provisions covered almost 80% of the potential losses from the loan portfolio, with the remaining part being covered by collateral.

The heavy burden of classified credits has been the main factor behind the poor profitability of the banking sector in the past three years. Banks have been able to generate a solid operating income, and their cost/income ratio (operating costs/operating income before write-offs and loan loss provisioning) has also been satisfactory. Provisioning and write-offs, however, are pushing net profits into the red.

7. Bankruptcy legislation

The amended Act on Bankruptcy and Settlement and the Act on Public Auctions became effective on 1 May 2000. The new legislation aims at accelerating bankruptcy proceedings and balancing creditors’ and debtors’ rights by allowing specialised firms or legal persons to act as trustees in bankruptcy proceedings and by offering the possibility to negotiate out-of-court settlements. It is expected that the changes in legislation will strengthen creditors‘ rights, reduce debtors' opportunities to dispose of property during the bankruptcy procedure and give incentives for the restructuring of enterprises rather than their liquidation. However, the successful implementation of this new legislation will depend on the qualification of the authorities involved in the procedures.

8. Banking business structure

Overall, financial intermediation by banks has been growing modestly over the past few years. Credit growth was restrained and below the levels of GDP growth. As a result, total credit fell to 57% of GDP over the period 1994-97. This is a relatively low level compared to EU member states' economies. This reflects both the prudent approach to monetary policy adopted by the CNB, and the more cautious credit policy adopted by the banks. In particular, smaller companies still find it difficult to access the credit markets. As this sector of the economy has been growing more rapidly than the large corporate sector, credit expansion has not kept pace with economic development and might, in some instances, have put a lid on a possibly more dynamic restructuring and growth of the Czech corporate sector. At the same time, financing via other channels, such as direct access to the capital markets, remains, for different reasons, restricted. Hence, the slow expansion of credit is a serious burden for the domestic economy.

This slow expansion is also to be seen in the context of a tighter stance from the regulatory authorities on the capital adequacy of banks, which itself is an important and overdue step towards strengthening the stability of the financial sector. However, it underlines the insufficient capital base of Czech banks, and the limited scope for increasing such capital. Partly to blame for this situation is the continued state ownership in banking. With the principal goal of privatising banks, the state seems reluctant to capitalise adequately the banks still in its control.

The share of loans to the private sector has, with the privatisation of the Czech economy, gradually increased and is now equivalent to more than 50% of total GDP. The balance sheet of the aggregate banking sector reflects the broad picture of the state of financial intermediation in the country. Credits still constitute the main type of assets. At the end of 1999 they amounted to 37%. However, this share has fallen considerably over recent years, down from nearly 52% at the end of 1994. Securities' holdings account for a relatively small share (19%) in the total assets portfolio of the banking sector. Interbank deposits, on the other hand, and particularly funds with the CNB, including CNB bills, have increased over the last few years. Credits to the public sector (mostly companies in public ownership and, to a much lesser degree, loans to government), are continuously decreasing in relative terms. At the end of 1999 they amounted to 9% of the total credit portfolio, down from 18% at the end of 1996. Credits to households rose from 6% to more than 7% during 1999. Thus, the bulk of loans are granted to the private corporate sector, standing at the end of 1998 at 69% of total credits, up marginally from the end of 1996.

9. Privatisation of the banking sector

The issue of completing the privatisation of the state-controlled banks has been discussed several times by consecutive Czech governments and has been postponed from year to year. With the benefit of hindsight, it is obvious that the method of voucher privatisation of the large state banks (see Table 2) was not an optimal technique. The structure of ownership was not transparent, too diluted, and the control by the state was inefficient.

The underlying motive for privatising the remaining state stakes in the large banks is to increase their efficiency, profitability and competitiveness and to strengthen their reputations, in particular with respect to future EU membership. Although the three largest Czech banks are the biggest in the central European transition countries, by international comparison they are only medium-sized banks. Thus, finding a strong strategic investor and partner is a crucial precondition for their stabilisation and further growth. The possibility of purchasing stakes in the privatised banks is open to any strong, trustworthy and strategic banking or financial investor, or to any transparent group of such investors.

Since 1998, substantial progress has been made with the privatisation process. In February 1998, the state's minority 36% stake in Investicni a Postovni banka (IPB) - the third largest Czech bank - was sold to Nomura International. Furthermore, in June 1998, General Electric Capital Services, a subsidiary of General Electric, acquired substantial parts of Agrobanka, the then largest private bank, but which had been effectively state-managed for the previous two years, as it had been put under conservatorship in 1996 due to financial problems encountered at the time.

Table 2
Privatisations of banks

Bank	CS	CSOB	KB	IPB
Voucher privatisation	1992		1992	1992
Vouchers (%)	37		53	52
Restitution investment Fund stake (%)	3		3	3
Municipalities (%)	20			
Sales to investors	2000	1999		1998
Investor	Erste Bank	KBC		Nomura
Acquired share in equity (%)	52	66		36
Share in voting rights (%)	56	66		36

The state's almost 66% stake in Ceskoslovenska obchodni banka (CSOB), the fourth largest bank in the Czech Republic, was sold off in June 1999. CSOB's sale at a good price to the Belgian Kredietbank (KBC) is an example of a successful privatisation resulting in the entry of a reliable and strong investor into the Czech banking sector.

In case of Ceska sporitelna (CS), the second largest bank, the government called for preliminary offers from potential investors in May 1999. In September it started exclusive sale talks with Austria's Erste Bank and in March 2000, it signed a contract with that institution about the sale of its 52% stake for CZK 19 billion.

As regards Komercni banka (KB), the Czech government is still considering and preparing the privatisation. After two capital increases in January 2000, the government effectively renationalised the bank and holds around 60% of it. More recent information indicates that the investor will be chosen only in 2001.

In June 2000 - based on liquidity problems and subsequent evidence of undercapitalisation, which were not addressed by majority owner of the bank in a timely manner - the CNB in a joint action with the government, decided to impose a forced administration on Investicni a Postovni banka, the third biggest bank in the domestic market. Subsequently, its assets and liabilities were sold to CSOB, one of the strongest private banks in the country. This quick action protected the banking sector from potential destabilising effects and preserved the stability of the resolved bank´s clientele.

10. Implementation of EU legislation

The Czech Republic is ready to implement the Community acquis concerning banking services by the date of accession. EC banking directive standards are now to a high degree incorporated in the Czech law in the Act on Banks and the Act on the CNB, in the CNB´s provisions and in relevant articles of the Commercial Code, Bankruptcy Law, Administrative Proceedings and Civil Proceedings.

During 1999, great attention was paid to further improving the regulatory framework towards gradual harmonisation with the prudential rules in force in EU countries and conformity with the Basel Core Principles. The main emphasis was laid on preparing new regulations implementing capital adequacy, incorporating market risk and consolidated banking supervision.

The next important harmonisation step will be adoption of the harmonisation amendment to the Act on Banks, which was submitted to the Government in March 2000. The Act is expected to enter into force in 2001.

In the field of capital adequacy and consolidated supervision, the only regulatory difference is in the scope of supervision on a consolidated basis, which will not cover financial or mixed-activity holding companies (of which a bank is a member) and will not incorporate market risk. This difference will be removed by a new Provision of the CNB on supervision on a consolidated basis, after the harmonisation amendment to Act No. 21/1992 Coll., on banks, enters into force. Single banking licence, mutual recognition and home country supervision principles will also be introduced by the harmonisation amendment to this act, although it is envisaged that full application of these principles will be effectively enforced as of the date of accession.

11. Concluding remarks

The banking system remains the core financial intermediary in the economy, so there is a need for change in the near future to diversify the risk of concentration. Faster development of other segments of the financial market must be achieved. And the foundations for promoting the trust of investors and the public in our financial system must be in place. This involves the following goals:

- ensuring stable macroeconomic and microeconomic policies;
- improving the legal environment and law enforceability;
- developing an effective regulatory framework, based on international standards, for all segments of the financial market;
- promoting market discipline in the corporate sector;
- improving accounting standards and public disclosure practices.

The Czech Republic’s application for European Union membership makes these issues all the more pressing.