Changes in the Czech Republic's financial intermediation during the last decade

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Abstract

This note outlines the development of the Czech Republic's financial sector over the last 25 years. Despite significant changes in their ownership and the banking crisis in 1990s, the banks have kept their dominant position while the capital market still plays only a minor role. One explanation is that non-financial corporations often use intragroup financing directly from their parent companies abroad, and thus have no incentive to search for market-based funding. Nevertheless, Czech corporations have been pursuing the global search for yield recently by issuing bonds to raise cheap funds. This trend applies only to a small set of large firms and the associated credit risk is borne mainly by non-residents. The banks have responded to the resulting fall in demand for their credit by lowering lending interest rates and interest margins. As a result, the risk of a gradual softening of credit standards has emerged.

Keywords: Czech Republic, financial intermediation, bond market

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Introduction

The Czech financial system has long been dominated by banks. While the depth of financial intermediation – as measured by the total assets of the financial sector as a percentage of GDP – has steadily increased, reaching 150% in 2014, the share of banks in the financial sector remains stable at around 75%. Insurance companies have a share of about 7%, followed by non-bank lenders and pension companies each with 5%. The financial system has seen no major changes in structure over the last 10 years. The capital market has long played only a small role in funding the private sector, although the share of bonds in external financing of the corporate sector has increased slightly in recent years.

Structural changes in the banking sector and credit provision

The banking sector has experienced substantial volatility over the last 25 years.[2] During the first half of the 1990s, in the initial phase of the Czech Republic's economic transition, the country's banking sector operated with a relatively high credit-to-GDP ratio and with loan portfolios concentrated almost exclusively in the corporate sector. Nearly 90% of loans in credit portfolios were extended to this sector. The share of households in the overall credit system stayed below 10% throughout the 1990s. The deep banking crisis of 1997–99 changed the banking sector dramatically, however. The sector went through noticeable downsizing and deleveraging as a significant amount of credit was written off banks' books. Decisive restructuring and (re)privatisation of banks followed, paving the way to the current structure in which the sector is controlled almost exclusively by foreign banking groups.

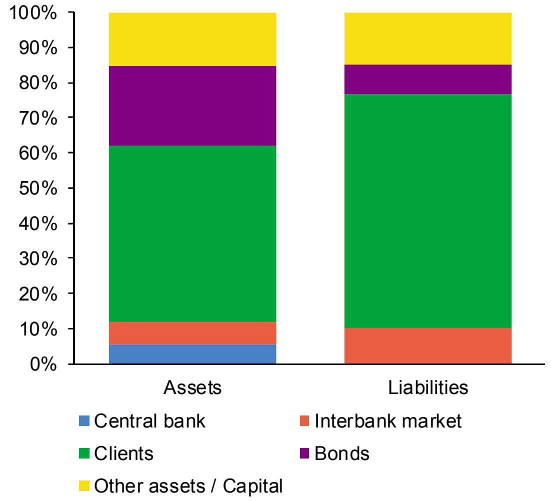
By the end of 2001, the banking sector had been restructured, and credit growth followed. Banks started to lend to households, which before the crisis had been largely ignored by the semi-state banks. This trend has been reinforced since 2008. The banking sector remains quite conservative, with client loans and client deposits dominating the assets and liabilities of banks (Graph 1). Credit growth has been driven mainly by housing loans, while bank consumer loans have stagnated (Graph 2).

While the majority of loans to the private sector come from local banks, non-bank financial intermediaries (such as other companies engaged in lending and leasing companies) also play a role. Around 2005 they accounted for almost 20% of loans to non-financial corporations (NFCs) and loans to households (Graphs 3 and 4). However, increasing competition from banks and tax changes (which have made leasing financing less favourable) have contributed to a decline in the relevance of these institutions. In particular, the rise of mortgage financing has caused their market share to dive. Like banks, non-bank lenders are facing declining demand for consumer credit.

[2] See J Frait, A Gersl and J Seidler, "Credit growth and financial stability in the Czech Republic", *World Bank Policy Research Working Paper*, no 5771, August 2011.

Bank assets and liabilities structure

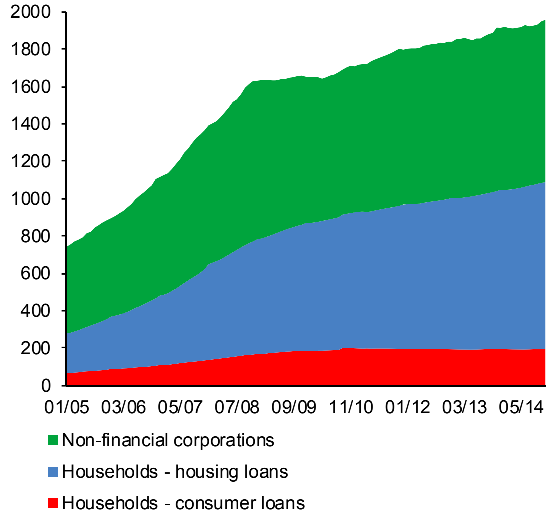
% of total assets; 31 October 2014 — Graph 1



Source: CNB.

Sector structure of bank credit

CZK bn — Graph 2

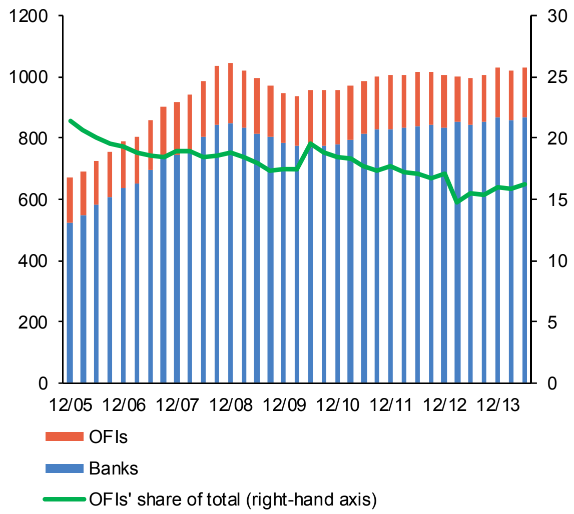


Source: CNB.

Direct cross-border credit to NFCs also plays a significant role in the Czech Republic. Due to the large share of foreign ownership in the corporate sector resulting from past foreign direct investment, corporations often use intragroup financing directly from their parent companies abroad. An analysis of broadly defined credit taken on by NFCs reveals that less than half of the credit comes from domestic financial institutions. A larger proportion comes from non-residents, which include both parent NFCs abroad and foreign banks providing direct cross-border loans (Graph 5).

Loans to NFCs: OFIs vs. banks

CZK bn, % — Graph 3

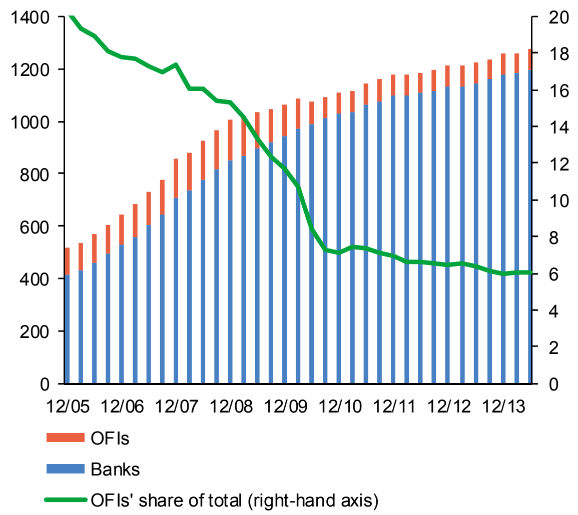


Source: CNB.

Note: NFCs – non-financial corporations, OFIs – other financial intermediaries.

Loans to households: OFIs vs. banks

CZK bn, % — Graph 4

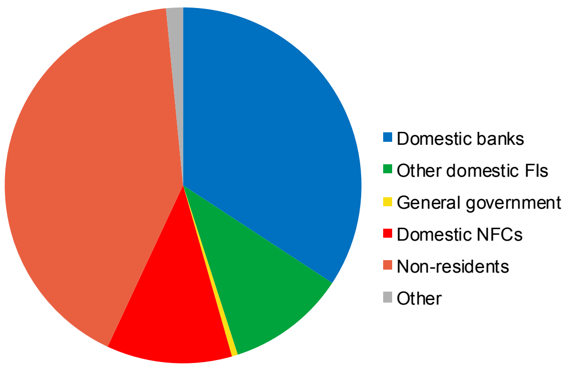


Source: CNB.

Like their counterparts in many other advanced countries, Czech NFCs have increasingly been raising funds by issuing corporate bonds in recent years (Graph 6). However, this trend only applies to a small set of large firms – bonds issued by the 10 largest issuers account for around 90% of the total issued by the sector as a whole. The bonds issued by Czech NFCs usually have maturities of longer than one year and are mostly placed abroad. The credit risk associated with Czech corporate bonds therefore has only a marginal impact on the Czech financial sector and is borne mainly by non-residents. Bonds account for around 20% of total NFC funding, so that bank loans still dominate. Some bond issues are denominated in foreign currencies, but the overall foreign currency indebtedness of NFCs does not represent a major risk to financial stability.

Credit to NFCs by creditor

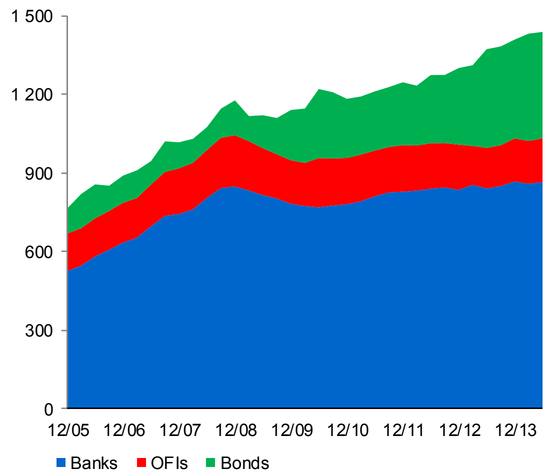
% Graph 5



Source: CNB.

Structure of funding of NFCs

CZK bn Graph 6



Source: CNB.

Foreign ownership and the post-crisis environment

The banking system in the Czech Republic is almost completely controlled by subsidiaries of foreign banks, usually from other EU countries. The role of foreign bank branches has always been rather limited. The role of government-owned financial institutions is also very low. The direct share of foreign banks in total assets is roughly 80% but, as some banks (mainly specialised building savings societies) are owned by other banks that are domiciled in the Czech Republic but have foreign owners, the share of the banking sector under (direct and indirect) foreign control is in fact more like 95% (the sector is mostly under the control of banking groups headquartered in Austria, Belgium, France and Italy). Despite the foreign ownership, the business of banks is predominantly domestic in terms of currency structure and sources of funding. Loans to households are extended almost exclusively in Czech koruna. Owing to the export orientation of the NFC sector, the share of foreign currency loans is higher, but still below 20%. In addition, banks generally fund their operations with local client deposits, which are rising steadily over time. The ratio of household bank deposits to NFC bank deposits is fairly constant over time (hovering between 2 1/2 and 3 to 1). These structural characteristics provide strong protection against external shocks and have helped to limit the consequences of the pre-crisis credit boom and the impacts of the global crisis on domestic financial institutions.

However, the above information about the structure of the financial system in the Czech Republic and its evolution over the last decade should not be interpreted as meaning that the Czech economy is insensitive to global developments. Global conditions in the pre-crisis years (high economic activity in an environment of excess liquidity) and in the period that followed (strong disinflationary pressures and low interest rates), coupled with developments in the banking sector and banking sector regulation in the EU, have in recent years been affecting monetary/credit conditions in the Czech economy and thus also the monetary policy transmission mechanism. Weak economic growth in the EU, the financial tensions in the euro area and the monetary policies of key central banks have helped to undercut demand for bank credit amid strong liquidity. In a climate of increased competition, banks have responded by lowering their lending interest rates and interest margins. At the same time, these factors are generating a risk of a gradual softening of credit standards. Banks are also increasingly investing their surplus liquidity in government bonds (Graph 7). Domestic currency issuance again predominates in the case of Czech government debt (FX issuance stands at around 20%) and the majority creditors are Czech financial institutions (non-residents account for roughly 25%). The proportion of floating rate debt has risen sharply since 2007 and is now close to one quarter at maturities of from one to five years. A large majority of the floating rate debt is koruna-denominated. Government debt has thus become more sensitive to sudden shifts in the koruna yield curve. However, volatility on the global bond market should not have a strong effect on the local bond market.

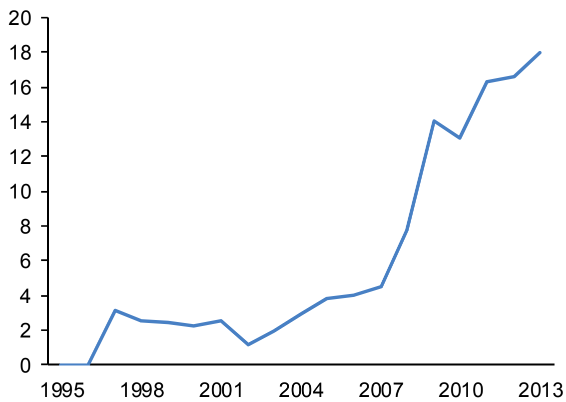
Government bonds in banks' balance sheets

% of total assets — Graph 7

Source: CNB.

Share of government debt with floating rate

% — Graph 8



Source: CNB.

Summary

The relative importance of banks and debt markets in the Czech economy has not changed significantly over the last decade. All we have seen is a slight increase in the importance of bonds in the funding of non-financial corporations. Structural factors (such as sufficient local funds, predominantly local currency funding, low significance of foreign bank branches) also ensure that the local banking sector continues to play an important role in the transmission of domestic monetary policy. Meanwhile, considerable scope still exists for domestic monetary policy autonomy, although the sensitivity of the economy to global monetary and financial conditions has naturally increased in recent years. The robustness of the domestic financial sector means that macroprudential policy can be focused on preventing the accumulation of potential systemic risks, not on coping with existing risks and imbalances. That said, the influence of macroprudential considerations on the monetary policy transmission mechanism has been limited so far, being a complement to, rather than a substitute for, interest rate policies. A potential tightening of the global funding conditions could have a direct, if not strong, impact on the balance sheets of several large non-financial corporations. For banks, most non-bank corporations and for government finance, however, the impact would be indirect and generally moderate.