The banking sector after 15 years of restructuring: Czech experience and lessons

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1. Introduction

Over the past 15 years, the banking sector in the Czech Republic has undergone a series of fundamental changes. Nowadays, the sector is stabilised, shows rather healthy financial results and has sufficient equity to cover the risks it undertakes. Apart from being almost exclusively controlled by foreign banking groups it is similar to the banking sectors in medium-sized advanced European economies. Thus, it could be suggested that the transformation of the banking sector has been completed.

The restructuring of the sector was anything but easy, smooth and painless. It was accompanied by numerous difficulties, and all stakeholders, i.e. bank owners, markets, lenders, depositors, supervisors and policy-makers, had to learn tough lessons in a hard way. The purpose of this country study is to summarise the basic features of the banking sector restructuring which took place in the Czech Republic during the 1990s and to present basic facts about the final phase of the restructuring process, i.e. after the privatisation of the big banks at the end of the 1990s. We focus on the role of the so-called "transformation institutions", which facilitated the privatisation process, and study the performance of the banking sector in recent years. We try to identify the most important relationships between the banking sector restructuring process, macroeconomic developments and the overall economic transformation. We present some estimates of the costs associated with the banking sector restructuring process and outline some tentative lessons emerging from the Czech pursuit of a competitive banking sector. We believe our findings to be useful for those emerging markets which are still undergoing the process of banking sector restructuring.

2. Banking sector restructuring during the 1990s

The development of the Czech banking sector during the 1990s has been thoroughly described in a number of studies.[1] In this section, we summarise only the most important developments. These can be organised under the following headlines:

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[1] Havel, J. (2004), *Bank privatisation - Critical view of the Czech deal*, Politická ekonomie 52; Tůma, Z. (2003), *Banking Sector Development in the Czech Republic*, In: Structural challenges for Europe, Cheltenham, U.K. and Northampton; Weill, L. (2003), *Banking efficiency in transition economies - The role of foreign ownership*, Economics of Transition 11; Hájková, D., Hanousek, J., Němeček, L. (2002), *The Czech Republic's Banking Sector: Emerging from Turbulent Times*, EIB Papers, Vol. 7; Dědek, O. (2001), *Bank Consolidation in the Czech Republic*. In: The Banking Industry in the Emerging Market Economies: Competition, Consolidation and Systemic Stability, BIS Papers, No. 4, BIS; Matoušek, R. (2001), *Banking Sector Restructuring and Debt Consolidation in the Czech Republic*, In: Financial and monetary integration in the new Europe: Convergence between the |EU and Central and Eastern Europe, Cheltenham, U.K. and Northampton; Racocha, P. (2000), *The Czech Banking Sector - The Role of Prudential Regulation*, In: European Union accession: Opportunities and risks in Central European finances, World Bank, Washington; Kunert, J. (1999), *Czech banking - Certainly not in year zero*, Finance a úvěr 49; Jílek, J., Jílková, J. (1999), *Impact of May turbulences in 1997 on profit and loss of banks in the Czech Republic*, Politická ekonomie 47; Bartlett, D. (1996), *Commercial banks and corporate governance in the Czech Republic and Hungary*, Post-Soviet geography and economics 37; Mervart, J. (1996), *Competitiveness of the Czech banking sector*, Politická ekonomie 44.

2.1 Splitting of the "monobank" and creation of big state-owned banks

The building of a competitive banking sector started virtually from scratch. The first step was the splitting of the former socialist "monobank", State Bank of Czechoslovakia (SBCS), and the creation of a two-tier banking system. From the ashes of the monobank, four large state-owned banks were established.

However, at the very beginning of the 1990s the banking sector was suffering from all conceivable deficiencies inherited from the former central planning system: undercapitalisation, a burden of bad loans, a shortage of the long-term funds necessary to support banks' development plans, inexperienced staff, non-existent risk management, legal loopholes, etc. (see for example Dědek (2001)). These features had far-reaching consequences: the banking sector was very weak and various forms of government assistance turned out to be practically inevitable.

2.2 Consolidation Programme I

The rather difficult starting position of the newly formed banks led to the implementation of "Consolidation Programme I". In 1991, Konsolidační banka (KoB) was established as a major vehicle for the takeover of bad loans. The Consolidation Programme involved operations associated with the removal of bad loans extended before 1990 from the balance sheets of Komerční banka (KB), Česká spořitelna (ČS), Investiční banka (IB) and SBCS, operations to strengthen the capital of the state-owned banks (KB, ČS and IB), and the clean-up of the balance sheets of other banks in the periods both before and after the division of Czechoslovakia. These operations were as follows:

(a) the transfer of assets to KoB;

(b) the write-off of loss loans from National Property Fund (NPF)[2] funds;

(c) increases in the equity of banks with NPF bonds and in the capital of the banks split off from SBCS;

(d) a capital increase in Československá obchodní banka (ČSOB);

(e) the transfer of credits and guarantees from ČSOB to Česká inkasní (ČI).[3]

The overall costs of Consolidation Programme I are estimated to have reached more than CZK 100 billion (which is about 7% of 1995 GDP).

2.3 Entry of small private banks

Shortly after the economic transformation began, new banks started to operate in the Czech economy. Licensing policy was quite benign at that time. This was a reflection of the rather liberal approach towards new start-ups in any industry in general and in the banking sector in particular. The principal motivation was to increase the competition of the four large banks (created from the monobank), which were considered too inertial and ineffective. The number of newly entering ("truly" private) banks in the Czech economy was impressive: 13 new banks were established in 1990, another 13 in 1991, 17 in 1992, 10 in 1993, and four in 1994.[4] However, this huge expansion in new banks later caused serious problems for the Czech financial system.

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2 National Property Fund of the Czech Republic was founded in 1991 for the purpose of providing for the technical implementation of individual privatisation decisions and the temporary management of state ownership interests intended for gradual privatisation, in accordance with act on the powers of bodies of the Czech Republic in the transfer of state property to other persons and the act issued by the Czech National Council on the National Property Fund No. 171/1991 Coll.

3 Česká inkasní (ČI) was a single-purpose financial institution controlled by the Ministry of Finance. It was established in 1993 and was authorised to clean up the portfolio of the state-owned ČSOB during the latter's transformation (particularly of inherited old receivables from state-owned companies having trading partners in countries with a high political risk). Agreements were concluded between the Ministry of Finance, the Czech National Bank and ČSOB. Česká inkasní for this purpose obtained a loan of CZK 29 billion from ČSOB guaranteed by the National Property Fund.

4 The total number of banks peaked at 55 in the mid-1990s. Of these, 32 were Czech-owned, 15 were foreign-owned and eight were foreign bank branches.

2.4 Crisis of small banks

Right from the outset, the small new private banks were operating under difficult conditions. They were typically undercapitalised and faced types of risk that had not been common earlier. Their strategies were focused on increasing their market shares at the expense of the relatively established big banks, which often drove them beyond prudent thresholds. The above-mentioned benevolent licensing policy, combined with inexperienced and still weak banking supervision and the specific process of small- and large-scale privatisation, caused the small banks to take on rather unsound development strategies. Banks assisted the rapid pace of transformation but, at the same time, took on risks comparable with those usually assumed by venture capitalists, risks which even the relatively high margins they enjoyed could not cover. The absence of effective legal and institutional supervision also invited fraudulent behaviour by the managements of these banks. Thus, the new small banks started getting into trouble shortly after the beginning of the economic transformation.[5]

During 1995, problems became apparent in some small banks with mostly Czech capital. Although these banks accounted for only a small part of the banking sector (about 4% of its total assets), the situation had to be addressed in order to ensure the consolidation and creditworthiness of the banking sector as a whole. The banking supervisory authority focused on those banks where the problems were most serious, forcing individual consolidation programmes on them. Despite all these efforts and remedial measures, the unfavourable trend was not prevented in most cases. This was chiefly because bank owners were often unwilling or financially unable to take radical action to solve their banks' problems, and also because the problems originating from when the banks started were just too big to solve. A lack of supervisory experience and motivation also contributed to the failure of the consolidation programmes.

2.5 Consolidation of small banks

The Czech National Bank (CNB) prepared at the end of 1995 and initiated at the beginning of 1996 a comprehensive programme of small bank consolidation to prevent a domino effect within the small bank sub-sector, which could have undermined public confidence in the banking sector as a whole. Consolidation Programme II clarified the negative financial situation facing a number of small domestic banks. The banking supervisory authority reacted with the uncompromising interventions allowed to it by law in cases where banks' shareholders rejected or were not able to accept an appropriate solution and/or where prolonging those banks' negative financial situation was unjustifiable. Of the total of 18 small banks, 15 were treated under Consolidation Programme II, with nine of them undergoing a radical solution consisting in the revocation of their licences or the introduction of conservatorship following a reduction in capital. In other cases there was co-operation with the existing shareholders, or new investors were found to cover the banks' potential losses.

The outcome of the greater pressure on the supervisory authority to remedy banks' shortcomings was a painful but ultimately purgative process, the postponing of which would only have harmed the economy further. It is estimated that the costs of Consolidation Programme II were comparable to those of Consolidation Programme I, i.e. more than CZK 100 billion.

2.6 Stabilisation Programme

The implementation of Consolidation Programme II had negative side-effects. The public's confidence in the banking sector was falling and the risk of a run on small banks was increasing. To reduce the risk of a liquidity crisis for small banks and to promote the overall stabilisation of the banking sector, a Stabilisation Programme was adopted in 1996. The programme was intended for the 13 small banks existing at the time. It entailed Česká finanční (ČF)[6] purchasing insolvent receivables from banks at

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5 Kreditní a průmyslová banka ran into problems in 1993, Banka Bohemia and AB Banka in 1994 and Česká banka in 1995, to mention just a few.

6 Česká finanční was given the task of technically implementing a programme to enhance the stability of the Czech banking sector. This "stabilisation programme", declared under Czech Government Resolution No. 539 of 16 October 1996, was designed for small and medium-sized banks. ČF was also tasked with implementing a so-called "consolidation programme" which had been announced earlier by the CNB in connection with the consolidation of the banking sector/mergers of small

their nominal value, up to a maximum of 110% of the banks' capital. This was done on the basis of, return on assets with the banks obliged to gradually create a reserve to repay their dues to Česká finanční after seven years.

The Stabilisation Programme turned out to be unsuccessful. Although six banks joined the programme, five of them were later excluded, closed and liquidated after failing to comply with its criteria. Only one bank emerged from the programme successfully. The costs of the Stabilisation Programme are estimated at about CZK 15 billion, still a fraction of the costs of the earlier programmes.

2.7 "Stabilisation recession"

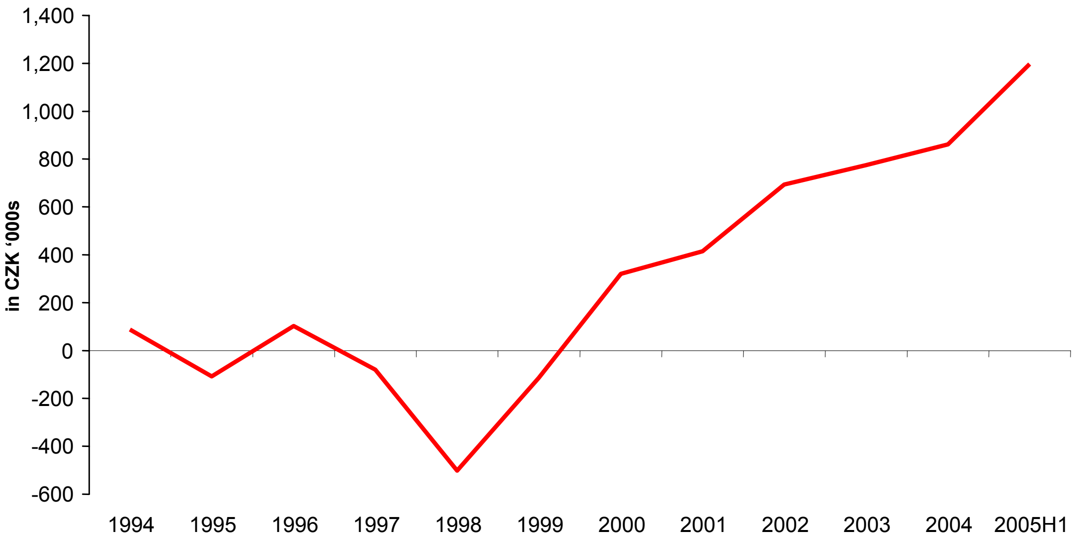
After 1996, the Czech economy struggled with macroeconomic destabilisation. The loss of the nominal anchor in May 1997, the bursting of the privatisation asset price bubble and a consequent koruna depreciation in the second half of the year increased inflation and inflation expectations. Due to the general economic uncertainties, poor supply-side performance and monetary policy tightening, the economy slipped into recession. GDP declined by 0.7% in 1997 and by 1.2% in 1998, and in 1999 growth was still sluggish (1.2%).

The negative economic developments and the related worsening in the economic situation of debtors continued to adversely affect even the large banks' financial results and the quality of their assets. Persistent shortcomings in the legal environment preventing banks from recovering receivables from debtors, together with the diminishing creditworthiness of the business sector and very high ex ante real interest rates, fostered a decline in lending and the maintenance of a relatively high ratio of classified loans to total loans. *Figure 1* illustrates the situation, showing that the profitability of banks per employee started to worsen in 1997 and remained negative for three consecutive years, bottoming in 1998.

Figure 1

Net profit per employee

In CZK '000s



Source: CNB

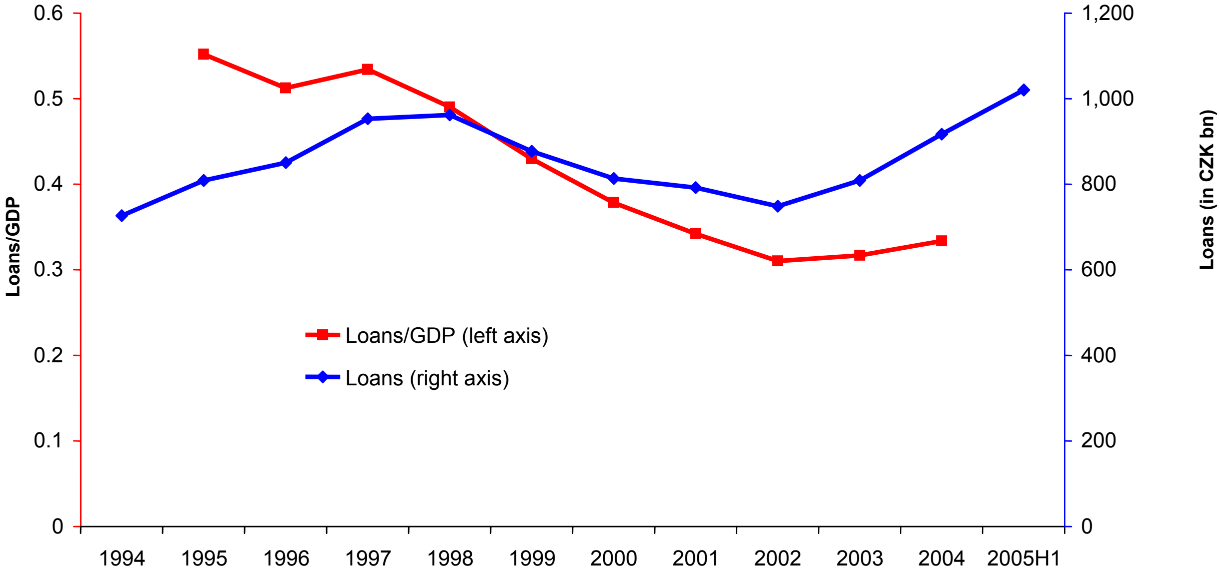
banks. ČF's objective is to manage bad debt purchased from small banks in accordance with the law with the maximum return in the shortest possible time and at the lowest possible cost.

The end of the 1990s was thus characterised by increased fragility of this vital component of the economy. *Figure 2* shows the decline in loans (in both absolute and relative terms) during the period 1998-2002. In popular terms, the decline in bank lending was termed a "frozen credit channel". Needless to say, the observed credit contraction impeded and slowed down the economic recovery and at the same time substantially weakened the efficiency of the transmission mechanism of CNB monetary policy. The situation of credit contraction was sometimes labelled a "credit crunch" (see Hampl & Matoušek (2000) for more details).

Figure 2

Bank loans and ratio of loans to GDP, 1994-2004

In CZK bn



Source: CNB, CZSO, own computations

Only in 2003 did loans recover in both absolute and relative terms, following a return to the black (see *Figure 1*).

The generally shaky situation of the banking sector can also be illustrated by the decline of deposits in banks (in relative terms) in 1999 and 2000, as shown in *Figure 3*.[7]

The negative macroeconomic trends and bank losses at the end of the 1990s hit the large banks hard. The state, as the main shareholder, contributed to strengthening ČS and KB's capital and cleaning up their balance sheets. The cost of the clean-up amounted to about CZK 76 billion for these two banks during the period 1998-2000. These operations temporarily rescued the big banks and preceded their privatisation; strictly speaking, they were a necessary condition for it.

[7] It can be suggested that the decline in deposits after 2002 also reflects the negative attitude of depositors. However, this can rather be attributed to a decline in nominal and real interest rates and a correspondingly low incentive to save.

Figure 3

Ratio of client deposits to GDP

Source: CNB, CZSO, own computations

2.8 Privatisation of big banks

The privatisation of the big state-owned banks was an ever-present issue during the Czech economic transformation process. It was often discussed by governments, but the decisive steps were repeatedly postponed in the first half of the 1990s, typically due to pressures from smaller parties in the coalition government and to very vocal leftwing opposition on this issue, despite clear interest from potential investors. In addition, the privatisation of the minority or majority equity stakes in large banks via the voucher method in the first half of the 1990s did not bring the desired results in terms of a strengthening of their management and corporate governance. Ownership was untransparent and excessively diluted, and control by the state inefficient. As a consequence, the efficiency, profitability and competitiveness of the big banks were, in line with the general macroeconomic picture, relatively poor and worsening in the second half of the 1990s.[8] Considering the unfavourable developments in the latter half of the last decade, finding a strong strategic investor became an imperative and a precondition for their stabilisation and further growth.

The privatisation of banks resumed in 1998. In January, the state's minority 36% stake in Investiční a Poštovní banka was sold to Nomura International. In June, General Electric Capital Services acquired substantial parts of Agrobanka, then the largest private bank, which had been effectively state-managed for the previous two years. In 1999, the state's almost 66% stake in ČSOB was sold to Belgium's Kredietbank. In 2000, the 52% stake in ČS was sold to Erste Bank Sparkassen, and finally, in 2001 the remaining state stake in KB was sold to Société Générale. By 2001, the privatisation of the banking sector had basically been completed, and further restructuring followed an evolutionary pattern without any active government involvement.[9] The costs related to the privatisation of the big banks are estimated by Havel (2004) at about CZK 100 billion.

8 The engagement of the state-owned banks in very generous lending in the mid-1990s was sometimes labelled "banking socialism". This term reflected the fact that state-controlled banks responded to politicians' calls to "support" the economic transformation at the expense of the soundness of their balance sheets.

9 Many insights into the procedures, transparency and fairness of the privatisation of the three big banks have been offered by Havel (2004).

2.9 Bankruptcy of Investiční a Poštovní banka

In June 2000, Investiční a Poštovní banka faced a dramatic run on primary deposits and a serious liquidity crisis. The emergency was resolved by imposing conservatorship on the bank and by a subsequent sale to ČSOB. During 2001 and 2002, six tranches of "black" assets and 10 tranches of "grey" assets were transferred to KoB. The total amount of these assets was about CZK 100 billion. Additional costs running to more than CZK 71 billion were associated with the transfer of off-shore funds and other operations.

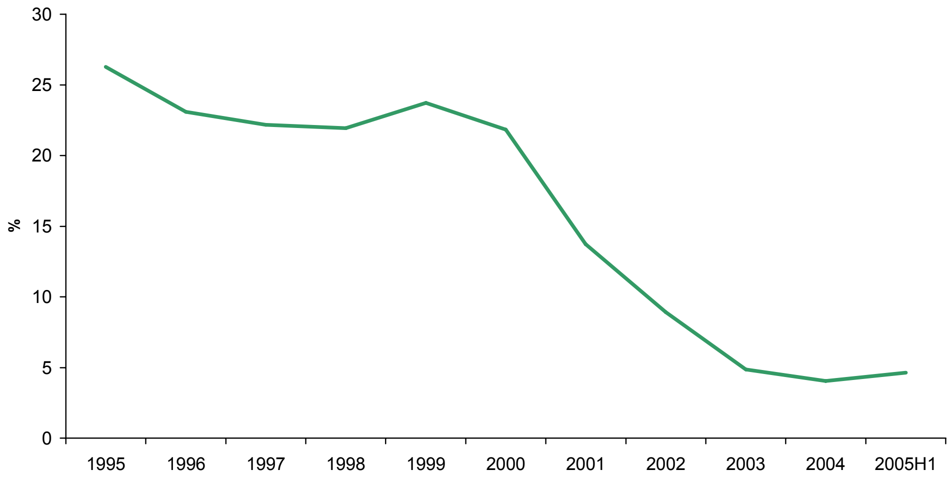
2.10 Banking sector recovery

The economic recovery, which started in 1999 and accelerated in 2000, the rescue operations carried out by the state (most notably the capital strengthening and takeover of bad loans by KoB) and the completion of the privatisation of the big banks had profound consequences for the performance of the banking sector. The burden of bad loans persisting throughout the 1990s started to decrease rapidly after 2000. *Figure 4* shows the plummeting share of non-performing loans in total loans.

Figure 4

Share of non-performing loans in total loans, 1995-2004

In %



Source: CNB

The above figure offers an interesting angle on the banking sector story. Remarkably, the crisis in small banks occurring in 1996-98 left no visible impact on the level of non-performing loans. On the other hand, losses incurred partly by the stabilisation recession temporarily increased the share of non-performing loans in 1999. The low ratio of bad loans in recent years reflects the soundness of the sector at a level unseen throughout the entire transformation period.

3. Costs of the restructuring process: volume, structure and time patterns

In this section we summarise the costs related to the banking sector restructuring process from the beginning of the 1990s until 2004.[10] It should be noted that the cost computation is strongly influenced by the methodology adopted and that different authors may arrive at different findings (see CNB

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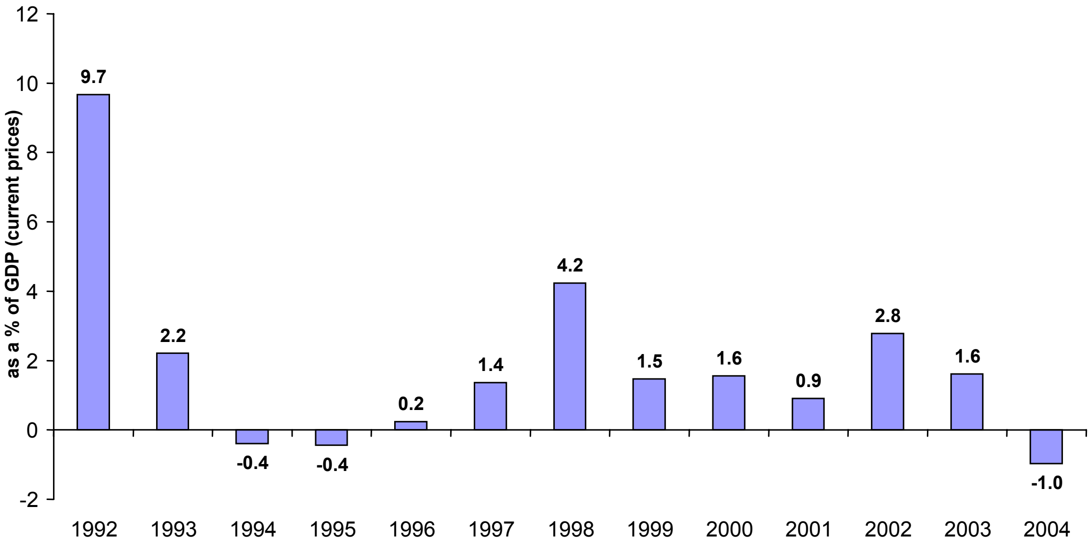
[10] We draw here from Ministry of Finance and CNB (2005).

(2000) and Ministry of Finance and CNB (2005) for more details). The estimated costs in terms of GDP each year are shown in *Figure 5*.

Figure 5

Transformation costs of the banking sector/GDP

In %



Note: The costs incurred each year are divided by nominal GDP (i.e. at current prices) in that year.

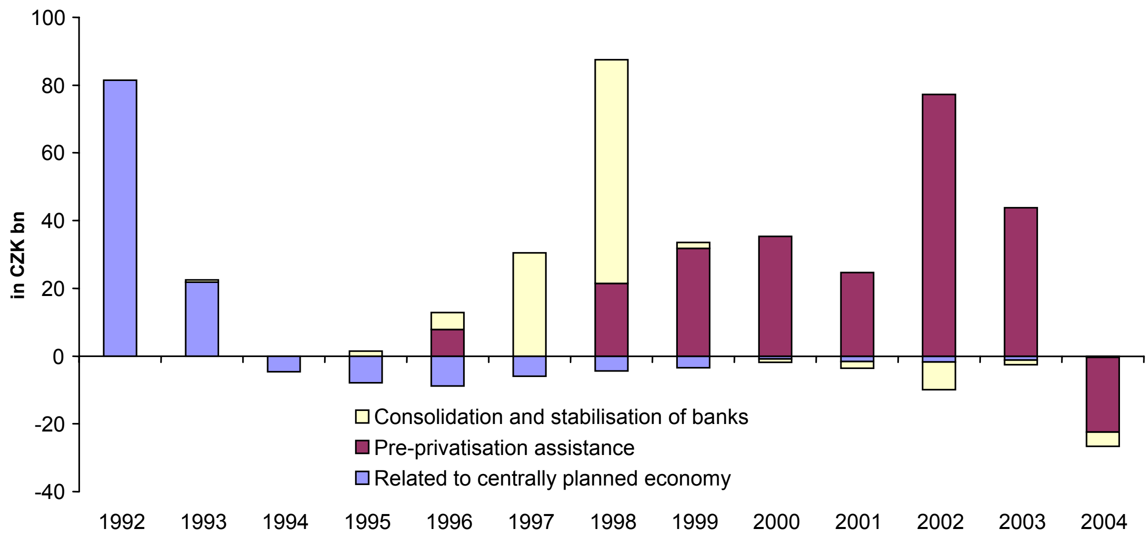
Source: Ministry of Finance and CNB (2005), CZSO and own computations

It is useful to discriminate between the different reasons for the transformation costs. *Figure 6* shows three kinds of costs associated with the restructuring of the banking sector, namely those inherited from the centrally planned economy, those incurred by the consolidation and stabilisation of banks, and those stemming from pre-privatisation assistance.

Figure 6

Structure of the costs of banking sector restructuring, 1992-2004

In CZK bn



Note: Positive values denote costs, while negative values denote revenues

Source: Ministry of Finance and CNB (2005)

The structure and time pattern of the transformation costs are intuitive. In the initial period the costs inherited from the centrally planned economy dominated (reaching about CZK 62 billion over the years), but in 1997-98 the consolidation and stabilisation costs (amounting to about CZK 88 billion) took the lead. With the onset of the privatisation of the big banks, pre-privatisation assistance clearly dominated and persisted until 2003, amounting to approximately CZK 220 billion.[11] The overall costs in money terms were about CZK 370 billion, which is equivalent to 24% of GDP accumulated on annualised basis over the period.

4. Costs of the banking sector restructuring and the economic transformation: lessons

We have tried to show that the development of the banking sector followed the overall pattern of the economic transformation. In the initial phase, the banking sector inevitably suffered from the socialist legacy. This implied rather unfavourable starting conditions in practically every aspect of its operation. In the first half of the 1990s, the banking sector faced new challenges stemming from a loose legal and institutional framework, inexperienced and underdeveloped banking supervision, privatisation, a lack of competition, political pressures to provide enough financing for the economy, and often fraudulent behaviour by bank owners and managers. This led to numerous bank bankruptcies, widespread distrust and a persisting burden of bad loans. The "stabilisation recession" in the second half of the 1990s also had far-reaching consequences. The banking sector started accumulating sizeable losses, thus exacerbating the overall fragility of macroeconomic performance. Also, the credit contraction weakened the efficiency of CNB monetary policy, which works mainly through the interest rate channel. Only after the privatisation of the remaining three big banks with large state-owned stakes did the restructuring of the banking sector reach completion.

We should mention that the transformation costs were borne by a whole range of public sector institutions. These included not only the "transformation institutions" (namely the NPF, KoB and its successor Česká konsolidační agentura, ČI, Česká finanční, KONPO, etc.), but also the government (via the budget) and the CNB. This indicates that the decisions to bear the transformation costs were often taken on an ad hoc and very pragmatic basis without applying any systemic approach or framework. It can even be suggested that decision-makers were repeatedly surprised by the depth of the problems concentrated in the banking sector, thus becoming followers of events rather than active leaders.

Simplifying somewhat, we can outline the following tentative lessons:

1. The very high initial costs related to the socialist legacy were most probably to a large extent unavoidable. The economic transformation started quite soon after the collapse of the centrally planned economy and there were no ready-made blueprints for a smooth regime change. The toll had to be paid.
2. The subsequent period (after 1992 or so) is more questionable. Exaggerating slightly, we can say that the banking sector partially substituted for (or mimicked) the former system of central redistribution of resources. The relative inefficiency of enterprises was transformed into banking sector losses. This process was fostered by political pressures and facilitated by underperforming banking supervision, a malfunctioning legal framework and underestimation of the risks involved. Initially, these losses were implicit and hidden, but over time they became explicit. The costs were dispersed over numerous agencies and unfortunately there was a tendency to neglect them and postpone remedial solutions. We believe that a large proportion of the costs incurred due to the consolidation and stabilisation of the banking sector could have been avoided and the corresponding risks shifted onto the private sector.

[11] The rather high costs in 2002 and 2003 refer, among other things, to the above-mentioned tranches of "black" and "grey" assets, i.e. bad loans and similar assets, transferred from the former Investiční a Poštovní banka to the balance sheets of KoB/Česká konsolidační agentura.

3. The timing of the privatisation of the big banks was intensively discussed throughout the 1990s. The postponements of these privatisations in the early 1990s were due to purely political motives based on the belief that some control of this crucial sector was advisable in a generally uncertain (= rapidly changing) environment. However, the sector of big state-owned banks extended (at least partially) the previously existing soft budget constraint and did not seem to foster any hardening. Moreover, the government did not prove to be a good owner, which implied operational inefficiency and managerial underperformance. We believe that earlier privatisation of the big banks would have yielded higher revenues (as their market shares were initially very high) and that the transformation costs incurred by the public sector during the stabilisation recession would have been much smaller, as the majority of the potential costs would have been covered by new private owners.[12] This observation is suggested by the substantially improved performance of the banking sector after the completion of the privatisation of the big banks. With the benefit of hindsight, the hesitation regarding privatisation of all state-owned banks sooner rather than later thus seems to have been unjustified. In other words, the postponement turned out to be unnecessarily costly.

5. Summary

The contrast between the banking sector in the former Czechoslovakia in 1990 and that in the Czech Republic in 2005 is extremely stark. Over the past 15 years, the largely state-owned, undercapitalised and poorly managed banks have been transformed into a foreign-owned, reasonably sound and competitive banking sector which meets the requirements of the post-transformation economy and complies with the standards of membership in the EU. The restructuring of the banking sector proved to be costly over the years of transformation. We believe that the costs related to the consolidation and stabilisation of the sector in the mid-1990s could have been mitigated, and those incurred by postponing the privatisation of the big banks even largely avoided. Unfortunately - or luckily - we cannot repeat the socio-economic experiment of the 1990s to see whether our belief is justified or not. Still, we believe that learning from the Czech lessons might benefit policy-makers in countries where the establishment of a competitive and privatised banking sector is high on the political agenda.

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[12] It should be noted that the pre-privatisation costs were incurred in the advanced stage of transformation, when the “rest of the economy” was basically private.