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Abstract

A survey of the current situation in the financial system of the Czech Republic is given on a relevant historical background. Special attention is drawn to the transformation of the banking sector during the economic reforms of 1990-1996. The situation on the capital market is discussed in connection to the emerging pattern of corporate governance, in which banks and investment funds tightly control the operations of the industrial enterprises in the Czech Republic.

Keywords
Czech Republic, financial system, banking

JEL-Classifications
C21, C23, C24, C28

Comments

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Introduction

Amongst the post-communist states of Central and Eastern Europe the Czech Republic is usually referred to as a success story, and rightly so. In slightly more than six years the Czechs have transformed what was the most orthodox centrally planned system into supposedly the most deregulated and privatised of the former communist economies. The so called "Velvet Revolution" of November 1989 in the Czechoslovak Socialist Republic opened the way to the sweeping reforms. In January 1993 Czechoslovakia was split in two, and the Czech Lands have enjoyed political stability and a well-performing economy, as table 1 testifies. The important role of the country in Europe was acknowledged in 1995 when the Czech Republic became the first of the former communist countries to gain membership in the Organisation for Economic Cooperation and Development (OECD).

When the communist government was overthrown in November 1989, Czechoslovakia (with the Czech Republic as its constituent part) enjoyed a relatively healthy economy in comparison with its neighbours. Its GDP per capita, estimated as $ 7,603 for 1988, was the second highest in the region (after the German Democratic Republic), and living standards were relatively high compared with most other countries of the Soviet Block (Griffith-Jones 1992, p.92). Thanks to a traditionally prudent monetary, fiscal and wage policiy of the communist government, by the end of the 1980s Czechoslovakia maintained a relatively satisfactory level of domestic macroeconomic stability along with a low level of foreign indeptedness ($ 7.9 bn at the end of 1989, when Hungary had $ 20.6 bn) (Hrnčiř and Klacek 1991, p.20).

Pre-1990 developments

History offers an important part of explanation of this relatively favourable economic situation. Before the communist takeover in 1948, Czechoslovakia had a well-developed market economy. Already in the 19th century the Czech Lands (Bohemia, Moravia and Upper Silesia) represented the most economically developed parts of the former Austro-Hungarian monarchy (Kroh 1992, p.120). Substantial deposits of coal and iron-ore provided a solid base for the development of heavy industry. The economy experienced a period of industrial promotion (known in Austria as "Gründerzeit") until the eve of World War I, with a 3.42 % annual growth of industrial output from 1880 to 1911 (Rudolph 1972, p.29). By the 1930s Czechoslovakia ranked among the most highly industrialised countries in Europe, with a strong tradition of skilled craftsmen producing machinery and other manufacturies and businessmen covering the export. The Czech industry was well placed to sell abroad, and did so to a remarkable extend. The quality of industrial production and exports was comparable to that of similarly advanced countries, and the per capita GDP of the Czech Lands exceeded that of Austria (the average Czechoslovak GDP per capita was similar to the Austrian one because of the backward agrarian character of pre-World War II Slovakia) (Griffith-Jones 1992, p.92; Švejnar 1993, p.22).

The financial system at that time reflected this high level of development of the market economy. The banks started to grow in the Czech Lands of the Austrian Crown from the second half of the last century. Živnostenská Banka, established in 1868, was the first, and it is now the oldest Czech banking institution (Kunert 1992, p.127). It was followed by other banks, and by the early 1900s Prague had become more and more of a rival to Vienna as a banking centre (Rudolph 1972, p.49–50). The big Czech banks could rely on a network of savings and cooperative banks which provided them with real savings. As Austrian banking laws required the case by case licensing of banks, a considerable bank concentration had thus been fostered in what should become Czechoslovakia. All but one of the Czech banks were of the "universal" type and followed the Austrian and German example and promoted growth of industry by rolled-over current account loans and by acquisitions of shares. However, to a much lesser extend than their equivalent in Austria or Germany, those banks had been able to sell these shares to a general public through the stock exchange, and therefore had ended up being more like holding companies of industrial and commercial firms than real universal banks (Cecco 1994, p.14).

When independent Czechoslovakia emerged in 1918, there were almost 100 banks and other financial institutions, including the stock exchange. They represented a significant managerial element in the economy of Czechoslovakia thanks to a well-formulated monetary policy. Unlike other successor states of the Austro-Hungarian monarchy, Czechoslovakia had managed to step back from the brink of hyperinflation in the early 1920s (Yeager 1981, pp.80–85). When a post-war boom and inflow of foreign capital caused a sharp revaluation of the Czechoslovak currency and put Czech exports in a competitive disadvantage. The large banks with their strong industrial connections had found themselves in great difficulties. After that the Czechoslovak Central Bank toughened the banking regulations and strengthened its supervision over the banks (Cecco 1994, p.15). The traditional conservative monetary and fiscal policy was followed throughout the 1920s and 1930s, and also lasted until the final phase of the communist rule.

After World War II and the restoration of the Czechoslovak State, the remarkable transformation of a once relatively advanced economy into an underdeveloped one occurred over four decades (Švejnar, 1992, pp.22–24). In 1945 all banks were nationalised, along with insurance companies and major parts of the industry, but in the years 1945–1947 the country was still run as a market economy. The Communist coup d'etat of February 1948 was followed by over a decade of totalitarian rule by a strictly Stalinist party. Soviet-type planning was imposed, the remaining private enterprises were nationalised, and priority was given to the heavy industry. Foreign trade was forcibly reoriented from the world markets towards the relatively less developed COMECON[1] countries.

[1] The Council for Mutual Economic Assistance (CMEA or COMECON) was founded in January

The centralisation of all economic activity initially created phenomenal growth, as the command system could rapidly mobilize existing resources. However, the shortcomings of that system – perverse incentives, limited innovation, rigidities and inefficient resource allocation – gradually became overwhelming. A period of an 8 % annual economic growth in the 1950s was followed by a virtual stagnation in the early 1960s, which led to a series of reform attempts culminating in the "Prague-Spring" of 1968. As a result of this relaxation of controls (partial price-liberalisation, increased enterprise autonomy and workers' participation in enterprise management) and coinciding with a thaw in the political system, growth resumed at about 7 % during the second half of the 1960s (Švejnar, Ibid.).

The process was reversed due to the fall of reformist leadership and the invasion of the country by the Soviet and Warsaw Pact troops. After that, economic reforms were dismantled and a highly conservative, centralised planning mechanism was reintroduced. State control had become more pervasive than anywhere else in East and Central Europe. The private sector was the region's smallest, accounting for less than 0.5 % of non-farm output. Industry, trade and farming were dominated by large units (Jones 1992, p.29). Only in the early 1980s, with a deteriorating growth rate and an actual negative figure in 1982, had the move begun towards some minimal flexibility coupled with the warning that this did not signal a return to free-market principles. A slight recovery took place, although the annual growth rates were consistently below a 3.5 % target set in the five-year plan for 1986–1990 (Schöppflin 1986, p.40; Myant 1993, p.155). With many observers noting that inflation was being increasingly underestimated, it is possible to argue that the 1980s were a decade of economic stagnation (Švejnar 1992, p.26).

In Czechoslovakia at that time money and prices were merely an accounting instrument for monitoring and controlling the implementations of the central plan (Nuti 1992, p.48–49; Catte and Mastropasqua 1993, p.788–789). This plan was constructed largely in non-value terms and determined not only the quantities of goods to be produced, but also the suppliers of required inputs with their quantities and prices for each enterprise of the economy. Investment was centrally decided and allocated in real terms, with finance provided to investors automatically interest-free from the state budget. Credit to enterprises was short-term and automatically provided at an almost symbolic interest rate for financing their working capital requirements necessary for fulfilling the plan. Interest rates had no allocative role whatsoever, and there was no tailoring of interest rate levels to repayment risks and maturities of particular loans. Direct credit between enterprises was not generally permitted, and enterprises had no incentive to accumulate financial assets.

Money flows were divided between the enterprise sector with a bank money circuit for

1949 by Bulgaria, Czechoslovakia, Hungary, Poland, Romania and the USSR. Later joined the German Democratic Republic (till 1990), Albania (till 1961), Mongolia, Cuba and Vietnam. The organization was dissolved in 1991.

inter-enterprise transactions and the household sector, with cash for wage payments and consumer purchases. Only in the case of the latter, money performed the functions of store of value and means of payment, while in the former case money served only as a unit of account. These financial flows were passively adjusted to the planned physical flows by a single institution that monopolised the functions of the commercial as well as the central bank (and therefore dubbed monobank in Western economic literature). In some cases specific functions were assigned to specialised banking institutions, such as those financing foreign trade or making loans to specific sectors. Czechoslovakia remained very close to this standard model of central planning until 1989 (Catte and Mastropasqua 1993, p.788–798).

The role of the central bank was played by the State Bank of Czechoslovakia (Státni Banka Československá). In 1948 the Investment Bank (Investični Banka) was established; it was responsible for controlling planned investment. In 1956 the oldest Czech financial enterprise the Trade Bank (Živnostenská Banka) was revived to serve foreign transactions of Czechoslovak citizens, and later in the 1960s it started to deal with small private businesses, like travel agencies, sport and cultural enterprises (Kunert 1992, p.127). In 1964 a joint-stock Trade Bank (Obchodni Banka) was established as a sovereign borrower for the Czechoslovak government. All types of savings banks were merged into one savings bank-holding the monopoly of retail banking for the personal sector. In 1969 it was divided into two: Česká Státni Spořitelna and Slovenská Státni Spořitelna, according to the newly created federal republican division of the Czechoslovak state. As lending to the public was relatively small, funds accumulated by the savings bank and deposited with the State Bank were the primary source for granting credit for national purposes.

As Catte and Mastropasqua (1993) show, the state maintained the predominant role in financing the accumulation process during the Eighties. Inside the enterprise sector, fiscal policies were used to reallocate profits among the enterprises in accordance with the plan targets. Taxes in proportion to GDP exceeded subsidies by 10 %, as the real resources were transferred from enterprises to keep the state budget balanced. This money was replaced by bank credits granted without maturity and at the lowest possible interest rates. The role of the financial system as such in intermediating resources and financing enterprise investment remained marginal (Čapek 1995, p.7). As it was the case in other spheres of economic performances, during the second half of the 1980s the existing financial system could no longer fulfil its expected role. Some changes were introduced inside the old economic system that could have found a home in more radical reforms. The most consistently market-oriented was the adoption of new rules in 1989, introducing a two-tier banking system, with separation of the central bank's and commercial banks' activity.[2] This splitting of the 'monobank' system had been set for 1st January 1990. The communist system did not survive till that date, however.

[2] The particular domuments of concern were the Law No. 130/1989 on the Czechoslovak State Bank, the Law No. 158/1989 on banks and savings banks and the Law No. 162/1989 ("foreign-currency law") – see Czechoslovak State Bank 1990, p.18.

The long-lasting political crisis of the Czechoslovak society reached a climax in the 'Velvet Revolution' of 17th November 1989 effectively demolishing the old political system. Serious economic reforms began in 1991, with 1990 being a year when essential legislation and institutions needed for the reform implementations were created.

From the Velvet Revolution to the dissolution of Czechoslovakia

At the beginning of the 1990s therewas a period of output decline in all the post-communist countries of Central and Eastern Europe. A major factor behind the output collapse was the dissolution of trading arrangements of the COMECON in early 1991 and the sharp reduction of imports by the former German Democratic Republic and the former Soviet Union. Intra-COMECON trade is estimated to have fallen by more than 50 % in 1991 (World Economic Outlook 1992, p.46). Czechoslovakia used to be one of COMECON's main manufacturing centres, with East Germany accounting for 10 % of the Czechoslovak foreign trade and the Soviet economy absorbing 33.4 % of the Czechoslovak exports. Loss of the East German market in 1991, steep reduction of demand for Czechoslovak goods from the recession-stricken Soviet Union and East European trading partners and the switch from COMECON trade to free trade based on world prices from 1st January 1991 onwards, resulted in a 22 % decline of the Czechoslovak terms of trade in the first three quarters of 1991 and amounted to an income loss of about 7-8 % of GDP in 1990–1991 (Švejnar, Op.cit., pp.34–35). No wonder that the Czechoslovak economy was severely hit. In 1991 the industrial output was down 30 %, with a total loss of output in 1991–1992 up to 50 %, nearly all of this due to the external shock, according to some experts (Kouba 1995, pp.456–457).

Internal developments also played their role. By applying restrictive macroeconomic policies the government succeeded to extinguish inflationary pressures brought on by price liberalisation in three to six months in 1991, and a significant price stability has been maintained since then. After an initial surge, inflation had been brought back to a moderate 12-15 %, partly because of the lack of any appreciable "monetary overhang" of bottled-up spending power, unlike Poland or the former Soviet Union.

The economy has adjusted remarkably as the private sector developed rapidly in response to the removal of administrative restrictions, price liberalisation and provision of bank credits, and exports picked up after an initial period of major decline with the European Union beginning to replace the former COMECON as the dominant trading partner.

On the negative side, restrictive government policies on top of a serious external shock resulted in a much more severe recession than was officially expected. In the Czech Republic the population was willing to undergo a painful transition. However, it was the Slovak Republic (contributing about 30 % of the Czechoslovak GDP) that had been especially badly affected. Therefore a significant part of Slovaks considered the tough measures of the central government to be too excessive and hence elected the republican government that promised to slow down the pace of reform. The Czech-Slovak differences in economic policies, as well as nationalism, resulted in the break-up of Czechoslovakia and the creation of two sovereign states: the Czech Republic and Slovakia on 1st January 1993.

A serious problem was that the state enterprises by and large avoided the impact of the restrictive government policies by relying to an increasing extent on inter-enterprise debt. Only limited enterprise restructuring occurred. Although the state stopped subsidising enterprises and proclaimed the end of state paternalism over enterprises, this paternalism survived in a modified form involving the newly created commercial banks.

1990 Banking Reform

From the beginning of 1990 the Czechoslovak State Bank had begun to operate as a real central bank with functions including control over money supply (the initial tools that were at its disposal in 1990 included credit ceilings, reserve requirements and a directed credit facility), regulating interest rates and exchange rates of the Czechoslovak Koruna (the foreign exchange reserves were moved to the State Bank by the end of 1990), and supervision of the newly created commercial and savings banks, including the issue of licences for the establishment of new banks and for the permission to deal in foreign exchange markets. Other components of the new system included (Kroh 1992, pp.121–122):

- the Commercial Bank Prague (Komerčni Banka Praha) and the General Credit Bank Bratislava (Všeobecná Úvěrová Banka) as newly established commercial banks for the Czech and Slovak Federal Republics respectively. Komerčni Banka became the largest in Czechoslovakia, as it inherited more than half of the available assets of the State Bank ($ 22 bn from $ 40 bn), 7,500 employees from 13,500 and took over all branch offices of the State Bank in the Czech Republic;
- the Investment Bank (Investični Banka) founded through revival with substantially expanded functions of a former institution that was still operating to a limited degree even before 1990. It administered most of the long-term loans authorised by the State Bank in the past, with the support of the Treasury;
- the Czech and Slovak Savings Banks (Česká Státni Spořitelna, Slovenská Státná Sporitelna);
- the Czechoslovak Commercial Bank (Československá Obchodni Banka) and the Trade Bank (Živnostenská Banka) continued to operate; in addition to former specialisation in foreign trade for corporate entities and private clientele respectively, they were allowed to operate in the domestic banking spheres as universal banks.

With the exception of the joint-stock Československá Obchodni Banka, all other banks had the legal form of state monetary institutions. It was perceived at that time that the specialisation of these banks will be eliminated so they will fit a unified system of providing banking services, and that they will be complemented with other banks, 'provided that it is useful and that a new bank has sufficient assets and manpower and technical prerequisites for a regular exercise of its activity' (Czechoslovak State Bank 1990, p.18). In 1990 the new banks were allowed to emerge subject to the issue of permit by the Central Bank, and by the end of 1991, 27 privately owned universal commercial banks (including foreign-owned and foreign joint ventures) were operating on the territory of the Czech and Slovak Federal Republic (CSFR) (Thorne 1993, p.967).

The idea of further splitting of Komerčni Banka and Všeobecná Úvěrová Banka as well as the republican savings banks into smaller units to promote a more competitive structure was turned down on the grounds that the disturbance to the financial system had to be kept to a minimum. As a result, at the end of 1990 six top banks accounted for about 96 % of all primary deposits and 93 % of all credits (*The Banker*, January 1993, p.32), 70 % of which were concentrated in Komerčni and VÚB banks (Hrnčiř and Klacek 1991, p.36).

The new Central Bank and commercial banking legislation was mirrored in the Western economies legislation. Czechoslovakia, as the most Central European post-communist country, opted for the German-Japanese model of universal banking. The banks were empowered to perform commercial as well as investment bank functions. The legislation also allowed banks to make long-term investments, such as in real estate and securities up to the limit of 25 % of the bank capital and reserves, excluding collateral taken by the banks which have to be sold within two years.

The problem of low capitalisation of the new banks had been recognised (see below). In line with the Basle Agreement, a ratio of capital adequacy of 8 % of risk-adjusted assets was imposed, with a transitional period of compliance. The banks were supposed to comply with 6.25 % by end-1993, and with the 8 % in the end-1995. The State Bank of Czechoslovakia was responsible for the supervision of the commercial banks. It imposed mandatory reserve requirements of 8 % of deposits, remunerated. It also set individual upper limits of credit activities for all major banks (they did not imply effective constraints in reality, as the concerned commercial banks were rather cautious in extending new credits). In addition, in October 1990 obligatory upper limits for interest rates for loans were imposed to prevent their "unduly" surging, given the existing non-competitive environment. These ceilings were gradually adjusted and finally abolished on 1st April 1991 (Hrnčiř 1993, p.18). Strict limits on exposures to a single borrower (up to 25 % of capital) and to shareholders (up to 15 %) were introduced as a way to limit banks' large exposures and preventing shareholders form benefiting from bank ownerships. The deposit insurance scheme covered only state-owned banks and government deposits. Concerning the entry of new banks, the legislation was more liberal than in neighbouring countries, with entry for new banks being limited only by the minimum capital requirements, with no limits on ownership (Thorne 1993, pp.968–971).

The efficiency of the newly created banking sector was seriously inhibited by its obvious weaknesses. It was considerably understaffed, with grossly inadequate accounting and auditing procedures and no experience whatsoever how the financial intermediaries operate in a market economy. With the exception of Komerčni and VÚB, most of the banks had a limited branch network. Most of the newly established banks were oriented to specific activities, a certain clientele or a given region. The banks were seriously under-capitalised, with capital/assets ratio in the range of 1 % to 2 % even for the largest banks. The banks' balance sheets were burdened with large amounts of non-performing loans that were produced partly by the methods of allocating resources in the pre-1990 economy, and partly by the way in which the reform of the banking system was enacted. These disequilibria tended to distort the credit flows and inhibited the banks' ability to act as active allocators of the financial resources.

The fragility of the banks' balance sheets increased during the severe recession which had started in 1990. The protracted fall in national income had given rise to growing enterprise losses, and consequently the shares of non-performing loans in the banks' assets had been rising. As banks had their assets invested substantially into fixed-interest rate medium- and long-term loans, the rise in interest rates could increase the cost of deposits and thus weaken the banks' income. An almost complete absence of risk-assessment skills in some cases led banks to a drastic credit rationing.

Reform of the payments system

A payment system capable of speedy settlement of transactions in goods, services and basic securities is a linchpin of a functioning market economy. It is a mechanism whereby financial institutions or other economic agents can transfer funds to discharge their obligations. The establishment of an efficient system of payments among the banks is important for several reasons: Intermediating payments involving households and firms. The process can be divided into two parts: clearing – the transmission and recording of the instruction to make a payment; and settlement – the actual transfer of some medium generally acceptable in fulfilment of the payment instruction.

Permitting active liquidity management. The inadequacy of facilities for money transfer is reflected in the banks' typically large excess reserves, which is nothing but a drain of their resources. Providing facilities for longer-term interbank lending to promote more efficient allocation of funds across disparate intermediaries.

Facilitating the development of security markets as assets' liquidity depends on the speed with which the medium, accepted in the final settlement could be obtained by selling these assets.

Establishing the basis for implementation of monetary policy: if sufficiently deep money markets do not exist, there is no way of carrying out meaningful open market operations (Folkerts-Landau et al. 1993, p.93–97).

Under the monobank system the volume of interbank payment was limited, as was the amount of competition within the system as every enterprise was assigned to a bank. Central planning did not attach any time value to money, so enterprises were not particularly concerned about receiving funds promptly. Underdeveloped telecommunication systems on top of all that led to a payments system that was very slow. When the monobank system was broken up, former intrabank transactions became interbank transactions, making the establishment of an interbank payments system an important goal.

Initially interbank transfers were settled through a system of bilateral mutual accounts. The two main commercial banks served as clearing banks: Komerčni Banka for the Czech Republic, VÚB for Slovakia (Baliño, Dhavan, and Sundararajan 1994, pp.11–15). The State Bank held clearing balances with the clearing banks. "Settlement" was completed on the books of the clearing banks at the end of the day by debiting or crediting the accounts of other banks, including the State Bank and other clearing banks, with no limits or interest charges applied. The savings banks in the Republics used similar arrangements for their settlements.

This system just mimicked the functioning of the old monobank. It was slow, with 7 to 14 days necessary for a bank cheque to be settled (Thorne 1992, p.24). There was no incentive for the development of a short-term interbank money market, and it was impossible for the State Bank to implement monetary policy through indirect instruments. Moreover, these arrangements led to a very high risk of exposure given the lack of knowledge about the solvency of banks.

From March 1991 the clearing banks continued to perform the clearings, but the final settlement was done on the books of the State Bank on a "morning-after" basis. The system required banks to hold reserves with the State Bank to settle, and the monetary management improved substantially. The imposed credit ceilings prevented the expansion of reserve money.

In April 1992, the new clearing centre in Prague was organised, in which all banks kept accounts and which simultaneously debited and credited their accounts according to the verified information on computer disks or tapes. If funds on debited bank's account were insufficient, this bank was notified and could either seek short-term financing from another bank or borrow at a penal rate from the State Bank. This centre could on average process 300,400 transactions per day.

During 1991 and much of 1992 banks continued to hold large and variable amounts of excess reserves. They rapidly declined by the end of the year after the phasing out of credit ceilings (replaced with indirect instruments of monetary control by the State

Bank: auctions of the State Bank credit to banks, a Lombard window, and an overdraft facility at a penal rate in 1991 and open-market operations in Treasury bills in 1992), better monitoring of bank reserve positions, and the ability of the new centre to provide reliable next- or same-day settlements. This system also facilitated the development of an interbank money market that began to include overnight operations instead of solely long-term (over 15 days) and the foreign exchange market.

In 1993, separate clearing and settlement centres were established in the Czech Republic (in Prague) and in Slovakia. Payments between the new states were settled through the two new Central Banks.

First attempt to solve "bad loans" problem

The poor quality of the loan portfolios of the newly created commercial banks was a legacy of the previous system, arising from past practices of providing permanently revolving credits for inventories to state-owned enterprises, extended at low interest rates and with no maturity dates. The volume of enterprise indeptness (including "secondary indeptness" or induced inter-enterprise credits) had been increasing with some ups and downs since the early 1970s. After 1987 it was somewhat reduced through the use of state budget funds. However, in 1990 an unprecedentedly sharp increase of enterprise indeptness had developed under pressure of tight monetary and credit policies, demand constraints and biased expectations of producers (about inflation and devaluation) (Hrnčiř and Klacek 1991, p.30). A large number of existing enterprises had become unprofitable. A substantial debt overhang developed as many firms could cover operating costs but were unable to service their debts. The banks were saddled with a large stock of non-performing loans, that initially could not be even easily identified because of inadequate accounting standards and an absence of auditing. The amount of non-performing loans in 1990 was estimated as Kčs 100bn-200 bn out of Kčs 700 bn total loan book (*The Banker*, December 1991, p.46).

The Czechoslovak authorities preferred to recapitalise banks and let them deal with the loans themselves. The following measures were adopted (Dittus 1994, p.339):

Long-term loans at low interest rates (e.g. loans for housing, nuclear power, and newly married couples) have been receiving a budgetary subsidy covering the difference between the loan rate and the discount rate since 1990.

Perpetual inventory loans carrying a fixed interest rate of 6 % accounted for more than 40 % of the total credit granted by Komerčni Banka and VÚB in 1990. When interest rates rose to above 20 % in 1991, these loans threatened solvency of these then undercapitalised banks (see above). In 1991, Kčs 110 bn (80 bn from Komerčni Banka) out of total of Kčs 180 bn of these loans (about 15 % of all banking loans) were transferred to a newly created agency, the Consolidation Bank (Konsolidačni Banka), and the loans were rescheduled with a maturity of eight years and an interest rate of 300 basis points over the discount rate. In late 1992 Konsolidačni Banka again purchased non-performing loans, with a nominal worth of Kčs 15 bn, at 80 % of nominal value (Hewer 1994, p.7; Salzmann 1994, p.17).

To increase banks' capital base, the National Privatisation Fund issued Kčs 50 bn worth of bonds in 1991 and handed these over to the commercial banks free of charge; Kčs 12 bn were interest-free and used to increase the banks' capital; the remainder carried a coupon of 200 basis points over the discount rate and had a maturity of five years, intended to allow banks to write off bad loans given with good respects to enterprises before 1990. Repayment of the Kčs 12 bn part is in currency, while the remaining Kčs 38 bn of the bonds will be repaid in the form of shares in privatised enterprises whose debt had been written down. The debt-equity-swap provided cash-flow relief for both, enterprises and banks because it was financed by the state, but as it was aimed at good companies, it did not fundamentally solve the problem of non-performing assets (Weston 1994, p.21).

Together, these measures improved the capital/asset ratio (national definition) of the two commercial banks concerned to 4.5 at the end of 1991 or to 6, general reserves included. Some experts considered the problem of non-performing loans in Czechoslovakia to be close to a solution. Authorities were confident that banks could now outgrow the problem through provisions and write-offs (Dittus 1994, p.343–344).

Economic developments after 1993

1993, the first year of an independent Czech Republic, was a turning point in her economic transformation. Recession hit the bottom and recovery began. A substantial structural change occurs in the Czech economy, stemming partly from the rapid re-orientation of the Czech export trade towards Western markets (with balance-of-payments account in a healthy surplus and foreign exchange reserves quadrupled to $ 3.8 by the end of 1993), but also from the removal of restraints on the private sector activity. Thousands of people moved from industry and agriculture into private sectors in services, trade, banking and finance, keeping unemployment at a low 3 %. Growth of new private firms was accompanied by a successful voucher privatisation (see below). The Czech Republic (with $ 2.1bn total foreign direct investment since 1990) became the second recipient (after Hungary) of foreign direct investment in Eastern and Central Europe.

1994 was the first year when the Czech economy experienced a positive growth: 2.6 % of GDP and 2.3 % of industrial production (*Transition Report*, p.193). The structural change in the economy continued. The service sector accounted for more than 50 % of the GDP against just 35 % in 1991 (Jones 1995a, p.50), and the state sector in GDP was less than 50 % by the middle of 1994 (Kaltenegger 1994, p.7). Inflation dropped below 10 % for the first time after the reforms had began. Economic growth continued in 1995 and 1996 (table 6.1.1), fuelled mostly by investment and private consumption.

This success of the Czech economy brought problems as foreign direct investment had been increasingly accompanied by inward portfolio investment, by foreign banks lending in hard currencies to Czech companies and by speculative inflows of money gambling on the revaluation of the koruna. Further deregulation was considered as an option, and in October 1995 all current account transactions were fully liberalised, as well as many capital account transactions, achieving the convertibility of the koruna in terms of Article 8 of the IMF guidelines.

In 1996 economic growth has failed to meet expectations (the official prediction for 1996 was 5.4 % growth of GDP). Another troubling development, visible from 1995 onwards, was a growing trade deficit as imports have risen faster than exports. The Czech government relies on strong financial inflows to finance this deficit. However, foreign direct investment had been increasingly accompanied by inward portfolio investment, by foreign banks lending in hard currencies to Czech companies and by speculative inflows of money gambling on the revaluation of the koruna.

The debate was opened about whether the Czech economy is losing some of its competitiveness. This issue is directly connected with the fact that the modernisation and restructuring of the Czech industry still lies ahead. After the mass privatisation it is controlled by big investment funds, most of them owned by banks and insurance companies. The question is whether they are capable of providing skilful corporate governance necessary for this major part of the Czech economy. Some economists worry that if the Czech industry continues to avoid restructuring, the country will be doomed to a long-term low growth (*Business Central Europe* 1996, annual issue, p.27).

Banking industry in the Czech Republic

The upper tier of the Czech banking system is occupied by the Czech National Bank. According to the Law on the Czech National Bank (1993), its main task is to ensure the stability of the Czech national currency. It is governed by the banking Board nominated by the state president. Thus the CNB has to be independent from the state government;[3] the only obligation that the CNB has towards the branches of power is to present a report to parliament twice a year (Tuček 1994).

The CNB is responsible for formulating monetary policy. For this end it has a range of instruments. It sets the discount rate, Lombard rate and penalty rate[4] and the reserve requirements; it could use rediscount and Lombard credits and open market operations

[3] According to the constitution of the Czech Republic, the president is the head of state only.

[4] Applies to overdrafts on clearing accounts of banks and in the event of failure to maintain the required minimum reserve.

in Treasury bills and bills issued by the National Property Fund. The CNB has the right to impose credit limits on banks' lending (although this instrument has not been used any more) (*Handbook* 1995).

The Czech Law on Banks is founded on the concept of universal banks, i.e. it does not distinguish between the activities carried out by commercial banks, saving banks, building societies or other types of banks. However, as the CNB grants the license for the new banks, some banking activities could be excluded or restricted in the license. In practice there are the following types of banks: banks with a general license to carry all banking activities, foreign exchange business included; banks with restriction on foreign exchange business; banks with a license to carry on only some of the banking activities; building societies which operate under a separate type of banking license (*Handbook* 1995).

As tables 2, 3 and 6 show, the Czech banking industry (after the dissolution of Czechoslovakia) is dominated by four big banks that enjoy virtual monopoly in their respective markets. There are almost no middle-sized financial intermediaries, and the small banks have difficulties to find a profitable niche, sometimes having only the lending opportunities that have been already rejected by these giants. Many savers and industrial borrowers had effectively only one choice of bank.

The former federal government was aware of the relative lack of competition in banking. Apart from sanctioning a growing number of new local and foreign banks, it had barred any bank from having more than a 30 % share of each of the markets for commercial and consumer loans and savings deposits, with a grace period to the end of 1994, as the biggest banks already exceeded the limits. This regulation remained unchanged in the independent Czech Republic.

The market share of the "big four" is indeed gradually decreasing as other institutions grow (table 6). But foreign banks prefer to serve foreign clients that have an interest in the Czech market. Attempts by smaller local banks to establish a firm foothold in the market too often means taking the risks that could prove disastrous. Agrobanka, the fifth largest bank (not counting Konsolidačni banka), almost collapsed in 1993 trying to grow quickly. All attempts to create a mid-sized tier of institutions to replace many undercapitalised small banks have failed despite encouragement from the central bank for the past years (Borland 1995b).

Table 4 presents the ownership structure of the "big four" Czech banks. Initially they were state-owned, as being carved from the State Bank. In 1991, after some debate, the Federal Czechoslovak Ministry of Finance agreed to the inclusion of all state-owned banks (except the foreign trade bank, ČSOB, and the newly created "sink bank" Konsolidačni Banka) in the first wave of voucher privatisation, while keeping back a significant (40 to 45 %) share of the capital. In the Summer of 1993, these banks issued shares to those who bid their vouchers for them, and since that moment these banks were technically considered privatised (Mortimer 1995, p.92). However, from the table 4 it is clear that the State is still by far the biggest single shareholder in all of them. Moreover, the supervisory boards of these banks are crammed with representatives of the National Bank and the Ministry of Finance. With widely dispersed shareholding and substantial shares owned by the investment funds founded by (sometimes the same) banks, much of the Czech banking is still under de *facto* state control.

The Czech government appeared to be committed to the full privatisation of the big banks, on condition that it controls the process and decides who receives the shares. That was the reason why the government refused to back Global Depositary Receipts issued by Česká Spořitelna, as it did not accept GDRs as a means of spontaneous privatisation (*Financial Times*, 10th May 1996). Nevertheless, Česká Spořitelna was able to press ahead with the GDR international offering, together with Komerčni Banka and IPB. GDRs are popular with foreign investors and the banks because they are approved in advance by the CNB, so investors do not have to seek specific CNB permission to buy them, as they have to with the direct purchases of shares (*Financial Times*, 13 May 1996). As the result, 17 % of Komerčni's shares in mid-1996 were foreign-owned, an increase of 9 % compared to 1995 (Calbreath 1996d, p.57).

In late November 1996, the government finally decided to speed up privatisation in the banking sector. The first bank to be fully privatised is IPB, as Nomura International, the investment-banking arm of Nomura Securities Co. of Japan, and ING Bank of the Netherlands expressed interest in acquiring the government's 31.5 % stake (*International Herald Tribune*, 22 October 1996). The privatisation of Komerčni Banka (with most important industrial holdings) is still in the distant future, although the CNB has plans to sell the 45 % stake through a series of international offerings. On the other hand, the CNB plan to encourage a merger between overwhelmingly state-owned ČSOB and Česká Spořitelna (to create a new institution to rival the dominant Komerčni Banka and to be able to compete with large foreign banks after the Czech Republic joins the European Union) could only dilute private shareholding of the latter and delay full privatisation of the enlarged bank for several years (*Financial Times*, 31 October 1996; Borland 1996d).

The privatisation of the big banks raises the question about their role in the economy, namely whether they should continue to be the conductors of government-designed industrial policy with wide strategic ownership roles in the Czech industry along the lines of the German banking model.

Banking supervision and regulation

The Czech National Bank has a responsibility of supervision and regulation of the banking industry in the Czech Republic. Its supervision department had been progressively developing its prudential requirements and monetary control techniques. The minimum capital requirement for new banks went up from Čk 50m to 300m (just over $ 10m) as a step towards requiring banks to meet the BIS 8 % guideline (since the end of 1993, a transitional solvency ratio of 6.25 % drawing upon BIS rules was applied, and the 8 % target ratio had to be reached by banks by the end of 1996 (*Transition Report*, p.155)). The next step was to increase this threshold to Čk 500m and to toughen questioning of a bank's proposed founders.

At the same time the National Bank had decided to revise and to make mandatory for all banks the system of loan classification and provisioning which the Czechoslovak State Bank originally introduced as a recommendation in June 1992. Since January 1994 the new rules required banks to allocate their assets into five categories – standard, followed, sub-standard, dubious and loss-making – with provisions rising from 5 % of all assets in followed category, to 20 % for those in the sub-standard, 50 % in the dubious, and 100 % of book value in the loss-making category (Blommestein and Spencer 1993, pp.148–149; Čapek 1995, pp.18–19). In 1995, the adoption of an amendment to the Act on Reserves changed the concept of provision and reserve creation, associating it directly with the volume of classified credits in individual categories (Czech National Bank 1995, p.101).

There are limits on large exposures and on equity investment. Exposures to any counterparty or group of economically connected counterparties may not exceed 40 % in capital by the end of 1993 and 25 % by the end of 1995; and not exceed 80 % by the end of 1995 if it is to a bank or a group of economically connected banks. Certain restrictions are imposed on equity investments with the aim of limiting transparency of equity holdings in bank and non-bank institutions connected with the investing bank (*Handbook* 1995).

New accounting rules based on European models have been introduced and accounting standards have been tightened. Nevertheless, differences to international accounting standards (IAS) remain, displayed by the discrepancy between national and IAS figures where both are available. For example, Komerčni Banka showed a profit in 1992 in national accounting, but a loss in IAS accounts (Dittus 1994, p.345).

The deposit insurance regulation respects the requirements of the European Union. Obligatory insurance of deposits has been imposed in amounts which protect especially small depositors. The amount of compensation is limited to 80 % with the ceiling of Čk 100,000 per depositor per bank. The Deposit Insurance Fund was a timely provision soon to be tried as the banking crisis started to evolve.

In mid-1994 the Czech parliament adopted an important amendment to the Act on Banks, which implemented provisions on increasing the efficiency of banking supervision and established obligatory insurance of natural persons' deposits (Czech National Bank, 1994, p.63). The Act defines as a shortcoming in a bank's activity not only a breach of legal regulations by a bank but also the execution of banking transactions in a way that impairs the interests of its depositors or threatens the stability of the banking system. The supervisory body now could demand a decrease of the basic capital, change of management and the creation of reserve funds. The Act increases possibly imposed fines from Čk 5m to Čk 50m and preserves the possibility to restrict and to withdraw the banking license.

These developments were preceded by the failure of three banks – 2 % of total banking assets in 1993 (Czech National Bank 1994, p.58) – in the first half of 1994. Small AB Banka and Kreditni a Průmyslová Banka collapsed because of securities trading losses and poor lending decisions, and mid-sized Banka Bohemia issued $ 1bn in fake securities. Banking supervision was strengthened after these cases and a moratorium imposed on the new banking licences, but the problems persisted, and more stormy clouds were gathering above the horizon to generate a new squall in the near future.

The development of banking services

As the economy of the Czech Republic resumed growth, total domestic credit issue grew steadily from Čk 49 bn in 1993 to Čk 77 bn in 1995 (Czech National Bank 1996, p.59). As the privatisation of the economy progressed, so the share of the loans extended to the private sector, also grew steadily and reached 69 % by April 1996 (Ibid.) There were other important developments in the market for banking services.

The money market in the Czech Republic had become a place to redistribute temporarily free short-term bank resources, as well as those of other investors. The basic legislative and institutional conditions for its development were created by 1993, when the CNB was the main market-maker. In 1994, when in June the repo tenders[5] of the CNB fully replaced the uncollateralised auctions of refinancing credits, the money market finally got its present shape. The CNB conducts open market operations on a daily basis to achieve its monetary goals. Besides the already mentioned repo tenders, it also uses outright sales and purchases of Treasury bills and the CNB and Fund of National Property bills and repo and reverse repo operations with individual market-makers (*Handbook* 1995).

As the strong foreign capital flow continued through 1993-1995, the CNB responded with an active sterilisation policy through the issue of the CNB bills and open market operations. The restrictive monetary policy adopted by the CNB was the cause of interbank interest rate rises in 1994 and 1995. Due to the increased importance of market instruments in monetary policy implementation and the systematic pressure of the CNB on the commercial banks, all money market segments developed the interbank deposit market, short-term bond and repo markets (Czech National Bank 1995, p.47–48).

[5]First introduced by the CNB in May 1993; the CNB accepts Treasury bills and the National Property Fund bills, and from September 1994 government bonds registered in the Securities Centre, as collateral.

Apart from that, the money market development was strongly influenced by an uneven and only slowly changing allocation of primary resources in the banking system, where the "big four" are the principal holders of the non-banking sector's primary deposits. So for the smaller Czech banks the money market is the main source of refinancing. Their interest rates on the newly granted loans are therefore more tightly pegged to the interbank interest rate than that of the big banks: in the second half of 1994, when the interbank rate was increasing because of the CNB policy, the small Czech banks also had their loan rates increased despite the fact that they already charged the highest interest for their loans to the clients and despite the substantial competitive pressure in their segment of market for banking services. At the same time, the major commercial banks that were less dependent on the interbank money market, had their loan rates in decline, narrowing the margin between the interest rates on deposits and loans (Czech National Bank 1994, p.47–51).

As Czech firms prefer to use bank-financing, bank intermediation is high, with loans to customers equivalent to 76 % of GDP at the end of 1995, compared with only 27 % for Hungary and 20 % for Poland. But borrowing from banks is expensive, with interest rates around 12-15 %, and few loans with maturity more than four years (Jones 1996b, p.29).

With respect to the time structure, the short-term loans were especially important, as their share in total newly extended loans was around 73-74 %. At the same time the medium-term loans' share declined from 19 % in 1993 to 13 % in 1995, and that of the long-term loans grew from 8 to 12 % (Czech National Bank 1996, p.59). In 1994 the short-term loans constituted 62 % of the total credit portfolio of the banks with majority foreign ownership, 42 % in the banks with minority foreign ownership (with the "big four" in this category) and 30 % in the Czech owned banks; the shares of the long-term loans were 7 %, 27 % and 46 % (Čapek 1995, p.24) respectively.

The big banks were content with extending loans to their old customers, mostly industrial enterprises (formerly state-owned, now considered to be privatised). So although the latter group of banks controls nearly three fourth of the total outstanding credits, only 37 % of the new loans were issued by them in 1994. Foreign banks mostly specialise on foreign companies that operate in the Czech Republic (55 % of their credit portfolio are loans extended to the foreign owned firms), and in many cases they represent only the local extension of the traditional financiers to these enterprises. The new banks were especially active in issuing new loans (29 % of all new loans in 1994), with more than half of them on long-term. These banks have the biggest share of state-owned enterprises among their clients (39 % against 25 % for banks with minority foreign ownership/big banks and 8 % for majority foreign owned banks), with the private and co-operative companies also substantially represented amongst the clients (Ibid., p.25–27).

The above quoted figures could give the base to speculation that the banks with no foreign participation (i.e. new small banks) extend substantial loans to the clients that have special relations with them, e.g. their founders or shareholders. These banks were founded and are functioning as the intermediaries for recycling the interbank money to loans to their special customers to solve their financial problems. The indication of this is that their asset portfolio for more than 70 % consists of loans to customers, while this figure is around 50 % for the big banks and even less for foreign banks. On the liabilities' side the share of interbank loans is 30-60 %, 10 % and 20 % respectively all figures on the end of 1993 (Ibid., p.37-38).

There is another indication that their lending is riskier. It was already mentioned that the small domestic banks charge higher interest for their loans than the two other groups of banks. That means that as the "blue chip" customers were already captured by the big and the foreign banks (which have cheaper resources and thus could offer cheaper loans), the small banks lend to clients on projects which other banks would refuse to finance (Ibid., p.35–37).

If we turn from the individual banks' balance sheets to the aggregated balance sheet of the banking sector (table 5), a substantial development on the assets side is recognizable. From the beginning of 1994 to the beginning of 1996 the importance of loans to clients had fallen, while the share of securities and ownership participation had increased seriously. This could be interpreted as reflecting both the development of segments of the financial market (other than the loan market), and the conscious policy of banks to build up stakes in industrial enterprises.

The interbank money market, that these banks so heavily rely upon, is dominated by Česká Spořitelna. This former state savings bank, in which the state still owns a considerable share, is the main source of liquidity for the banking system. It has a strong deposit base (65 % of retail deposits) and some 1,800 branches inherited from the earlier era. It could be a leader in areas such as pensions and building society accounts. It is not, however. The management adopted a very conservative and cautious approach and allowed the competitors to take these markets. The vast network of branches and obvious overstaffing, on the other hand, translate into high cost of retail business. The bank started its lending business as late as 1990 and has now 13 % of the corporate loan market. But it decided to concentrate on lending to the new businesses without sound know-how of credit assessment. As the problem loans were built up, the bank had to set aside over Čk 9bn of gross profits for 1995 as reserves against them. Roughly a half of its balance sheet was devoted to the interbank market in 1993 (roughly a third was lent to individuals and companies), and this exposed the bank to the collapse of several small banks. By the end of 1996, the share of interbank lending has become substantially smaller than of lending to other clients. In general, during 1996 the bank has managed to decrease slightly its share of problematic loans from 26 % to 24 % (Borland 1996a; Kapoor 1996b, p.51; Vondrák 1996c).

IPB (Investični a Poštovni Banka; created after the 1994 acquisition of the Poštovni Banka (Post Bank) by one of the "big four") is the competitor that penetrated the retail sector successfully, building on the network of post-offices. It plans to triple its deposit base by 1997. The bank acts aggressively in different other sectors, too. IPB participates in the capital market both independently and through its investment fund subsidiary. IPB acquired stakes in other financial institutions like Agrobanka (see below) or Českomoravská Stavebni Spořitelna building society; some of these stakes turned out to be too risky, as it was with some purchased securities. The critics say, however, that if it really wants to prove its endurance it should concentrate on improving its services (Cook 1995a; Kapoor et al. 1995; Vondrák 1996b).

The leader of the Czech banking scene is Komerčni Banka. It that dominates the corporate lending market inherited from the old State bank. It is considered to be the most restructured commercial bank (its shares are listed on the London Stock Exchange) and as the bank that is solving the problem of the bad debts successfully. It still has more than 35.4 % of substandard loans in its portfolio (one of the worst figures amongst the big banks) but this is a reduction compared 43.4 % in 1994, and in the new loans of 1996–75 % are standard, while loss-making ones are only 0.9 %. The bank had a considerable success in provisioning for bad debts. As the interest rate margins fell substantially, it was possible for Komerčni Banka to increase net profits by 6 % in 1995, mainly from non-interest income and from fees and commissions. The profits continued to grow in 1996 (Vondrák 1996a).

The interbank foreign exchange market was strongly influenced by the CNB regulations on the open foreign exchange positions of commercial banks and by pegging of Czech koruna to the dollar-mark currency basket. In 1995 the role of the CNB on this market decreased gradually, and the introduction of the koruna convertibility provided an important momentum, leading to increased activities, especially to direct trades between the commercial banks (Czech National Bank 1995, p.56).

The financial derivatives market has emerged, but it is rather underdeveloped. Less than half of the banks are involved, mainly the branches of the foreign banks operating in the Czech Republic. Amongst the contracts, swaps (debt equity swaps, cross-currency interest rate swaps etc.) are predominant, followed by forward rate agreements. Option contracts are only 4.1 % of the total Čk 31 bn market (1994 figures, Jilek 1995, p.25).

The Czech Republic has a relatively better situation with long-term finance than its neighbours. Loans are available up to about five or six years. This is not enough, however for the projects such as the Greenfield factory or for property development. The time structure of the bank credits is determined by the time structure of commercial bank resources, and the capital base of banking remains shallow. The reasons are underdevelopment of retail markets and of institutional long-term investors like pension funds. Nevertheless, there are encouraging developments.

In December 1994 Česká Spořitelna announced its plans to offer real estate mortgages, creating a new market and starting long-term capital market instruments (not to say that the mortgage banking could ease the Czech Republic's housing crunch). The legal framework was created by parliament later, and from July 1995 mortgage credits can be granted for up to 70 % of the price of existing pledged property. Only in October 1995 the CNB began authorising mortgage banking licenses, which are now also granted to the Českomoravská Hypotečni Banka (mortgage operation of Investični Banka), Komerčni Banka, and two subsidiaries of foreign banks – Vereinsbank CZ and Hypo Bank. The market is thin, as only about 3,000 Czechs have so far taken out mortgage loans – because of prohibitive costs. The prospective development lies with issuing mortgage bonds (the first was issued by the Vereinsbank in July 1996) that could provide enough capital for mortgage lending allowing mortgage costs to fall (Calbreath 1996a; Tùma 1996; Volkman 1996).

On the other hand, after the Ministry of Finance authorised the first three pension funds in September 1994, the Czech pension market exploded, so that according to official estimates it could total as much as Čk 12.5bn ($ 330m) in 1997. Dozens of pension funds exist (as only Čk 20m of starting capital were required), but the market is dominated by three big ones. One is run by Komerčni Banka and another one by a stock market investment firm. The problem is that although Czech law requires investments to be stable and conservative, there are few such investment opportunities. With the stock market illiquid and unpredictable and the bond market too thin, most big pension funds are opting for bank term deposits, thus providing Czech banks with vital long-term funds (Calbreath 1995b).

In other banking services the Czech Republic leads other transitional economies in leasing. As the banks continued to serve loans to their big industrial customers while offering little to the bulk of new businesses, and the state of the stock market continued to be pitiful (see below), leasing has become a general financing tool for small- and medium-sized companies. In 1994 the Czech Republic witnessed 69 % growth (the highest in Europe) of leasing volumes: from e.c.u. 480m to 820m. As the example of CAC Leasing, a joint venture between Creditanstalt and Komerčni Banka shows, the best banks feel the potential gains and try to establish themselves on the market. The demand for leasing service in enormous, but increased competition has squeezed the profit margins to not much more than 3 %. In 1996 leasing accounts for 18 % of all investment in the Czech Republic (Kapoor 1995/1996; Válek 1996).

The banking crisis

The basic problem of the Czech banking sector is the poor quality of the credit portfolio, especially in the small banks ("banks with Czech capital" in the official CNB publications), as it was already mentioned earlier. This poor quality applies not only to the loans inherited from before 1990, but to the new loans as well. At the beginning of their activities and in the interest of greater visibility on the banking market, banks extended many loans without adequate loan assessment. The Czech National Bank's estimates stated that even the best of the new (small) banks had a large (around 25 %) ratio of risky loans, attributed to the "non-standard conditions of economy", and that less experienced banks have an extremely large number of non-performing loans (Michelson 1994).

Doubts about the soundness of the small banks existed already in 1993. The collapse of three banks in 1994 (already mentioned), which had been dealt with quickly, strengthened these doubts and gave rise to some new regulations on banking supervision. These regulations had not prevented the collapse of Česká Banka that was caused by mismanagement, bad loans and, perhaps criminal activity. The extension of large loans to shareholders, which is outlawed now, was not illegal in 1992. The scandal involved foreign banks - Latvian Banka Baltija (now defunct) and some Russian financial institutions with uncertain connections (Freeman 1996).

The real crisis came in 1996. It started with the takeover of Ekoagrobanka by the CNB because of non-repayable connected loans. The CNB had launched the programme to clean up the banking sector. It consisted of three points: by the end of 1996, all Czech banks must increase their share capital to cover problem loans; if a bank's shareholders refuse to co-operate, the CNB will put the bank under forced administration and look for outside investors; if no other investors can be found quickly, Konsolidačni Banka will temporarily take over the bank (Calbreath 1996b).

The governor of the CNB estimated that only between 5 and 8 % of the entire banking sector faces potential problems, and that the health of the country's banking system is not threatened. However, a series of failures among small banks, resulting from mismanagement, bad lending (often to the banks' shareholders) and fraud, culminated in the collapse of Kreditn Banka in August 1996 with estimated losses of Čk 12bn and a resulting liquidity crunch at Agrobanka, the fifth largest bank and the largest privately owned bank, as it was frozen off the interbank lending by the "big four". Both Kreditni and Agrobanka were controlled by the notorious Motoinvest investment group (see below), and some of its directors were charged with fraud. Most disturbing is the fact that the problems in Kreditni were undetected by the banking supervision and this raised questions about its quality. The rumours emerged that one of the "big four" could collapse in a year or so. In order to restore confidence in the system, the CNB placed Agrobanka under forced administration and guaranteed all its deposits. Another move was to pledge Čk 13.7bn to strengthen the capital and liquidity of the small banks by, *inter alia*, purchase of non-performing assets from 13 named banks by Konsolidačni Banka (Borland 1996c; Borland 1996d; Cook 1996; Slay 1996).

The result of this banking sector shake-up, is the growing understanding that the small banks could/can not compete with the "big four" universal banks across all the range of banking services. They have to look for their specific market *niche*, either products or regions. The mergers and consolidation of the small banks will definitely go ahead. And the most important is the development of human capital, both in bank supervision and auditing, and in credit assessment (Klvačová 1996).

Securities market

The Law on the Stock Exchange and Securities was adopted in 1992. The organised capital market in the form of the Prague Stock Exchange and the RM-system (an over-the counter exchange) began operating during the first half of 1993 under the supervision of the Ministry of Finance that appoints an Exchange Commissioner. Afterwards the unorganised trading in enterprise shares that had began after the start of the mass privatisation programme, was steadily decreasing (Veverka 1995, p.III). Foreigners are free to trade shares (except for bank shares for which they need an explicit approval of the CNB) with profit repatriation subject to payment of income taxes on capital gain.

Voucher privatisation has put the Prague Stock Exchange far ahead of all other Central European exchanges in terms of number of traded shares and in market value ($ 14bn by January 1994 against $ 3bn for Warsaw and $ 1bn for Budapest). By April 1996, the Prague Stock Exchange traded in 1684 share issues (44 of which on the primary market) including unquoted shares of 674 enterprises from the second wave of privatisation, 59 (23) bond issues and 39 (1) share certificates. Stocks account for 70 % of turnover and bonds for 30 %, although it is estimated that around 60 % of trading is focused on the top 10 stocks (Czech National Bank 1996, p.35).

The problems of the Czech stock market are connected with liquidity, transparency, quality of trading and settlement procedures. Share trading suffers from a fragmented market: besides the Prague Stock Exchange with its computerised and direct block trading, the Securities Centre and the RM-System are used. The respective shares of 43 % (36 %), 49 % (46 %) and 8 % (17 %) of volume (number of items) of share trading in the first quarter of 1996 (Czech National Bank 1996, p.36). The total liquidity (i.e. the ratio of traded securities to total market capitalisation) of the organised capital market in 1994 was only 11 %, with only 4 % for the RM-System. The index for the Western economies lies between 20 % in Finland or Sweden to 80 % in the US or UK (Veverka 1995, p.IV).

In February 1995, the Rules for Direct Stock Exchange Trading were amended and a new method for recording, concluding and setting direct stock exchange trades was introduced with an emphasis on automated data processing. However, there were some scandalous affairs like lightning empire-building by the US investment company Stratton in leading Czech industries (ship-building, glass, brewery, oil, pulp etc.), or the buy-out of Austrian Creditanstalt bank-owned voucher fund CAIC by little-known Motoinvest firm in concert with two Czech banks, that stressed the need of reform of the stock market (Jones 1996a, p.43; *Business Central Europe*, December 1995/January 1996, p.52).

The poor stock market regulation and bad transparency[6] created a bad reputation for the Czech stock market. According to some estimates, up to $ 500m of foreign portfolio investment moved out of Czech equities (Kapoor 1996/1997, p.55). To improve the situation, at the end of April 1996 the Czech parliament passed an amendment to the wide range of legislation,[7] effective from 1 July 1996 (unsurprisingly, they were met with criticism from Stratton managers). From now on, any investor buying a stake of 10 % and on certain thresholds above in a listed company has (under threat of losing the voting right) to inform the enterprise within five days, and the company notifies the Securities Centre about the changes in ownership structure. Disclosure requirements are tightened as listed companies are obliged to publish annual and half-year results, and investment funds must disclose the size of their portfolios each quarter. Finally, greater legal protection given to the equity holdings has to strengthen foreign investors' confidence in the Czech capital market (Klug 1996a; Calbreath 1996b). However, these regulations are still not properly enforced due to the lack of resources in the Finance Ministry.

As the banks' shares comprise most of the liquid issues on the Czech stock market, the banking crisis of 1996 (see above) caused a loss of confidence of foreign investors with the resulting reversal of stock market trends from a steady rise to a steep fall in autumn 1996, with bank stocks suffering particularly heavy price losses. This drastic development also caused further changes in stock market regulations. As of 1st February 1997, the Securities Centre deals' prices will be published. In addition, the creation of an independent securities commission is envisaged by the parliament (Klug 1996c).

The development of a capital market created the possibility for the enterprises to obtain long-term credits through bond issues. All large companies with sufficient credibility and a good long-term outlook (especially those with strong position in the respective markets, such as ČEZ Praha, Chemapol Praha, SPT Telecom and especially in the energy sector) moved in this direction, and their issues dominate the market for industrial bond issues. For such companies, bond issues were much more frequent than primary share issues (Czech National Bank 1994, p.45). The volume of bonds traded

[6] Although the Stock Exchange maintains a list of information insiders, who are only allowed to buy and sell securities with the consent of the Exchange management. Under the Securities Act of 1992, any use of confidential information in securities trading is prohibited (*Transition Report*, p.166).

[7] Commercial Code, Securities Act, Stock Exchange Act and law on Investment Funds and Investment Companies (de Lion 1996, p.16.

on the Prague Stock Exchange trebled in 1995, and in 1996 their share in total volume of trade grew from 15.5 % to 20.2 %, with a growing interest in bonds of maturities over one year (Czech National Bank 1995, p.53; Czech National Bank 1996, p.35–37).

Voucher Privatisation, Investment Funds and Corporate Control

Czech investment funds were created in the process of the highly-advertised large-scale privatisation programme that had started in 1991 (when the federation of Czechoslovakia still existed).[8] The core of this programme was called "voucher privatisation". Because of the limited savings of the (then) Czechoslovak citizens, standard privatisation by sale to them (as the sales to foreigners were seen as undesirable) had been estimated to last up to 600 years. So the state selected a group of (finally) 1,491 medium and large size companies that were rather arbitrarily considered to be more ready for privatisation, to be privatised by vouchers in the first wave of privatisation, with the rest to be sold for cash in the second wave. All Czechoslovak citizens were endowed with 1,000 voucher points (with no explicit monetary value) that could be exchanged only for shares; voucher holders could diversify their investment into as many as 10 companies or investment privatisation funds (IPFs).

The first wave was technically finished by December 1992, but the share distribution was delayed to May-June 1993. About US$ 10 billion of property, 70 per cent of which was in the Czech Republic, had been privatised by then. On average, in the first wave Czech companies gave 63.5 per cent of their shares for voucher privatisation, with the remaining shares sold to foreigners, or transferred to municipalities, or left in the Fund of National Property. More than 6m of Czech citizens took part in the first wave, and three quarters of them preferred to entrust their points to some investment fund (Oswald 1994, p.43).

During the first round of voucher privatisation, 429 IPFs were established, obtaining 72 per cent of all available voucher points. At that time, an investment fund was only a joint-stock company representing the voting rights of its individual shareholders. It emerged that the joint-stock company arrangement was troublesome and so in the second wave the funds very often became closed or open ended unit trusts, where individuals who gave their voucher points to those funds have no voting rights.

As any single investment company could establish several investment funds (e.g. Harvard Capital & Consulting a.s. established 8 funds, Investični Banka established a daughter company Prvni Investični a.s. that in turn established 12 IPFs etc.). As a result, the top 14 investment groups controlled 4,744 m voucher points, 77 per cent of voucher points given to IPFs and 55 per cent of all points, that were transformed into 119 m shares, i.e. 67 per cent of IPF shares or 43 per cent of all shares. Although IPFs

[8] The description of the Czech privatisation programme is based on Dlouhý and Mládek (1994).

are not the biggest shareholders[9] (according to Borland (1995b), they control about 29 per cent of all outstanding Czech shares while the Fund of National Property holds 40 per cent and industrial and portfolio investors own 25 per cent) they are the most influential. Nine of these major investment groups were created by Czech banks, and since the banks are also the major providers of loans to the economy and can perform privatisation through other methods than vouchers, clearly banks received nearly absolute control over the Czech economy (Dlouhý and Mládek 1994, p.168). If the fact is taken into account that the Fund of National Property owns important shares in all big banks, the result of the five years of Czech privatisation in the "typical" Czech industrial enterprise is a complex chain of ownership, the end of which rests with the state.

The small banks accused Komerčni, Investični and Ceská Spořitelna which own large investment funds through which they control big stakes in the countrys leading companies (table 7), that they could force lending decisions on company executives who are thus prevented from seeking more competitively priced resources elsewhere.

There is a contradictory evidence about the role of IPFs in corporate governance of the Czech companies. On the one hand, IPFs brought crucial stability to companies at a time of tax oversight and sometimes wild conduct by communist-era managers who established their own companies-within-companies to line their own pockets. An example is the track maker Tatra Koprivnice (King 1995, p.25). Eventually five funds which had a combined stake of 60 per cent of shares in the company, fired the top managers and hired an American team, headed by a former Chrysler executive (who was later also forced out by IPFs). Another example is Živnobanka IF which replaced 10 per cent of managers of companies of its portfolio following illicit asset-striping (Calbreath 1995a, p.47).

On the other hand, the efficacy of Czech IPFs as institutions of corporate governance remains unproved, as only four funds at the most are interested in the restructuring of the companies they control,[10] or even in active trading in shares. Other funds are only interested in taking equity positions as a way of cementing the relationship between their parent-bank and companies (Kapoor 1996, p.11–12). Moreover, there is a potential conflict of interests between the banks that manage investment funds, and those banks owning corporate lending arms.[11] More often the banks act as a restraining force, holding back the pace of restructuring, being motivated more by a desire to avoid costly bankruptcies than by a desire to achieve efficient outcomes. So they could quash riskier innovation while trying to steer crucial business their way. Sometimes companies are forced to borrow for investment or to undertake bond issues often handled by their

[9] They are prohibited by law from owing more than 20 per cent of any single company (which does not prevent them from pooling their resources).

[10] Komerčni Banka chairman argued, for example, that it is not a bank's job to manage companies.

[11] The strategy of different banks differs: Spořitelna tries to keep bank managers off 70 or so boards where it has seats, while Komerčni actively puts bank employees on some 120 corporate boards.

house bank. The banks own IPFs take the lion's shares of these issues, increasing its influence on a company. A classic example arose in April 1995, when several bank funds pushed construction giant Metrostav a.s. to pay tidy dividends despite the companys need for reinvestment; worse, Metrostav would have had to borrow to pay the dividends (King 1995a, p.25). Consequently, the proposed amendments to the banking law are likely to insist on a specific division of the activities ('the Chinese Wall) between the banks and their funds of banks and their funds, as there is no such regulation at the moment, and at least some funds (like A-Invest of Agrobanka) presently show an open disregard with handsome profits as a result (Coffee 1994, p.32).

Another problem are large stakes in the countrys biggest companies owned by the State (incarnated in the Fund of National Property), whose goal is to sell them to large single shareholders. As FNPs stakes sometimes outweigh those of IPFs, managers could be reluctant to listen to the IPFs representatives in the governing bodies until the 'true owner is chosen by the government (Calbreath 1995a, p.48). However, IPFs are afraid to dilute their holdings in companies and trade their shares in the stock market and are also reluctant to consider new equity issues, which some IPFs may not be able to subscribe for, due to lack of liquidity. The result is a stock market paralysis.

IPFs had a choice: to become either portfolio managers or strategic long-term investors. In 1995 parliament was considering a proposal that would convert the funds into two different breeds. At the beginning of 1996, some funds started to act by themselves and transformed themselves into more loosely regulated (with no 20 % barrier) joint-stock companies. The Harvard Group showed the way, followed by PPF and other big funds (see tables 7 and 8) (Calbreath 1996b, p.62).

Despite a heroic attempt of the architects of Czech privatisation to create a US-style capital market, the economy has finished with something close to the German system of corporate banking ownership. The difference is that the Czech banks control the companies not through the proxy votes but through their daughter companies-investment funds. Another difference is a wide-spread cross-ownership in the Czech banking industry, the benign consequence of which could conceivably be a more stable system that could better resist different shocks. But the down side of it is a limited competition and an implicit redistribution of resources by the banking sector (Dlouhý and Mládek 1994, p.169).

With the banking sector itself under strong influence of the state and with growing evidence that the banks and funds do not provide an impact for the restructuring of the Czech industry, the priority must be given to a true bank privatisation (including involvement of international investors) and strengthening of the 'Chinese wall' between banks and their funds to stop the distortion of lending (and in general – resource allocation) decisions.

Table 1. Czech Republic: Key Economic Indicators 1989-1997.

	1989	1990	1991	1992	1993	1994	1995	1996	1997 (forecast)
Private sector: % GDP	na	na	na	27.7	45.1	56.3	70.0	na	na
GDP growth, %	1.4	-0.4	-14.2	-6.4	-0.9	2.6	4.8	4.0	4.0
Industrial production growth, %	0.8	-3.5	-22.3	-7.9	-5.3	2.3	9.2	9.0	9.0
Unemployment: % end year	0.0	0.8	4.1	2.6	3.5	3.2	2.8	3.5	3.8
Inflation (CPI): % end year	1.5	18.4	52.0	12.7	18.2	10.2	9.1	9.0	10.8
Broad money growth, % end year	3.5	0.5	26.8	17.3	20.5	21.5	19.4	na	na
Budget balance: % GDP	-2.8	0.1	-2.0	-3.3	1.4	1.0	0.6	0.0	-1.1
Trade balance: $ bn *	0.4	-0.8	-0.4	-1.0	0.3	-0.4	-3.8	-5.9	-6.6
Current account: $ bn *	0.4	-1.1	0.4	0.6	0.4	0.3	-1.9	-3.3	-4.0
External debt, net of reserves of the banking system: $ bn	6.8	7.7	8.3	8.6	3.9	2.8	na	na	na
Foreign direct investment: $ bn	na	na	na	0.9	0.5	0.9	2.0	na	na
Exchange rate: Čk to US$ end year	14.3	28.0	27.8	28.9	30.0	28.2	26.7	28.0	29.0

* In 1989-1991 excluding trade with Slovakia

Source: *Transition* 1995, p.193; Jones 1996, p.38; *Business Central Europe*, 1996 Annual issue, p.27.

Table 2. Structure of the market for banking services in the Czech Republic.

	1994		1995
	Share of loans market, %	Share of deposits market, %	Share of assets held, %
Komerční banka	33	22	20
Česká spořitelna	17	42	19
Investiční a Poštovní banka	14	9	11
Československá obchodní banka	9	5	10
Others	27	22	Agrobanka 4% Živnostenská Banka 2% Others 35%

Source: Borland 1995b, Borland 1996c.

Table 3. Top 25 Czech Banks. Ranked by capital in Čk m on 1.01.1995.

Name	Capital	Total assets	Deposits	Loans	Net profit	Cptl/assets,%	Prof/cptl,%	Personnel	Branches
Komerční banka[3]	27,653	309,715	206,795	202,793	4,827	8.93	17.46	16,797	386
Konsolidační banka[1]	23,341	110,509	na	na	54	21.12	0.2	194	na
Česká spořitelna[3]	17,091	357,555	301,498	119,102	980	4.78	5.73	18,128	2,090
Československá obchodní banka[3]	12,479	159,994	68,040	81,585	1,969	12.81	17.25	na	48
Investiční a Poštovní banka[3]	10,747	156,360	84,419	105,696	698	6.85	9.06	4,325	140
Agrobanka[1]	8,010	62,159	39,174	41,352	171	12.89	2.13	3,447	28
AB banka[2]	2,625	14,363	1,068	11,846	-292	18.28	-11.12	na	na
Česká banka[3]	1,939	8,742	1,747	7,072	3.0	22.18	0.15	na	na
Pragobanka[2]	1,936	18,422	7,660	14,626	4.2	10.52	0.51	600	16
Živnostenská banka[3]	1,884	27,303	23,137	6,009	384	6.90	25.11	620	4
Kreditní banka[1]	1,861	15,360	9,285	9,366	1.6	12.12	0.09	685*	55*
Českomoravská záruční a rozvojová banka[2]	1,300	5,857	2,969	595	12	23.32	0.87	na	na
Citibank[4]	1,196	13,516	7,699	8,390	384	8.85	32.11	na	na
Union banka[2]	1,079	8,055	4,353	4,991	0.2	13.58	0.86	160	8
Foresbank[2]	1,029	2,520	1,020	1,723	13	40.83	1.30	na	20
Banka Hana[3]	997	14,559	9,271	9,357	62	6.85	6.22	425*	8*
Societe Generale banka[4]	973	12,285	4,768	4,391	121	7.92	12.44	na	na
Ekoagrobanka[2]	946	16,529	11,075	8,756	-120	5.92	-12.20	na	na
Evrobanka[2]	934	7,378	4,129	5,316	-119	12.68	-12.74	na	na
Bank Austria (ČR)[4]	906	4,907	3,040	2,158	88	18.49	9.71	na	na
HYPO-BANK CZ[4]	894	5,600	1,905	1,528	-0.5	15.96	-0.05	na	na
Creditanstalt[4]	882	11,910	3,489	5,110	5.4	7.41	0.57	na	na
Bankovní dům Skala[3]	804	6,343	4,968	4,323	-80	12.68	-9.96	na	na
COOP banka[1]	745	6,266	2,711	4,083	-18	11.89	-2.42	na	na
Moravia banka[3]	735	8,926	5,652	4,793	5.6	8.24	0.76	602	12

[1] State financial institution.
[2] Commercial banks — Czech owned joint stock companies.
[3] Partially foreign owned banks.
[4] 100% foreign owned banks.

Source: King, 1995, p.30; Jones, 1995, p.31.

Table 4. Ownership of Top Czech Banks (in per cent).

	Komerční Banka	Investiční a Poštovní Banka	Česká Spořitelna	Československá Obchodní Banka
National Property Fund	48.00	32.80	45.00	19.60
Investment funds (IPFs)	33.00	52.90[1]	32.50	
Municipalities			14.75	
Individual shareholders	7.50		4.75	
Restitution Investment Fund	2.50	6.80	3.00	
Foreign institutions	9.00			24.00[2]
Czech National Bank				26.50
Ministry of Finance				20.00
Others		7.50[3]		9.90

[1] Including 14.75% of První Investiční a.s., IPB's fund management arm.
2 National Bank of Slovakia.
3 Česká Pojišťovna insurance company.
Source: Borland, 1996a.

Table 5. Structure of Banking Sector Assets and Liabilities.

	1.01.1994	1.01.1995	1.01.1996
Total assets	100.0	100.00	100.00
of which in %: credits	55.2	53.13	46.90
deposits with other banks	22.0	20.10	16.98
state and other treasury bills	4.3	4.98	8.35
securities in stock	3.8	6.15	8.07
ownership participation	0.4	1.14	6.53
Total liabilities	100.0	100.00	100.00
of which in %: CNB resources	6.1	5.15	3.97
banks' deposits	20.1	18.79	20.93
clients' deposits	51.4	55.40	51.00
reserves	3.9	5.11	3.07
reserve and capital funds	3.8	3.66	3.93
equity capital	3.7	3.82	3.53

Source: Czech National Bank, 1994, p.60; Czech National Bank, 1995, p.101.

Table 6. Structure of the Czech banking system, 1994-1996.

	Total assets			Equity capital		
	1.01.1994	1.01.1995	1.01.1996	1.01.1994	1.01.1995	1.01.1996
Total banking sector (Čk m)	1269388	1498536	1866941	46521	57289	65919
of which in %: large banks	82.3	79.32	73.70	58.6	61.41	57.93
small banks	8.9	8.78	9.20	22.9	22.08	23.67
foreign banks	5.7	7.17	9.96	12.5	12.67	13.85
branches of foreign banks	1.5	4.12	6.03	X	X	X
building societies	0.2	0.61	1.11	2.6	3.84	4.55

Source: Czech National Bank, 1994, p.59; Czech National Bank, 1995, p.100.

Table 7. Top 10 Czech investment funds ranked by capital ($ m), first wave of privatisation.

	Fund	Fund management company	Market capitalisation
1	Spořitelní Privatizační	Spořitelní Investiční Společnost[1]	296
2	Harvard Dividend	Harvard Capital & Consulting[2]	159
3	Komerční Banka IF	IKS Komerční Banký[1]	148
4	RIF	První Investiční a.s.[1]	147
5	PIF IPF	KIS Česká Pojisťovna[3]	98
6	Harvard Growth	Harvard Capital & Consulting[2]	91
7	Fond Rychleho Vynosu	První Investiční a.s.[1]	74
8	Creditanstalt IPF	Creditanstalt Investment Co.[1]	66
9	Rentierský	První Investiční a.s.[1]	63
10	Zivnobanka IF	Zivnobanka Trust a.s.[1]	57

[1] bank
[2] private investment fund
[3] insurance company
Source: King Jr., 1994, p.24.

Table 8. Biggest investment groups in the first wave of privatisation.

	Name of Investment Group	Number of Funds	Millions of points	Millions of shares
1	Česká Spořitelna	1	950	21
2	Investiční Banka Group	12	724	14
3	Harvard Group	8	638	15
4	Komerční Banka	1	465	12
5	Česká Pojišťovna	1	334	8
6	Creditanstalt	2	166	4
7	PPF	4	118	5
8	Živnostenská Banka	1	118	2
9	Agrobanka	17	112	4
	Total first wave (in Czechoslovakia)	429	8,541	278

Source: Dlouhý and Mládek, 1995, p.168.

Table 9. Investment Funds in the Second Wave of Czech Voucher Privatisation.

Type of fund	Number of funds	% of total	number (bn) of voucher points	% of total
IPFs from 1st wave	133	37	1.6	40
New 2nd wave IPFs	63	18		
Unit trusts closed	120	34	1.4	38
Unit trusts open	38	11	0.9	22
Total	354	100	3.9	100

Source: Dlouhý and Mládek, 1995, p.168.

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