International Center for Economic Growth
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The Expected Effects of the EU Accession on the Banking Sector in the Czech Republic

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Executive summary

The EU accession will not present any shock to the banking sector. It will rather be a formal and successful outcome of long and difficult process of preparations. The EU is the largest trading partner for the Czech economy (over 60% of the Czech imports and exports), which is reflected by tight financial links resulting in such integration of the Czech banking sector that is comparable to that of some smaller non-core member states.

Despite of severe difficulties with large proportion of non-performing assets at the end of 1990s the Czech banks are now stabilised and profitable. Foreign owners now control over 70% of bank equity and 95% of assets; net profit on assets and equity is at 1,43% and 27,62% respectively. Banks were bailed out as a part of their privatisation to foreign strategic owners and are not burdened by the excessive proportion of non-performing assets anymore.

Growth of the banking sector

The expected growth of the deposits in 2001-2004 is between 7 and 10 percents on different segments. New products and distribution channels together with improving living standards will facilitate growth on the deposit side. The foreign strategic owners will apply their home country products and practices, and so such phenomenon as cross-selling, bancassurance and direct banking will be utilised up to their potential.

In the Czech Republic, the total volume of credits granted stands at 45% of GDP, compared to around 97% in the Euro area. Between the years 2001 and 2004 it is expected to grow by about 10%. Moreover, growth potential is currently constrained by weaknesses of legal framework, which makes SME lending too risky. Banks currently extend credits predominantly to larger companies and invest in government papers financing public budget deficits. When these constraints are lifted, the amount of extended credit may grow fast.

The household indebtedness in the Czech Republic is mere 9,4%, whereas the EU average is around 50%. The households do not suffer from legal weaknesses thus there is an immediate growth potential on which all banks intend to concentrate. Forecasted growth of the retail credit market in 2001-2004 period is 20%.

Foreign trade and exports

The Czech banks mobilise more funds then they can allocate domestically. However, exports of excess liquidity are restrained by foreign exchange regulations, lack of experience and falling interest rates. The Czech banks limit these transactions to deposits in non-resident banks.

Competitiveness

The international competitiveness is hardly relevant to the Czech universal banks. The pressure on productivity and efficiency improvements comes primarily from parent multinational financial groups, which own the Czech banks.

FDI flows and privatisation

The Czech banks gained enormously from the accession prospects, which reduced country risks and improved business and regulatory environment. In combination with state bail outs this helped to attract credible strategic investors, which restructure banks up to the European standards. Large inflow of FDIs was associated with privatisation of the Czech banks between the years 1998-2001. The Czech banks now belong to the EU based financial groups (Societe Generale, KBC, Erste Bank, GE Capital Services, Raiffeisen and HVB). The adverse side of the successful privatisation is the huge bill taxpayers were left with after transition related losses were transferred from banks to the state run work out agency.

Currently, there are no more opportunities for FDIs to the banking sector unless it would play a role in the rescue operation of Union banka, which is now experiencing severe difficulties.

Labour market

The EU accession will hardly have any effects on banking employment, which is now stabilised. The recent large restructuring layoffs in large banks were, to some extend, compensated by parallel expansion of medium banks. Nevertheless, the number of employees in the Czech banking was reduced by 10 thousand over the last 5 years, which is almost 20% of the original workforce. The domestic demand for skilled labour is kept high by expansion of medium sized banks. The layoffs related to restructuring of large banks and introduction of new technologies affected primarily general banking staff.

Lack of modern banking skills presented one of the key causes of the disastrous performance of Czech banks during 1990s. Today, this constraint was considerably reduced by improved education at universities and plentiful opportunities to gain experience abroad, especially in parent banks. The Czech senior managers are often appointed to work in banks of the second wave of the EU candidate countries.

Migration

Migration after the accession is not an issue. The more senior management is very mobile and works in parent companies all over Europe. The accession is unlikely to increase their numbers. Quite on the opposite EU membership may reduce the transaction costs of employing more expatriates in Prague.

Regulatory framework

The regulatory framework is fully harmonised with the EU laws as well as with the Basel Capital Accord. The prospect of EU accession was the key driver behind the improvement of the banking regulatory framework over the last 6 years. The banking supervision was reviewed by the World Bank as well as by the EU in 2001. They both found it compliant with the best international standards and submitted recommendations which were incorporated to the existing system. It is now fully compatible. Supervisory bodies should, however, strengthen their cooperation, especially in the field of insurance regulation.

Adopting Euro is yet to become major issue. The policy debate has already started, but the banks rather concentrate on the adoption of the New Basel Capital Accord as the next major regulatory challenge ahead.

Market structures

Despite the long term trend of increasing share of medium banks the „Big Three" banks still dominate the market. Their pricing strategies, motivated by both the growth of non-interest revenue and by conversion to direct banking channels, raise competition concerns.

Competition

The large banks are just about to finish stabilisation and restructuring. So far, new owners aimed on keeping their market share on the growing markets. They will probably start aggressive expansion in some sectors such as consumer credits. However, cosy oligopoly on retail market and institutional weaknesses on corporate market will prevent more intensive competition in these crucial segments.

Concentration and mergers

Future mergers in the Czech banking sector will be initiated by mergers among their parent companies. Concentration and distribution of the market are likely to stabilize around current state.

Policy measures

Compatibility of state aids

During the pre-accession negotiations the European Commission raised the issue, whether the state aids granted to Czech banks as a part of their privatisations are compatible with the single European market. The Commission asked the Office for Protection of Economic Competition to issue statement on compatibility of past state aids and drafted a procedure within Accession Treaty, which gives it the right to disapprove this statement. This puts the privatised banks in some legal uncertainty. The Office should issue statements quickly so aids can be found compatible and listed in the Annex of the Accession Treaty.

New Basle Capital Accord

New rules drawn up by the Basle Committee on Banking Supervision are to be implemented by 2006. The EU will use the New Basle Capital Accord as a basis for a new directive. On the top of the Accord the directive will incorporate some EU specifics such as uniform application across single market and concerns for SMEs lending opportunities. The Czech banks and the regulator are already preparing for this major challenge, which will provide greater flexibility but also require increased sophistication on both sides.

Strengthening financial sector regulation

The recent dramatic improvement in the banking sector was not complemented by equal improvement in regulation of non-bank financial industries, especially of insurance. Currently the regulatory framework does not quite respect some important specifics of financial corporations in the area of bankruptcies and accounting. Moreover, the insurance regulator is neither independent nor posses sufficient capacities to act as an equal counterpart of the banking regulator in the supervision of the financial conglomerates consisting of both bank and insurance company.

Legal framework supporting SME financing

The key bottlenecks for increased SME lending are difficulties related to data gathering and the creditors' rights enforcement within the work out and/or bankruptcy process.

The Czech Ministry of Industry and Trade had launched an ambitious project to improve the general business environment in the Czech Republic, which, ideally, should resolve all of the above described problems. However, the programme has only been launched and is yet to deliver any tangible results. Moreover, the Czech Republic needs to amend the Act on Banks, which is not in full compliance with the acquis in the area of personal data protection.

EMU and public finance reform

The Czech Republic will participate in EMU upon accession as a non-participant in the Euro area. The policy debate had just started and the Central bank had presented two potential scenarios of EMU accession – slow and fast one. However, EMU is still beyond the horizon and the crucial challenge on the Czech way to Euro area will be the public finance reform to reduce current deficits of about 6% of annual GDP. The reform is needed not only to meet the Maastricht convergence criteria in the area of public deficit and debt but also to resolve some of the long postponed problems such as a pension reform. It is clear that prospects of EMU accession will induce some further reforms influencing the banking sector; however it is not a question of the short and medium term policies yet.

Introduction

The Czech Republic is one of the candidate countries that will join the European Union in 2004. This historical event is not only expected to have political but also far-reaching economic consequences. This paper should identify some of the effects of accession on the Czech banking sector.

However, it should be stated upfront that the accession as such will have only negligible effects, because the major changes have already taken place. Market related changes will be limited as there is effectively no single European market in financial services on which Czech banks would become players. Instead they will remain in cosy oligopoly situation on the Czech market. Regulatory changes will be of minor importance as well because the regulatory tightening from 1996 gradually evolved into today's full harmonisation with international standards of banking supervision and EU laws.

The main and most important effect of EU accession was the pre-accession drive to (i) stabilize the Czech banking sector, which at the end of 1990s suffered from huge proportion of non-performing assets accountable to the transition process and to (ii) harmonize the legal, regulatory and institutional framework for stabile operations of banks. This process is now successfully over. Important changes have already been done, thus the accession itself will, from the pragmatic banker point of view, be a formal event. This said, however, there are still some transition related specifics to be resolved prior to accession or as soon as possible after the Czech Republic becomes a member state of the EU.

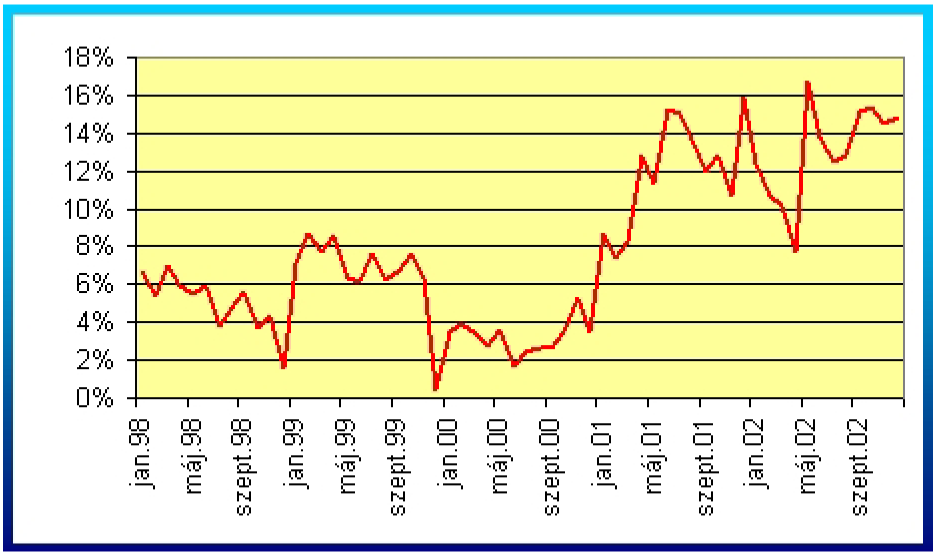
The structure of this paper respects the ICEG/AMCHAM conference format and describes the effects of the EU (pre)accession on growth of the sector, privatisation and FDIs, performance and competitiveness, market structure and competition, labour market and regulatory framework. Instead of conclusion several short and medium term policy recommendations are proposed.

Growth effects

Deposits

The banking sector faces growing competition on the client deposit market. After some years of steady growth during 2002 its funds stagnated while non-banking forms of investment of households' income, in particular in life insurance, pension schemes or investment funds displayed continuous growth.

Exhibit 1 Growth of the client deposits (year-on-year)



Sources: CNB, www.cnb.cz

There is a substantial potential on the supply side to support and facilitate future growth in deposits. As Exhibit 2 illustrates there is a large gap between the use of products on the well advanced Austrian market and markets of the four Visegrad countries. This gap ought to be successfully explored by banks offering new products to current customers as well as to new customers. The Czech banks are yet to offer innovative products, which on one hand explore the economies of scope within the financial groups and on the other allow increasing the number of customers and profit margins on each of them.

In retail banking, new innovated banking services in the credit, deposit and payment instruments will be introduced. The new strategic owners of large banks are expected to play an active role. The development of products will be based on knowledge transfer and will be an important factor in supply induced growth of deposits.

Exhibit 2 Use of retail banking products

	AUT	CZE	HUN	POL	SLK
	% of total population over 15 years who use given product				
Account (any)	89	64	46	34	55
Bank card	57	49	35	21	36
Savings books	68	38	16	13	58
Time deposits	29	12	8	6	14
Mortgages	56	20	2	0	15
Loans	18	7	7	14	6
Securities	15	3	4	n.a.	4

Sources: EIB 2002, p. 111

The Czech banks are based on the universal banking concept and they are part of large financial groups which typically include daughter companies or divisions offering mortgages, construction saving, insurance, asset management, supplementary pension insurance and other financial services. Banks had already started to implement new innovative product bundles based on better market segmentation, clients' life-cycle and on cross-selling. The bancassurance is also popular in banks' strategies.

The new technologies also give rise to new products and distribution channels. Major Czech banks have adopted aggressive changes in pricing policies to drive retail clients towards cheaper phone and electronic banking channels. The density of the branch network would unlikely reach such level as for example in Germany. Instead, the sector will jump over one stride in its development rely to a greater extend on electronic banking.

Rise in a number of payment cards continues in all clientele segments but the growth rate is slowing as the market becomes increasingly saturated. Cards are mostly used for withdrawing cash from ATMs. The number of ATMs is growing continuously since 1996, as is the number of card withdrawals and the volume of cash withdrawn each time. In 2001 number of such transactions reached 100.7 million, with annual turnover of CZK 232.7 billion and the average amount per withdrawal in 2001 was CZK 2,311. The banks had raised the fees for using ATMs to both increase revenue and give incentive for greater volume of non-cash payments.

There were 4,516,300 debit cards at the end of 2001. The upward tendency in the number of debit cards, terminals, transactions and even volume slowed in 2001. The number of credit cards remained low at 53,200.

Alternative forms of payment made up just 7.4% of the total number of payments. Payments received by banks via electronic channels accounted for 20.3% of the total volume of such transactions (which reached CZK 84,633.5 billion). Telephone banking also accounted for a major proportion of non-cash payments, with 5.3% of the number of transactions and 14.4% of the total volume. Altogether, 1.7% of the transactions and 5.9% of the volumes transferred were executed via PC or other terminal. Mobile telephones, despite their high penetration, do not play a significant role.

As the economy converges to the EU levels, the volume of deposits will grow. However, it is questionable, whether all of them will be captured by the banking sector as it faces growing competition. The main advantage of banking products is their greater liquidity but the alternative forms of investment generally offer higher returns, owing to lower taxation, state contributions and suchlike.

Exhibit 3 Expected growth in deposits in 2001-2004

Market segment	2001 - 2004
Individuals	10%
SMEs	7%
Large corporates	8%

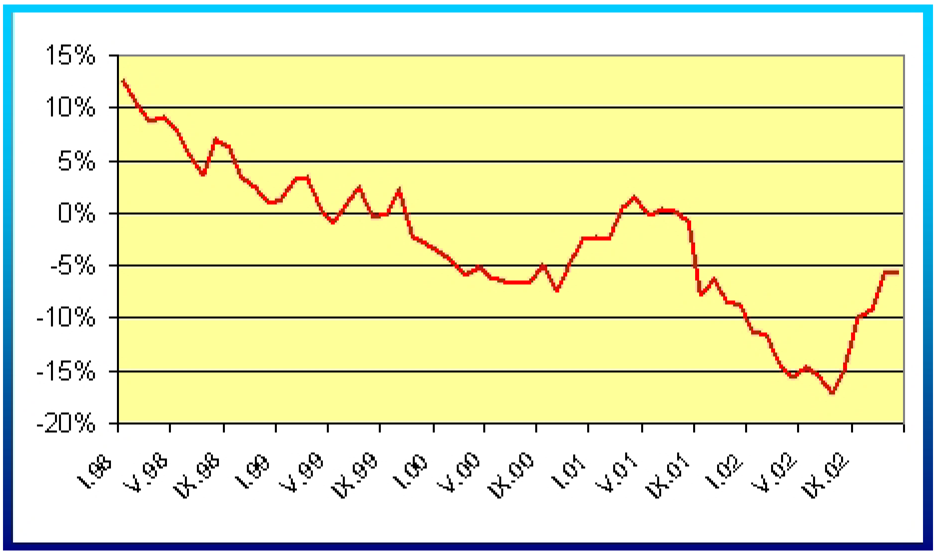
Sources: KB market research 2001

Bank deposits will remain a primary form of investment for the public, mainly because of the ease of payments and other transactions to be performed and also because of certain conservatism among part of the population. However, the effect of disintermediation is strengthening due to increasing returns on investment of households' funds and the public's growing knowledge of new products. This trend can be expected to continue.

Credits

In the Czech Republic, the total volume of credits granted stands at 45% of GDP, compared to around 97% in the Euro area. Although the figure for the Czech Republic is the highest of all Visegrad countries, the comparison with the EU countries suggests considerable growth potential. However, only modest growth in lending can be expected in the period ahead not due to a shortage of funds, but primarily due to continuing cautious behaviour of banks. This caution has been fostered in part by the recent economic slowdown and by the banks' continuing problems with recovering debts.

Exhibit 4 Growth of the client credits (year-on-year)



Sources: CNB, www.cnb.cz

On the supply side the growth of the extended corporate credits is limited on one hand by the tough competition and limited demand on the blue chip segment of the market and on the other hand by the weaknesses of the institutional framework in the corporate/SME financing segment. Considerable potential is in the retail/consumer loans which virtually all Czech banks are currently trying to explore but where they also face considerable competition from non-banking financial companies.

There is a stiff competition on the large corporate market segment, which the foreign-owned banks entered already by the mid 1990s. They offered better services and more innovative products than locally-owned banks and won substantial market share. Later on all banks faced additional competition from off-shore financing, comprising non-resident bank lending and inter-company loans from foreign parent companies. Consequently, prevailing competition and limited size of the market reduces opportunities for profitable growth in the corporate segment.

Exhibit 5 Expected growth in credits in 2001-2004

Market segment	2001 - 2004
Individuals	20%
SMEs	11%
Large corporates	9%

Sources: KB market research 2001

Slightly better growth prospects are on the SME market segment, which currently falls short of the expectations of both financial institutions and potential borrowers. This could be remedied by creation of the more effective legal and institutional environment, which would mitigate some of extra risks associated currently with SME financing. These risks arise from two areas:

- difficulties with gathering of the information during the decision process, where the main obstacles are: (i) absence of the pre-approved process, which would allow courts and other state authorities to provide credit institutions with information relevant for credit approval; (ii) slow and corrupt registration process at the Commercial and Land Registries, which slow down and thus increase the costs of approval process; and (iii) very strict interpretation of personal data protection laws, which effectively prevent functioning of the consumer credit bureaus. The information constraint could be also reduced by the Central Register of Credits of business entities operated by the CNB since November 2002.

- Severe obstacles to an efficient functioning of the workout process, which is currently hampered by (i) difficult realisation of the pledge rights, where lengthy procedure is needed to get a court approval, (ii) expensive and time-consuming process of establishing a pledge of movable assets, (iii) malfunctioning bankruptcy law, which puts creditors in a weak position vis-à-vis receivers appointment, actions and remuneration.

We can expect that banks will, on top of the traditional range of products and services, introduce new investment-banking products as well as financial insurance and consultancy products and combinations thereof. This all should facilitate growth of credits to SMEs despite the above constraints. However, whether banks will eventually invest in such products affordable to SME depends also on the costs and returns of other investments available on the market.

The largest growth potential is clearly on the consumer credit market segment. The household indebtedness in the Czech Republic is mere 9,4%, whereas the EU average is around 50%. The share of the total volume of retail loans granted remains below 15% despite some recent growth. Providing loans to private individuals is also generally considered less risky than lending to corporate clientele and does not suffer to such extend from the legal framework weaknesses.

The lending process to the individuals is being streamlined, among other things, by a commercial register of loans provided to private individuals, through which banks can exchange information on the payment history of their clients. Further important factor in standardising terms and conditions for granting consumer credit is the new Consumer Credit Act, which requires lenders to state clearly their annual interest rates.

Privatisation and FDIs

The Czech Republic was the first country in Central and Eastern Europe to privatise a bank to the hands of foreign capital already in 1992. However, this proved to be an early exception to the rule as the bank privatisation was resumed only in 1998, when major banks faced severe problems with accumulated non-performing assets. The government decided to cure them by bringing in foreign strategic investors. To attract credible investors the banks had to be bailed out, which proved to be very expensive for public purse.

Zivnostenska banka was privatised already in 1992, when 52% of its shares were sold to the German BHF-BANK and IFC. The ownership structure then changed twice, first when Bankgesellschaft Berlin acquired 85% stake and again in 2002 when this stake was bought by the UniCredito Italiano.

Agrobanka was the only larger bank of over 25 small Czech-owned banks, which spurred under the give-away licensing policy of the CNB in 1990-1993. However, it did not escape the faith of virtually all small non-foreign owned banks and ended up under forced administration in 1996. In 1998 the General Electric Capital service acquired substantial part of its assets and continues its operation as GE Capital Bank.

Investicni a Postovni banka (IPB) was the first of the "Big Four" Czech banks dominating the market that was sold to foreign investor. It was partially privatised within the voucher privatisation scheme already in 1992. The state held controlling interest only until 1993, when it failed to take part in an equity increase. Since then the bank was controlled by private shareholders financed by the bank, who also closely cooperated with the incumbent management. One of these shareholders was Nomura, which bought the remaining 36% state-owned stake in 1998. Despite the fact that IPB was in a difficult situation, Nomura bought the stake without any bail out for a low price of CZK 3 bn.

Nomura increased the capital so that IPB met the capital adequacy requirements but resigned on further restructuring. However, later on it concentrated only on very profitable transactions in brewery business, which were detrimental to the bank. IPB's financial health continued to worsen and its management kept covering up losses in a complicated structure of SPVs in off-shore territories. At the end of 1999 the CNB performed an on-site supervision with some disturbing results. Moreover, the auditor was reluctant to sign its books for 2000. As these information were leaking to the public, there were several runs on the bank. On the top of solvency concerns of the side of both CNB and auditor, in June 2000 the bank ran into liquidity crisis. The CNB issued a full guarantee on deposits and imposed forced administration on IPB. The administrator sold the IPB's franchise to CSOB over the weekend. The sale was complemented by extensive state guarantees. Later it was proven that IPB had negative value of about 70 bn CZK.

Ceskoslovenska obchodni banka (CSOB) could arguably be concerned as the success story of the transition. The bank had inherited heavy burdens from the centrally planned past and after they were carved out it avoided incurring further transition related losses. It kept low profile, did not expand but rather concentrated on sound risk management. In 1998 state's 66% stake was successfully privatised to the KBC of Belgium. In 2001 the CSOB finished its merger with IPB and thus became the largest bank on the Czech market.

Ceska sporitelna (CS) served as a retail savings bank within the socialist economy. In the beginning of 1990 it transformed itself to a standard bank and supplied credit to both small banks and corporate entities. Unfortunately, it incurred substantial losses in both segments. The government organised several rescue packages in 1998 and 1999. Privatisation of the 52% stake in CS to an Austrian Erste Bank in 2001 was accompanied by further guarantees (ring fencing).

Komercni banka (KB) was the largest bank delimited from the state monobank in 1990. It served predominantly corporate clients. KB too had been cleansed off the inherited losses in 1990-94 but then accumulated further losses. The second round of bailouts came in 1999 and 2000 as the bank was preparing for privatisation. The privatisation was delayed by a fraud scandal so KB was the last of formerly state owned Big Four banks to be privatised in 2001. It went to the French Societe Generale.

Although it is very difficult to estimate the real costs of the bank privatisation, the conclusion well illustrated in the two tables is clear: the costs of the bailouts which were needed to attract credible strategic foreign investors by far exceeded the revenues from privatisation. Moreover, the total costs of the consolidation of the banking sector in the Czech Republic are huge.

Exhibit 6 Cost and revenues from banking privatisation

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

Sources: Hanousek, Nemecek, Hajkova 2002

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

Exhibit 7 Costs of the banking sector consolidation

	Net costs	Expected net yields
Consolidation programme I (1991-94)	104,8	-5,5
Consolidation programme II (1995-96)	103,5	5,2
Stabilisation programme (1996)	≈13,5	≈7.6
Preparation of privatisation (1998-2001)	84,8	9,8
IPB case (2000 - 2003)	-	≈(-95,0)
Total I	306.6	-77,9
Yields on bank stocks	-106,8	0
Total II	199,8	-77,9

Sources: Tuma 2002

Explaining reasons for the Czech experience is not relevant for understanding the effects of the accession on the banking sector. However, it is relevant that following very troubled years the Czech banking sector is now stabilised and ready to join the evolving single European market. On the other hand, its turbulent past is not yet far behind the horizon. Some of the state organised bailouts need yet to be confirmed as a state aid compatible with the EU rules.

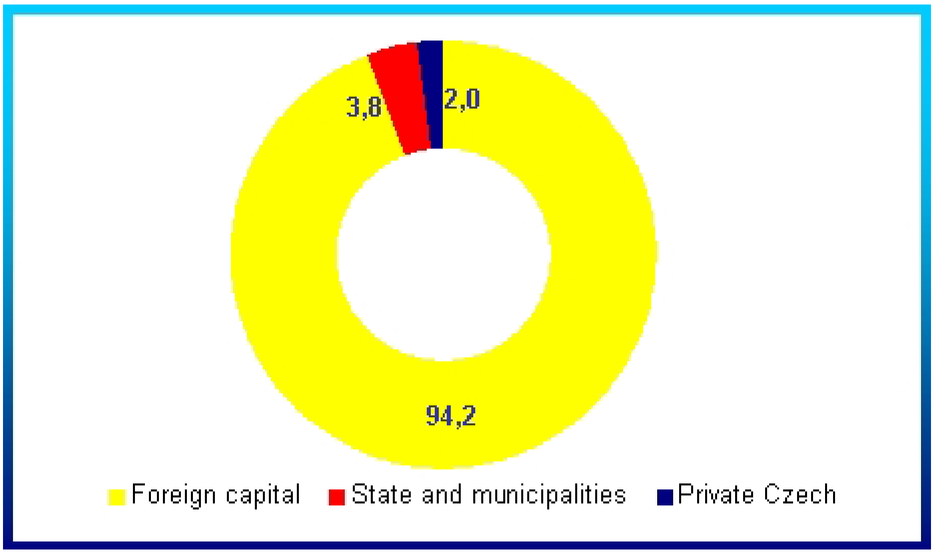
Exhibit 8 Ownership structure of the Czech banking sector in 2002 (%)

	1998	1999	2000	2001
State, municipalities	25,1	27	23,6	4,3
Czech capital	36,2	24,7	21,9	25,7
Foreign capital	38,7	48,3	54,5	70
- EU	28,6	37,3	43,5	58,1
- USA	4,6	7,5	7,7	6,3
- other foreign	5,5	3,5	3,3	5,6

Sources: CNB, www.cnb.cz

As a result of privatisation, the share of foreign capital in the equity of the banking sector increased markedly. Foreigners currently hold 70% of total equity of the Czech banking sector. At the same time, the share of banking sector assets under direct and indirect foreign control is 94%. Via the control over the banks foreign investors now control up to 80% of the total financial sector assets as a majority of them is managed by bank headed groups.

Exhibit 9 Structure of total banking sector assets by ownership in 2001 (%)



Sources: CNB, www.cnb.cz

The Czech banking sector, under the leadership of strategic foreign owners, is just about to conclude the process of integration into the European market. The integration started already in 1992 when the first Association agreement opened EU and Czech markets to each other. Since then the trade flows redirected completely towards EU when 62% of the Czech imports come from the EU and 69% of Czech exports goes to the EU. The banks followed their customers and are now fully integrated within the European payment and banking systems.

The new owners’ key role was to complement the external integration by the internal reorganisation and restructuring, which would introduce the modern banking standards to all banks' activities, especially to those which suffered most in transition: risk management and internal audit. This is indeed happening and the internal standards of the foreign parent companies are already implemented.

Now that virtually all Czech banks are foreign owned, there is little scope for further foreign direct investments to the banking sector. The green-field investments to already quite dense market are unlikely, thus one of the last opportunities to “buy in” to the market is taking place during the spring 2003. The Union banka (UB), one of the few still existing small banks established at the beginning of 1990s, found an investor last year, which insisted on the state aid to take over the bank. However, the bank failed to come up with the realistic restructuring plan on basis of which the state aid could be approved. Without the aid UB does not have sufficient capital adequacy ratio, thus the CNB initiated the process of licence revocation. Whatever the solution will be chosen part of it could well be the last chance for any foreign investor to buy larger retail network (90 branches and offices).

Performance and competitiveness

The privatisation of the largest banks brought about much needed reorganisation and restructuring, which in turn resulted in increased profitability, efficiency as well as prudence.

Profitability

The aggregate net income from banking activities seemed to be falling over last years. This can be accounted primarily to falling interest profit, which is substituted only to limited extend by rising non-interest income primarily from fees and commissions. The interest income remains the primary source of revenue, although its share declined from 68% to 61% from 1998 to 2002. The share of fees and commission rose from 13 to 25 percent, which is still below the EU average of 30%.

Exhibit 10 Absolute profitability indicators

	XII.98	XII.99	XII.00	XII.01	IX.02
	Absolute indicators in CZK millions				
Profit from banking activities:	96 860	87 370	77 272	89 447	70 425
interest profit	65 994	56 559	50 614	56 925	42 970
profit from fees and commissions	12 916	14 772	16 554	20 970	17 271
profit from shares and interests	2 270	1 253	654	942	1 075
profit from other transactions	15 680	14 785	9 451	10 610	9 108
Administrative expenses	48 094	42 580	41 840	47 939	34 765
Net reserves and provisions	14 673	70 298	59 549	22 228	7 299
Other operating expenses(-)/income (+)	-42 218	18 322	34 997	991	4 815
Gross operating profit	-8 126	-7 187	10 881	20 270	33 176
Extraordinary expenses(-)/income (+)	2 958	2 700	1 403	1 726	861
Pre-tax gross profit	-5 167	-4 487	12 284	21 996	34 037
Taxes	3 069	1 085	-2 100	5 046	7 505
Net profit (+) / loss (-)	-8 236	-5 572	14 385	16 951	26 532

Sources: CNB, www.cnb.cz

In comparison with the EU countries, the Czech Republic exhibits greater diversification of margins (i.e. the difference between the interest rate and the market reference rate) on particular products, while the overall margin is only slightly lower than in the EU. Banks in the Czech Republic enjoy margins on credits granted to households, which are roughly three times higher than in the EU (thanks to high demand and a willingness on the part of the public to accept market conditions). Conversely, they achieve lower margins on credits granted to businesses. Deposit margins are at roughly the same level as in the EU. The return on average assets (ROAA) of the banking sector's net profit increased annually from 0.9% to 1.32%, which is more than double the usual level of the banking sector in the European countries (0.53%).

Net profits are increasing as banks books are cleaned from non-performing assets and they do not need to create massive reserves and provisions any more. Since 2000 the banking sector net profit is positive and for the 2002 the banks had announced record profits, with KB recording the absolutely largest profit ever achieved by any Czech company (CZK 9,23 bn, though not consolidated and audited yet). However, these profits are composed largely from one off gains achieved by tough cost cutting and dissolution of reserves.

To sustain the level of profits with falling interest spread the banks need to increase income from fees and charges and at the same time to control the costs further. Cost control requires also high quality risk management to avoid repetition of high needs for reserves and provisions.

All major retail banks had adopted corresponding pricing strategies and sharply increased fees and charges. Especially over-the-counter services are much more expensive as the banks try to induce clients to use the lower-cost channels. Thanks to a strong increase in the volume of transactions (retail payments, card transactions), large retail banks are best positioned to increase fee income by repricing charges on retail services.

Exhibit 11 Relative profitability and efficiency indicators

Key profitability indicators in %	XI.98	XII.99	XII.00	XII.01	IX.02
Profit from banking activities/average assets	4,6	4,15	3,59	3,77	3,80
Net profit/average assets	-0,3	-0,26	0,67	0,72	1,43
Net profit/capital (Tier 1)	-5,2	-4,32	13,08	14,41	27,62
Total interest income/interest earning assets	11,7	7,76	6,35	6,23	5,07
Total interest expenses/interest bearing liabilities	8,2	5,34	4,08	3,87	2,91
Interest rate spread	3,5	2,43	2,26	2,37	2,17
Key efficiency indicators in CZK thousands:					
total assets per employee	43213	43 144	50 193	61 176	62 382
profit from banking activities per employee	1889	1 786	1 720	2 189	2 332
net profit per employee	-142	-114	320	415	878
operating expenses per employee	930	930	931	1 173	1 151
personnel expenses per employee	255	404	434	563	547
Number of employees in banking sector	51650	48 924	44 932	40 871	40 274

Sources: CNB, www.cnb.cz

Efficiency

The efficiency of the banking sector had improved as a result of major restructuring programmes in the largest recently privatised banks. Over the last five years the number of employees fell by 22%, which was the main driver behind efficiency improvements.

The pressure to increase efficiency in the current climate of a slowdown in economic growth and stiff competition on the banking market is focused primarily on the costs. Cost management – via further staff cuts, optimisation of cost-benefit ratios and higher returns on capital – is the order of the day. Although administrative costs are growing in absolute terms, the growth rate is gradually slowing. Owing to increases in efficiency and introduction of new technology, more employees will be laid off from the banking sector, although this might be offset in part by growth in banking business.

Organisational structures are being simplified and many non-financial, non-core activities were sold off already. In addition many activities are outsourced or pooled among different companies in the same financial group.

The ratio of administrative costs to profit from banking activities in the Czech banks is below the EU average and, conversely, administrative costs on assets are higher. This shows that the banks in EU countries are able to manage a markedly higher volume of total assets with comparable operating costs, despite the fact that the candidate countries have an advantage in lower wages.

Higher costs per unit of assets question the competitiveness of the Czech banks on the future single market. It could be assumed that clients will allocate their funds to more efficient EU institutions, which will be able to offer them higher returns thanks to lower management costs. This could indeed be the case, however, to a limited extend as deposits in banks serve also transaction purposes. Clients do not aim only to maximise their returns, but also to have access to high quality services, which often can be provided only locally, i.e. with adequate branch network. Thus it is unlikely that the banks would experience any outflow of clients and deposits as a result of accession. Potentially, this could have an impact if the cross-border internet banking would become common, which is not yet the case even on some of the most integrated and developed banking markets in the EU.

The pressure on higher efficiency is more likely to come from new owners of Czech banks, which are all multinational financial conglomerates with no reason to tolerate higher costs of some of their subsidiaries without a good reason. The pressure coming from the market is rather weak due the oligopolistic nature of the Czech retail banking but the bank managers will be forced by the foreign owners to be as efficient as possible.

Export potential

Banks currently mobilise more deposits than they can lend domestically. In theory, they could become net exporters of capital; even more so if the institutional barriers constrain SMEs lending opportunities. Instead, despite of excess liquidity bank lending abroad is currently very limited without any potential for a change upon the accession. There are three constraints to the export of capital:

- extensive regulation of banks foreign exchange positions with high requirements on hedging, which make foreign lending expensive,
- lack of experience with such operations, which is an obstacle even to lending to or through the parent financial groups and
- declining interest rates, which make it less profitable.

This could of course change, but unlikely before the Czech Republic adopts Euro and before the single European wholesale market is implemented by 2005 as foreseen by the Financial Services Action Plan. These two changes could reduce the transaction costs of exports and make them more attractive for banks. Currently the exports do not go beyond deposits in non-resident banks.

Structure of assets

The excess liquidity is evidenced in particular by the ratio of client credits to client deposits (government institutions excluded). In the Czech Republic the volume of deposits significantly exceeds that of credits (by around 46%), whereas in the EU countries the opposite applies, owing to the greater involvement of the banks in lending.

Exhibit 12 Structure of assets held by the banking sector

	XII.99	XII.00	XII.01	IX.02
Assets, total	2110768	2255259	2500321	2512360
Cash and deposits with central banks	3,0%	2,7%	3,2%	2,9%
Government and central bank bonds	3,7%	4,9%	5,8%	7,2%
Receivables from banks	38,3%	36,5%	33,5%	36,9%
central banks	11,5%	11,4%	11,1%	20,0%
other bank	25,7%	24,7%	21,7%	14,1%
Receivables from clients	38,3%	35,9%	36,9%	35,1%
Debt securities	7,5%	10,2%	10,7%	8,0%
issued by government institutions	0,1%	0,1%	0,0%	3,3%
Shares, units and other interests	2,0%	3,0%	2,1%	2,0%
Other assets	7,2%	6,9%	7,9%	7,8%

Sources: CNB, www.cnb.cz

Banks are investing their surplus funds in medium and long-term government bonds. These instruments are one of the most frequently used risk-free alternatives to corporate lending, as they guarantee small but nearly certain profits. In their portfolios, banks hold around 62% of the total volume of government securities issued, while government bonds account for 9.5% of their total assets. The total amount of the safer assets, such as deposits with the Czech National Bank and other banks, T-bills and CNB-bills, has increased from 32% in 1996 to over 46% now. The credits to clients fell during the same period from 46% to 35%. Banks can make almost the same profit from government debt as from lending to large creditworthy clients, but with lower credit risk. Returns are comparable (comparably low) especially when the bonds are held to maturity.

Banks are actively involved in transactions with the central bank. Banks have minimal involvement in securities trading on the stock and bond markets (except in the case of government securities). This is chiefly due to the low volume of non-government bonds on the market and the high risks associated with shares.

In the medium term the EU accession itself is unlikely to create new opportunities for fund allocation. Save government issued assets will remain dominant among banks assets. Currently, the government runs large public budget deficits financed primarily by borrowing from domestic banks. Despite large supply of the government securities some issues are heavily oversubscribed. Frequent oversubscription accompanied by the gradual reduction of budget deficits, may force banks to allocate their assets elsewhere and reduce this "crowding out" situation.

Market structure

The share of total assets in GDP was 131% in 1995 and 116 % in 2001. By this measure, the Czech Republic exhibits the highest degree of bank intermediation among all Visegrad countries and, in fact, has attained a level that it comparable to some EU member states such as Spain and Italy.

The banking sector in the Czech Republic comprises of:

1. banks and branches of foreign banks which, by the scope of their activities, can be characterized as universal banks;

2. banks with a special products and services profile, namely:

- six building saving banks - building societies collecting long-term deposits from the public and granting long-term housing loans. Their banking activities are regulated by the Act on Building Saving Banks. Natural persons' deposits with these banks are subsidized by a state contribution up to a limit set by the law;
- one specialised mortgage bank (seven of the universal banks are also authorized to issue mortgage bonds) entitled to provide state-supported housing mortgage loans to natural persons;
- Ceskomoravska zarucni a rozvojova banka, a development bank supporting small and medium-sized private businesses;
- Ceska exportni banka, established for export support.

Exhibit 13 Permissible activities of the Czech banks

<table>
<tr><th colspan="3">Banking activities in</th><th colspan="2">Investment by</th></tr>
<tr><th>Securities</th><th>Insurance</th><th>Real estate</th><th>banks in non-financial companies</th><th>non-financial companies in banks</th></tr>
<tr><td rowspan="2">permitted</td><td>1. selling of insurance policies as an agent is permitted;</td><td rowspan="2">not permitted</td><td>1. Controlling interests (>50%): prohibited (except in companies providing auxiliary banking services</td><td rowspan="2">CNB approval required for investments which lead to shares of ≥ 10%, 20%, 33% and 50%, respectively, in the total bank shares bearing voting rights</td></tr>
<tr><td>2. other activities permitted via independent subsidiaries</td><td>2. "Qualified" interests (> 10% and ≤ 50%): permitted as long as (i) individually ≤ 15%, and (ii) in aggregate ≤60% of the banks capital</td></tr>
</table>

Sources: Commission 1999

There are also some credit unions established in 1995 according to a special Act. However, they do not have direct access to the money market and are allowed to offer their products and services only to their members. Moreover, after a row of fraud scandals in 2000, which were caused by a poor regulation, their very limited role in the financial sector became negligible.

Number of banks and branches

At the end of 2002 the Czech banking sector was made up of 36 banks and foreign bank branches. This is the smallest number since 1993, when there were 63 banks. Out of this total 27 ceased operations, 18 of them because of the poor financial condition and non-compliance with prudential rules, 7 because of sales and mergers, one bank failed to start operating within the mandatory deadline. Konsolidacni banka, charged with the management of bad debts taken over by the state, was transformed by law into a specialised state work-out agency (Ceska konsolidacni agentura).

Exhibit 14 Number of banks in the Czech Republic

Year	of which:									
		Czech-controlled					foreign-controlled			
	Banks, total	Czech controlled	state financial institutions	state-owned banks	Czech-controlled	forced administration	**total**	foreign-controlled	foreign bank branches	ceased operation
1990	**9**	9	4	1	4	0	**0**	0	0	x
1991	**24**	20	4	1	15	0	**4**	4	0	x
1992	**37**	26	1	4	21	0	**11**	9	2	x
1993	**52**	34	1	4	28	1	**18**	12	6	x
1994	**55**	34	1	4	28	1	**21**	13	8	2
1995	**55**	32	1	6	25	0	**23**	13	10	5
1996	**53**	30	1	6	18	5	**23**	14	9	7
1997	**50**	26	1	6	15	4	**24**	15	9	11
1998	**45**	20	1	5	14	0	**25**	15	10	18
1999	**42**	15	1	4	10	0	**27**	17	10	21
2000	**40**	14	1	4	8	1	**26**	16	10	23
2001	**38**	12	0	3	8	1	**26**	16	10	25
2002	**36**	11	0	2	9	0	**25**	16	9	27

Sources: CNB, www.cnb.cz

The number of banks peaked in 1994/95, at 55 and since then it continues to fall each year owing to the consolidation of the sector. The first wave of concentration in 1997-99 was driven by poor financial condition of banks concerned. These closures could be attributed to the nature of the Czech transition process. The second wave in 2000-02 occurred primarily due to bank mergers, which reflected mergers on European level. These mergers affected mainly foreign-owned banks whose parent bank either merged (HypoVereinsbank and Bank Austria Creditanstalt formed HVB Bank Czech Republic) or acquired a Czech bank in privatisation (Czech branch of Societe Generale merged with Komercni banka).

Continued dominance of the Big Three

The most significant group of banks in terms of total assets are large banks. At the end of 2002 this group comprised of CSOB, Komercni banka and Ceska sporitelna, al of them banks with a universal orientation in terms of both type of business and type of clients. They control dominant market shares in most segments of the Czech financial market. However, their shares of retail and corporate markets vary.

The largest group in terms of the number of banks is that consisting of 10 medium-sized banks. The number of foreign bank branches decreased to 9 after the merger of Societe Generale Prague with Komercni banka. More than two thirds of the medium-sized banks are controlled by foreign owners and therefore tend to specialise on foreign exchange transactions and services to their home country corporate clients. They are also heavily involved in derivatives transactions.

The eight remaining small banks are very diverse, in terms of preferred types of business and with regard to the orientation on electronic banking. Although foreign entities are continuing to increase their equity holdings in small banks, the ratio between foreign and Czech capital is still almost 50:50. The same goes for building societies.

Branch network

The number of branches at the end of 2001 was at 1,751[1], a 3.1% decline compared with a year earlier. The large banks alone closed 45 branches. The downsizing of branch networks represents a reduction in the quantitative level of service only The availability of banking services is being re-directed towards direct distribution channels, which improves the quality of services with regards to predominantly simple transactions.

Market shares and concentration

The long term trend on the Czech banking market seems to be a falling market share of three[2] major banks. Since 1990, when they controlled virtually 100% of the market, their share in assets was reduced to 58%. The same is true for client deposits (69%) and credits to clients (55 – 60%). The decline in total assets and loans in last two years is related to transfers of a large proportion of non-performing assets to the state work out agency (Ceska konsolidacni agentura) as a part of the bank privatisation scheme.

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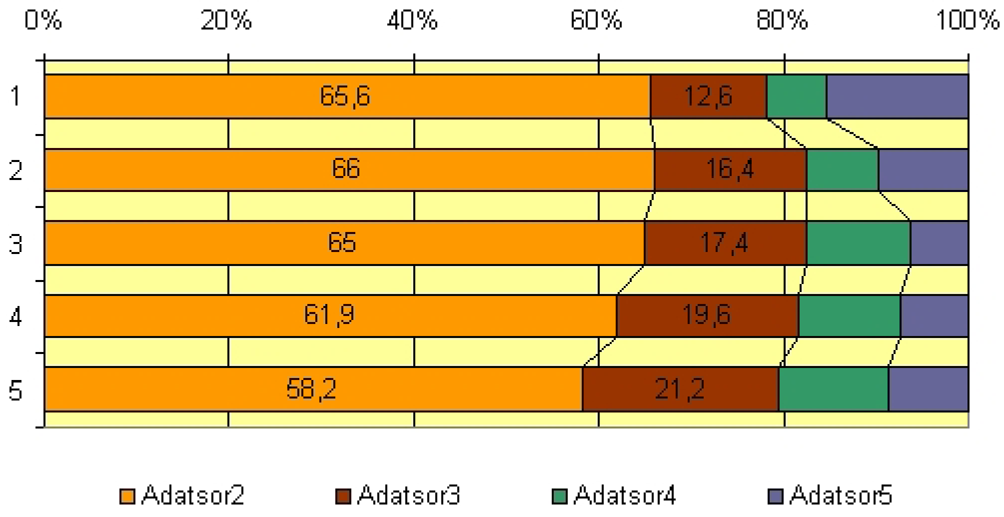
[1] Excluding almost 3500 counters at the Post offices.

[2] Until the merger of CSOB and IPB in 2000 they were four – ČS, ČSOB, IPB and KB.

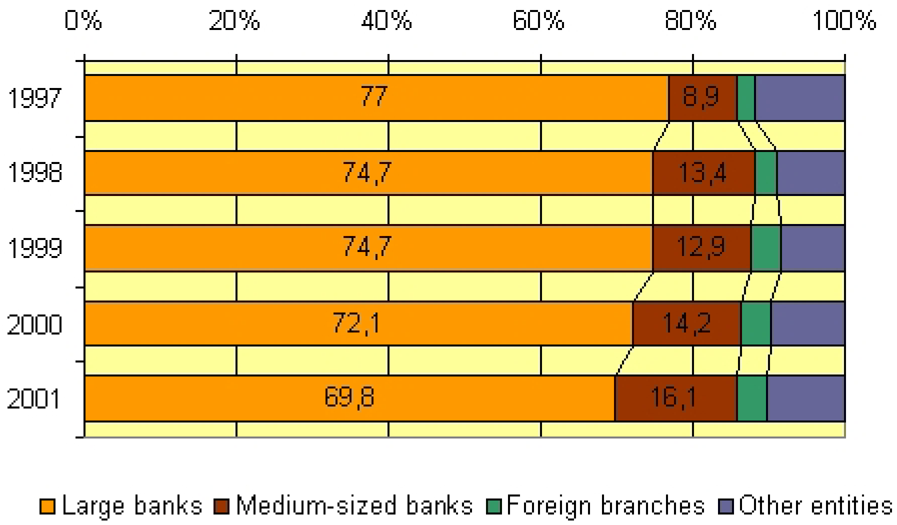
Exhibit 15 Trends in assets



Sources: CNB Banking supervision 1998, 1999, 2000, 2001

Conversely, all other bank groups continue to strengthen their shares in total client credits in 2001. Especially medium-sized banks became relevant players with almost a quarter of the credit market, hopefully ending the near monopoly situation soon. Over last five years they managed to capture 2 to 4 percentage points of the growing market annually.

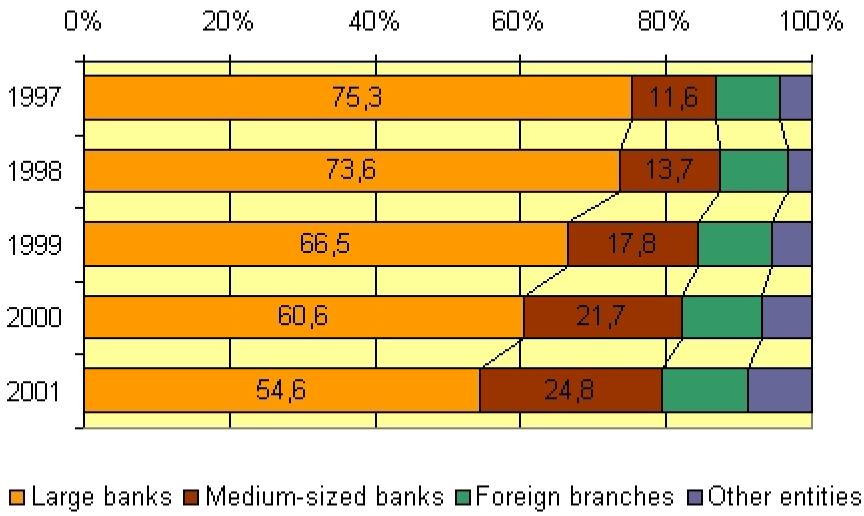
Exhibit 16 Trends in client deposits



Sources: CNB Banking supervision 1998, 1999, 2000, 2001

On the client-deposit market the importance of large banks is gradually receding too. Medium-sized banks and foreign branches already captured one fifth of the market. The share of the three largest banks shrinks by about two percentage points each year.

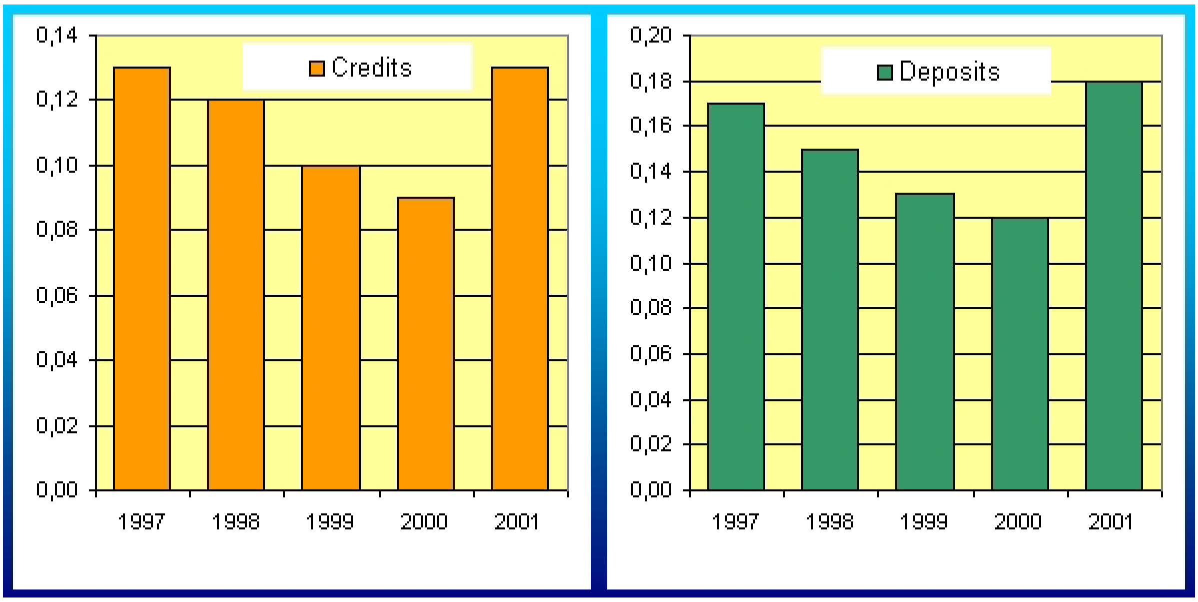
Exhibit 17 Trends in client credits



Sources: CNB Banking supervision 1998, 1999, 2000, 2001

When comparing the relevant shares it is clear that the medium-sized banks specialise more in credit transactions than in deposit transactions as they lack extensive branch network. On the other hand the difference between the large banks' percentage share of total assets and their percentage share of total client credits demonstrates the lower credit exposure of the large banks. This feature was above explained by the limited competitiveness of the largest banks on the blue chip corporate market, especially during the pre-privatisation period, and by the legal framework weaknesses, which reduce opportunities for SME lending.

Exhibit 18 Herfindahl indices of market competition

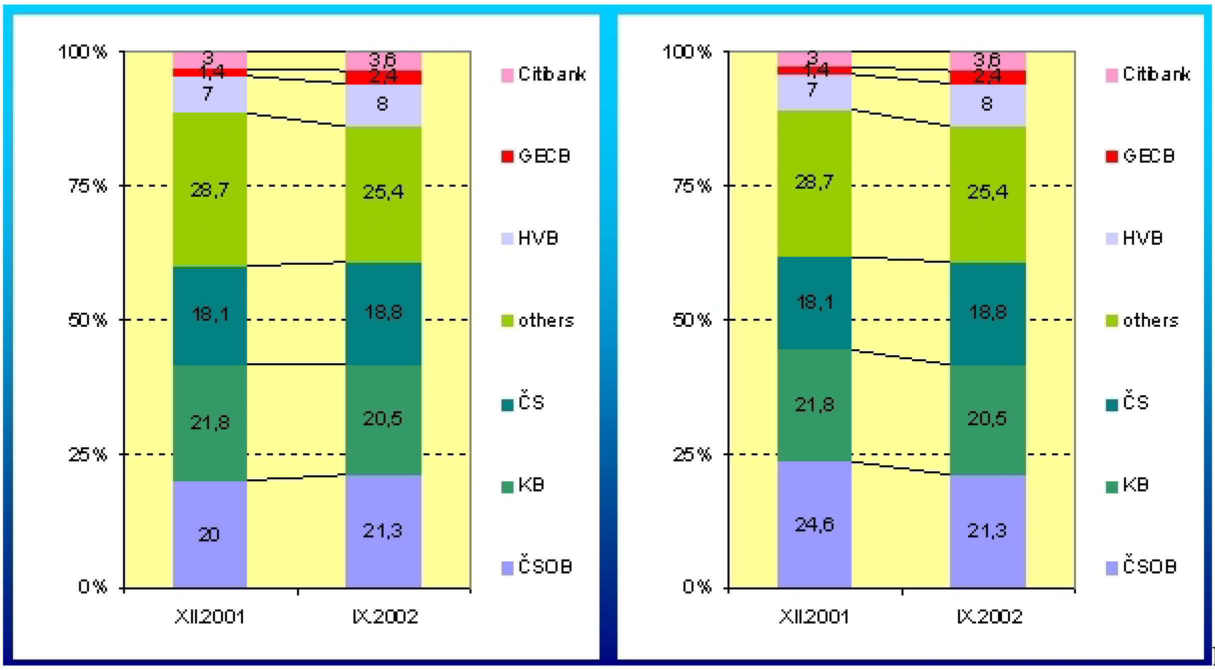


Sources: CNB Banking supervision 2001

After the five year of gradual decrease of the Herfindahl index[3], which measures of market concentration, had increased to its mid-1990s levels in 2001. This was a result of the merger of HypoVereinsbank CZ and Bank Austria Creditanstalt Czech Republic and of the conversion of Konsolidační banka into a non-bank institution. In 2002 there was only one merger of SG branch and KB with negligible impact on concentration. As is argued below the market shares seem to stabilise as the sector stabilises and there is no reason to expect significant changes in the foreseeable future. The concentration within the banking sector, as measured by the Herfindahl index or otherwise, will remain unchanged unless there are any mergers on European level, which would induce subsequent merger of the Czech subsidiaries.

The following tables show the current market shares of the three largest banks as well as three largest medium-sized banks. It can be seen that the decline of the market share of major banks stopped altogether in the credit segment and decreased at lower pace in the deposit segment. It seems that the distribution of market converges to some steady state, where large banks will control about 60% of loans and 65% of deposits.

Exhibit 19 Current market shares in loans and deposits



Error!

Sources: CSOB market research

Exhibit 19 also sheds some light on the nature of competition within each group of banks. The three largest banks hold almost equal shares of loan market (around 20 percent each) as well as of the one of deposits (around 23 percent). Their conduct remains far from extremely competitive one. The increases in fees and commission both at the beginning of 2001 and 2003 gave rather an impression of cosy oligopoly, which was only reaffirmed by the fact that prices for some of the retail transactions exceed in real terms prices on the EU

[3] The Herfindahl index of market competition can take values in the range of 0 to 1, where 1 represents a totally uncompetitive environment. Competition on the market increases with decreasing Herfindahl index value.

market. We are yet to see whether any of the new owners, which currently concentrate on restructuring and improvements of product lines, later engage in a price war to win greater market share.

As has been said above the banks control large financial groups. In some segments their subsidiaries dominate the market, which only leverages their market power and raises competition concerns.

Exhibit 20 Market shares of banking groups in non-bank financial services

IX.2002	Mortgages	Constructi on saving	Pension Insurance	Leasing	Investment companies	Non-life insurance	Life Insurance	Factoring	Consumer loans
ČSOB	23,8	40,1	10,7	14	14,5	4,8	10,1	36,5	3,9
KB	21,5	17,2	14,4	12,2	49,7	2,8	11	17,6	12,5
ČS	27,8	17,3	10,7	4,3	22,8	5	2,3	10,9	35,3
Big3	73,1	74,6	35,8	30,5	87	12,6	23,4	65	51,7

Sources: CSOB market research

The structure of the Czech banking market is stabilised and still dominated by the "Big Three" largest banks. Their market share is gradually falling however further significant reduction is unlikely, especially on the deposit market. The banks adopt very similar pricing policies aimed on increase of fees and commissions revenue and on driving customers off the counters towards direct banking channels. The profit from fees and commissions is indeed increasing by about 2% per annum and currently is a source of 25% of total profits. The price changes at the beginning of 2003 were very significant thus banks are likely to increase this share as the Czech customers remain conservative and unwilling to change the bank due to higher costs of services. Also the recent problem of the last Czech owned medium-sized bank – Union banka – is likely to reduce the potential outflow of clients from large credible and recognised banks.

Labour market

There is a continuing downward trend in the number of banking employees. As the restructuring in large banks nears the end the rate of downsizing slows down. After laying off 8% in 2000 and 9% in 2001, the rate for 2002 will be below 2%. Reductions occurred only in large banks and foreign bank branches. The medium-sized banks and building societies, on the contrary, strengthened their workforces.

The reduction of the workforce in the largest banks was one of the main drivers behind the productivity and efficiency improvements of the whole Czech banking sector. New owners already took advantage of this one-off opportunity and further improvements will be more demanding.

Exhibit 21 Number of employees in the Czech banking sector

	XI.98	XII.99	XII.00	XII.01	IX.02
Number of employees	51650	48 924	44 932	40 871	40 274
Citizens per employee	199	210	229	251	255
Total assets per employee	43213	43 144	50 193	61 176	62 382
Profit from banking activities per employee	1889	1 786	1 720	2 189	2 332
Net profit per employee	-142	-114	320	415	878
Operating expenses per employee	930	930	931	1 173	1 151
Personnel expenses per employee	255	404	434	563	547

Sources: CNB, www.cnb.cz

In 2001 there were 1,076 employees per bank on average, a fall of 5.5% from 2000 whereas by September 2002 the average increased to 1119 (+4%). Moreover, there were 270,300 citizens per bank in 2001, 5.3% more than a year earlier, and 5,900 citizens per banking unit, 3.5% more than in 2000. Each banking employee was serving 251 citizens on average, a rise of 11.4% compared with a 2000.

The layoffs from the banking sector were concentrated in the larger Czech cities which serve as regional financial centres. There is also a demand for skilled administrative workforce thus it is unlikely that large proportion of former bank staff would remain unemployed. However, as the average wage is the highest in the banking sector the former bank employees are unlikely to get better paid jobs.

As regards the mobility of the banking sector employees it can be separated into two segments. General banking staff, whose mobility is very limited as is the mobility of the Czech workforce in general, and senior bank mangers, which are at the opposite extreme on the mobility scale. More senior banking staff is prepared to migrate to gain skills abroad, often at the parent companies of Czech banks. The experienced Czech bank managers are also increasingly appointed to run various subsidiaries in the second wave EU candidate countries and/or in states of CIS.

There will be hardly any direct effect of accession on the banking related labour markets. The general workforce is already reduced close to the efficient levels and no major changes in demand are to be expected.

The supply of banking staff may be improved qualitatively as it will be easier to study and/or work for experience in the EU country. However, as Czech universities are already well integrated within the student exchange programmes this is unlikely to bring considerable change. The very skilled management staff is already mobile and temporarily migrates within EU. Quite on the opposite the reduced transaction costs of settling down in the Czech Republic may attract more expatriates to the Prague based banks.

Regulatory framework

The regulatory framework has improved considerably since 1996 both in terms of its legal definitions and more importantly in its enforcement. There were two main drivers behind this positive development: (i) the effort to cure the critical shape of the banking sector during the second half of 1990s and (ii) the harmonisation of Czech regulations with International standards and European Community law. These two goals were accomplished with some success and in the medium term the major changes will arise from the introduction of the New Basle Capital Accord.

Banking supervision

The most throughout evaluation of the Czech supervisory framework was performed by the World Bank in 2001. It assessed the implementation of the Basle Core Principles for the Effective Banking Supervision and the Transparency of Banking Supervision. The World Bank concluded that the Czech banking supervision is largely compliant with 20 out of the 25 principles of recognised international standards.

Exhibit 22 The observance of the individual core principles

Basel Core Principle of Banking Supervision	Assessment
Clear objectives, operational independence and legal powers	2
Clearly defined permissible activities of banks	2
Clearly defined and enforced licensing criteria	2
Right to review significant ownership changes	2
Right to review major acquisitions or investments for undue risks	1
Minimum capital adequacy requirements and definition of the capital components	2
Evaluation of credit practices and of loan and investment portfolio management	3
Loan Evaluation and Loan Loss Provisioning	2
Prudential Limits to restrict bank exposures to single borrowers	2
Connected Lending on an arm's-length basis with effective monitoring	2
Identifying, monitoring and controlling country risk	2
Measuring, monitoring and controlling market risks	2
Comprehensive other risk management process	3
Internal control and audit	2
Money Laundering and „know your customer" rules	3
Effective on-site and off-site supervision	2
Regular contacts with the bank's management and understanding of operations	2
Off-Site Supervision on solo and consolidated basis	2
Validation of Supervisory Information	2
Consolidated Supervision	3
Accounting Standard	2
Remedial Measures	2
Internationally Consolidated Supervision	3
Host Country Supervision	2
Supervision Over Foreign Banks' Establishments	2

Scale: 1 = Compliant; 2 =Largely compliant; 3 = Materially non-compliant; 4 = Non-compliant

Sources: World Bank and IMF 2001

Furthermore, in 2001 the EU and CNB jointly conducted a Peer Review and arrived at similar conclusions as the World Bank. It has stated that following the adoption of the amendment to the Act on Banks, banking supervision in the Czech Republic is up to the internationally acceptable standard, both in terms of the legislation and the quality of supervisory work. The CNB has sufficient means and professional staff for its supervisory duties. It is independent and is working towards the implementation of modern methodologies and concepts. In the area of regulation and supervisory work, the World Bank mission recommended that the CNB should focus on consolidated supervision and on further development in key areas of modern supervision, in particular the methodology for assessing banks' risk profiles.

On the basis of these evaluations the Czech National Bank, which is vested with both supervisory and regulatory powers over the banking sector, launched the medium term programme designed to remove remaining weaknesses, namely by:

- introduction of the banking supervision on consolidated basis,
- redefining of permissible activities of banks,
- issuing new bylaws on provision of information, loan evaluation and loss provisioning, internal audits and on money laundering, and
- operating the credit registry.

Most of these goals were successfully achieved by the 'harmonisation' amendment to the Act on Banks, which entered into force in May 2002, with some provisions applicable as of accession. The amendment to the Act on Banks addressed all major outstanding issues. Specifically, it provided for:

- tighter and more transparent licensing proceedings (including the recognition of licences issued in Member States) and proceedings to grant prior consent to the acquisition or increasing of a qualifying holding in a bank;
- greater emphasis than the previous legislation on the quality and transparency of the relations between a bank, its major shareholders and related entities;
- introduction of consolidated supervision not only of bank holding companies, but also of financial and mixed-activity holding companies that include a domestic bank;
- change of the deposit guarantees so they are fully compatible with the EC laws, despite objections that the amount of guaranteed deposits is in real terms very high within the context of the Czech economy;
- enhancement of international co-operation on banking supervision and
- starting operations of the Central Register of Credits administered by the CNB.

Further, it also abolished all existing anonymous accounts as of January 2003. This task was in time successfully accomplished by the Ceska sporitelna, which managed thousands of these accounts.

All needed secondary legislation for the above areas such as a Decree on the Prudential Rules of Parent Undertakings on a Consolidated Basis has been put into force by the end of 2002. The new measures, however, need further stabilisation and strengthening especially with regard to consistent enforcement.

As regards accounting, the international accounting standards – especially in the area of financial instruments – have been incorporated to the maximum possible extent. This regulation should foster transparency and market discipline in the banking sector. It also unifies the charts of accounts, the accounting procedures and the essential elements of the solo and consolidated financial statements of banks, credit unions, securities dealers, investment companies, and pension, investment and mutual funds. In connection with these regulations, the CNB is drafting a new regulation on disclosure of information by banks.

Further regulatory challenges

A qualitative shift in regulation is apparent at international level. The monitoring, measurement and control of risks is to be done by more sophisticated methods than before, focusing in particular on disclosure of information by banks and regulators. The Basle Committee on Banking Supervision is drafting an entirely new capital adequacy concept – the New Basle Capital Accord. Subsequently, the new Accord will also be issued in the form of a new directive by the European Community. For this purpose it will also include further recommendations concerning sound practices in all the bank related risk areas.

These changes are being introduced to the Czech regulatory framework. As an example may serve new liquidity management standards applied since 2001. These are based on a new recommendation of the Basle Committee on Banking Supervision. Unlike the previous regulation, this focuses on each bank's own strategy for managing liquidity and on the minimum standards that each bank must comply with. It has stipulated requirements for the bank's internal rules and for separate management of liquidity in each major currency. It requires banks to set limits on the size of liquidity risk and obliges them to take into account alternative scenarios for the conditions affecting it. It also provides for requirement on internal control systems and information policies.

The CNB started the preparations for the New Basle Capital Accord (NBCA) itself. It takes part in the preparatory debate and it asked the Czech banks to prepare studies of expected impact. Both banks and the regulator are preparing themselves for this major challenge, which will substantially increase demands for sophisticated financial skills on both sides. The preparations will be particularly important if the NBCA is to be introduced to the Czech environment still suffering from some general legal weaknesses.

Exhibit 23 Structure of the financial regulation in the Czech Republic

Czech National Bank	Securities	Ministry of Finance	Supervisory Office
Commercial Banks	Investment companies Investment Funds, Securities dealers	Insurance Companies and Pension Funds	Saving and Credit Cooperatives

The banking supervision faces new challenges arising from the integration of financial markets both across industries and countries. Integration creates the need for open and effective cooperation among various national and international supervisory bodies. The current stand of the Czech National Bank is such that there is no reason for integration of all financial supervisors into one authority. Instead, the CNB chose to sign a letter of cooperation with the Securities and Exchange Commission and with the insurance regulator at the Ministry of Finance. The regulators also meet regularly to discuss issues of common interest. The aim of the supervisory bodies is to jointly develop a system of consolidated supervision, but yet no consensus has been achieved.

On the other hand, a further integration of the regulators would be very desirable. Especially, due to weaker status of the insurance supervisor, which is neither politically nor financially independent to perform its duties. Its accountability is only limited as it is a mere department at the Ministry of Finance. Also the regulatory framework of the insurance industry is less developed then in the case of banks. For example a consolidated supervision is yet to be implemented. This gives an "advantage" of weaker regulation to the financial groups dominated by the insurance companies and opens the potential for regulatory arbitrage. The supervisors should reflect the integration of formerly separated financial industries and close gaps which create incentives for some kind of moral hazard.

On the international level the banking supervision established a co-operation with foreign bank supervisors on the basis of letters of understanding. These were signed so far with regulators from Germany, Austria, Belgium, France, Slovakia and United States.

Moreover, as banks seek to improve their efficiency and productivity, they increasingly rely on outsourcing, which creates stability concerns to regulators. CNB issued two official information documents defining the regulator's views concerning prudent and safe outsourcing in the banking sector. Emphasis is put on management of the risks associated with the outsourcing of banking and ancillary activities and for observance of banking secrecy and information security in general.

Deposit insurance

A revision to the deposit guarantee scheme in the Czech Republic was adopted in September 2001. This increased the upper limit for coverage of insured deposits to the equivalent of EUR 25,000 (CZK 750,000) in the event of insolvency of a bank. The guarantee remains limited to 90% of the insured deposits.

At the same time, the deposit insurance was expanded to include foreign currency deposits, and branches of foreign banks were given the right to opt out of the Czech deposit guarantee scheme, if they can demonstrate that the scheme, in which they participate, ensures eligible persons at least the same level of protection as that offered by the Czech scheme.

Simultaneously with this amendment, Parliament decided to compensate retroactively the depositors of Pragobanka, Universal banka and Moravia banka, which failed in 1998 and 1999 (all of these former banks are now in bankruptcy), with amounts of up to CZK 4 million per person. Such decision, seemingly inconsistent, creates risk of moral hazard on the side of both banks and depositors. However, it was one of last ad hoc transition measures and the commitment of the government to avoid similar inconsistencies in future is strong and credible.

Prudential status

The Czech banking has standard and well functioning supervisory framework complemented by relatively well developed skills of supervisors. Also the banks are currently stabilised as huge proportion of non-performing assets, which troubled the sector throughout the 1990's, had been transferred to the state run Czech Consolidation Agency.

Exhibit 24 Prudential statistics for the Czech banking sector

	XII.99	XII.00	XII.01	IX.02
		Capital adequacy		
Capital in CZK millions	133 155	124 228	132 312	140 508
Capital requirements for banking portfolio in CZK millions	0	61 950	63 323	67 737
Capital requirements for trading portfolio in CZK millions	0	4 898	5 488	5 783
Capital adequacy in %	13,59	14,87	15,38	15,29
		Liquidity		
Quick assets in CZK millions	411 418	438 567	519 069	890 060
Quick assets/total assets in %	19,49	19,45	20,76	35,43
Cumulative net balance sheet position/assets in % 1)	-4,39	-9,12	-3,72	-0,48
		Credit portfolio quality		
Classified credits, total, in CZK millions	291 061	257 762	209 866	160 249
of which: watch credits	92 124	85 814	75 984	71 177
substandard credits	39 379	54 910	32 295	25 933
doubtful credits	38 433	27 276	29 725	19 424
loss credits	121 125	89 762	71 862	43 716
Classified credits as % of total credits	32,15	29,83	21,53	17,22
Non-performing loans, total, in CZK millions	198 937	171 948	133 882	89 072
Non-performing loans/total loans in %	21,97	19,90	13,73	9,57
Weighted classification, total, in CZK millions	152 823	118 672	96 982	62 173
Weighted classification as % of total credits	16,88	13,73	9,95	6,68
Weighted classification incl. collateral in CZK millions	98 817	61 852	57 446	49 144
Reserves and provisions in CZK millions	103 783	77 141	79 193	70 247
Surplus of reserves, provisions and collateral in CZK millions	4 966	15 289	21 747	21 102
Coverage of weighted classification with reserves and provisions	67,91%	65,00%	81,66%	112,99%

Source: Tůma 2002, CNB, www.cnb.cz

By the time of accession the Czech banks will operate within the same regulatory framework as their EU based counterparts. There will be no regulatory shock as the convergence of the regulatory standards has been relatively long and transparent process. The banking sector is currently stabilised and profitable without any concerns that any bank could have troubles to comply with given rules. Further regulatory changes, coming either from Basle or Brussels, will affect Czech banks the same way as all other banks in the EU. Their competitiveness, growth or investments are unlikely to be affected differently by these changes.

What is, however, specific to the Czech banking sector is the substandard general legal framework, which is still far less efficient then is common in the EU.

Policy measures

As has been suggested above throughout the text there are at least two general measures and two sector specific measures that are within the reach of policy makers, within the short and medium term.

An important short term, sector specific measure is to get the approval of the European Commission that public aids, given to the Czech banks as part of their privatisation, are compatible with the single market. In the medium term the banking sector ought to prepare for the adoption of the New Basel Capital Accord and later for entry to the EMU.

As regards the general measures the most pressing problems to be resolved are the weaknesses of the legal framework, which block the SME lending and reforms related to the public finance deficits.

Compatibility of state aids

During the pre-accession negotiations the European Commission raised the issue whether the state aids granted to the Czech banks during their privatisations are compatible with the Single European market. Despite the fact that these aids were granted several years ago the maturity of some guaranteed assets extends beyond the accession date. In theory this may affect the single market. The Commission driven by the transparency concerns asked the Office for Protection of Economic Competition to issue statement on compatibility of past state aids.

A mechanism was defined in the draft of the Accession Treaty, which gives the Commission the right to raise doubts if it disagrees with the evaluation given in the statement of the Office. If the Office finds the state aids compatible and the Commission does not raise doubts then they will be included to the Appendix of the Accession Treaty and, following the accession, considered to be an undisputable existing aid. However, if either the Office or the Commission considers aids incompatible with the single market rules, then these aids will be treated as new aid and reassessed by the Commission after the EU accession.

Unfortunately, the above procedure could potentially lead to retroactive reassessment of some of the state aids, which puts the privatised bank in some legal uncertainty. The Office should issue its statements quickly so they can be found compatible and added to the Annex of the Accession Treaty.

New Basle Capital Accord

The new rules drawn up by the Basle Committee on Banking Supervision are to be implemented by 2006. There are extensive preparation under way. The Czech banks have already been asked to prepare a quantitative impact study on the basis of the draft of new rules, which is due in February 2003.

By 2006 the Czech Republic will be a member state of the European Union. The EU will incorporate the New Basle Capital Accord into its new directive, which will also reflect upon some EU specifics such as uniform application across the Single Market and concerns for availability of SME lending. All Czech banks as well as the regulator will have to adopt the new rule and adjust their procedures adequately.

The new rules will give banks greater flexibility in managing their risks according to their own model. The obvious impact will be the need for increased sophistication on both sides – in banks and in CNB. Failure to prepare adequately could have serious consequences for the stability of some banks or even the whole sector.

Strengthening financial sector regulation

After the very painful and expensive lesson from the first half of 1990s, the banking regulation has improved dramatically. This process has been to a large extent driven by the accession prospects. Surprisingly, this drive did not do equally well in other industries of the financial sector, especially the insurance regulation remains, in comparison to banks, reatively underdeveloped.

The bankruptcies of insurance companies and non-bank financial corporations in general, require further attention. Currently the legal framework does not quite respect some important specifics, which are not relevant for non-financial corporations. Moreover, the insurance regulator is neither independent nor posses sufficient capacities to act as an equal counterpart of the banking sector regulators in supervision of the financial conglomerates consisting of both banks and insurance company. Currently, if the financial group is headed by the bank its consolidated supervision is far stronger than if the group is headed by the insurance company. In the former case the consolidated supervision is yet to be implemented. This should, however, change soon as the package of laws strengthening the insurance regulation is already in the parliament.

Legal framework supporting SME financing

As has been explained in the Chapter 0 the key bottlenecks for increased SME lending are difficulties related to data gathering and the creditors' rights enforcement within the work out and/or bankruptcy process.

The Czech Ministry of Industry and Trade had launched an ambitious project to improve the general business environment in the Czech Republic, which ideally should resolve all of the above described problems. However, the programme has only been launched and is yet to deliver any tangible results.

Moreover, the Czech Republic needs to issue an amendment to the Act on Banks, which the Commission currently does not consider to be in full compliance with the acquis with regard to the protection of personal data and free movement of such data.

Removal of key bottlenecks is very important for the economic growth and development as currently underfinanced SMEs produce over 42% of the GDP and employ more then 60% of the total workforce.

EMU and public finance reform

The Czech Republic will participate in the EMU upon accession as a non-participant in the Euro area. None of the current candidate countries had an opt-out option and all of them harmonized their legal system with the EMU acquis. Thus the question is only when, not whether, to join EMU.

The policy debate had just started and the Central bank had presented two potential scenarios of EMU accession – slow and fast one. However, from the point of view of the paper this is still beyond the horizon as there will be no direct effect of EMU at the time of EU accession. Nevertheless, it is already clear that the crucial challenge on the Czech way to Euro area will be the public finance reform.

The Czech Republic needs to reduce the mandatory spending which is currently consuming about 82% of the total budget (25% of GDP). Large mandatory spending results in large deficits, amounting to 6% of annual GDP in 2003. The deficit is financed primarily by the commercial banks, which buy low risk state papers in bulk. Any reduction of the deficit would reduce this opportunity for asset allocation, which crowds out the more risky corporate lending.

The reform is needed not only to meet the Maastricht convergence criteria in the area of public deficit and debt, but also to resolve some of the long postponed problems such as a pension reform. Any substantial pension reform would be a major commercial opportunity for universal banks, which are main players in supplementary pensions. They would benefit if any form of private pension plan is adopted.

It is clear that prospects of EMU accession will induce some further reforms influencing the banking sector; however it is not a question of the short and medium term policies yet.

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