Development of Banking sector and PSE

Banking sector

- One of the most tickler problem of whole economic transformation was development of the banking sector.

Banking sector before 1989

- **Mono-structure** banking system
- In 1950 was established **State Bank of Czechoslovakia** (SBCS).
- SBCS “**hybrid**” between state and private bank and investment bank.
  - Central bank functions
    - Monetary police
      - Issue of paper money and
      - Foreign exchange rate policy
  - Government function
    - Tax collection
    - Control of wage development
  - Commercial bank functions
    - Collection of savings
    - Granting credits
    - Exchange of foreign currencies
    - Organization and running of payment mechanism
- Clients of SBCS were **only business companies** not households.

Banking sector before 1989

- In Czechoslovak banking system existed banks with specific functions
  - **Trading bank** (Zivnostenska banka) the most important bank during interwar period that was confiscated in 1945.
    - In communism regime provided **foreign exchange operations** for private clients
    - It had business **branch in London** for
      - Arrangement relations with foreign banks
      - Foreign trade and other international transactions

Banking sector before 1989

- **Czechoslovak business bank** (CSOB) was established in the 1960's
  - Owned by SBCS and businesses of international trade (monopoly for trading with foreign countries)
  - Provided international payment with subjects in RVHP markets (social countries in Europe, Asia and Africa)
- In banking sector existed two saving-banks
  - Czech state savings-bank
  - Slovak state savings-bank
    - Collected savings from households and granted credits for households.
    - Surplus of savings were transferred in SBCS and divided into state companies.

Banking sector before 1989

- Communism regime was aware of problems in banking system.
- In 1989 was decided about transformation of mono-structure banking system in two tire banking system.
- From SBCS were set off three state banks
  - Commercial bank (Komercni banka)
  - General Credit bank (Vseobecna uverova banka)
  - Investment bank (Investicni banka)

Development of banking sector in the 1990's

- Development of banking sector in the 1990's can be divided in three phases
  - Establishing of new small banks
  - Privatization of large state banks
  - Banking crisis

New banks

- The number of new banks in Czech market was growing since the beginning of the transformation process.
- At the beginning of transformation process **conditions** for establishing of new banks were **weak**.
  - Shareholder’s capital **50 million CSK** in 1990
  - But was **accepted every tenth application** for banking license

- Government and State bank set these weak and liberal conditions to **improve competition in banking sector.**
  - This conditions were **getting more restrictive** in the process.
  - In April 1991 basic capital 300 millions of CSK and
  - from 1993 till nowadays 500 millions CZK
- Despite of these liberal conditions banking sector in the Czech Republic was concentrated.
  - Small banks were weak and financial resources for their business activities were getting in the form of credits from large banks in interbank market.

New banks

Share of commercial banks in savings and credits in 1990		
Bank	% of credits	% of savings
Commercial bank	47,8	17,5
General Credit bank	20,1	7,9
Investment bank	14,6	8,3
State credit-houses	10,3	62,3
Others	7,2	4

New banks

- In 1991 were established first credit banks (kampelicky)
- Simultaneously the number of small Czech bank was growing and also foreign banks opened their subsidiaries in the Czech republic.
  - Foreign bank focused only on the best clients -
    - Foreign companies that they were familiar with them from their domestic market.
  - According to government expectation:
    - Foreign banks should have promoted real competition in banking sector.
    - But these institutions were interested only in the most lucrative clients with the lowest rate of risk.

New banks

- In domestic market arose double pressure
  - Foreign banks overtook the most profitable clients and domestic banks cared only about subject with high level of risk or insolvent clients
  - Foreign bank pushed down banking fees for these profitable clients and thus limited possible fees of domestic banks

New financial institutions

- Specific group of institutions in banking sector were transformation institutions.
- The best known is **Consolidatory bank**
  - In Consolidatory bank were transferred
    - Bad liabilities of companies doing business in central planned economy
    - Bad loans in time of cleaning assets of banking sector
- Other institution is the Bohemia and Moravia Guarantee bank established in 1992 by government and large banks
  - Support of small and middle-size companies with credits and bank guarantees
- Czech Export bank
  - Granting cheap credits for export companies
  - Owned from 66,7% by the government

Consolidation bank/agency

- Established in February 1991 originally only for 126 days but in fact existed till 2007.
- In this bank were transferred
  - bad debts from state companies in the value of 80 billion CSK and
  - bad assets from large state banks.
- Primary aim of Consolidatory bank was
  - restructure or decay of companies that transferred assets in Consolidatory bank.
  - This aim was not never fulfilled.
- Consolidation bank became a store for bad loans and played important role in cleaning of Czech bank before their sale to foreign investors.

- In Consolidation bank were during 1999 – 2000 five institutions
  - Revitalization Agency – cleaning financial accounts of specific companies like Aliachem, CKD Praha, Skoda Plzen
  - Czech Financial – buyout of classified credits in small banks
  - Konpo – control and debt recovery of the Commercial Bank
  - Prisko – transferred all liabilities from former state company Skoda – Car
  - Sanakom – transferred bad credits of bank Investment banks

- Because Consolidatory bank was established as a bank it had to fulfill all conditions suitable for commercial bank although its purpose was different
  - E.g. According to Banking Act
    - Consolidation bank had not acquired a majority share in non-banking subjects and it limited its restructured aims in controlled companies.
    - Capital adequacy
- In 2001 Consolidatory bank was transferred in Consolidatory agency and became its continuator without limitation related with its former bank statue.

Bank privatization

- At the beginning of the 1990's existed 4 large fully state banks
  - Czech state savings-bank
  - Trading bank
  - Commercial bank
  - Investment bank
    - And Czechoslovak business bank with significant state share.
- According to current opinion the highest revenue from bank privatization could be obtained **in 1991-1995** because of weak position of foreign bank in Czech market and Czech banks were not suffered by classified credits from transformation process.

- In 1992 were 4 fully state banks transferred in joint stock companies and part of their stocks designed for privatization process.
- After privatization process state became minority shareholder in these banks with share from 48-49 %.
- In next years privatization process left off
  - Because of lack of rules for sale of banks to foreign investors.
  - Whole process was slowed down by several minority shareholders actions against important bank decisions.

- Dispute point of whole transformation process is slow privatization of banking sector.
- The main problem was existing credit channels between banks and state companies established in central planned economy
- This credits became uncollectible and in final phase they were paid off by tax payers.

- Privatization process of banks was postponed because of privatization process as a whole.
- The main fear was related with turn off the financial resources for domestic companies that did not fulfill strong international criteria.
- If privatized bank stopped credit granting to state companies these companies would get in troubles.

- On the other hand postpone of bank privatization arose opportunity for political pressure in banks to grant credit to companies that did not satisfy bank conditions.
- Banks nourished companies that should have bankrupted and granted credits for losing projects.
- It is reason why important part of credits became classified.
- State proprietorship encourage **morale hazard**
  - Bank expected that in case of financial problems will get financial support by government that also happened for several times.

What does term-classified credits mean

- All bank's credits are classified according to Czech National Bank criteria
- Five main groups:
  - Standard credits
  - Watch credits
  - Substandard credits
  - Doubtful credits
  - Loss credits

What does term-classified credits mean

- Standard credits - no doubts about future pay-off of the credits. Instalments and securities are settled regularly.
- Watch credits - high probability about future pay-off. Instalments and securities are settled with some troubles, but there are not longer than 90 days after settlement.
- Substandard credits- higher improbability of total settlement, but partly settlement high probable. Instalments and securities are settled with troubles, but there are not longer than 180 days after settlement.

What does term-classified credits mean

- Doubtful credits - total settlement high improbable. Instalments and securities are settled with troubles, but there are not longer than 360 days after settlement.
- Loss credits total settlement impossible, will not payoff or payoff in small rate. Instalments and securities are longer than 360 days after settlement.

- Classified credits are the last three groups of credits.
- In the Czech Republic in the 1990's high share of these classified credits, mainly loss credits.

- For example: in 1995 21.3% of credits were loss credits.

- In 1998 was privatized Investment bank to Japan investment company Nomura
- Price of this bank was low only 6 billion CZK
- Bank was weak with classified credits about 20%
- Nomura was not a strategy partner and their main purpose for this business was getting the portfolio of companies owned by this bank
  - Especially brewery and glass companies
- In recession this bank got in serious trouble with high flow off of savings (34 billion CZK) and became insolvent.
- In 2000 bank was move on Czechoslovak Business bank.
  - Sometime is this process labeling as a state confiscation
  - Czechoslovak Business bank overtook this bank with government guarantee (it is expected that this guarantee are in value of 160 billion CZK)

- In 1998 was elected left oriented party Social Democracy that promised no other state aids in banking sector.
- In reality new government started looking for new foreign owners for state banks and offered state guarantees.
- Government promised sell all state banks till 2000.
- In spring 1999 Czechoslovak business bank was sold Holland KBC
  - 40 billion CZK
  - The higher revenue from bank sale in transformation period
  - This bank was the most healthy bank in Czech banking system

- In 2000 was sold Czech state savings-bank to Austria Erste Bank
  - Erste Bank paid for 52 % shares 19,3 billion CZK
  - Government must invest in his bank 46 billion CZK before sale to recover bank balance sheet.
  - Classified credits were transferred into Consolidatory bank.
  - The main loses of this bank were from
    - Bad loans from the beginning of the 1990’s
    - Poor quality guarantees
    - Losses form collapse of Russian market after 1998

- Privatization of the Commercial bank was stopped by company **B.C.L. Trading** when bank lost 8 billion CZK in one single trade
  - Between 1998 and 1999 the Commercial bank lent 100, 150 and 200 millions dollars.
  - Documentary credits were bound by delivery of agricultural products from Ukraine and Russia.
  - Investigation found out that this supplies never happened.
- Commercial bank was privatizes as the last large bank in 2001 when was bought by Societe Gererala in 40 billion CZK.
- Total cost for recovery of this bank are estimated in value of 75 billion CZK.

Crisis in banking sector

- During the 1990's banking sector in the Czech Republic passes several crisis
- At the beginning of transformation process there was a need of credit and fears from oligopoly structure of banking sector.
- Bank licensing was benevolent till the first banking crisis in 1993.
- In first transformation phases only small banks were suffered by crisis.

- First small bank in troubles was
  - Credit and Industry bank
  - Classified loans in this bank got 90 % and in bank lost 450 millions dollars.
  - The reason was over limit granting of credits in general manager that was also owner of the bank.
  - CNB withdrew license this bank.
- In the same year other banks got in financial troubles
  - AB bank
  - Credit bank
  - Czech bank
    - In largest debtors of these bank were their shareholders.
- Other bank that went bankruptcy was Bank Bohemia
  - Managers of this bank signed guarantee in value 30 times higher that was basic capital of this bank.

- As a reaction to problems in small bank sector there was announced program for consolidation of banking sector.
  - Consolidation program II
  - Central bank stopped licensing for new banks
  - Banking supervision became more restrictive
- But other small banks got in troubles.
- In 1996 the largest private Czech bank Agrobanka got in troubles with total lost 35 billion CZK.

- Total costs for recovery small banking sector were insignificant in compare with recovery of large bank sector.
- Large bank with some level of state proprietorship were consider to be too large for fail.
- Large banks were supported during pre-privatization period.

- Sector of **credit banks** get in trouble at the end of the 1990’s.
  - Since 1996 they became more popular and had approximately 110.000 members with savings 10,3 billion CZK
  - They were attracted because of higher interest rate in compare with commercial banks
  - In 1999 problems in three largest credit banks
    - In these three credit banks was concentrated 60% of all deposits
- In next year in the troubles get next 12 credit houses.
- As a reaction in 2000 was adopted of Credit houses act that
  - forbidden transfer of credit house savings in subsidiary companies
  - Limited licensing
  - Restricted supervision

Reasons of banking crisis

- I. **Debts of companies and problems with debt redemption**
  - In banking sector existed 1900 billions CZK bad debts from central planned economy.
  - Banks were vulnerable in face of failure of large debtors.
  - In the lack of capital companies oriented only in credits because capital markets did not work.
- II. **There was a lack of experiences with market oriented economy at the beginning of the 1990's**.
  - Subjects in the market existed without any business history
  - No market skills of bank employees
  - Information asymmetry in banks
    - Most active credit applicants were applicants with the most risk projects
    - Problem with bank supervisory
      - In small banks lots of cheap credits granted to shareholders
      - In large state bank no control of bank activities by government.
        - Political pressure for credit granting to support privatization and whole transformation

- III. **Worst situation in small bank in compare with large banks**.
  - In these small banks were lack of basic capital thus carried out operation with higher risk
  - Lack of capital influenced the confidence of savers and limited possibilities for gaining cheap financial resources.
  - In this sector was also significant level of criminal acts
- In whole sector was combination of lack educated management, disproportionately high interest rates and criminal acts

Recovery of banking sector

- In 1991 number of classified credits between 15-20 %
  - Consolidation program I for large state banks
    - Cleaning of banking sector from bad debts
    - This bad debts were taken over Consolidatory bank
    - Total costs of this program 100 billion CZK
- Problems in sector small banks solved by
  - Consolidation program II
    - Designed for banks that did not pass capital adequacy (8 %)
    - Total costs of this program 33 billion CZK and bank in this program finished by withdrawing of license
- Rescue of credit houses sector was related with withdrawing of licenses
  - Total loss from this sector 90 billion CZK.
- Total cost for recovery of banking sector are differentiate
  - Recovery of 4 largest bank costs – 216 billion CZK
  - Revenue from sale of this banks – 112 billion CZK

Stock Exchange

- Beside banks other important institution is capital market.
- Important event for establishing Prague Stock Exchange (PSE) was voucher privatization.
- Till establishing of PSE all trades was realized in temporary market.
- First issue outside of PSE was Commercial bank stocks traded since 1990.
  - Total volume was 1 billion CZK and was traded in primary market
- In 1990 Ministry of Finance issued first Government securities for financing property restitutions.
- At the end of 1992 all activities of temporary market was overtaken by PSE.

- In 1993 was in PSE placed 622 issuances from voucher privatization and till the end of the year next 333 issuances were added.
- 8,5 million Czechoslovak citizens became shareholders.
- In 1993 first official Government bond was placed
- 1994 was started day-to-day trading
- In the half of the 1990’s was traded with more than 100 issuances in PSE.

- The interest about securities in PSE was low.
- The main volume of trade was with bonds.
- The character of trade was “direct trades”
  - Bilateral trade with subjects out of PSE
    - Only with registration in PSE
  - Direct trades had no influence in prices of securities
    - 90 % of trading with stocks
    - 100 % trading with bonds

- In 1996 a lot of foreign investors left PSE
  - Weak regulation
  - Fraud conductions
  - Lack of interesting investment possibilities
- In the process the rules and trading conditions were improved.
  - Market was spitted in
    - main with the most quality stocks – blue chips (14 blue chips in 2010)
    - Mid market and free market

Long-term trends

- The most important event was decrease of issuances traded in PSE
  - Low liquidity and neglect of duties of PSE
  - In 4 phases were cancelled 1300 issuances
  - A lot of majority shareholders cancelled securities from PSE after controlled of company
  - In PSE did not entrance new primary issuances for long time
    - First IPO in 2004 Zentiva
    - PSE did not fulfill its primary function as a source of capital
  - As a reason companies gained new capital only in the form of bank loans that established narrow relationship between companies and banks
- Successful segment in PSE was debt market.

Sum up

- Whole transformation process was closely connected with banking sector.
- Banks play key role in process of transformation money in investments and if this relation is harmed it will influence whole economy.
- Czech banking sector cumulated troubles during transformation
  - Faults in management
  - Lack of banking skill
  - Fraud conduction
- It led to crisis of banking sector as a whole.
- Suffered were small banks as well as large.
- Small banks left banking sector
- Large banks was rescued by tax payer's money
- Development of PSE was questionable
  - PSE did not become alternative resource of financing and in transformation process helped in concentration of proprietorship.