

The Institutional Framework in Question

*Financial Regulation
in the CR*

Pavel Vacek

Czech National Bank

1. Banking reform
2. Restructuring of supervision
3. Impacts of the crisis on Czech financial sector

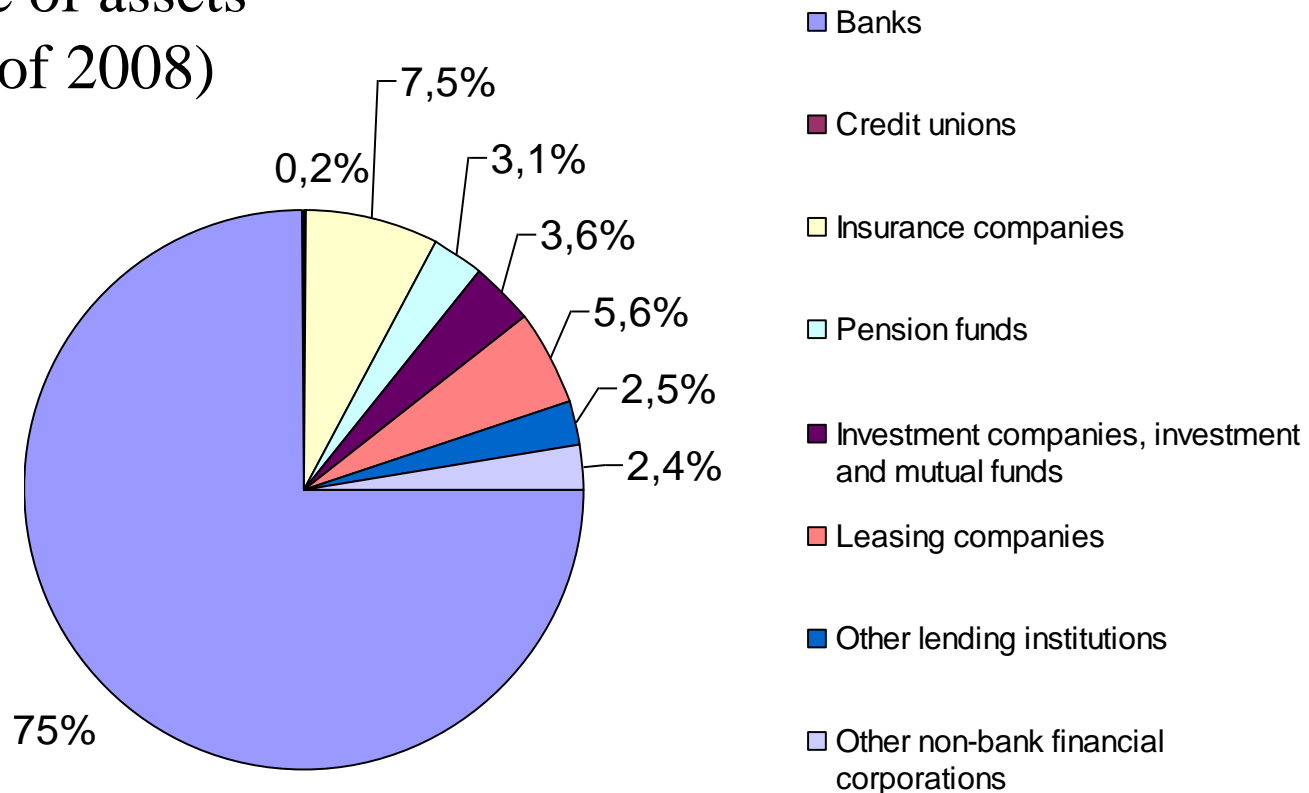
Banking reform

- dominant role of the banking sector since the start of the transition from the centrally planned economy in 1990
- despite an increasing weight of non-banking financial institutions, 75% of the assets of the financial system are currently owned by banks
- over the past 19 years the banking sector has undergone a fundamental restructuring
- the sector is now stabilised, shows healthy financial results, has sufficient equity to cover its risks and is resilient to potential shocks
- the basic restructuring of the banking sector can be therefore considered finalised and successful, although anything but easy, smooth and painless

Banking reform

Banking sector is the key element of the financial system

Share of assets
(end of 2008)



Banking reform

- the first stage - from the “monobank” to the creation of a two-tier banking system: the split of the State Bank of Czechoslovakia into four large state-owned banks
- no other viable option of financing than the banking sector; banks were the core of the financial system during the transition
- heritage from the past:
 - undercapitalisation of banks
 - high share of bad, non-performing loans
 - shortage of long-term funds
 - inexperienced staff
 - almost non-existent risk management
 - defective legal framework
 - absence of market-consistent regulatory rules
 - weak, understaffed and inexperienced banking supervision

Banking reform

What type of banks should play the main role in future?

- large banks established through the split of the previous monobank?
- dismantle them into smaller units?
- support newly formed domestic private banks?
- rely on banking institutions from the developed market economies?

How to cope with the heritage of the centrally planned economy - the options:

- to draw a dividing line and to solve the legacy at an early stage of transition; to clean up the balance sheets of banks and firms when they were still part of the state sector, or
- to postpone the solution to the privatisation phase and to the follow-up restructuring

Banking reform - Large banks

- formerly state-owned banks transformed into joint-stock companies, partially privatised within the voucher scheme
- major stakes remained in state hands (National Property Fund)
- ambivalent goals and policies: banks expected to “support” the transition and enterprise sphere, also to keep afloat non-viable firms and, at the same time, to comply with prudential rules
- instead of enforcing discipline and pushing towards restructuring, banks became captives of their traditional major clients, depending on their survival, and mostly refrained from initiating bankruptcy procedures
- the inherited bad loans problem was not worked out; rather, its volume and risk kept increasing in the 1990s
- if not under the state umbrella, banks’ net worth would have been negative
- only after massive pre-privatisation assistance (recapitalisation) the state shareholdings were sold to foreign investors in the period 1998–2001

Banking reform - Small private banks

- impressive increase in new entries of small private banks in the early 1990s:
 - 20 new small private banks were established in the years 1990 – 1993
- political motivation to increase competition in the banking sphere vis-à-vis the four large banks
 - liberal approach towards new start-ups
 - loose (benevolent) licensing policy
- the new small banks soon started getting into trouble; a sort of vicious circle developed
 - banks mostly undercapitalised; access to funds limited by their small size and small number of branches; higher borrowing costs to attract more depositors; had to take greater risks; problems of selection bias and moral hazard
 - inexperienced staff and temptation of fraudulent behaviour and corruption in conditions of a defective legal framework and loose institutional supervision

Banking reform - Foreign banks

- liberal regime for their entry since the start of the transition
- Act on Banks 21/1992 allowed for both subsidiaries and branches of foreign banks
- nevertheless, their real engagement and competitive pressure remained rather limited for some time
- they mostly confined themselves to specialised services in foreign exchange for multinationals and joint ventures, not moving into retail business
- given the early stage of transition, the costs and risks of a move to retail banking were evidently considered too high
- radical change initiated through the process of large banks' privatisation in the late 1990s
- at the present stage, foreign-owned banks have a dominating role in the Czech banking system; foreign entities account for 81% of total equity, and 97% of assets are directly and indirectly controlled by foreign shareholders

Banking reform – Steps to consolidate the banking sector

- initial clean-up of large banks' balance sheets and their recapitalisation in 1991, later dubbed Consolidation Programme I
- establishment of Consolidation Bank in 1991, later transformed into the non-bank Czech Consolidation Agency
- comprehensive programme of consolidation of small (private) banks in 1995– 1996, prepared and implemented by the CNB, known as Consolidation Programme II
- Stabilisation Programme, declared under a Czech government resolution of October 1996, focusing again on the segment of small and medium-sized banks with the aim of reducing the risk of a liquidity crisis and promoting the overall stabilisation of the banking sector
- pre-privatisation assistance (recapitalisation) of large state-owned banks in 1998–2001

Banking reform

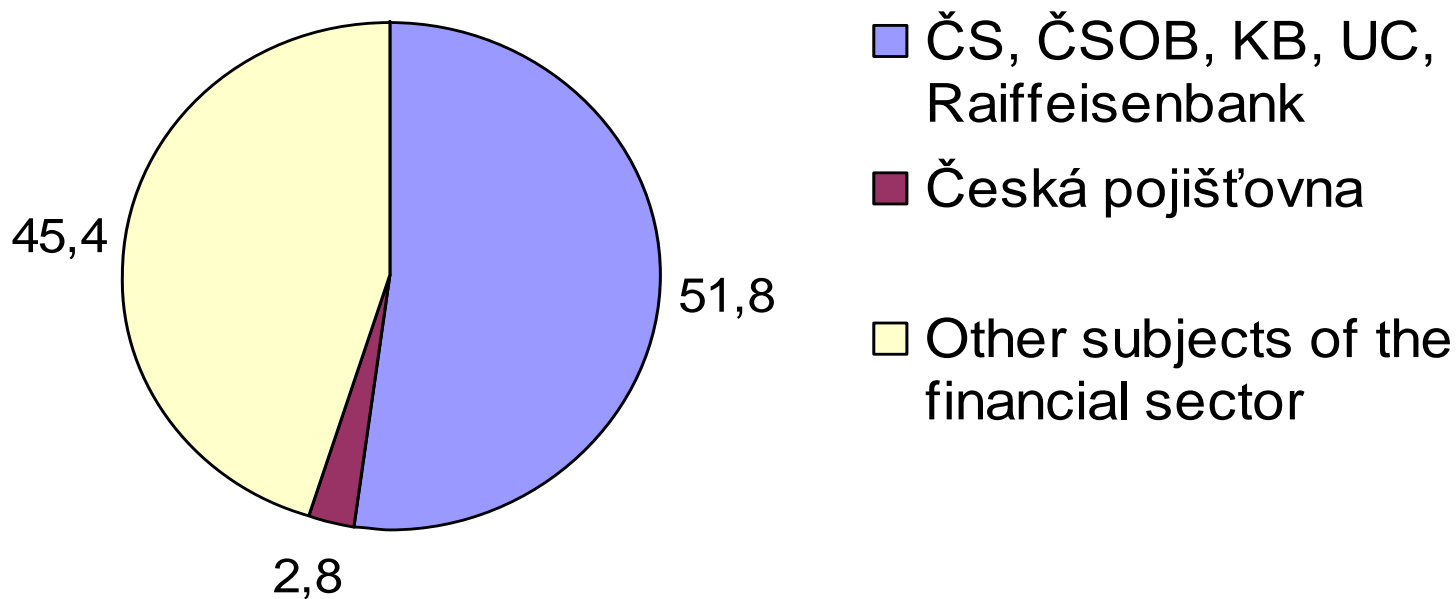
- the process of privatisation of the Czech banking sector was successfully completed in 2001; the state stakes in large banks were sold to foreign strategic investors
- the clean-up and privatisation of banks have launched the entire banking sector on a successful path, underpinned by the accelerated growth performance of the Czech economy
- the banking sector as a whole has been profitable since 2000
- its capital adequacy has been maintained at a very satisfactory level around 12%
- the once high share of non-performing loans has decreased to 4% of total loans extended
- banks are operating in a highly competitive, low interest rate environment resembling that of the developed EU countries
- Czech banks employ standard risk assessment procedures and up-to-date know-how
- the dominant foreign ownership is not considered something extraordinary in terms of a small open economy and in the environment of globalisation and integration of financial markets

Banking reform - Mistakes

- the banking reform process was inevitably a learning process, in conditions of transition from a centrally planned economy lacking previous experience and in the environment of weak players and weak corporate governance
- defective legal framework and some underestimation of its importance
- up-to-date banking regulation and supervision developed only in the course of transition, almost from scratch
- to some extent naive expectations that market discipline can be effectively imposed in the banking sphere without standard market players, institutions and rules
- lack of a comprehensive strategy for the implementation of the banking reform; steps were taken mostly ad hoc, in a pragmatic way, as a rule under pressure of increasing risk; the implied costs were dispersed over a number of agencies
- however, the most costly aspect appears to be the significant delay in the privatisation of major banks; the period between the shift to a two-tier system and the sale of banks to strategic investors was longer than in some neighbouring countries; this delay was paid for by a high ratio of non-performing loans, incurred costs and lower revenues

Restructuring of supervision

Share of large financial groups in the financial sector
Share in assets (in %, as of 31 Dec 2008)



Restructuring of supervision

Four-tier sector based model

Supervisory authority	Supervised entities
CNB	Banks
Czech Securities Commission	Capital market
Ministry of Finance	Insurance + Pension funds
Office for Supervision of Credit Unions	Credit unions

Restructuring of supervision - Problems

- uneven level of supervision in the sub-sectors (quality, quantity)
- varied policies and procedures (quality)
- insufficient training in some spheres of supervision
- lacking information exchange among the supervisors

Restructuring of supervision

- **2 alternatives:**
 - 1) Sectoral model
 - 2) Functional model – the champion

- **April 1, 2006:**
one-step (institutional) integration of all supervisory institutions into the CNB

Restructuring of supervision - Advantages

- more effective supervision of financial groups
- better monitoring of overall financial sector from one place
- easier attainment of the level playing field for all financial market participants
- higher flexibility and faster response to innovations and changes in financial market
- greater efficiency and synergies
- clearer responsibilities

Restructuring of supervision - Disadvantages

- increase of some administrative costs
- spread of moral hazard to whole financial sector
- loss of good employees causing weaker efficiency of supervision
- changes to laws in individual sectors necessary
- harmonization of internal procedures and regulations

Restructuring of supervision - Why in the CNB?

- independence
- appropriate operational infrastructure
- suitability in terms of know-how, capacity, cost efficiency
- in position for dealing with possible crisis situations
- the CNB is respected by market players
- comparative advantage in the labour market

Restructuring of supervision

- Subsequent tasks

- harmonisation of technical and sectoral differences
- identical approach to the same kind of risks
- creation of common culture of financial regulation
- better quality of regulation and supervision

Restructuring of supervision

Further step towards fully integrated supervision

Sectoral model (Apr 2006 – Dec 2007)

Banking*
Regulation and
Supervision
Department

Capital Market
Regulation and
Supervision
Department

**Insurance
Companies**
Regulation and
Supervision
Department

Functional model (since 1 Jan 2008)

Financial Market
Supervision
Department

Financial Market
Regulation and
Analyses
Department

Licensing and
Sanctions
Procedures
Department



* Covers banks and credit unions

Impacts of the crisis on Czech FS

- Factors of lower vulnerability

- high profits
- excess of liquidity
- high regulatory prudence
 - + traditional conservative model of banking
 - => negligible share of toxic assets (< 1% of assets)
- sound non-financial sector + households
 - => low NPL ratio

Impacts of the crisis on Czech FS

- declining credit growth rate
(both supply- and demand-side factors)
- gradual rise in default rate on bank loans
- growing risk margins
- stock market, pension and investment funds affected

the financial sector still remains stable

Impacts of the crisis on Czech FS

- Responses to the challenges

- regular info (daily or weekly)
- ad hoc info (toxic asset holdings)
- consultations (weekly or fortnightly)
Governor + Vice-Governor + Banking Association
- increased deposit insurance to EUR 50 000
(but no universal guarantees or assurances)
- measures to support liquidity
 - interest rate cuts
 - liquidity-providing facility

Impacts of the crisis on Czech FS

- Conclusions

- implementation of the banking reform proved to be a key factor in the completion of the transformation to a market economy and to the creation of conditions for sustainable growth of the Czech economy; bank privatisation being the milestone of the reform
- a necessary counterpart proved to be improvements in the legal framework (in particular, more efficient bankruptcy procedures, enforcement of market discipline and repayment of debt contracts)
- the same goes for the implementation of up-to-date concepts of regulation and banking supervision
- integrated supervision has proved effective (daily info about the whole financial sector, efficient communication)

Thank you



Pavel Vacek

Director of Financial Market Regulation Division
Financial Market Regulation and Analyses Department

Pavel.Vacek@cnb.cz

Tel.: +420 224 413 366