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The Consolidation of the Czech Banking Sector with Respect to the Experience of Central and Eastern European Countries

a bachelor thesis

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Affirmation

Author declares that the thesis was elaborated on his own with the use of listed sources only.

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Abstract

The aspiration of the thesis is to give reasons for high costs of the Czech banking sector's consolidation in comparison to the other transitive countries i.e. Estonia, Hungary, Poland, Slovenia and the Slovak Republic. Indeed, there are plenty of monographs devoted to the consolidation of the banking sector in each of the transition countries. There is also a considerable amount of texts devoted to the comparison of the banking sectors based on the data collected in these countries.

This thesis tries to penetrate to the roots of the banking sectors in these countries and utilizes recent theoretical knowledge of the banking in transition. Sometimes it goes even further, to the concepts of Douglas North or Joseph Schumpeter. Therefore, it might be perceived to be inconsistent with older (pre 1998) surveys based on the analysis of individual banks´ performance. In our opinion, information published by banks did not provide accurate information due to the weak accounting standards which might have led to misleading conclusions.

Problematic development of the sector is not reviewed separately from other issues of the transition. It is perceived as its indivisible part. We conclude that high costs of the Czech banking consolidation are the result of the calamitous mixture of the factors labelled as "banking socialism". Experience of other countries indicates that none of the factors causing "banking socialism" in the Czech Republic has to cause difficulties, when prepared properly and/or in no connection with other mentioned factors.

Abstrakt

Cieľom tejto práce je zdôvodniť vysoké náklady konsolidácie českého bankového sektora v porovnaní s ostatnými tranzitívnymi krajinami, t.j. Estónskom, Maďarskom, Poľskom, Slovinskom a Slovenskou republikou. Samozrejme, existuje množstvo monografií venovaných konsolidácii bankového sektora v každej z tranzitívnych krajín. Existuje takisto nemalé množstvo textov venovaných porovnaniu bankových sektorov, založených na dátach zozbieraných v týchto krajinách.

Táto práca sa však pokúša preniknúť ku koreňom bankových sektorov týchto krajín a pokúša sa pri tom zhodnotiť doterajšie teoretické poznatky z oblasti tranzitívneho bankovníctva. Miestami ide ďalej, až ku konceptom Douglasa Northa alebo Josepha Schumpetera. Preto môže byť považovaná za nekonzistentnú so staršími (spred roku 1998) hodnoteniami založenými na analýze výkonnosti jednotlivých bánk. Domnievame sa, že informácie publikované bankami neposkytli presné informácie kvôli slabým účtovným štandardom a mohli tak viesť k mylným záverom.

Problematický vývoj bankového sektora nie je posudzovaný oddelene od ostatných problémov sprevádzajúcich tranzitívne krajiny. Je vnímaný ako jeho neoddeliteľná súčasť. Zastávame názor, že vysoké náklady konsolidácie českého bankového sektora sú výsledkom nešťastnej kombinácie faktorov, označovaných ako „bankový socializmus“. Skúsenosti z ostatných krajín poukazujú na to, že žiaden z faktorov spôsobujúcich „bankový socializmus“ v Českej republike nemusí spôsobiť problémy, ak je pripravený dôsledne a/alebo nie je v spojení s iným zo spomínaných faktorov.

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Preface

This thesis is devoted to the development of the Czech banking sector during the transition period. Moreover, it tries to provide comparison with other post socialistic countries´ development in the region of Central and Eastern Europe – Estonia, Hungary, Poland, Slovak Republic and Slovenia. Yet many publications have been written on the topic of transition banking, however mostly monographs devoted to the single country, or surveys based on the collected data. This thesis does not aspire to be one of these surveys; hence compare the results of banking transition approaches. It tries to answer the question: "What are the reasons for these results?"

Text collected for elaboration of this thesis can be perceived as heterogeneous. Reason of diversity might be the other point of view, experience and attaching importance to the different events, which anticipated, or accompanied the process of transition. Last, but not least, the time when they were elaborated matters. In our opinion, studying banking sector disregarding the transition process as a whole may lead to the misperception of banking sector's problems. Therefore as much attention as possible was given to the circumstances characterizing this period. Transformation of the banking sector will be perceived as an indivisible part of the transition process. During the time after the collapse of the socialistic system, all agents had to handle changing environment, hence stabilisation of the macroeconomic conditions was perceived as a key issue of the early stages of transition in all economies. However, in some countries excessive emphasis on macroeconomic indices led to the neglect of other important issues. Macroeconomic indices are reflecting the microeconomic development but only to some extent.

In transition period many governments postponed reforms of the banking sector regarding them as less important than those of real economy. In other cases, reforms of the banking sector were put off purposely with a view to fund progress in the real economy since banks with proper risk management would finance only feasible projects and might be perceived by the government as too prudent. We would like to hold on teaching of Adam Smith and his "invisible hand" concept, which demonstrates that an individual maximizing his revenue maximizes also total utility of the society. Therefore being prudent in money allocation will not be perceived as a failure and setting of a hard budget constraint will be advocated.

Banking sector is affected by the development of the enterprise sector and vice versa. Thereby development of the banking sector will be investigated with a close linkage to the enterprise sector. Extension of banks´ soft approach to the enterprises is postponing the restructuring and prolonging the survival of the nonviable firms. Renewing of the nonviable firms´ credits is only worsening the situation of banks since it leads to the accumulation of nonperforming loans. Bankruptcy procedures are an inseparable part of the transition to the market economy, stemming from the Schumpeterian teaching and his "creative destruction" concept. Stress will be given on the privatization and its results, which significantly influenced enterprise sector and banks as well. Markedly creation of a hard budget constraint is of the highest importance.

The process of transition is also a process of the institutional change. Agents were exposed to the daily changes in legal framework, what sharpened the uncertainty in the region. However, functioning and effective institutional framework is not available in instant form, institutional "Xerox" is not sufficient. It is a process of learning by doing, but should not be rolled out on the side track. Some institutions survived also the socialist regime; some were produced by the socialist regime but were applicable in the environment of the market economy but great portion had to be fundamentally changed, or did not exist at all. Since banks are at the centre of the course of events, deficiencies of the institutional framework are affecting them significantly.

The regulation of the banking sector did not exist in the socialist regime, while banks were more or less bookkeepers and the regulation was not necessary. Regulation, the word itself, is an eyesore of liberals or rather libertarians. In case of banking sector strict regulation is in place. While enterprises are working with their own funds using credits only partly, banks are working with little fraction of own capital and a large portion of deposits. Depositors will receive only contracted returns, so they are interested in conservative behaviour of the bank. Shareholders will receive eventual higher profits when undertaking riskier projects, while they are not bearing full burden in the case of bankruptcy. Depositors do not know how the bank managers will behave, hence information asymmetry between depositors and bank managers exists. This asymmetry is in fact the reason why the regulation is necessary. In many countries regulators were benevolent and licensing policies were very liberal in the early stages of transition. In contrast, rising of capital requirements can enhance shareholders' interest in conservative behaviour and thus reduce the moral hazard problem.

Albeit institutional aspects of transition are sometimes omitted, most of the literature dealing with this issue takes it into account. We would like to add that transition is also a process of a political change and all trials, which are scarified, were not subject to the decisions of the economic theoreticians, who can "simply" find the optimal solution. All the resolutions were made by politicians, who had to apperceive the political cycle and respect the public opinion in contrast to the Chinese politicians who postponed changes pointing democracy. One might think of transition process inferior to political cycle as a set of suboptimal solutions. However, one of the aims of the transition was building of a democracy. Trampling the rights of society to express the public opinion by voting is in contrast with this aim.

Rent-seeking is the other aspect of the political process. For rent-seeking groups it is easier to push their intentions, which are in accordance with the public opinion albeit they are suboptimal. Privatization can be perceived as a sample; public opinion was against the sales to the foreign investors, therefore it was not very hard to push privatization of the enterprises to the domestic investors and promote voucher privatization. The same holds for the banks. If the bank managers are not interested in foreign strategic investor, but would like to have dormant partner, than voucher privatization will be preferred. The more is at stake, the more active the rent-seeking groups are. During the transition, there was a lot at stake. One might perceive the transition as a meeting of interest groups aspiring to the prize.

The third pillar of the thesis lies on the Douglas North's "path-dependency" principle, which is implicitly present along the thesis. It is obvious that socialism prior to the collapse was more rigid in the Czechoslovakia than it was in Yugoslavia, Hungary or Poland and it was at least as rigid as in USSR. Enormous role of central planning in the past is visible in the approaches of the authorities in the Czech Republic to the transition. Voucher privatization was paraphrased as a "last socialist plan". However, computerized matching of the interfirm claims and debts instead of bankruptcy procedures and "banking socialism" as a result of the voucher privatization, raise the notion that it actually was not the last socialist plan. The explanation lies in the descent of economic transition process´ designers, thus in prognostic office. Too much attention was given to the macro indices but restructuring needs of the enterprises were neglected.

Chapter 1
Introduction

1.1 Transition overview and issues to be done

After the collapse of socialist system, there was need for fundamental changes in economies but no experience with similar event. Kornai (2005) formulated six important characteristics of the transformation in Central and Eastern European (CEE) countries: The transformation followed (1) capitalist economic system and (2) democracy, (3) was parallel in all spheres: political system, legal system and in the stratification of society. (4) It was non-violent, (5) took place under peaceful circumstances and (6) with incredible speed. The CEE countries transition was unique trial according to these characteristics and had no precedent in history. Moreover, the situation was somewhat different in each country. It is not surprising that there was no guide book for these countries and therefore approaches were diverse. Notwithstanding there was a reform program called "Washington consensus" which denominated the main pillars of reforms, it hardly could give manual for the reforming governments[1]. Some of the economists thought, that transition would be a fast and painless process, privatization could be accomplished in haste. It might be illustrative to remind you on the attitudes of Jeffrey Sachs (1993): "market springs up as soon as central planning bureaucrats vacate the field." Nowadays, the more sceptical and cautious views seem to be more realistic.

According to Stiglitz (1993): "If capital is at the hearth of capitalism, then well-functioning capital markets are at the heart of a well-functioning economy." In socialist countries there was no capital market; resources had been allocated along planners' decisions. Money missed one of its main functions – allocation. According to this, we can accept Stiglitz`s (1999) view that it was wrong to think of socialistic banks as "banks" in western sense. No need for regulation and supervision of banks – "bookkeeping institutions" were at place. It is not possible to jump from central planning to the system where all trades are preceded on capital markets; there is need for financial intermediaries – banks. Neither in the USA or Great Britain the stock market is the most important market to raise funds. EBRD (1998) points that there was no choice between bank-based

[1] For further discussion see Kouba et al. (2005)

and securities-based finance, the task was to develop both. In accordance to this it was necessary to create legislative and regulatory framework for banks and markets, to institute accounting and auditing standards.

1.2 The privatization[2]

Privatization was one of the important issues of transition, which had a fundamental effect on the banking sector as well. One must take into account that privatization in the CEE countries was much different to the privatization in Western countries. Privatization in Great Britain realized by the cabinet of Margaret Thatcher involved tens of enterprises, while in the Czechoslovakia there were 4 864 of state owned enterprises (SOE) to be privatized. But not only quantity matters, it is not the same task to privatize in functioning market economy with adequate and well established institutions, where public sectors achieves 11 %, as it was in the case of Great Britain, compared to 97 % in the Czechoslovakia.[3] There were many scenarios how to privatize SOEs – restitutions, transfer to the municipalities, sale via public tender to the domestic or foreign investor, sale via initial public offer (IPO), distribution of SOE's shares to inhabitants via voucher privatization, etc. In Czechoslovakia the privatization was heterogeneous process – it was a combination of all methods mentioned above.[4]

Restitution covered assets of the total value of 200 billion CSK, transfer to the municipalities 350 billion CSK of the total amount of 1 780 billion CSK. Till the end of 1993 there were 30 billion of property sold in public auctions according to Small Privatization Act. As Mertlík (1995) pointed, disqualification of foreign capital from auctions was inefficient, while foreigners hired local people to fulfil their intentions. Nevertheless, great deal of properties was sold to local entrepreneurs without capital. Banks were forced to borrow them, which resulted in bad loans problem.[5]

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[2] Data used comes from Kouba et al. (2005).

[3] For detail discussion see Kouba et al.(2005).

[4] There were two teams of specialists with different recommendations about privatization approach. Team entrusted by František Vlasák (team included Messrs. Kouba, Fogel, Hanzelka, Mlčoch, Šulc and Turek) suggested to transform all SOEs to joints stock companies with 100% share of state and to be privatized by standard methods according to individual privatization projects. Large SOEs should have been restructured before being privatized. Nevertheless, team around Minister of Finance Mr. Klaus (team included Messrs. Ježek, Tříska) pushed their model. Enlarged in Mlčoch et al., 2000. Bös (1996) and Wijnberger (1998) reveal pitfalls of such approach.

[5] This will be discussed later on.

Large privatization involved the rest of assets, which meant 1 200 billion CSK. SOEs with the book value of 30 billion CSK were liquidated. It was resolved to keep another SOEs with the book value of 300 billion CSK in entirely state ownership. These enterprises were marked as strategic, or had a monopoly position on the market. 81 billion of assets were sold using conventional methods such as public auctions, competition of tenders and direct sale. SOEs of total book value of 754 billion CSK were transformed into the joint stock companies and were intended to be sold via voucher privatization in two waves or using other method. In the first wave of voucher privatization assets of 374 billion CSK were transferred, in the second wave it was 200-250 billion CSK, and for 150-200 billion CSK of property other methods were chosen.[6]

The voucher privatization was the core method of privatization according to the book value. The philosophy of voucher privatization was to make privatization as fast as possible. The market was expected to solve the situation onward.[7] Authors of the privatization project were correct when they thought that 1 780 billion CSK of property could hardly have been sold to foreign investors but they used scarcely any of the opportunities to sell SOEs to foreign institutional investor as it was in the case of Hungary. Also ongoing privatization projects were abolished to promote the voucher privatization. According to Dlouhý (2007), some privatization projects were abolished not because of the ideological reasons to promote voucher privatization, but because of objective reasons. For example 3 foreign subjects were interested in Poldi Kladno, but their offers were absurd. Low offers of foreign investors can be explained by the uncertainty, which stems from the lag of transparent legal rules, enforceable by a competent judiciary (EBRD, 1998). Ježek (2008) refers to the change of privatization policies after June 1992 elections because of political unwillingness of Klaus´ government to sell enterprises and banks to the foreign investors.

It is strange that the overhang of supply over demand in case of promoting conventional privatization was expected but complications in „real“ privatization, when the ownership would be dispersed and the overhang would remain, were not foreseen. Weak legal framework, weak regulation of the IPFs[8] and capital market enabled looting of many funds (Ježek, 2006). Coasean theorem says that incipient ownership structure is

[6] The values are different in the literature, even Kouba et al. (2005) use only this estimates.

[7] It might be illustrative to remind you on words of Ježek: „There are 10 % of assets to be privatized or to decide about it, but basically 90 % is done. It truly holds that we are in post privatization period (Tříska et al., 1994). “

[8] Kouba et al. (2005) refer to the ex post regulation of IPFs and adjustment of the regulation to the interests of the strongest players on the market.

irrelevant for allocation of resources if ownership rights are freely transferable and transaction costs are zero. Coasean theorem was misused in this case. Mlčoch (2005) argued correctly when focused on the low enforcement, ineffective bankruptcy procedure and transaction costs which were much higher than zero.

The other aspect of the voucher privatization was to distribute shares of SOEs to inhabitants and it was expected that 1000 CSK value of coupon book would be much lower than value of shares, which would be beneficial for inhabitants. Shares could be invested either directly or in Investment Privatization Funds (IPFs). IPFs were entitled to own at best 20 % of a company shares and to invest at best 10 % of capital in a single company (IPFs with common owner were limited to own 40 % of a company, later reduced to 20 %)[9]. Commercial banks had played a remarkable role in establishing of the IPFs, either directly or indirectly via daughter's investment companies.

The outcome of the privatization in the Czech Republic was: (1) dispersed[10] and non-transparent ownership, (2) weak corporate governance[11], (3) undercapitalised companies and (4) sizeable direct or indirect state ownership across whole economy. Berglof (1997) refers that "very weak or non-existing legal protection for shareholders leaves managers in control, unless a strategic investor can be found with a big enough stake to force his interests upon the manager." Kočenda and Lízal (2003) confirmed hypothesis, that dispersed ownership was more risky in light of bankruptcy and concluded that SOEs privatized by voucher privatization were not and basically could not have been sufficiently or permanently restructured. Weiss and Nikitin (1998) examined performance of the Czech companies and stated that concentration of the ownership in hands of other subjects than IPFs had fundamental and positive effect on the performance. This might be explained by Nellis (1999), who claims that IPFs did not treat aggressively with nonperforming companies. If the banks, as IPFs owners, had suspended further financing, they would have been forced to write off loans to these companies.[12] The outcome is clear – soft budget constraint. EBRD (1998) think of unclear ownership structures resulting from privatization as a reason for slow process of industrial restructuring.

[9] In contrast, in Slovenia IPFs were not limited and could own 100 % of a company, only rarely limited to 20 % (Simoneti et al., 1999).

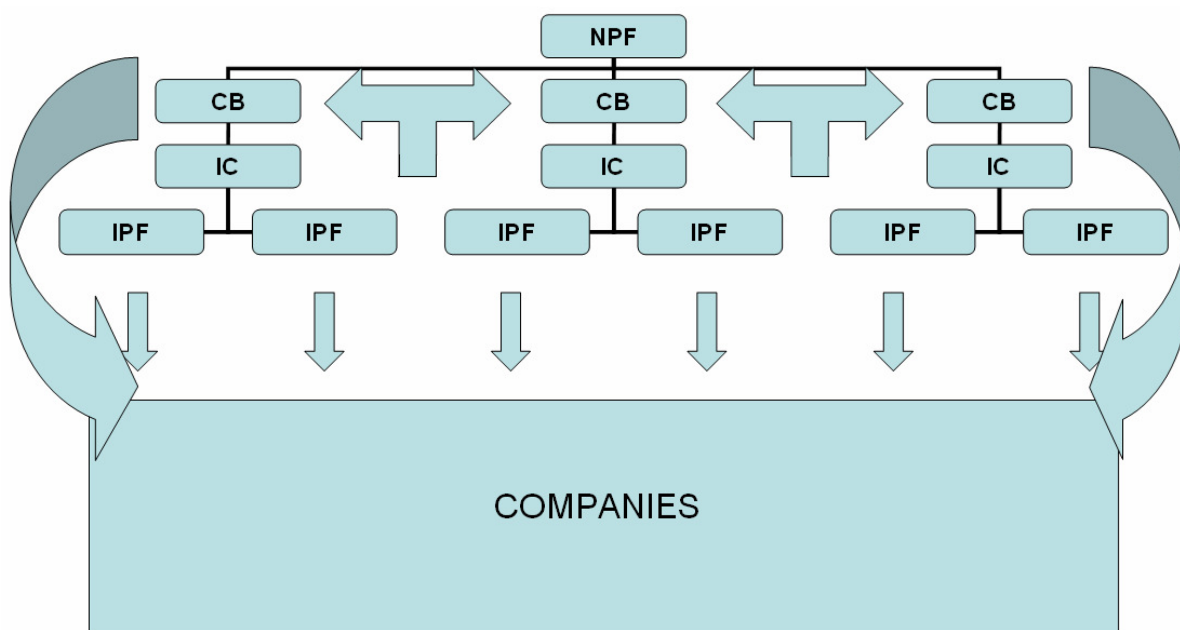
[10] Laštovička et al. (2004) show that the ownership was not as much dispersed as it had been expected and claimed. In 727 out of 919 firms privatized in the first wave of voucher privatization four largest funds obtained effective voting majority. See annex 1.

[11] Stiglitz (1999) found the reason in weak managerial interest (0.4 % of company value), because of limitation of 20% stake and 2% of asset value as discouraging factor.

[12] See Hanousek and Roland (2001) for detail discussion of bank passivity.

Mertlík (1995) concluded that: “privatized in the Czech Republic means just transformed from unshared public ownership into shared public ownership.” In fact, the National Property Fund (NPF) was major or significant shareholder in commercial banks. Banks established Investment Companies, which founded IPFs. IPFs had an ownership control in companies (where in many cases state was still a significant shareholder) and commercial banks (in some cases of grandmother’s banks as well). Banks provided credits to these companies and the circle was complete (See picture 1.1). By and large, the situation can be called as “Banking socialism”[13] or by a phrase: “Socialism is death, leviathan alive“ (Buchanan, 1997).

Picture 1.1: Ownership Structure of Czech Economy



Explanation: NPF = National Property Fund, CB = Commercial Bank, IC = Investment Company, IPF = Investment Privatization Fund**.** Squared arrows represent ownership control, round arrows represent credits

Source: Mertlík (1995)

Privatization of the enterprises by means of leveraged buy-outs gave no much better outcome. In fact, the outcome was very similar to the outcome of voucher privatization. It was another type of privatization without capital**,** hence banks´

[13] Kreuzbergová (2006) defines banking socialism as a control of privatized companies by banks controlled by the government. The government thereby uses its influence to avoid mass bankruptcies and unemployment.

involvement was needed. Mejstřík (2004) refers to the prevailing short-term game incentives in such cases. Weak legal framework enabled looting to be a non-punishable activity.

Speed of voucher privatization was perceived as a major advantage. As chart 1.1 suggests, this argument is ambiguous, too, state retreat was to some extent only illusory.[14]

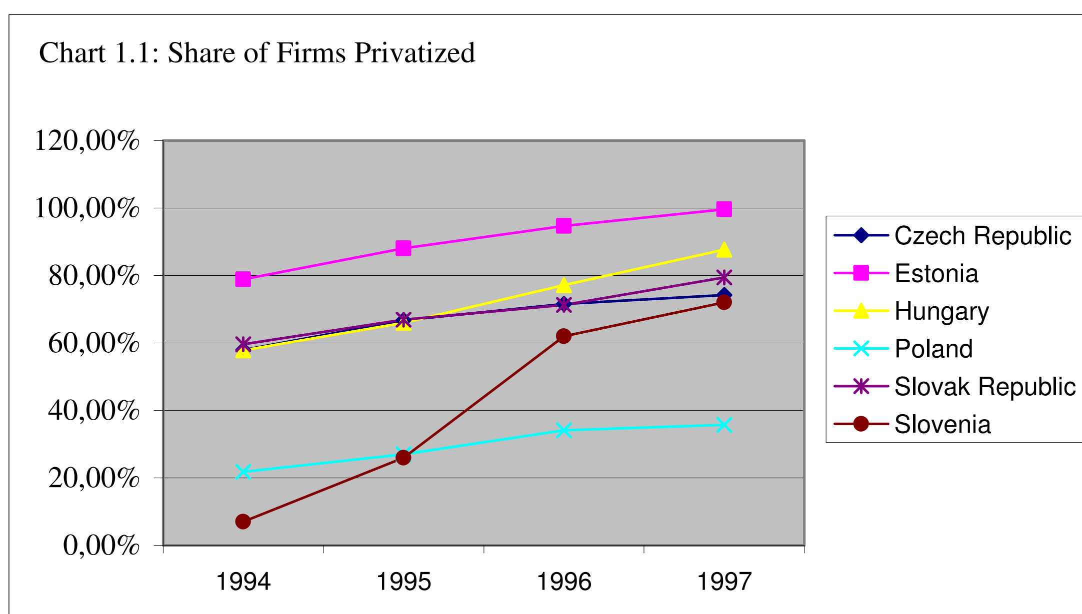


Chart 1.1: Share of Firms Privatized

Source: EBRD (1998)

1.3 Economic environment of the Czech Republic

When comparing countries in transition, we must confess that the conditions in Czechoslovakia were quite favourable. There was almost no debt, only little overhang of demand and low official inflation. On the other hand, there had been a very rigid socialism in Czechoslovakia, when comparing to Hungary or Yugoslavia. Some reform measures in Hungary took place before 1989. Reorganisation of enterprise governance begun in 1984, two-tired banking system was established already in 1987. Yugoslavian socialism never had the rigidity of the Czechoslovakian one and was permanently reformed towards the market-oriented system.

[14] Turnovec (1998) provides method how to measure the state influence in the Czech environment after voucher privatization very rigorously.

Policies advanced by the government in the early stage of transition were consistent with the "Washington consensus": deregulation, price liberalization, liberalization of the foreign trade and reform of the legal framework. Restrictive macroeconomic stabilization policies, based on the fixed exchange rate, price liberalization and deregulation were managed successfully. The outcome of the early phase of transition was drop in GDP and rise of the unemployment but inflation was early of reasonable magnitude. Another shake came with the Czechoslovakia break-up.[15]

Marcinčin (2000a) claims that there was too much attention given to the macroeconomic indices implicitly assuming perfect correlation with microeconomic development in the Slovak Republic. The same holds for the Czech Republic. As mentioned in previous subchapter, microeconomic environment was not sound and needs of SOEs restructuring were unnoticed. Phelps et al. (1993) refer that "instituting a price system through the decentralisation of resource allocation and the deregulation of enterprises and instituting private shareowning and mass privatization are necessary but far from sufficient to achieve the potential of capitalist market economy. The step that is so far missing in the privatization plans for most of the Eastern European countries is the creation of an appropriate mechanism of enterprise control." Dispersed ownership is not perceived as a problem in Anglo-Saxon model, with strong protection of the minority shareholders. In the case of transition countries, weak legal framework led to the violation of the minority shareholders´ rights in several forms.[16] Bauer et al. (2002) refer to the detrimental credits obtrusion as an instrument, how banks acquired whole profit of the companies, where majority was achieved by the daughter and granddaughter funds. Other form of acquiring the whole profit was the sale of products to the companies established by the majority shareholders for prices below those on the market.

Problem of weak creditor's protection arose after the leveraged (managerial) buyouts. Disability or unwillingness to repay the credit frequently resulted in looting. The government was unable to adopt proper bankruptcy law for a long time fearing the domino effect of bankruptcies in economy.[17] Long bankruptcy procedures and their dubious results resulted in reluctance to initiate a bankruptcy procedure, which boosted interfirm indebtedness. Průmyslový a zápočtový ústav (Industrial and Inclusive Office) was a centralized institution to solve the problems of rising interenterprise indebtedness.

[15] For further discussion see Dědek et al. (1996).
[16] See EBRD (1998), Mejstřík et al. (2004).
[17] See Knot and Vychodil (2006) for discussion of pros and cons of soft bankruptcy law.

However, 9.1 % of the collected claims and debts were not perceived as a success (Anderson and Kegels, 1998). Mlčoch (2000) refers to corporate governance as a boldest problem.[18] Stiglitz (1999) and Mlčoch et al. (2000) conclude the Czech transition as a sample of disregarding of institutional changes´ needs. EBRD (1998) refer to the slow improvement in bank privatization and regulation comparing to other transitive countries.

[18] This will be discussed in a separate subchapter.

Chapter 2
Development of the Czech banking sector

One of the important tasks for transitive countries was to establish a two-tired banking system, allow emergence of new banks, create effective legislative and regulatory framework to achieve effective and competitive banking sector and its supervision. Czechoslovakia had a disadvantageous position since Hungary and Poland established two-tired banking system prior to 1989, in Yugoslavia it existed since the reforms of 1950´s. With the development of the banking sector new tasks emerged**,** i.e. to ensure hard budget constraint to the enterprises and avoid political pressure on banks, enhance accounting and reporting standards etc. This chapter will be devoted to the development of the banking sector in the Czech Republic.

2.1 Banking regulation and supervision

During the period of socialism, there was no need for prudential regulation and supervision; banks were more or less bookkeeping institutions. In the market economy, strict regulation of the banking sector is in place. Banks are working with a little fraction of own capital and larger portion of deposits. Depositors are interested in prudent bank behaviour, while they will receive only contracted returns, therefore risk taking aimed at higher profit of banks is not on their behalf. Shareholders, contrary to depositors, are interested in profits, therefore might force management to undertake riskier projects with eventual higher profits. They are not bearing full burden in the case of bankruptcy, the depositors will bear large part of it, in terms of deposit insurance absence. Depositors do not know how the bank managers will behave, hence the information asymmetry between depositors and bank managers exist. That is the reason for prudential regulation. Green and Patrick (2002) suggest that in case of symmetric information and complete markets there is no need for regulation. In terms of the deposit insurance fund existence, depositors are losing their motivation to monitor the situation of the bank**,** hence the bank activities are monitored only by the supervisory authority. However, Stiglitz (1993) argues that monitoring of banks is public good since individuals do not have access to the relevant information and they are not competent enough.

We must distinguish regulation and supervision; regulation as a creation of the banking activity's rules and supervision as their adherence. EBRD (1998) remarks that many countries have well-developed laws and rules[19], but they face serious problems in their enforcement. It is disputable if something like proper supervision exists. Most developed countries, as for example Norway, Japan or USA, suffered from banking crises as well. Fraudulent practices were detected in the British bank Barings or most recently in the French bank Société Générale, imprudent activities were recognized in the French bank Crédit Lyonnais, etc. One might conclude that efficient supervision is not available in instant form and the requirements on supervisors are changing over time. Following the directives of the European Union or recommendations of the Basel Committee on Banking Supervision might have been perceived as a sufficient condition to create broad supervision. However, they are only necessary conditions but far from sufficient ones. Basel Committee on Banking Supervision is an institution providing knowledge of broad supervisory standards and guidelines and recommendation statements of best practice in a banking supervision. However, the recommendations formulated by the Committee are assuming developed market economy, not a transition one. Therefore obtaining a proper supervision is a learning-by-doing process and it had taken few years until satisfactory level was achieved in the Czech Republic and other CEE countries as well.

The very basics of the banking supervision can be described as follows. (1) Licensing is a tool, which enables supervision authority to limit the entrance in the banking industry. Supervisory authority reviews the adequate capital, suitable shareholders and management, their qualification and moral ability, feasible operating and financial plans. (2) Gathering and verifying of relevant information of bank activities. (3) Supervision of prudential behaviour of banks. This can be achieved by controlling of capital adequacy[20], bank liquidity, market risk, loan classification and provisioning and involvement. (4) Withdrawal of bank licence, if needed.

In many countries governments believed that liberal licensing policy would allow many banks to be created what would enhance the competition. Capital adequacy requirements were low, reviews of management's expertise, shareholders suitability and feasibility of operating and financial plans were very light, if any (Bonin, Wachtel; 2002). It was expected that competition of banks would lead in consolidation of the banking

[19] See Green and Petrick (2002) for details.
[20] In transition countries, capital adequacy ratio higher than 8 % is recommended due to the higher risk (EBRD, 1998).

sector, while more effective banks were expected to take over the less effective ones. Expectation did not prove true; Hansabank in Estonia is the only newly established bank within the CEE countries, which acquired sizeable market share. Bonin et al. (1998) point out that banking sector consisting of few big banks and many small banks is not competitive. EBRD (1998) concludes that quality of banks has higher impact on the competition than quantity. Therefore competition of fewer banks with adequate capital, experienced management, staff and proper monitoring and risk evaluating procedures is superior to the number of weak banks.

Low capital adequacy requirements are of course in contrast with the effort to reduce the moral hazard problem in banks, while increase of the capital requirements will enhance shareholders interest in the prudential behaviour. Moreover, if capital requirements are too low, problems are not detected until the bank is truly insolvent**,** hence strong incentives to “gamble on resurrection” are present (Stiglitz, 1993). Hereafter Stiglitz considers capital adequacy requirements as the most important element in banking regulation, since if they are set at sufficiently high level then other issues are less important.

In order to gather accurate information there is need for introduction of international accounting principles and for verification of the reports by external auditors. In order to achieve a proper supervision of the bank behaviour, there is need for disclosure on consolidated basis, to avoid hiding of the bank’s problems by its affiliates (EBRD, 1998). The Czech Republic introduced international accounting standards for banks as lately as 1995. Thereby Hanousek and Roland (2001) show that banks were able to hide their problems, and serious information asymmetry between supervisory authority and banks existed. What is more, they provided evidence that balance sheet information collected by Czech National Bank[21] (CNB) were not better predictor of the bank failure than the height of interest rates.

One of the biggest problems of supervision in the transition countries are understaffed supervisory bodies, with lack of skill and experience. The number of banks was in many countries larger than the capacity of supervisory authority. For illustration, in the early 1990´s supervisory bodies consisted of no more than 10 employees in many countries, while number of banks rose sharply and soon dwarfed the number of

[21] CNB was given the supervisory authority in 1993, since than Ministry of Finance was charged with the regulation and supervision of banking sector. Supervisory powers were strengthened by the amendment of the Banking Act from July 8, 1994. See Anderson and Kegels (1998) or Green and Petrick (2002) for details.

supervisory employees by several times. Bank managers found easy means how to abuse weak supervision. Bonin et al. (1998) declares that central motives of founders were advantageous financing of other activities, tax avoidance, spontaneous privatization and money laundering, but not the profitability of banking business.

General outcome of recent, but also older discussions is that there is need to make the supervisory authority independent on the government. If not, government can put pressure on the supervisory authority not to handle too hard with the state banks and boost the supervisory authority's forbearance. To limit unjustified forbearance and political pressure as well, it may be necessary to reduce discretion of authorities with respect to the timing of intervention and their ability to support bank in troubles (EBRD, 1998).

2.2 Bank establishment and development

State bank of Czechoslovakia (SBCS) was playing a role of central bank but acted as a commercial bank prior to 1990 as well. Česká spořitelna (formerly Česká státni spořitelna, ČS), Živnostenská banka (ŽB) and Československá obchodní banka (ČSOB) were established until 1989. On January 1, 1990 Komerční banka (KB), Všeobecná úverová banka[22] (VÚB) and Investiční banka[23] (IB) were divided from SBCS. Later in 1992 Investičná a rozvojová banka[24] (IRB) was divided from IB. ČS, IB, KB and ČSOB have played a major role in the Czech banking sector. Their problem laid in old loans, which were a heritage of socialist planning system where allocation was not in compliance with the market principles. These loans were not performing in many cases and banks were not responsible (and did not feel responsible) for them and government was expected to solve them[25].

Acts No. 158/1989 Coll. on Banks and Savings Banks and No. 130/1989 Coll. on the SBCS came into force on January 1, 1990. Licensing policy was very liberal; 50 million CSK (1.8 million USD in terms of 1990 exchange rate, which was far below EU standards 5 million ECU), of capital was required to establish a new bank. Similar conditions applied also for banks with foreign capital (Mejstřík, 2004). The number of banks was rising rapidly, as table 2.1 suggests. Small banks had very little to lose in this

[22] Všobecná úverová banka operated in the Slovak republic.
[23] Since 1993 Investiční a poštová banka (IPB) after the merger with Post Bank.
[24] Investičná a rozvojová banka operated in Slovak republic, the division was because of preparing the break-up of Czechoslovakia.
[25] This will be discussed in a separate subchapter.

time, new banking license was easily available and capital requirements were low. Undercapitalized banks were not risk averse. When undergoing risky projects whole profit will flow to the shareholders, but in the case of bankruptcy, creditors will bear their portion (Jonáš, 1998; EBRD, 1998). Not surprisingly the problems of small banks emerged early.

Table 2.1: Number of banks operating in the Czech Republic

Year	1989	1990	1991	1992	1993	1994
Number of Banks	5	9	24	37	52	55

Source: Mejstřík, 2004

In 1992 SBCS raised capital requirements for establishing a bank to 300 million CSK (10 million USD in terms of 1992 exchange rate), and since October 7, 1993 it was 500 million CSK (17 million USD in terms of October 7, 1993 exchange rate). Indeed the number of banks was rising rapidly, but their market share was still low, see table 2.2.

Table 2.2 Market share of banks operating in the Czech Republic in %

Subject	1990e	1991	1992	1993	1994	1995
KB	33.8	23.2	24.6	23.6	22.9	23.3
ČS	20.6	22.5	24.8	26.1	24.6	21.1
IPB	9.6	8.9	9.5	9.8	10.3	11.3
ČSOB	33.6	28.9	17.8	9.9	11.1	11.6
KoB	0.0	10.3	9.3	8.4	7.6	7.1
AGB	0.4	2.1	3.3	4.9	4.3	3.9
ŽB	1.9	1.7	1.7	1.8	1.9	1.8
Foreign banks	0.0	0.8	2.4	3.9	5.4	8.2
Small banks	0.1	1.5	6.2	11.0	10.9	10.4
Co-operative banks	0.0	0.0	0.0	0.2	0.6	0.9

Source: Chmelík, 1997

The process of privatization involved privatization of major Czech banks as well and was heterogeneous, as usual. Privatization methods involved voucher privatization, foreign direct investment, domestic direct investment and the rest was shifted to the

National property fund (NPF) and Restitution investment fund (RIF). Methods chosen for banks are in detail in table 2.3.

Table 2.3 Privatization plans for major Czech banks[26] in % of share capital

Bank	Voucher privatization	Foreign direct investment	Domestic direct investment	NPF	Other
ČS	37	0	20	40	3
IB	52	0	0	45	3
KB	53	0	0	44	3
ŽB	45	52	0	0	3
ČSOB	0	0	0	0	100

Source: Mejstřík, 2004

ŽB was the only bank with the majority stake in hands of foreign investors. Foreign investors were not allowed to enter major Czech banks: ČS, IB, KB and ČSOB**,** hence they were privatized during the voucher privatization. According to Dlouhý (2007) banks were offered in voucher privatization to attract more citizens and to increase the expected value of their investment. On the contrary, according to Ježek (2008) "federal minister of finance was hostile to privatization of banks in favour of foreign investors who were expected to be much more restrictive in granting credits[27] and cause therefore bankruptcies and rise of unemployment". Hereafter Ježek refers to the good relationship between IB management and federal minister of finance[28] and the pressure of IB to be privatized in the voucher privatization. One might conclude that voucher privatization was favourable for the government, since it was more popular than privatization of the "family silver" to the foreign investors and allowed it to pursue its intention. It was favourable for the managements of banks as well since they retained the power[29]. It was very likely that new owner would change the management. Further, it was favourable for rent-seeking

[26] Plans were created during the existence of Czechoslovak republic, but Slovak banks are not discussed in this part.

[27] Verity of Ježek´s claims can be confirmed by claims of then federal ministry of finance Klaus in Respekt (50/2000) where accused ŽB of being too prudent and not willing to "soil themselves with real economy".

[28] Good relationship can be found also in the KB management since Richard Salzman, general director of KB became a senator for ODS.

[29] Abuse will be discussed on the sample of IPB.

groups, since the "banking socialism" which resulted from the privatization of the banks was object of their interest and thereby source of their rents.

Banks were in the case of voucher privatization on both sides, as privatized ones, but also as the founders of IPFs. According to the law, IPFs established by the banks were not permitted to own shares of (other) banks. The prohibition was bypassed by founding granddaughter funds, which were not subject of the regulation. This led to the cross-ownership and also to the situation when the granddaughter was a big shareholder of grandmother's bank. Management of IB controlled at least 17 % of IB itself through IPFs.[30] Only ŽB did not invest in shares of (other) banks. At the same time ŽB was the only former state bank with the majority stake in the hands of foreign investor. It can be perceived as a contribution of the investor to the higher ethical standards. Situation is illustrated in table 2.4.

Table 2.4 Cross-Ownership in the Czech Banking Sector

Name of Bank group	ČS	IB	KB	ŽB
ČS	-	0,5	4,9	5
IB	8,8	17,0	10,8	10,4
KB	3,9	-	3,4	-
ŽB	-	-	-	-
ČSOB	0,2	1,1	0,3	0,6
Total of 5 groups	12,9	18,6	19,4	16

Source: Mejstřík, 2004

2.3 Obstacles of effective credit policy

Allocation of credits was decided by the central planners prior to 1989. Moreover, when state banks are providing loans to the state enterprises, providing loan is nothing more than accounting. Thereby credit risk management did not exist. State Savings Banks[31], where the only institutions where citizens were able to deposit their funds. All

[30] Bauer et al. (2002) refer to 20% through PIAS and 6,9% through PSIAS.
[31] One in each of the republics.

other banks had no experience with retail. It is not surprising that banks´ staff was not trained to work in the environment of market economy and situation did not improve overnight. Bauer et al. (2002) actually speculate that it was less time-consuming to build up quality retail network on the green field than to change stance of personnel accustomed to socialist banking. The only chance for banks was to train the personnel to get used not only to western standards, but also to be able to work in unsteady setting of a transitive country.

Banking industry is very sensitive to the changes in whole economy. Banking sector as a whole will probably gain when the economy is doing well. During the recession, banks are affected**,** too, when bearing the bad loans problem. In addition**,** during recessions banks suffer more than they can gain in phases of growth. In the period of growth there is rise of deposits and inflow of foreign capital. In effort to retain their market position banks are providing more loans and therefore they must undergo higher risk (Jonáš, 1998). This is in fact the infancy of a new crisis.

In general, when banks are providing loans to the clients, they are exposed to the informational asymmetry, which leads to the problem of adverse selection.[32] Asymmetry might be reduced by long term knowledge of the clients, which is common in stabilized market economies, but not in transition ones. In transitive economies it was hard to allocate loans because of absent credit history of new entrepreneurs. Even credit history of the enterprises existing prior to 1989 is not very decisive because of vague auditing and reporting standards and changes in the environment. High inflation distorted the relative prices and made the calculations more difficult. The instability of economic environment was worsened by frequent institutional changes in all transforming countries. When comparing transitional countries**,** it is important to note that relatively stabile macroeconomic situation was an advantage of Czech Republic compared to other transitive countries.

Akerlof (1970) points that in underdeveloped countries "credit is granted only where the granter has easy means of enforcing his contract or personal knowledge of the character of the borrower." In this sense we must confess that enforcement was poor due to the week legislative framework. Czech Republic contrary to the Hungary was unable to adopt and enforce proper bankruptcy law to achieve financial discipline and protect the

[32] Since best clients can raise funds on capital markets, so the worse clients apply for the credits.

creditors. Comparison of declared bankruptcies in the Czech Republic and Hungary is in Table 2.5.

Table 2.5 Declared bankruptcies in the Czech Republic and Hungary in 1992-1997

Country	1992	1993	1994	1995	1996	1997
CR	1	66	294	727	808	1251
Hungary				1616	2000	4569

Source: Turnovec et al. (1998)

Due to the existence of weak legal framework, personal knowledge was a significant factor when providing loans in many cases. KB controlled some 120 management and supervisory boards through their IPFs (Bonin et al., 1998). In the case of IPB 35 % of the loans portfolio was the "folder S", which meant decision of board of directors and was not subject to the standard credit risk management procedure (Bauer et al., 2002).

Informational asymmetry is lower in the German type of banking, where banks are both lenders and shareholders of the enterprises and thus are better informed.[33] But each coin has two sides. When the problem of asymmetric information vanishes, conflict of interests arises. Banks often allocated loans not according to the principles of prudent banking but with a view to help the enterprises in troubles.[34] View to help the enterprises in group and refreshing of old loans can change in the situation when credits to the single firm achieve critical volume. Otherwise banks would have to admit bad loans and in situation of inadequate provisions to declare bankruptcy (Mullineux and Green, 1999; Nellis, 1999). In addition, banks in the Czech Republic were undercapitalized and therefore had not enough sources to create strong groups (Kenway, 1994). Mejstřík et al. (2004) point out that close bank/firm relationship causes the lack of transparency of financial systems in the conditions of the emerging financial markets. Moreover, it has not improved the monitoring and enforcement of debt contracts due to the biased corporate governance (Mejstřík et al., 2004).

When providing loans, banks can insure themselves by demanding adequate collateral. Otherwise, problem of looting can emerge. Banks in the early stages of transition accepted collaterals with sufficient book value, but often with fractional market

[33] Therefore this model is favoured for transitive countries by Stiglitz (1993).
[34] This holds also for enterprises controlled indirectly through IPFs as stated above.

value and low liquidity as well. Introduction of International Accounting Standards (IAS) would have been useful.

Box 2.1: Enterprises and loans

After the collapse of the Council for Mutual Economic Assistance there was need for reorientation of exports to the western markets. Consumption of domestic households was low due to the restrictive wage policy. Low wages and devaluated Czech currency created pillow, which softened drastic and sudden change in the environment, for the enterprises. In the medium term horizon it was expected that the pillow would be vanishing. Massive investment in the enterprises and their restructuring was required to achieve competitiveness with foreign enterprises in the long run.

Kočenda and Lízal (2003) investigated situation of the Czech firms in the transition. They conclude that large SOEs were not suffering from the credit shortage. Calvo and Coricelli (1994) rejected the hypothesis of GDP and investment drop caused by credit crunch. On the other hand, Kočenda and Lízal (2003) in the case of small firms and cooperatives found a positive dependence between profits and investment. Hypothesis of credit shortage in smaller firms and cooperatives can not be rejected. Gomulka (1993) concluded similar findings for Poland. Rostowski (1995) goes further and claims that credits were misallocated, have not gone to the winners – rapid growing private sector and formulated a hypothesis of microeconomic unimportance of bank credit in the early stages of transition in post communistic economies. The source of growth seems to be in retained earnings.

Jonáš (1998) claims the state not to be a good bank owner. Credit policy might be biased or otherwise affected by politicians to achieve their political objectives and not to maximize bank's profit. Klaus, himself, in 1998 stated that he purposely decelerated the privatization of big banks[35] due to the forbidding sample of Živnostenská banka. Živnostenská banka was "accused" of being too prudent and not willing to "soil itself with the real economy".[36] Voucher privatization is in fact the easiest solution how to privatize

[35] See Ježek (2008) claims above.
[36] See Respekt 50/2000.

the bank but retain the influence over the bank since the ownership is dispersed.[37] Banks continued to provide loans to the enterprises in portfolio of daughters´ IPFs. They were supported by the government, as Václav Klaus says. They expected their bailout if nonperforming loans would accumulate, or assistance addressed to the enterprises, which would allow them to repay the debts.

Anderson and Kegels (1998) point out that since 1992 the rates on long-term deposits have been substantially above the rates on long-term credits what might reflect persistent credit subsidies channelled through the banking sector.[38] Bank managers are indeed responsible for shrinking under political influence, but politicians are responsible for generating the pressure on banks to fund nonperforming enterprises as well. Not only banks´ bailout, but also opportunity costs should be added to the total bill for resulting misallocation.

2.4 Differences in credit policies among banks

When discussing credit policies of banks it is necessary to notice the differences among the banks in the Czech Republic. Banks can be divided into three groups: (1) foreign banks, (2) big banks with persisting state influence and (3) newly established private domestic banks. The common outcome of literature on banking in transition is that foreign-owned banks[39] performed very well when compared to other banks because they provided loans to the best clients. Foreign firms, which entered the Czech Republic, chose generally banks from their country of origin. Hence rise of foreign investment meant rise of their opportunities. Moreover, foreign banks provided loans and other services to the best Czech firms since they had easy access to the cheap money from mothers´ banks and were able to provide the best conditions to their clients.

Nevertheless, the behaviour of all foreign banks was not identical. Foreign banks´ branches and subsidiaries followed the behaviour of the mothers´ banks. For example, Austrian banks founded IPFs, thereby were directly involved in corporate sector. ŽB, the biggest foreign owned bank[40] in the first half of 1990´s followed the German model and

[37] Case of IPB was the exception since, management of IPB was able to consolidate the shares of IPB itself.

[38] They presented similar findings for Hungary and Poland.

[39] Pioneering foreign banks with the banking license were: Citibank, Bank Austria Creditanstalt and BNP-Dresder.

[40] German BHF bank held 40% stake, another 12% stake was held by IFC.

participated on the corporate governance of its customers. On the contrary, Citibank was searching the biggest clients and providing services such underwriting bond issues, frequently on the international markets, but it was not interested in the entry to the corporate governance (Bonin et al., 1998).

The group of domestic banks with persisting state influence encompasses ČS, ČSOB, IPB and KB. Market share of these four banks did not fall below two thirds in the first half of 1990´s, as table 2.2 suggests. At the same time, these banks established very successful IPFs in terms of investment points´ attracting. Hence it follows that these banks played a significant role in the Czech transition. Dominant position with persisting state influence is often called "banking socialism". As mentioned above, state put pressure on the banks to finance enterprises to avoid bankruptcies and high unemployment. Nollen et al. (2005) refer that Czech officials could not put pressure on the ČSOB to make risky loans fearing international cause with the Slovak Republic since Slovak National Bank held considerable share in ČSOB. Further, ČSOB's top managers were sufficiently educated in banking and had enough of experience. The bank avoided the creditor-owner conflict of interest and provisioned the bad loans properly. Albeit performance of ČSOB did not look much better than other banks´ performance due to disclosure of bad loans to full extend, when privatization took place and proper audits were elaborated, it was clear that ČSOB outperformed other banks by far.

Behaviour of the IPB was in contrast with the ČSOB's behaviour. IPB was very active participant of the voucher privatization, its funds PIAS gained control not only of enterprises but of whole industrial branches. Bauer et al. (2002) describes the industrial empire to be based not only on the capital participation but on the credit, personal and capital linkage.[41] Indeed, IPB was the most successful bank in building retail network and rise of deposits, but it was not the objective of the management, it was only a tool of gaining money necessary for the industrial empire. The objective was the consolidation of industrial branches[42], which were fragmented after the collapse of socialism. However, the empire was not transparent; shares of enterprises changed their owners regularly, ending up outside the IPB. Bank provided loans for all operations and thus has been the source of rent-seeking of the management and persons connected to management at the expense of shareholders. Moreover, "folder S" was subject to the managers´ decisions, hence it was

[41] Bauer et al. (2002) mention also attempts of management's firm PIF – Podnikatelský investiční fond to buy PIAS using the money of PIAS itself and other activities of bank's management, which are not the subject of the thesis but rather examining office.

[42] PIAS gained significant influence in beer, glass and food industry.

not subject to the standard risk management procedure. "Folder S" made the difference between IPB and other banks since the rest of credit portfolio was comparable to the portfolios of KB or ČS (Bauer et al., 2002; Turnovec et al., 1998). One might conclude that bank management was actually not interested in banking business; shareholders with the state as the largest shareholder resigned on the exercise of corporate governance and ČNB unable to carry out the supervision enabled management to behave without effective restraint. Taxpayers footed the bill for the government assistance amounting to 198 billion CZK (Nollen et al., 2005).

Big (former) state banks had a competitive advantage vis-à-vis new emergent banks due to the access to cheaper and long-term primary deposits (Anderson et al., 1996). Small banks were therefore forced to use interbank market or to attract clients with higher interest rate on their deposits. While deposits were more costly, they were forced to offer loans with higher interest rate, too. Foreign banks had the best clients. Big (former) state banks provided loans to the rest of borrowers. The quality of borrowers was the lowest in case of emergent banks, which can be perceived as a lender of last resort. As the result of the adverse selection, they naturally suffered more with the bad loans problem. While capital requirements were low, entrepreneurs found establishing of a bank as an easy way to raise funds. They could get larger bank's loan than was the amount needed for establishing of the bank. This was an attractive option for the companies, which could not obtain loans (or at least not as favourable) for their projects on the market, because of their high risk (Jonáš, 1998).

2.5 Corporate Governance

One of the important transition issues is how to create mechanisms of the enterprise control. Phelps et al. (1993) present two strategies. The first strategy is an instant creation of owners with a faith in subsequent evolution of suitable mechanisms of enterprise control. The other one is creation of such mechanisms from the very beginning of the privatization process. Mlčoch (2000) refers that state resigned on exercise of corporate governance in the pre privatization agony, later disposed of corporate governance by voucher privatization. Dispersed ownership, as a result of voucher privatization is usual in Anglo-Saxon model, where shareholders "vote" by exit. Exit voting is effective only in the case, when markets are liquid. Management cannot be put

under pressure when shareholders are dispersed and no exit is possible due to the markets´ illiquidity. Phelps et al. (1993) recall that in situation when all shareholders are too small to monitor and analyse managers, each shareholder acts as a free rider. Moreover, weak protection of minority shareholders´ affected exercise of corporate governance in a negative way. Managerial buy-out did not resolve the situation since banks in the role of creditors did not monitor the enterprises closely. Mejstřík (2004) points out that consolidation of corporate governance was precluded by short-term game incentives prevailed in domestic environment. La Porta et al. (1999) refers to concentrated ownership as a standard mechanism of exerting corporate control, which does not rely as much on the legal framework. It is consistent with arguments of Berle and Means that concentrated ownership is positively correlated with company's performance (Berle and Means, 1932).

The problem of corporate governance affected banks twice. Table 2.3 suggests that in major Czech banks, NPF was by far the largest shareholder in ČS, IB and KB; other shares were distributed by voucher privatization and therefore dispersed. Czech stock market was illiquid when compared to the stock markets of developed market economies; therefore exit voting was not efficient. In the "third wave" of privatization consolidation of shares proceeded. As Table 2.4 suggests**,** in particular IB was very active in consolidation of banks´ shares. Cross-ownership of banks can only hardly be perceived as a step forward in enhancing corporate governance. One might conclude the need for the core investor in each enterprise and bank as well. EBRD (1998) regards core investor as the best guarantor of monitoring of managers in transition economies, which can be documented on the case of Bank Handlowy privatization. According to Bonin et al. (1998) this holds also for minority stake in hands of foreign institutional investor or EBRD.

Phelps et al. (1993) were afraid that privatization, which was not enhancing the enterprise control, would not be good enough to promote enterprises´ restructuring. Fears were adequate, as was discussed in part 1.2.[43] Weak corporate governance of debtors, which were unable to restructure the enterprises, resulted in bad loans. Therefore weak corporate governance can be perceived as one of the major factors causing problems of banks in the Czech Republic.

[43] See Kočenda and Lízal (2003), Nellis (1999), EBRD (1998)

2.6 Theory of bank consolidation and the evidence from the Czech Republic

Banks, established by division of monobank's commercial activities, inherited loans allocated on the principles inconsistent with market principles. Moreover, the environment had changed and great portion of these loans was not performing. However, the portion of nonperforming and bad loans was too big to be sorted out by the banks themselves and therefore some assistance of government was necessary. Solving the problems by the banks themselves would have been painless process, potentially resulting in collapse of several banks, and costs for the real economy would have been high. Discussion whether to bail out or not is a never ending story, because in economy there is nothing like lunch for free. Resolution not to help banks in problems might lead to the bankruptcy of bank(s), and subsequent run on other banks, which is more serious problem for transitive country than for well established market economy. The confidence in banking sector is low, therefore bankruptcy of one bank might be considered as a system failure. This might lead in further reduction of badly needed trust in banking sector and to the overall lower level of bank intermediation.

On the other hand, there were also doubts that state assistance would potentially lead to irresponsible behaviour of banks in the future. It is always very important to give signal to the bank managers that the event is non-recurring and it is not a precedent for the future (Rostowski, 1995). Bailout should not create an expectation of tomorrow's bailout. To avoid undesirable consequences, it is suitable to change the management and to secure that ingoing management will be independent of the government (Bonin et al., 1998). Privatization of the banks after cleaning up of their portfolio is welcome (Fries, Lane, 1994). In contrast, Aghion et al. (1998) point out that if there exist an information asymmetry between management and regulator and management can hide the extent of losses or delay bank insolvency, than ex ante rules of management dismissal might be counterproductive. In this case management will not force bankruptcy procedure of defaulters and will continue to provide credits. Enterprises´ soft budget constraint, which existed prior to 1989, will be extended. Existence of information asymmetry and ability of managers to hide the problems of banks were observable in the case of the Czech Republic and other CEE countries as well due to weak accounting and auditing standards.[44] In this

[44] See Hanousek and Roland (2001) for details.

case Aghtion et al. (1998) and EBRD (1998) prefer recapitalisation programs, which create incentives to reveal bad loans problems of the banks in a full extent.

The method of bailout matters, too. Aghtion et al. (1998) referring to the financial crises in Norway, Mexico and Japan suggest that capital injections are prompt, but they are not solving the essential problem, which are bad loans. Rosati (1994) cautions that resolving accumulated bad debts problem is not sufficient; it is necessary to prevent the re-emergence of bad loans in the future. There are two possibilities how to achieve this objective. The one is enhancing banks´ credit policy, hence banks´ privatization is recommended. The other is to solve the bad state of enterprise sector seeing that problem of bad loans is implicitly the problem of enterprises´ bad state. Not surprisingly, EBRD (1998) prefers decentralised approach in transition countries, which is superior to the creation of specialised agency, which is favoured in well established market economies. Decentralised approach, whose aim are not only the bad loans solutions, but also enterprise sector restructuring, can be perceived as superior for transition countries with respect to the prevention of the bad loans´ re-emergence. Voljc (1994) suggests privatization of enterprises after such restructuring and sorting out of old loans. On the contrary, Kreuzbergová (2006) refers to advantages of the centralised approach, which enables collecting claims of big enterprises from banks and solving the situation onwards, as for example in the case of Škoda Holding. Decentralised approach with claims among more banks would have been much harder.

Evidence from the Czech Republic

The government founded Consolidation programme I, whose aim was to deal with the pre 1989 heritage of bad debts. In this case the problem of moral hazard was relatively low, because loans were provided under the conditions of central planning and the then managers were not liable for them. This programme was thus designated for KB, IB, ČS and ČSOB. In order to achieve these objectives Konsolidační banka (KoB) was established. Non-performing assets were transferred to KoB[45], loss loans were written off and banks were recapitalized. Programme proceeded during the years 1991-1994 and its costs achieved roughly 110 billion CSK.[46]

[45] Further settlement of the bad loans in KoB portfolio is described by Kreuzbergová (2006).
[46] See Mejstřík et al. (2004) for details.

At the same time voucher privatization was launched and 37 % of ČS, 52 % of IB and 53 % of KB was offered, too. Also 3 % of each of these three banks was transferred to the RIF[47]. State retained only minority stakes in each of the banks: 40 % in CS, 45 % in IB and 44 % in KB. As stated above, it was recommended to change the ownership structure after the bailout, so voucher privatization might be perceived as fulfilment of the advices. Because of dispersed ownership and cross-ownership the state had de facto majority in all three banks. In fact, managers strengthened their position. Through IPFs they controlled relevant shares of other banks and also of themselves.[48] Strong position of bank managers and their unwillingness to find strategic investor can be documented by the words of Richard Salzman, KB director: "We are not interested in having a massive partner. Three years ago it might have been a good idea, but now, if we need advice, we can buy it" (Wall street journal, September 18, 1995).

As stated above, it is not sufficient to sort out accumulated bad debts; it is necessary to prevent the re-emergence of the same problems in the future. In the light of these advices we must admit that not much was done in the Czech Republic; neither banks' credit policy was enhanced nor were enterprises restructured.

Problems of small banks appeared as soon as 1993. These problems stemmed from the post 1989 period and therefore they are more serious. The reasons were diverse. In some cases it was inexperience and inexpertness of banks´ staff and managers, worsened by the unstable environment and premature institutional framework.[49] Moreover, they suffered from the deficiency of primary deposits and were dependent on the interbank market. On the other hand, not infrequently management performed beyond the line of legality. Kreditní a průmyslová banka had 90 % of nonperforming loans and criminal activities of the director were investigated (Mervart, 1998; Chmelík, 1997). Situation in Banka Bohemia[50], AB Banka and Česká Banka was not much better. The reaction of the Czech national bank (CNB) to the problems of these banks was suspension of new licenses, program of consolidation of the banking sector, according to act No. 21/1993 Coll. and issue of rules of prudent banking behaviour (Mervart, 1998).

The Consolidation programme II, which proceeded in 1994-1995, had been created to sort out the problems of small to medium banks. The moral hazard problem arising from the Consolidation programme II was more serious than it had been in the case of

[47] RIF was administrated by PIAS – investment fund founded by IB.
[48] See Table 2.4.
[49] Bankruptcy procedure was ache of Czech Republic for a long time.
[50] Banka Bohemia was investigated in connection with illegal business in foreign exchange.

previous consolidation programme. Not only the title suggests, that bail out might be perceived as recurring, but also the fact that loans were provided as a will of bank managers in market economy and not as a will of central planners. Market share of all small banks together was small when comparing to KB, ČS and comparable to that of IB or ČSOB. The aim of Consolidation Programme II was to re-establish the confidence of the banking sector after the problems of Kreditní a průmyslová banka, Banka Bohemia, AB Banka and Česká Banka. External audits of all banks were elaborated and banks with the capital adequacy ratios lower than 8 % according to the BIS standards had to achieve this target by December 31, 1996. Not all banks were able or willing to achieve this target and went bankrupt or were liquidated.[51] Other banks were sold to new investors.[52] Shareholders of Banka Haná, Moravia Banka and Universal Banka were willing to increase capital and were therefore eligible to undergo the consolidation programme.

Deposit Insurance Fund was founded in 1994. Its aim was to boost the trust of depositors in the banking sector and avoid run on banks. On the other hand, Deposit Insurance Fund is deepening the moral hazard problem in the banking sector, since depositors are loosing intentions to monitor the situation of banks. All parties should be penalized for the non-prudential behaviour. Non-anonymous depositors were insured only up to 80 % of their deposits and 100 000 CZK, which might be perceived as a sufficient punishment for non-prudence.

Total costs of the Consolidation programme II were 103.5 billion CZK. It is surely quite a high bill for the consolidation of one tenth of the market. Reasons were as follows. CNB guaranteed the pay-outs of bankrupted banks not only up to 100 000 CZK, but up to 4 million CZK, which satisfied 99 % of depositors.[53] One might only speculate if CNB guaranteed higher pay-outs as the rules guaranteed to strengthen the trust of depositors in the banking sector thereby help the banks to improve their liquidity by the new deposits and boost credit expansion.[54] Solving the problems of Agrobanka with roughly 4% market share was costly, too. Other aspect is time of intervention of CNB. According to EBRD (1998)**,** prompt intervention requires accurate financial reporting by banks and system of "alarm bells" that can draw the regulator's attention to a bank in distress. Solving the problems of bank with 90 % of nonperforming loans is simply too late.

[51] It was the case of AB Banka, Banka Bohemia, Česká Banka, COOP Banka, Kreditní a Průmyslová Banka, Kreditní Banka Plzeň, První Slezská Banka, Realitbanka and Velkomoravská Banka.

[52] This was the case of Bankovní Dum Skala, Ekoagorbanka and Evrobanka, which were sold to Union Banka, and Podnikatelská Banka, which was sold to J&T Finance Group.

[53] CNB guaranteed 4 million in all cases expect of Česká Banka.

[54] Since the government was forcing banks to finance the transition, as was already mentioned.

2.7 Final solution – the privatization

Unfortunately, problems of banks did not end with the second consolidation program. Credit policies of banks described in subchapter 2.3 and the depression in 1997 led to further accumulation of non-performing loans in banks´ portfolios. The solution was seen in the privatization of the major banks enabled by the resolution No. 732 adopted by the government on November 19, 1997. The objectives of the resolution were as follows: capital strengthening of the banks, improvement of the banks´ economic performance and management[55], extension of the range of products and services, strengthening of international business activities, reduction of the risk of bank destabilization, preparation of the banks for the liberalized European market and strengthening of the international competitive ability of the banks and completion of the formative stage of ownership relation (Dlouhý, 2004).

Since their portfolios were not very attractive, the government could not expect high revenues. It was possible that no interest in privatization would occur or it would attract only doubtful investors aimed at rent-seeking since all banks were perceived as too big to fail.[56] Therefore bank recovery programs were created to promote the privatization. The approach was similar as it had been in the previous consolidation programs**,** i.e. using the KoB. ČSOB was the healthiest bank and it was the easiest to privatize. Hence it is not surprising that it was the first to be privatized in June 1999. The revenue achieved 1,084 billion CZK for the 65.7% stake. Privatization of CS (in March 2000) and KB (in June 2001) were less easy. Dlouhý (2004) describes the privatization of the KB and refers to many unexpected obstacles, which emerged only during the privatization**,** such a BCL affair. Revenues for 52.1% stake in CS achieved 530 million CZK and 60% stake in KB was sold for 1,184 billion CSK. Dlouhý (2007) mentions that achieved price in privatization process reflected trust in the market to a large extent. Banking and financial institutions from the USA and United Kingdom were not interested in the privatization of KB since they did not trust the Czech market.

The case of IPB was somehow strange from the very beginning. IPB was the most successful bank in retail, but the practices of IPB and firms allied with IPB were at least

[55] The fact that government itself resolved to improve the performance and management can be perceived as a confession of a weak performance and poor management of the banks and unwillingness to improve the situation until the recession in 1997 occur.

[56] The case of IPB can be perceived as a fulfilment of doubts. See Box 2.2.

strange.[57] State owned the largest stake by far (45 %) but was unable (or unwilling) to execute its rights, hence management and allied firms controlled the bank.[58] The situation of the bank started to deteriorate in 1996. IPB tried to emit Global Depository Receipts (GDR) through Nomura and prolonged the hiding of the problems to the spring 1998 by the means of the auditor's exchange (Bauer et al., 2002). When Nomura showed the interest to enter the bank, the government was left with Nomura as the only potential buyer, since Nomura advanced in accordance with shareholders controlled or allied with management (Turnovec et al., 1998). For the government it was perceived as cheap solution since Nomura did not demand any state assistance. However, Bauer et al. (2002) speculate that the entry of Nomura was financed by means of a loan provided by the IPB itself, alike the previous machinations of IPB management. Moreover, they refer that Nomura was in fact not interested in the acquisition of IPB but in acquisition of České pivo by the means of IPB acquisition (Bauer et al., 2002).

Bonin et al. (1998) refer that if the bank is too big to fail, the government does not retreat efficiently from the bank. When the problems of IPB in 2000 emerged, it was obvious that the government would not let the bank go bankrupt. In June 2000 the government entered in the decadent bank and resolved to sell it to the ČSOB. Expected net gains or losses of banks are in Table 2.6.

Table 2.6 Expected net gain or loss including guarantees (in billion of CZK)

Bank	ČS	ČSOB	IPB	KB
Expected net gain or loss including guarantees	-48 to – 40	+10 to +37	- >100	-13 to +7

Source: Nollen et al. (2005)

[57] See Bauer et al. (2002) for the disclosure of such activities.

[58] Bauer et al. (2002) point out that management controlled 20 % directly via PIAS, onether (another?) 6,9 % via PSIAS. Since 7 % was dispersed, management achieved a blocking minority already in 1993.

Chapter 3

Comparison of the development of the Czech banks and the banks of other Central and Eastern European countries

Previous two chapters provided a transition overview of the Czech Republic and perspective of the development of the Czech banking sector. It was concluded that the approach had been "overprotective" since political pressure had been created to ensure the soft budget constraint for enterprises for a long time due to the postponement of bankruptcy procedures, reluctance of banks to initiate bankruptcy procedures and refreshing of the old loans in contrast to the prudential principles. Debt Insurance Fund was set to 80 % and 100 000 CZK, but the reality was that, in all cases except for the Česká Banka case, ČNB resolved to compensate creditors up to 4 million CZK.

Czech Republic was not the only country in the transition**,** hence comparison of the Slovak Republic, Slovenia, Poland, Hungary and Estonia to the "overprotective" Czech approach will be provided in this part. Initial conditions were not the same in all countries. We will show that Slovenia, Hungary and also Poland started the reforms from central planning towards market oriented economies prior to 1989. However, the starting points were not very distant. We will discuss initial conditions, macroeconomic stabilization, privatization methods and its impact on the corporate governance. Hereafter, licensing policies, bank establishment, credit policy, bank performance and consolidation of the banking sectors will be described.

3.1 Slovak Republic: facing the same problems, finding the same solution

Since Czechoslovakia existed until 1993, initial conditions in the Slovak Republic were similar to those of the Czech Republic and also the economic policies were common in this period. Macroeconomic stabilisation was successful albeit slightly less favourable. Privatization proceeded until 1993 under the same conditions but contrary to the Czech Republic, the second wave of voucher privatization was obsolete. The government resolved to privatize the enterprises to the domestic entrepreneurs or to be privatized by managerial buyouts. Privatization was criticised by EBRD (1998) for controversy and lack

of transparency. Marcinčin (2000b) describes the most visible and controversial ones. Banks controlled by the government were forced to provide loans. Weak corporate governance in the Slovak Republic in enterprise and banking sector are described by Marcinčin (2000c) and Jánošíková (2003). Insufficient bankruptcy legislative and resulting slow bankruptcy proceedings complicated the situation of creditors. Marcinčin (2000a) claims that too much attention was given to the macroeconomic indices implicitly assuming perfect correlation with microeconomic development in the Slovak Republic.

Banks can be divided into 3 groups: (1) big state banks, (2) small and medium banks with foreign owners and (3) small and medium banks with domestic owners.

Big state banks were gradually loosing their market position, in 1993 controlled 88 % of deposits and 66 % of balance sheets; in 1999 it was only 52 % and 46 % respectively. Political pressure to finance the privatization projects resulted in increasing proportion of classified loans. Due to the weak bankruptcy legislative and political pressure on banks to avoid rise of unemployment, banks did not initiate bankruptcy procedures. Instead they were refreshing nonperforming loans, as it was in the case of the Czech Republic. Criminal activities such as looting of privatized enterprises and corruption behaviour of state banks´ staff were investigated, unfortunately most of the cases without sufficient result.

Moreover, situation of the banks deteriorated after May 1997, when the Slovak National Bank (NBS) reduced liquidity to support Slovak currency against speculations on the currency market. In December 1997 Investičná a Rozvojová Banka (IRB)[59] collapsed with losses accounting for 100 million USD (EBRD, 1998). At least 40% stake in IRB was held by VSŽ and daughter firms of VSŽ.[60] Management of VSŽ was not hiding the intension to use IRB for risky operations.[61] Capital adequacy of three major Slovak banks was roughly 4.4 %, far below required rate of 8 % (Stavárek, 2005). NBS remained inactive. After 1998**,** new government was forced to recapitalize banks and immediately resolved to sell them to foreign institutional investors. Costs of recapitalization achieved 132 billion SKK, or 20 % of Slovak GDP (Stavárek, 2005).

Performance of a group of six small and medium banks with domestic owners was not much better. Development of these banks was similar to the development in the Czech

[59] IRB was the third largest bank in the country.
[60] To obtain more than 15% stake in bank, approval of NBS was needed. However, NBS disagreed, VSŽ held 14,64% stake, ARDS held another 13,46 % and approximately 15 % was held in the hands of companies, which acted in proxy with VSŽ, but their stake was below 5 % so they did not have any duty to report it to the authorities. (Marcinčin, 2000b).
[61] Mesa 10 (1997)

Republic counterparts; these banks were suffering from lack of experience and primary deposits. Group of small and medium banks with foreign investors was doing well at the same time. All banks started operating on the green field, but with foreign technologies and know-how. Their behaviour was very prudential from the beginning. Weighted capital adequacy ratio of these banks was 15.6 % in 1999; net profit in 1998 achieved 3.5 billion SKK (Barto and Kmeť, 2000). Performance of these banks shows that also in a substandard environment banks independent of government can behave prudential and achieve profits.

When comparing Czech and Slovak Republics, we can find many similarities stemming from mutual development until the break-up of Czechoslovakia. We can see the similarities in behaviour of agents in economy and misusing of the weak institutional framework. Reasons for the similarity can be found in the message of Douglas North**,** hence in the path-dependency principle. In both countries there were banks performing very well but the performance of major banks was very poor. Well performing banks were foreign owned and were beyond the political pressure. The exception of the ČSOB shows that not only foreign investor can achieve good performance, but also state-owned bank can perform when political pressure is avoided.

3.2 Slovenia: the same approach with crucial differences

Initial conditions in Slovenia, the succession Yugoslavian country, were somewhat different to those of the Czech Republic. The impact of Yugoslavian break-up on Slovenia was much stronger than the impact of Czechoslovakia break-up. The loss of the market with 23 million inhabitants was worsened by the war**,** hence the market almost disappeared overnight. Stabilization program based on the currency reform and floating exchange rate allowed inflation to emerge.[62] High inflation persisted in the beginning of 1990´s and did not fall under 10 % until 1996. On the other hand, Yugoslavian socialism had never had the rigidity of the Czechoslovakian one since the whole existence of Yugoslavia was in fact a set of reforming programmes towards the market economy after some troubles occurred.[63] Socialism in Yugoslavia can be described as a self-management system, what can be perceived as an advantage in transition, when compared to the managerial inexperience resulting from Czechoslovakian socialism.

[62] See Mencinger (2004) for detail description of the Slovenian gradualist transition approach
[63] See Mencinger (2004) among others

Similarly to the Czech Republic, Slovenian government was reluctant to the bankruptcy procedures fearing rapid growth of unemployment. Moratorium on the bankruptcy of companies was introduced in July 1991 and pre-bankruptcy programme was introduced (Bojnec, 1995). Zizmond (1993) refers to 1295 companies with 15 % of total employment in the economy, which should have gone bankrupt if the moratorium had not existed. Slovenia, analogous to the Czech Republic, was not very open to the foreign investors[64], hence privatization by means of managerial buy-outs[65] and vouchers was launched. Simoneti et al. (1999) mention major differences between Czech Republic and Slovenia in the framework of the voucher privatization. First, the entry of IPFs was well regulated[66] contrary to the spontaneous establishment of funds in the Czech Republic. Second, IPFs were not limited and were permitted to hold up to 100% share in an enterprise, since IPFs were expected to restructure the enterprises in their portfolios.

Two-tired banking system was established by the first Yugoslavian reforms already in 1950. During socialism banks were owned by self-managed enterprises and were perceived as cheap creditors for the owners. It is therefore obvious that problems of founding enterprise would have markedly affected the banks since their portfolios were less diversified. In addition, after the dissolution of Yugoslavia, Slovenian banks were burdened by the irrecoverable debts allocated in the rest of the former Yugoslavia. However, Yugoslavia suffered from the hyperinflation at the end of 1990´s, thereby not only savings of citizens but also credits were erased. Initial situation of banks was therefore better in Slovenia than in the Czech Republic. Licensing policy was quite liberal; 7 million DEM was set as a minimal capital requirement, but from the beginning Bank of Slovenia (BoS) declared that the requirement would be gradually increased.

Problems of banks emerged when BoS imposed restrictive monetary policy aimed at fighting inflation. Banks raised the interest rates rapidly and enterprises found themselves in troubles (Simoneti et al., 2004). Voljć (1994) points out that bank rehabilitation in transition economies, in Slovenia in particular, cannot be viewed in isolation from restructuring and privatization of the enterprise sector. Centralized approach was chosen for solving of bad debts problem and bank restructuring; Bank

[64] Bojnec (1995) refers to the pilot programme of small number of companies´ privatization on the case-by-case basis with the help of international consultants. However, parliamentary and governmental controversies accompanied this programme and parliament rejected this approach in spring 1991.

[65] Bojanec (1995) points out that weak legal framework enabled insiders to misuse their informational advantage and led to the spontaneous privatization also before passing of privatization programme.

[66] Most of the funds were established by banks.

Rehabilitation Agency (BRA) and Development Fund[67] were established. Procedure after BoS placed bank under the rehabilitation status is described by Štiblar and Voljć (2004) as follows: write off of current losses, swap of bad assets for BRA or state bonds, transfer of bad assets to the BRA and engagement of the BRA as temporary owner.[68]

Reaction of the authorities to the problem of banks was prompt (i.e. in 1993 and 1994 when the bad assets share of the banks achieved 10 percent), hence the crisis was avoided and the rehabilitation of banks was completed in 1997. The rehabilitation programme was aimed not only at the recapitalization with a view to achieve capital adequacy. Achieving positive cash flow, reducing interest rates, regaining credibility in international financial markets and introduction of the basic principles of prudential behaviour were the objectives, too (Štiblar and Voljć, 2004).

Slovenian experience shows that prompt reaction of the supervisory authority can reduce the costs of the rehabilitation of the banks. Total expenditures for recapitalisation of the banks achieved 1.9 billion DM, thereby less then 10 % of GDP (Štiblar and Voljć, 2004). Enhanced banking practices along with the restructuring of enterprise sector created basic prerequisites for avoiding the re-emergence of the bank problems. Albeit privatization of major Slovenian banks started after 2001 with the privatization of Nova Ljubljanska Banka, performance of the Slovenian banks was satisfactory (Štiblar and Voljć, 2004).

3.3 Poland: decentralized approach

Macroeconomic conditions in Poland were not as favourable as in the Czech Republic. Poland suffered from hyperinflation in 1990; furthermore, inflation fell under 20 % in 1996 and under 10 % in 1999. However, hyperinflation erased debts of enterprises, hence initial conditions of banking sector were better. Privatization in Poland was a heterogeneous process involving both conventional methods[69] and voucher privatization. The privatization approach was much different to the Czech approach. In

[67] Development Fund was established to restructure unprofitable enterprises and enhance the corporate governance. The programme was quite succesful, however, short-term mandate was gradualy prolonged. See Simoneti et al. (2004) for details.

[68] However, also other interventions were necessary and executed in the framework of the rehabilitation programme, as for example creation of Nova Ljubljanska Banka and Nova Kreditna Banka Maribor. See Štiblar and Voljć (2004) for the more detailed description.

[69] Initial public offers were used in Poland to a larger extent than in other countries thanks to the well regulated capital market.

Poland, only 15 IPFs were established, international firms with good reputation and conjunction with Polish banks managed the firms. Thereby managers were well motivated, independent supervisory boards were established. Poland followed US standards in capital market regulation and introduced a very tight regulation of the capital market from the very beginning. Simoneti et al. (1999) refers that good corporate governance of the IPFs affects corporate governance of the enterprises in the IPFs´ portfolios in a positive way.

In Poland, four specialised bank institution and three other banks existed prior to 1989. Reform of banking sector begun in 1989, when the two-tired banking system was established, commercial activities of NBP (Polish national bank) were transferred to nine newly established banks and PBI (investment bank). In terms of high inflation and unstable relative prices credit allocation is hindered, therefore Mortimer (1995) still sees foreign banks as not performing much better than domestic banks. After the inflation had decreased, the credit allocation was easier. Therefore Bonin et al. (1998) already mention that even minority stake[70] in hands of foreign institutional investor or EBRD had a positive and fundamental impact on the practices of banks.

The Law on Financial Restructuring of Enterprises and Banks promoted in Poland was an attempt to solve problems of banks and enterprises at once. Bad loans of banks and debts of enterprises unable to repay them are only two sides of the same coin and should be resolved simultaneously (Rosati, 1994). The process was decentralised on the case-by-case basis, banks themselves had to resolve how the bad loans would be worked out. No special agency was established to purchase the bad loans, state executed only supervision. Debts of viable enterprises were rescheduled or partly cancelled. In the case of unviable firms, bankruptcy or liquidation procedures were initiated. The less attractive option for banks was a debt-equity swap. Rosati (1994) points out that commercial banks should be initiative in bad loans solution because they are much better informed and prepared to evaluate financial viability of their clients than a state agency. Both Rostowski (1995) and Bonin et al. (1998) refer to Poland's solution of bad debts problem as the best seeing that it did not create any expectations of further bailout. Total costs until the end of 1998 achieved 9.9 % of GDP (Wagner and Iakova, 2001).

The government's objective was to privatize two banks each year. Bank managers in Poland were motivated to find strategic investors, therefore were conservative in credit

[70] Minority stake in case of dispersed ownership after IPO can achieve de facto a majority at the general meeting.

allocation and invested also in the T-bills.[71] However, privatization of all banks has not been accomplished by now; PKO Bank's largest shareholder is State Treasury with 51.49 %. When we compare the Polish and Czech developments, one might conclude that macroeconomic instability and high inflation, which is hindering credit allocation, did not affect Poland so badly. Proper execution of corporate governance in banks and enterprises, tight regulation of the capital market and careful restructuring outweighed the macroeconomic stability and total costs for banks consolidation were lower. Polish approach also shows that performance of the bank managers improves with good incentives to prudential behaviour and finding of foreign investor is not the only solution.

3.4 Hungary: finding foreign institutional investors

When comparing Hungarian transition approach to the Czech one, we can find five major differences. First, liberalization and stabilization of prices were not very successful since high inflation persisted for the whole period of 1990´s. Second, the reorganization of the enterprise governance by means of self-management system begun already in 1984, when Law on Enterprise Council was adopted (Phelps et al., 1993). Third, Hungary was much more opened to the foreign investors than Czech Republic**,** hence attracted much more foreign capital. Fourth, Hungary adopted very radical bankruptcy legislative[72], aimed at introduction of financial discipline and protection of creditors. Fifth, tight regulation of capital market, similar to Poland, was introduced. One might imply better corporate governance when summarizing last four points.

Reforms towards two-tired banking system started in 1985; in 1987 the reform was completed. Three commercial banks adopted commercial activities of monobank. Thereby five banks were operating as soon as 1989. Hungarian supervisory authorities imposed significant obstacles to universal banking by the issue of prudential rules (Anderson and Kegels, 1998). Hungary was opened to the foreign banks, which played inconsiderable role in the establishing of new banks from the beginning. Citibank Budapest was established already in 1986. The presence of foreign capital and know-how allowed stability of the banking sector despite not very favourable macroeconomic conditions. The

[71] Part of T-bonds in portfolio emanates from restructuring because government provided bonds with 15 years maturity as a compensation for the restructuring programme.

[72] Enacted on January 1, 1992. New bankruptcy law substituted the older one from the 1986. However, government feared bankruptcies of large enterprises and created a consolidation programme for enterprises marked as "of national interest" (Anderson and Kegels, 1998).

government did not hesitate to privatize major state owned banks and launched the first privatization in 1994. Albeit foreign strategic investors were preferred, minority shares were sold on the capital market in all privatizations. In case of OTP, domestic investors retained majority. The less successful privatization was that of Postbank; government was forced to renationalize and reprivatize it in 2003.

Prior to the privatization, there was a need to sort out problems of bad loans in the state owned banks. This seems to be a pitfall of the consolidation of the Hungarian banking sector. Instead of one consolidation of each bank prior to privatization, there was repeated recapitalization of banks in the period of 1992-1995, which created an expectation of further bailout.[73] All in all**,** Hungarian strict bankruptcy procedure levelled at enterprise sector was in contrast to soft procedures in banking sector. In Hungary, bad loans were exchanged for the government bonds with 20-year maturity. This restricted liquidity of the banks, which might be perceived as a reason of the loan deficiency in SME sector (EBRD, 1998). Anderson and Kegels (1998) refer to the crowding out of the enterprise sector by the government because of the rapidly increasing amount of loans to the government. Consolidation of Hungarian banking sector[74] was completed earlier than in other countries in transition with total costs achieving 13 % of GDP, but if we deduct costs of Postbank, it is only 4,8 % (Stavárek, 2005).

The common finding from the Hungary and the Czech Republic is that form of privatization matters. One might reckon dispersed ownership lacking transparency in Postbank similar to the IPB**,** hence conclude that transparency and effective corporate governance in the banks are of high priority when privatization takes place. Finding of an institutional investor for state-owned banks is fast, albeit not the only possibility, as was shown in Poland, how to consolidate banking sector and retreat from it. This effect outweighed the possible effects of moral hazard stemming from repeated recapitalization.

3.5 Estonia: counterpart to the Czech approach

The Estonian transition effort can be considered as an opposite to the Czech one. Privatization, which took place between 1993 and 1997, took a form of individual tenders for 471 enterprises. Aspiration of privatization process was to find effective owners, who

[73] See Anderson and Kegels (1998) or Stavárek (2005) for details.
[74] When we do not take into acount the Postbank, see Stavárek (2005) for details.

would promote restructuring and enhance corporate governance. Privatization process was designated as German Treuhand. EBRD (1998) assess this process as successful.

Similarly to Poland, Estonia is a country which suffered from hyperinflation in the beginning of 1990´s. Contrary to Central European countries, Estonia is characteristic with very tight regulatory policy towards the banks. Until the banking crisis in November 1992, BOE (Estonian central bank) had been weak in enforcing of rules. Estonian banks were expecting bailout from BOE but it did not come. BOE declared moratorium on the three largest commercial banks: Tartu Commercial Bank, Union Baltic Bank and North Estonian Joint-Stock Bank.[75] Managements of all these banks in problems were changed and it was declared that no bailout would be provided.[76] Tartu Commercial Bank was liquidated after the non-existence of credit analyses, weak bookkeeping, fictitious bank capital and deviations from prudential behaviour had been stated (Hansson, 1995). Claims of (part of)[77] depositors were satisfied from the auction of bank's assets.[78] Union Baltic Bank was bought by government and merged to the North Estonian Joint-Stock Bank.

A vital knowledge stemming from this approach is that no run on other banks was recognized in Estonia. What is more**,** BOE deflected the treat of moral hazard in Estonian banking sector and obtained reputation. Prudential bank behaviour can be documented by holding of the foreign T-bills in bank portfolios. Increasing capital adequacy requirement to 10 % and lending restrictions led to mergers, which might be perceived as a positive signal of the consolidation of the banking sector. However, later development in Estonia reveals also possible criminal activities in Houipank and Eesti Maapank (EBRD, 1998).

[75] BOE had a 100 % stake in North Estonian Joint-Stock Bank. In this case BOE was on both sides – as owner and regulator but regulatory policy was superior in this case.

[76] Situation in Estonia was very difficult at this time and bailout would have had extra inflationary pressures, so the government was forced not to bailout. See Hansson (1995) for more details.

[77] Claims were satisfied on the principle of their seniority.

[78] Only deposits at Savings Banks were fully guaranteed.

Chapter 4
Conclusion

What we have learned from the development of the Czech banking sector is that troubles of banks are not caused by a single factor but they are result of the calamitous mixture of the factors labelled as a "banking socialism". In Chapter 3 we described the development of other CEE counties and we can see that none of the main factors**,** i.e. voucher privatization, postponing of the banks privatizations, postponing of the bankruptcy procedures etc. caused so huge costs of banking sector's recovery. We have also provided a comparison of the approaches of the CEE countries and the Czech Republic to the banking sector. Transition of each country was a unique process stemming from different initial conditions, hence the terms for the banks were different, too. However, the difference was not too wide to preclude the comparison. Little differences are also between Czech and Slovak Republic which executed common policies during the existence of Czechoslovakia but after the dissolution the policies started to differ. However, conditions in Slovakia were closest to the Czech Republic as the leveraged buy-outs which substituted the second wave of the voucher privatization were perceived as a privatization method without capital. We state common institutional problems and abuses of the legal framework and persisting state influence over banks in both countries hence "banking socialism" was present also in the Slovak Republic. As the result rehabilitation programmes of the banking sectors of both countries fall in the category of the most expensive ones. "Banking socialism" can be perceived as an acknowledgement of the Douglas North's "path-dependency" principle under the conditions of the Czech and Slovak transition.

We have stated that method of privatization had a fundamental impact on the performance of the enterprises and thereby also on the banking sector. We fully agree with La Porta et al. (1999) who refer to concentrated ownership as a standard mechanism for exerting corporate control, which does not rely as much on the legal framework. Conventional sales to the strategic investors are indeed recommended in light of this claim and also taking into account the experience from the transition countries. Estonia and Hungary can be perceived as bright examples. EBRD (1998) shows that Estonian and Hungarian approaches regarded as gradual were faster than the radical Czech one (see Chart 1.1). Experience of Slovenia and Poland, who managed voucher privatization

reasonably, suggests that this privatization method should not be perceived as a disaster, when prepared properly. However, the prerequisites necessary for reasonable management of the voucher privatization exceeded the framework of the Czech voucher privatization by far. There is a need for regulation of the IPFs´ entry and their activities, to avoid the entry of dubious entities, fraudulent practices labelled as "tunnelling" and other abuses observed in the Czech Republic. Clear institutional framework, which will enable the IPFs to exercise corporate governance and restructure enterprises in their portfolios, is necessary as well. Tight regulation of the capital markets was important issue in further consolidation of ownership in both countries. Moreover, the governments of Poland and Slovenia executed the corporate governance in the banks and streamlined them to the prudential behaviour what was in contrast with the Czech Republic.

It was stated that restructuring of the enterprise sector was the essence of successful transition and that bad loans of banks and poor performance of enterprises were only two sides of the same coin. To achieve success in transition, there is a need for a feasible bankruptcy legislative, which will lead to the exit of unfeasible firms from the market and as by-products it will introduce the financial discipline and will protect the creditors. Prolonging the existence of unfeasible firms increased the costs of transition. Hungary was the only country which introduced a very radical bankruptcy legislative and did not hesitate to bring it into effect hence the total bill for bank rehabilitation would have been the lowest if the privatization of the Postbank had not gone wrong. In Poland, Slovenia and partly in Hungary the policymakers recognized the need to solve the problems of the enterprise sector along with the problems of the banks. Therefore, rehabilitation programmes of banks along with the restructuring programmes of the enterprise sectors allowed both countries to solve the problem of banks and enterprises once and for all. Not surprisingly, the bills for the banks´ recoveries were much more optimistic in these countries than in the Czech and Slovak Republic.

Moreover, proper execution of corporate governance in banks allowed profitability of the banks in state ownership and consequently the need for privatization was not acute hence the banks could have been sold when suitable offer had been at place. On the contrary, privatization of the banks, when prepared properly, almost immediately enhanced the corporate governance, introduced the prudential behaviour and had a positive effect in the spreading of the buyer's know-how. In the cases of Hungarian Postbank or Czech IPB bank, the privatization projects were not prepared properly hence the anticipated final solution of these two banks did not come into being. With respect to

the experience of the ŽB privatization there is some evidence that the German bank owners followed the practices of the mother's bank, hence the German model, and thereby aspired to the improvement of the enterprise sector corporate governance. With respect to the findings we can only accept the EBRD (1998) recommendations for finding an institutional investor and the assignment of Bonin et al. (1998) referring to the significant role of the institutional investor despite holding the minority stake.

Estonian approach to the consolidation of the banking sector was not described in the thesis accidentally. The approach of the Estonian central bank toward the banks was very radical as it resolved not to bail-out the troubled banks but resolved to liquidate them. Claims of depositors were satisfied only by means of auctions of the bank's assets. On the contrary, central banks of other five countries described in this thesis feared runs on banks and reduction of the trust in banking sector. There is no evidence of such events in Estonia. What is more**,** Estonian central bank deflected the treat of moral hazard in the banking sector, obtained reputation and banks introduced prudential principles fearing liquidation.

Czech approach to the development of the banking sector enriched the world with the term of "banking socialism". It was in fact the result of the privatization without capital**,** i.e. by means of voucher privatization and leveraged buy-outs with the persisting state influence over the banks aimed at financing the transition process. It was hard to imagine that after four decades of central planning and soft budget constraint the state would suddenly impose hard budget constraint and threat of bankruptcy on all enterprises, but permanent hardening was expected. Mass privatization was perceived as a quick solution how to impose hard budget constraint on the enterprises since the government would lose its responsibility for these enterprises. The scheme of mass privatization and the results of it, described in Chapter 1.2 did not fulfil these expectations. In fact government feared domino effect of bankruptcy procedures regardless of owner.

The outcome was far from the proclaimed liberalism and liberal rhetoric, which claimed 90 % to be completed. In fact, privatized enterprises were financed by the state owned banks, with minimum or no own capital. Banks were also privatized but the government retained the influence over the banks due to the dispersed ownership. On the attitude of Mr. Klaus towards the privatized and "too prudent" ŽB we have showed that the state as the largest shareholder did not aspire to implement prudent behaviour in the state-owned banks and did not exercise the corporate governance efficiently. The position of the CNB was very difficult as it was responsible for regulation and enforcing of

prudential behaviour of banks in the situation when the state did not aspire to implement it. Situation of the banks was worsened by the weak legal framework, which favoured the debtors on the expense of the creditors. However, on the cases of IPB and ČSOB we have shown that under the same legal framework banks performed diametrically differently. What made the difference was the ability of the government to put pressure on the banks and willingness to streamline the prudent behaviour in banks since in the case of ČSOB the government feared the international controversy with Slovak Republic due to the minority stake of NBS in the bank.

Thereby state retreat was only illusory, central planning office was only relocated to the banks and credit allocation became a part of economic policy of the government. Burden of the socialism was not solved but only shifted to the banks. Final bill was paid by the taxpayers before the privatization took place.

Annexes

Annex 1: Adjusted relative power of investors in companies privatized in first wave of voucher privatization

Investors	50%	40%	30%	20%	10%
Single Investment fund	146	231	442	737	895
Two Largest Funds-cumulative	473	644	782	974	916
Three Largest Funds-cumulative	669	760	847	892	918
Four Largest Funds-cumulative	727	790	860	897	918
Five Largest Funds-cumulative	754	809	867	900	918
Six Largest Funds-cumulative	761	817	869	902	918
Seven Largest Funds-cumulative	768	821	872	903	919

Source: Laštovička et al. (1995) in Mejstřík et al. (2004)

Annex 2: Largest privatization funds´ financial groups in 2 waves of voucher privatization (% of total points in the first and second wave)

Investment company within Financial Group	Second wave	First wave
1. A-invest	8.2	1.8
2. Expandia, Chemapol	7.8	-
3. Harvard CC	7.5	0.5
4. OB Invest, CSOB	**5.1**	**0.8**
5. KIS, Česká Pojišťovna	4.8	5.5
6. IS entrepreneurs	4.0	-
7. YSE	4.0	1.2
8. Czech Coupon	3.9	0.6
9. PPF	3.3	1.9
10. SIS, Česká Spořitelna	**3.2**	**15.6**
11. IKS, Komerční Banka	**3.2**	**7.6**
12. MorCe IS	2.9	-
13. PIAS, Investiční a Poštová Banka	**2.5**	**11.9**
14. CS Funds	2.4	0.8
Top 14 Funds´ Financial Groups	60.1	77.6

Source: Mejstřík et al. (2004)

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Interviews

1. Vladimír Dlouhý (1989-1997 Minister of industry and trade in Czechoslovak and Czech Governments, interview on 10.12.2007)
2. Tomáš Ježek (1990-1992 Minister of privatization in the Czechoslovak Government, interview on 1.4.2008)

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TEZE BAKALÁŘSKÉ PRÁCE

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Garant studijního programu Vám dle zákona č. 111/1998 Sb. o vysokých školách a Studijního a zkušebního řádu UK v Praze určuje následující bakalářskou práci

Předpokládaný název BP:

The Consolidation of the Czech Banking Sector with Respect to the Experience of Central and Eastern European Countries

Charakteristika tématu, současný stav poznání, případné zvláštní metody zpracování tématu:

The aspiration of the bachelor thesis is to explain the situation of the Czech banking sector in the period after 1989 and to compare selected solutions with other transition countries` experience. The introduction will be focused on transition issues, initial conditions and selected solutions in the Czech Republic. Privatization process and creation of institutional framework cannot be omitted. The second part will be devoted to the development in the banking sector in the early stage of transition. Liberal regulation and a fast-growing number of banks, resulting in early emergence of problems, and their solutions will be discussed and compared with the experience of other countries. Attention will be addressed to bank behaviour – credit policy and the influence of shareholders as well as corporate governance performance with comparison to other transition countries. Across the thesis there will be theoretical parts focused on problems of informational asymmetry, the moral hazard problem, regulation issues, etc. The conclusion will contain the final solution – privatization of the main Czech banks, and there will also be a part summarizing the knowledge resulting from the Czech way of transition.

Struktura BP:

1. Introduction
   1.1. Transition overview and issues to be done
   1.2. Privatization
   1.3. Economic environment of the Czech Republic
2. Development of the banking sector in the early stage of transition
   2.1. Banks establishment and liberal regulation
   2.2. Problems and solutions – recapitalisation of banks
3. Behavior of banks
   3.1. Corporate Governance
   3.2. Credit Policy
4. Conclusion
   4.1. Final solution – privatization
   4.2. Lessons from the Czech republic

Seznam základních pramenů a odborné literatury:

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