Banking Sector Stability Report

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FOREWORD

Since the mid-1990s the emphasis placed on financial sector stability analyses and "macro-prudential" analyses has been growing throughout the world. Financial stability can be understood as a situation where the financial sector functions efficiently and with no undesirable impacts on customers, state finances or the macroeconomic environment. A necessary condition for achieving this is stability of key financial institutions and the financial system as a whole.

The interest in financial stability analyses has been prompted, among other things, by the wave of financial crises that have hit developing economies in various regions since the 1990s. In many cases these crises have been caused by the interaction of vulnerabilities at the macroeconomic level and in the financial sector. The financial sector plays an irreplaceable role as intermediator of financial flows in the economy, and malfunctions in the sector can have serious economic consequences. These consequences can then spill back into the financial sector and cause systemic crises that often spread beyond the frontiers of nation states.

For this reason, international financial institutions – among others – have started to take a more systematic interest in financial stability analyses. A key role is being played by the FSAP missions organised jointly by the International Monetary Fund and the World Bank. The Czech Republic was involved in this project in 2000 and 2001. Domestic authorities – including central banks – are also increasingly engaging in such analyses, and many of them are currently publishing financial system stability reports. This interest stems from the role of central banks in stabilisation policy – whose success is strongly conditioned by financial stability– and in many cases also from the role of central banks as regulators of the banking system or the financial system.

Financial stability analyses do not generally set out to provide a "mere" forecast of the most likely evolution of the financial system and the economy. On the contrary, in many cases they focus on investigating remote – but nonetheless plausible – scenarios. The aim is to reveal points in the financial sector which could be vulnerable in the event of strong unforeseen shocks. Timely identification of these vulnerable points can help to contain such shocks and thereby foster greater resilience of the financial system.

The Czech National is fully aware of the importance of financial stability analyses. This awareness is demonstrated, among other things, by this *Banking Sector Stability Report*, which aims to provide a rather different angle on the banking sector than the existing *CNB Banking Supervision* reports. The *Banking Sector Stability Report* can be regarded as the first step towards reports on overall financial stability. In the years head, the CNB intends to continue in its efforts to deepen and broaden the scope of these types of analyses.

I. Conclusions

The banking sector can at present be regarded as stable. The completion of the bank privatisation process and the presence of credible strategic investors are playing a positive role. The banking sector is achieving good financial results and its capitalisation significantly exceeds the regulatory thresholds. Banks have sufficient liquidity to develop their business activities. No fundamental changes in trend in the orientation of banking business are expected for 2004. Banks' activities will be founded on a prudent approach to risk-taking, and at the same time banks will pursue profit maximisation and efficiency gains. Although the corporate sector's financial condition is steadily improving, lending is still dependent primarily on the quality of, and returns on, the projects submitted to banks. Accordingly, no major growth in lending to corporations can be expected next year either. Banks will continue in their strategy of greater exposure towards households in all product areas. In particular, continuing growth in mortgage loans is expected, given the untapped potential existing in this area. In the case of consumer credit, banks face strong competition from other financial and non-financial institutions which are not members of bank groups. Activities on the capital and foreign exchange markets will remain outside the banks' centre of attention.

A positive premise for continuation of the banking sector's current stable financial condition is the gradual recovery of the Czech economy – combined with export growth and investment activity – expected in 2004. Slightly accelerating growth, coupled with a relatively stable forecast for the household sector's income situation, should be favourable with respect to the banking sector's exposure to credit risk. The comparatively stable outlook for interest rates and the exchange rate are factors speaking in favour of no increase in the low level of market risk.

One of the risk areas impinging on the banking sector is the high growth rate of household indebtedness, despite its still relatively low volume. Continuing problems in the institutional environment – in particular low enforceability of claims and protracted bankruptcy and liquidation procedures and collateral realisation proceedings – also remain a bottleneck. Another source of uncertainty is the unsustainable trend in public finances and related issues regarding the reform of public finances. Increased property price volatility is likely in the run-up to accession to the EU, and this in turn may affect the value of mortgage loan collateral.

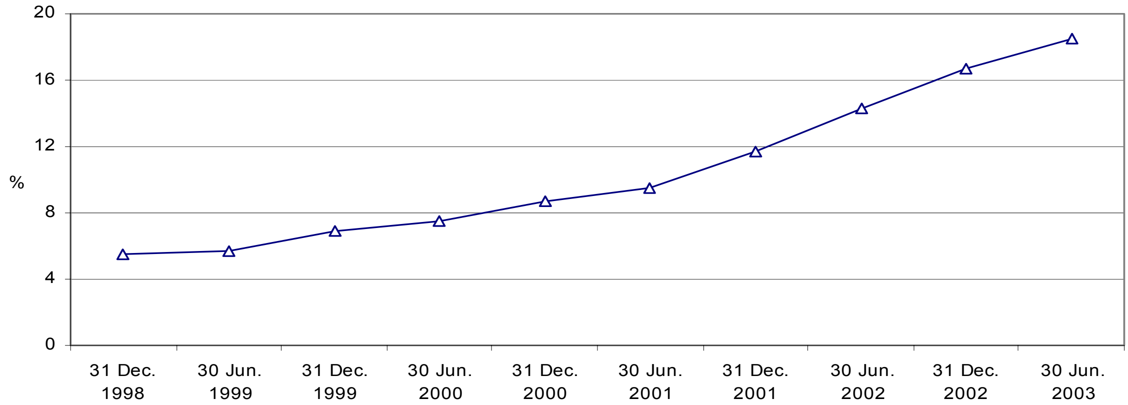
The identified risk areas may impact adversely on banks' profitability and solvency, especially if the current macroeconomic forecasts for next year do not materialise. Given the banks' current financial condition, however, the banking sector can be expected to absorb the potential negative impacts, albeit at a cost of a decrease in net earnings and/or a modest reduction in capital adequacy.

II. Situation in the Banking Sector

Traditional banking remains predominant…

The primary activity of the banking sector remains the accepting of deposits and providing of loans. Given the underdeveloped domestic capital market, banks are not focusing to any great extent on trading in securities (except for government bonds). Foreign currency transactions and transactions with non-residents are showing a long-term fall in volumes and are moreover for the most part concentrated in transactions with other banks (especially parent banks). In the framework of traditional banking, banks are diversifying their businesses and enlarging the range of banking products they offer. Amid strong competition for market share they are appealing to customers with a sophisticated range of new products and distribution channels.

Loans to households as a percentage of total loans
(for banks with licences as of the given date, including the CNB)



Source: CNB - ARAD

Loans to households are rising dynamically…

A major change has been occurring recently in the banking sector's loan portfolio structure as a result of buoyant growth in loans to households. In the middle of 2003 these were up by more than 30% on a year earlier, accounting for 18.5% of total loans. Housing loans – most of which have long maturities – account for the bulk of loans to households.

Loans to corporations are stagnating…

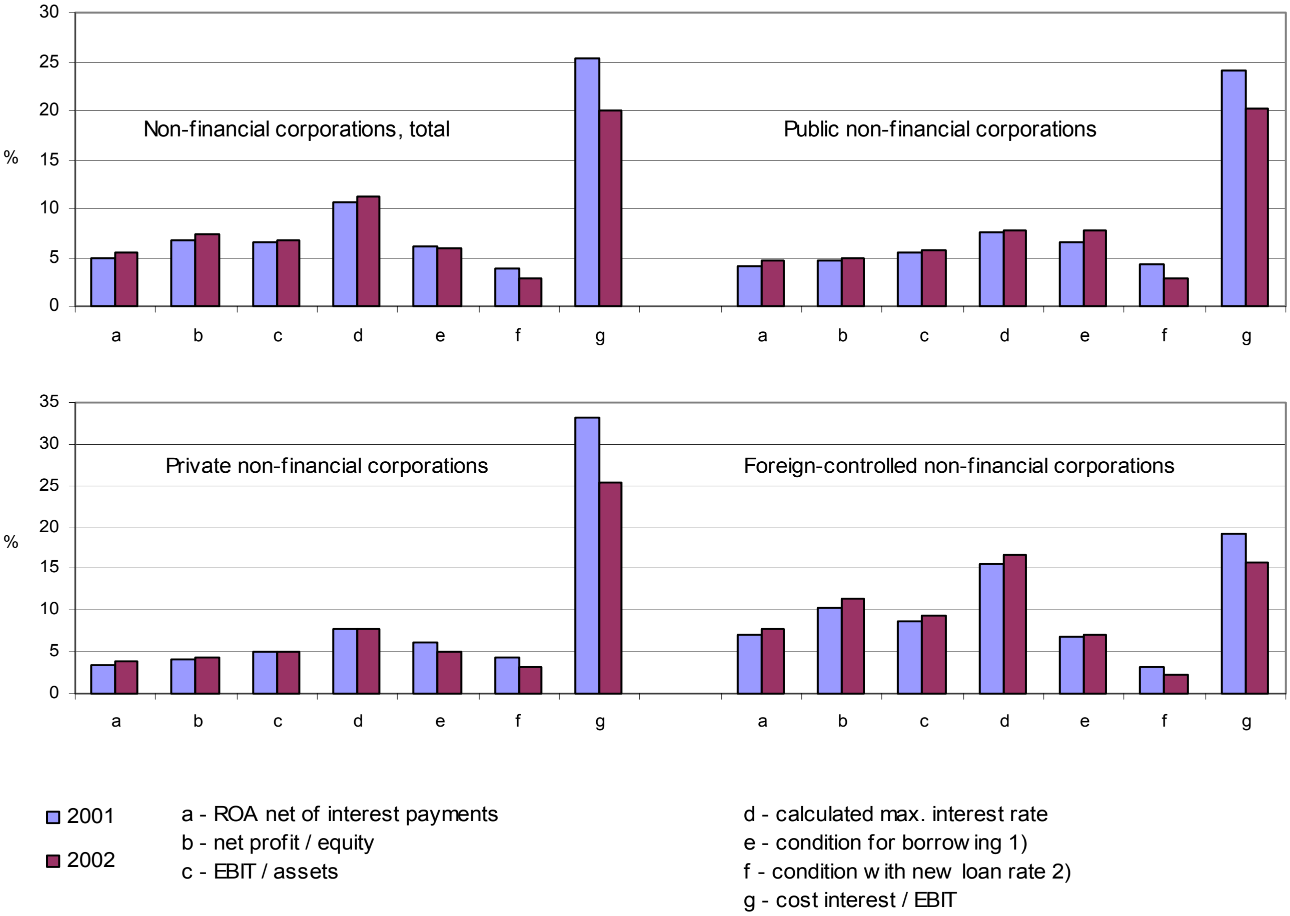
The stagnation in loans to corporations stems chiefly from the banks' cautious approach to lending, which in turn derives from their negative experiences in the past. When it comes to lending, banks prefer creditworthy corporations. They do not encounter enough high-quality business plans on the market suitable for efficient financing and they do not have enough transparent information to assess the creditworthiness of some customers. Corporations' financial condition, as characterised by profitability, indebtedness, sales opportunities and other factors important for assessing creditworthiness, is showing only patchy improvements. In the case of foreign-controlled corporations, the availability of funds from parent companies or foreign banks may also be playing a role in the limited supply of credit.

Corporations' financial indicators
(for non-financial corporations and employers with 100 employees or more)

	Pre-tax profit / assets (%)		(Liabilities - equity) / liabilities (%)		Dynamic debt coverage 1) (%)	
period	2001	2002	2001	2002	2001	2002
Total (A + B)	4,0	4,9	50,4	49,1	18,5	21,3
A. Non-financial corporations, total	4,0	4,9	50,4	49,1	18,5	21,3
- public	2,3	2,1	35,8	32,8	20,0	18,8
- private	3,7	4,8	53,3	48,6	16,3	21,4
- foreign-controlled	6,3	6,9	61,2	60,7	20,6	22,1
B. Unincorporated employers	6,7	12,1	61,4	64,3	19,6	26,9

1) (Profit after tax + depreciation)/(liabilities - equity)*100
Source: CZSO

Selected corporate indicators for lending
(for non-financial corporations with 100 employees or more)

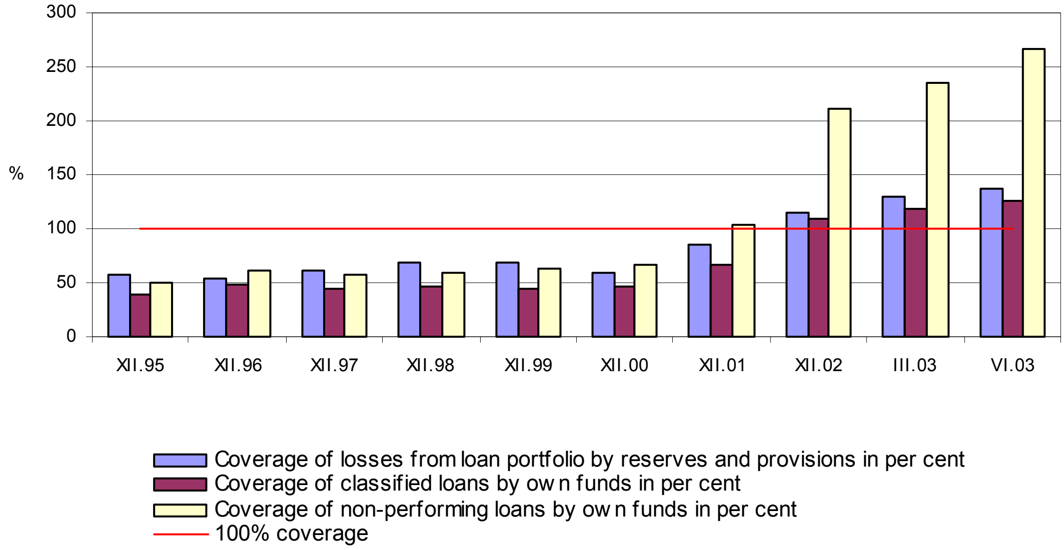


1) EBIT/Assets > (Cost interest/(bank credit+bonds)) * ((equity+bank credit+bonds)/assets), expresses the ability to pay interest and funds in the current conditions.
2) Ratio b,c > (av. interest rate on new loan) * ((equity+bank credit+bonds)/assets), expresses the potential ability to pay interest and funds in the new conditions.
Source: MIT CR, CNB - ARAD

Loan portfolio quality continues to improve…

The quality of banks' loan portfolios has improved sharply, mainly as a result of clear-outs of bad loans from the large banks prior to their privatisations. In addition, improved credit risk management in banks is having a positive effect, as is their caution in extending new loans. The significant reduction in non-performing loans as a share of the total volume of loans – to 6.3% as of 30 June 2003 – represents convergence towards the level in EU member states to a difference of 2.2 percentage points. The potential loan portfolio losses are currently fully covered by provisions and reserves.

Coverage of potential losses from loan portfolio
(for banks with licences as of 30 June 2003)



Source: CNB - BSIC

Banks have sufficient funds…

… even in a situation of roughly two years of minimal growth/stagnation in primary deposits and long-term decline in secondary funds. The stagnation of the main component of primary funds, namely clients' koruna deposits, is due to the low interest rates on such deposits in banks, households' preference for consumption, competition from alternative products (especially pension funds and various forms of life and annuity insurance) and to increased saving for post-productive age. However, these funds remain partly in the banking sector via financial groups. The generally lower creation of funds is connected with the lower rates of economic growth and lower creation of sources of money from abroad. Building societies, which thanks to state contributions offer higher returns on deposits than other banks, are recording stable deposit growth (at the expense of other koruna time deposits). The decline in secondary deposits is linked primarily with the surplus of funds: banks do not need any supplementary funding from non-resident banks. One component of the banking sector's funds that has seen growth is deposits by government institutions. This is linked to a large extent with transactions with the Czech Consolidation Agency.

The volume of quick assets remains high…

The subdued lending activity coupled with the sufficient volume of funds in recent years has given rise to an ever increasing volume of quick assets in banks' portfolios. These are concentrated chiefly in government bonds and repos with the central bank. At roughly 35% of total assets, the level of quick assets is much higher than would be necessary under normal circumstances to guarantee the banks' liquidity. One negative phenomenon in the liquidity area is the increasing proportion of koruna demand deposits in total client deposits (approximately 38% as of 30 June 2003), which is impairing both the short-term and long-term liquidity indicators. It is due mainly to the low level of interest rates and the very narrow difference between the rates of return on demand and long-term deposits.

The profitability of banking business is falling slightly…

… given the still falling interest rates, narrowing interest rate margins and modest decline in lending to the corporate sector. Owing to the banking sector's orientation, interest profit is the main component of its earnings. The decline in interest rates on the interbank market in particular is gradually reducing the interest profit on interbank transactions and transactions with the central bank, where the banks have much of their assets located. The interest profit on client transactions steadily increased in the first half of 2003 owing to dynamic growth in lending to households, which is typified by high interest rates. Profit from fees and commissions, which constitutes around a quarter of profit from banking activities, is recording an upward trend but is not proving sufficient to offset the fall in interest income from interbank transactions and lending transactions with corporate clients.

An increasing emphasis is being put on efficiency of banking business…

Over the last two years the banks have managed to reduce their operating expenses. Last year's modest decrease is gathering pace this year, thanks chiefly to restructuring in the large banks. The continuing growth in productivity and the efficiency gains achieved have yet to reach their limits, so this trend can be expected to continue in the years ahead.

The sector's net profitability has risen…

The banking sector has been in the black for three consecutive years now. The rise in net profit is due mainly to improved loan portfolio quality. Banks are now able to set aside a smaller amount of provisions and reserves. Only three banks posted a loss in the first half of 2003; the remainder all turned in a profit. The overall return on capital was around 27% in 2002, while the net-profit-to-average-assets ratio was 1.58%. The rise in the sector's profitability is feeding through into high dividend income. Shareholders took away 42% of the sector's year-2000 net profit in the form of dividends (in 2001), and the figure for a year later was another 2 percentage points higher.

Capital adequacy is stable above the required 8% ratio…

Since the end of 2000 the capital ratio of the banking sector has been stable around the 15% level. The ratio is high in all the categories of banks. With a ratio of 15.3%, the large banks contribute in large measure to the stability of the sector. Out of the 26 banks (excluding branches of foreign banks) operating in the domestic sector, a total of 13 had a capital ratio higher than the average of 15.8% in mid-2003. Just one bank lies in the 8%–10% band. The strengthening of the sector's capital is based on regular additions to Tier 1 from the previous year's retained profits.

The concentration of the banking sector continues…

A characteristic feature of the banking sector is the continuing dominant position of the large banks. At present the domestic market is dominated by four large banks, which administer 65% of the sector's total assets and generate almost 80% of its operating profit. All the large banks are in the hands of strategic foreign investors from EU member states. The former product orientation of the privatised banks is gradually narrowing, and these banks are now competing particularly hard in the area of retail banking.

Evaluation of banks by the market…

Komerční banka is the only Czech bank whose stocks are traded on the capital market. On the other hand, all of the "Big Four" – including their parent banks – have ratings from the major rating agencies (Standard & Poor's, Moody's and Fitch Ratings). All the large banks have been moved out of the speculative band and now have an investment rating. The rating agencies have welcomed the loan portfolio improvements, the contributions of foreign owners to credit risk management, and the strengthening of retail transactions. The positive outlook is based on sufficiently strong capitalisation. The foreign parent banks of the domestic large banks have higher ratings than the Czech Republic. Judging from the agencies' ratings, the four large banks on the domestic market are regarded as stable and not under threat from systemic risks. According to their ratings their position is strengthening.

Current agency ratings of the country and banks

(Foreign currency long-term sovereign debt ratings)

Moody's		Standard and Poor's		Fitch Ratings
Investment rating				
Aaa		**AAA**		
Aa1		**AA+**		
Aa2		**AA**		
Aa3	**KBC, SG**	**AA-**	**SG**	**KBC, SG, HVB**
A1	**Czech Republic** **ČSOB, KB , Erste, HVB**	**A+**	**KBC**	
A2	**ČS**	**A**		**Erste**
A3		**A-**	**Czech Republic** **HVB**	**Czech Republic** **ČS, ČSOB, KB**
Baa1		**BBB+**		
Baa2		**BBB**	**ČS, ČSOB, KB**	
Baa3		**BBB-**		
Speculative rating				
Ba1		BB+		
Ba2		BB		

Note: HVB - outlook applies to the entire HVB Group

Source: Rating agencies

III. Macroeconomic Developments

Slowing economic growth and low inflation…
The rate of economic growth slowed in the first half of 2003 to just above 2%. This was due to unfavourable external demand combined with the fading effects of the overvalued exchange rate of the previous year. Conversely, households' rapidly rising real incomes and the rise in lending to this sector (fostering dynamical growth in household consumption), along with expansive fiscal policy and low interest rates, had a favourable effect on growth. These factors were a response to the disinflationary pressures in the economy, which led inflation to fall far below the CNB's target band. Another major factor was the halt in the koruna's appreciation since the second half of 2002 and its depreciation against the euro during 2003, although this had yet to work its way through fully into the economy.

The prospect of a gradual recovery…
In 2003 and 2004 the growth rate of GDP will steadily gather pace. GDP growth of 2.8% is expected for the whole of 2003, driven chiefly by household consumption. In 2004 the growth should be somewhere around 3% and its structure is expected to change. The forecast is for a gradual decline in the growth rate of household consumption as a result of a slowdown in real income growth, stabilisation of the unemployment rate just above 10%, and the lagged effect of an autonomous tightening of the interest rate component of the monetary conditions in the first half of 2003. The growth will also be depressed by the launch of the government's reform of public finances. On the other hand, 2004 will see a pick-up in export growth in response to an easing of the exchange rate component of the monetary conditions, and a steady rise in investment activity is also expected. Then, at the start of 2005, a further modest increase in the GDP growth rate is predicted, thanks to an easing of the monetary conditions during 2004 and a continuing recovery abroad.

Inflation back on course for the target…
Headline inflation should be about 0.5% at the end of 2003. By the end of 2004 it will have risen to almost 3%. The pick-up in inflation will be due mainly to a gradual closing of the output gap and a steady rise in food prices, as well as to changes in indirect taxes. For the start and in the course of 2005 inflation is expected to pick up further and return to the target band.

A stable outlook for interest rates and the exchange rate…
Consistent with the forecast are interest rates just below 2% and then a modest rise from mid-2004 onwards. Turning to the koruna-euro exchange rate, the baseline scenario of the prediction is for stability at the present level of CZK 32/EUR up to the end of 2004. On aggregate the monetary conditions outlook is evaluated as easy.

A continuing high unemployment rate…
The number of employees is falling faster than forecasted. The unemployment rate is expected to reach 10.4% at the end of 2003 and stabilise at this level in 2004. The expected moderate economy growth will not lead to any fundamental change in the aggregate employment trend. Judging from the experience of other member states we do not expect any major short-term changes on the labour market in connection with the Czech Republic's accession to the EU.

Implications for financial stability…

The baseline scenario of the prediction thus generally implies an environment fostering continued financial stability. The modestly accelerating growth coupled with the relatively stable forecast for the household sector's income situation should be favourable for credit risk, while the comparatively stable interest rate and exchange rate outlook reduces the probability of market risks materialising.

Alternative predictions and risks…

Besides the baseline scenario it is of course also vital to evaluate uncertainties surrounding future macroeconomic developments. The current prediction identifies downside risks in the form of a stronger dollar-euro rate and a possible lower growth rate of regulated prices. On the upside there are uncertainties around the equilibrium levels of interest rates and the exchange rate and the potential upshifting of hotel and restaurant services to the basic VAT rate. On aggregate, though, the alternative scenarios do not produce an outlook different enough to present significant risks to financial stability – up to the end of 2005 the fan of alternatives for most indicators (GDP, inflation and interest rates) lies in a range of around 0.5–1.0 percentage points, or CZK 1/EUR in the case of the exchange rate. The aforementioned scenarios, however, were not generated in order to test the resilience of the financial system. Consequently, when discussing the risks it is necessary in many cases to go beyond the existing alternative scenarios (see Section IV).

IV. Risk Outlook

1. Definition of Risks

The banking sector's current situation, predicted macroeconomic developments, the functioning of the infrastructure and expected developments on foreign markets are areas that predetermine the potential vulnerable points of the banking sector in terms of its financial stability. Conversely, developments on the capital markets and functioning payment and settlement systems are not major risks in this respect. The banking sector has enough capital to absorb the consequences of potential negative developments without the kind of negative shocks that could culminate in a systemic crisis.

Banks' credit exposure is generating the key risk of banking business…
Credit risk ensues from banks' prevailing orientation towards traditional banking, represented primarily by lending. The banks' focus on retail banking has set off a dynamic trend in lending to households. This may be a source of risk for the banking sector for the following reasons in particular. At a time of modest economic recovery, banks may lose some of their caution in lending and may partly underestimate the risks involved; this is currently being encouraged by the tough competition in the banking sector amid consolidation of market positions (most notably vis-à-vis the household sector). The future incomes of household sector debtors may be assessed incorrectly both by banks and by households themselves. The psychological effect of the historically low nominal interest rates – known as "nominal illusion" – may also play a role. This may result in rise in risky borrowing by this market segment and an inability to meet all its obligations. This risk might materialise in the event of a highly adverse macroeconomic scenario comprising, for example, a combination of rising interest rates, slowing economic growth, growing unemployment and falling property prices. The likelihood of such a scenario, however, is very low at the present time. The current forecast up to the end of 2005 is for stable macroeconomic development with just a slight turnaround in the interest rate trend, including in the alternative scenarios.

The risks associated with growth in lending to households can thus be regarded as long-term rather than short-term, belonging perhaps in the next cyclical downturn.

The corporate sector's financial condition and its ability to repay loans has recently improved somewhat, but banks will on the whole probably continue to exhibit heightened caution. In this case, too, risk scenarios of an economic growth slowdown, a stalled start to economic growth in the EU member states or a rise in interest rates can be contemplated. However, the macroeconomic forecast is consistent rather with an outlook of a stable economic situation in the corporate sector.

Combined with the banks' still cautious approach to lending to the corporate sector, credit risk can thus be generally assessed as more moderate than in the past.[1]

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[1] The results of replication of the stress tests used by the FSAP mission in 2000–2001 for the current Czech banking sector data are also consistent with this view – see M. Čihák's research paper: *Designing Stress Tests for the Czech Banking System*, CNB Internal Research and Policy Notes, 2003 (in print).

Market risks do not pose a threat to the banking sector' s financial stability…

The exchange rate should not be a source of banking sector instability in the near future provided that we see a continuation of the relatively low volatility of the koruna-euro rate typical of 2003. In terms of direct impact, foreign exchange risk is constrained by the banking sector's comparatively low exposure to foreign currency transactions (15% of total assets) together with the preponderance of activities geared towards interbank transactions (usually with parent banks) and the banks' generally low open foreign exchange position. Foreign exchange risk could also indirectly bring about an increase in credit risk, if the stability of the corporate sector were to be endangered. Foreign currency loans, however, form only 16.2% of the total loan volume. The 2001–2002 experience moreover suggests that the corporate sector is able to withstand fairly sizeable exchange rate swings. What is more, the macroeconomic forecast is for stability of the koruna-euro exchange rate up until the end of 2004 and an only moderate appreciation trend thereafter, and the exchange rate conditions are assessed as easy for the entire forecast period. Overall, then, the indirect exchange rate risk is much lower than, for instance, during the monetary turmoil in 1997.

Nor should the capital markets become a source of financial instability in the Czech banking sector in the short term, thanks to the banks' relatively low exposure towards the capital markets. Trading shares and mutual fund shares, which generate equity risk, make up just 0.02% of total assets. In the first half of 2003 there was a slight increase in foreign issuers' foreign-currency-denominated stocks in banks' portfolios[2], which could imply a partial increase in the risk from potential instability on foreign capital markets. The very low exposure (just tens of millions of korunas) basically eliminates any impact on the overall financial stability of the banking sector. New issues of debt securities on the domestic capital market may be an important external source of funds for central government, but for corporations and the lower echelons of the state administration they are a negligible source. By comparison with the extent of corporate sector financing on the financial markets, loans extended by the domestic banking sector, despite a slight decline, remain the major source of external financing for firms. Management of related banking risks, which forms part of banks' standard risk management activity, is at a good level. Consequently, the occurrence of destabilising influences is unlikely even in the medium term.

The effect of foreign markets on the domestic banking sector is constrained by the sector's relatively low exposure towards the relevant markets (roughly 18% of total assets), which is moreover concentrated primarily in interbank transactions with EU member states. Loans located outside the domestic banking sector have an inconsequential weight, constituting just 6.5% of the sector's total loans. Funds located abroad partly resolve the liquidity situation of domestic – chiefly large – banks, being a means of diversifying the use of funds and, in a climate of low interest rates, contributing to efficient allocation of those funds. However, given the low level of interest rates abroad as well as in the Czech Republic, these activities are slowing sharply. Deposit rates on the dollar market have fallen, as have foreign bond yields. The potential yield in the domestic currency is reduced by the need to hedge against foreign exchange risk. The fundamental trends will persist into 2004, although given the very

[2] However, the same tendency can be seen for non-banking financial intermediaries as well. Owing to the lack of suitable investment opportunities in the Czech Republic, they are increasingly being forced to turn towards foreign markets. Foreign funds are most strongly oriented towards foreign markets, investing most of the money they acquire in the Czech Republic on foreign markets. The equity of these funds rose by 22% in the last half-year and now stands at 1.6% of GDP. Domestic mutual funds, which have almost triple the equity and are also gaining in popularity, may also be a source of transfer of funds to foreign markets.

low growth rate of the economy and the lack of investment opportunities the outflow may strengthen. The current macroeconomic forecast, however, is based on a steady pick-up in economic growth and a gradual rise in investment activity.

The existing payment and settlement systems, which form part of the financial intermediation stability assessment, operate on the basis of risk minimisation, including minimisation of operational risk. Over numerous years improvements have been made to payment clearing on the interbank market (performed by the central bank's clearing centre in Czech korunas) and settlement of securities trades (operated by UNIVYC, a.s.) in order to enhance the security and running of the system. New legislation (the Act on Capital Market Business) sets out a framework for greater concentration of securities-settlement services at the level customary in EU member states.

2. Monitoring of Risk Areas

The banking sector in mid-2003 can be evaluated as stable…

The current financial stability of the banking sector is founded on a completed privatisation process, a clear-out of bad loans from loan portfolios, and improved know-how in the areas of banking products and, in particular, risk management as supplied by the new foreign strategic owners. It is also evidenced by the financial results achieved, most notably in the areas of profitability and capital adequacy. The banks currently have enough funds to develop their business activities. The probable macroeconomic scenario indicates a high likelihood of continued financial stability with no major negative impacts on the sector.

The coverage of the current risks, coupled with the continuing good financial results and level of capital, lays the groundwork for smooth coverage of the potential higher risks associated with negative future developments. Although the present macroeconomic forecast reduces the probability of such risks materialising, it is also desirable to test the improbable risk scenarios implied by possible extreme situations and their potential concurrence. Extreme situation scenarios form the basis for defining and monitoring areas in which risks may arise.

⇒ *In the household sector…*

The rapid upward trend in household debt…

… stems from changes in behaviour on the part of both banks and households. Banks are encountering a lack of opportunities for efficient allocation of funds in the corporate sector. In particular, the new owners of privatised banks are looking to develop the untapped potential in retail banking. They are targeting reliable and profitable clients with good prospects and are making use of existing retail networks and new distribution channels. Similar tendencies can be seen also in other banks of the domestic banking market. Non-banking competition (credit cards and instalment sales) is also becoming increasingly prevalent. Households' willingness to take on more debt relatively quickly stems from their low initial indebtedness and from a change in behaviour (especially among the younger generation) as regards the acceptance of living on debt. Other factors include the low price level and growth in households' disposable incomes. Expectations of moderate inflation and the historically low interest rates on both loans and deposits are also factors bolstering the propensity to consume. A significant stimulus is the Czech Republic's approaching accession to the EU in May of next year and the uncertainty surrounding possible price shocks. These conditions are the starting point for a restructuring of the banking sector's loan portfolio and an expansion of lending to households. The resulting wide range of household credit products on offer is translating primarily into high increases in loans to this segment, which in mid-2003 were more than 30% up on a year earlier at CZK 176 billion. Between the end of 1998 and mid-2003 they increased 2.8 times in value. Rapid growth in such loans can be expected in the near future as well, although the growth rate may steadily ease as some of the factors supporting the growth gradually weaken.

Quality of loans to households (residents) as of 30 June 2003
(for banks with licences as of the given date, including the CNB)

	Total	of which: loans to households (residents)			
			of which		
		total	building savings	mortgage	consumer
Total loans in CZK billions	951,6	176,2	52,0	60,8	56,1
Share in loans to households in per cent	x	100,0	29,5	34,5	31,8
Share in total loans in per cent	x	18,5	5,5	6,4	5,9
Non-performing loans in CZK billions	100,4	6,1	1,2	0,8	3,8
Share of non-performing loans in per cent	10,6	3,5	2,2	1,3	6,8

Source: CNB - ARAD

Rapid development of housing loans…
The fastest growth is being recorded for housing loans. Housing needs in new privately-owned flats and houses are being financed to an ever greater extent by mortgages or combinations of various mortgage-based products. Investment in housing and property is viewed as investment in the future. One new trend is the use of mortgage-financed property as a means of diversifying household savings and partly for speculative reasons connected with the expected rise in property prices on accession to the EU.

Similarities with the situation in the EU…
The upward trend in loans to households in the Czech Republic conforms to the trend on the EU market. In 2002 the lending activities of EMU countries' banks were likewise affected in particular by very low economic activity and falling interest rates, which in turn led to a move away from lending to the corporate sector towards faster growth in lending to households. Just as in the Czech Republic, countries with a low starting position, such as Greece, recorded growth of over 30%, whereas the already stabilised Germany saw an increase of just 2%.

In terms of credit financing of households' living needs, the Czech banking sector is gradually starting to converge towards the less developed EU member states. In the developed countries the level of household debt is much higher, reflecting a lifestyle that is only starting to emerge in the Czech Republic. The main difference lies in the funding of housing needs; in the Czech Republic these needs are now starting to be financed to a greater extent through credit products, although such financing is currently available mainly to high and middle income groups. Although the share of loans to households in total loans has almost tripled since 1998, it is still very low by comparison with the EU (18.5% in the Czech Republic in mid-2003[3], as opposed to 66.4% in the euro area in 2002). In the euro area, households owe banks the equivalent of 45% of GDP in consumer credit and mortgages. In the Czech Republic the figure is only around 10% of GDP. From the structural perspective, too, the tendencies in the Czech Republic are similar to those in the EU. The buoyant growth relates chiefly to mortgage loans and building savings loans for housing purposes – with large cross-country differences in the EU. Consumer credit is no longer increasing so dramatically in the EU.

The proportion of classified loans in the household sector is 3.4 times lower than in the overall loan portfolio…

… although there are substantial differences between the individual types of loans extended to households. The resulting figures are affected by the high year-on-year growth rate of loans to households and by the relatively short period over which they have been provided. Mortgage loans and building savings loans have classified loan ratios of 3% and 4% respectively, whereas for consumer credit the figure is 9–10%. As regards debt repayment the household sector is generally deemed to be a less risky debtor. It constitutes a relatively transparent clientele as far as proof of income and guarantee quality are concerned, and not only with regard to collateral on long-term mortgage loans. Its willingness to repay and its mobilisation of funds is much higher than the corporate sector's, especially in the case of housing loans.

The lower level of risk associated with housing loans is linked with the banks' greater emphasis on assessing customers' ability to repay these long-term loans and with the existence of real estate, which is used by the majority of banks as a high-quality guarantee. The loss of the roof over one's head is a strong motivation for debt repayment. The risk arising from adverse life events is eliminated by good-quality life insurance policies. By contrast, consumer credit, which is more common but which tends to be provided in lower nominal amounts and often in the absence of collateral, pose a greater default risk for banks. In terms of weight they account for approximately one-third of loans to households. Their lower quality (9.1% of classified loans) raises the classification of total loans extended to households to 5.9% as at mid-2003.

Loans to households are an important source of profit for banks…

Despite strong competition the public tolerates relatively high interest rates, which moreover have stayed at the same level over time, unlike in other segments. Loans to households have become a lucrative alternative for the development of the banking sector. In mid-2003 nominal interest rates on loans extended to corporations had fallen to 4%, chiefly as a result of a fall in the price of funds on the interbank market, while overall average interest rates on loans extended to households were around 9% and rates on short-term loans to households were as high as 12%. The interest rate reflects both stability of earnings and level of risk, which in turn feeds through most of all into lower mortgage interest rates and higher rates on consumer credit.

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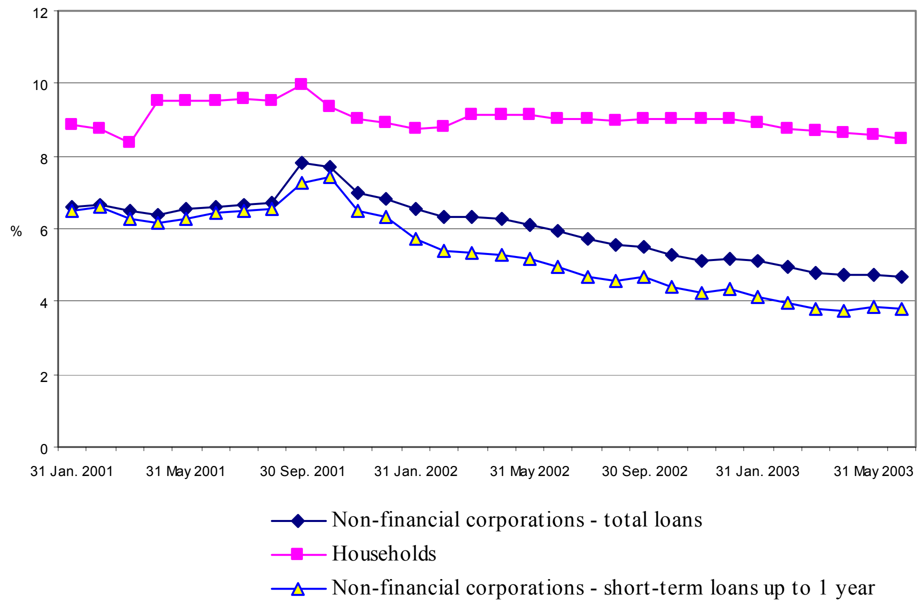
[3] Household debt increases by instalment sale liabilities and use of agreed debit, including credit cards.

Average interest rates on loans
(for banks with licences as of the given date, including the CNB)



Source: CNB - ARAD

The growth rate of lending to households is a risk factor…

Households' ability to repay loans may be affected in the medium term by the expected increase in inflation from its currently very low levels, provided that wages are meanwhile flat. Given the reform of public finances the likelihood is that the wages of state sector employees will not continue rising quickly. The enterprise sector can increase wages only on the basis of labour productivity gains. Increasing efficiency is leading to a reduction in the number of employees, with a knock-on effect of a moderate rise in unemployment. The public finance reform measures will also probably lead to a changed income position of certain household debtors. There may be negative effects from the possible decline in property prices and the expected rise of interest rates from their historical lows, which may impinge even more on households' ability to repay loans taken out in the past. The aforementioned historical information on the low risk of loans to households may thus underestimate the degree of risk attaching to the potential adverse macroeconomic scenarios.

However, based on the current macroeconomic forecast one can say that the expectations of moderately accelerating economic growth, stability on the labour market, continuing (albeit slower) growth of real household incomes and interest rate stability will tend to support a continuation of the current trends. We therefore do not deem the current risks associated with household borrowing to be significant; this is more of a long-term issue.

The expansion of household borrowing is also a factor underlying the growth in the banking sector's interest profit. Profitability could be undermined should there be a combination of fulfilment of the alternative, unfavourable macroeconomic scenarios, higher unemployment growth and a fall in the disposable incomes of households. A revision of the estimate of ability to repay future liabilities would lead to a fall in the sector's lending transactions. Likewise, competition from EU member states following accession (under the single banking licence principle) may bring about a fall in retail transactions. In addition to a reduction in lending activity, strengthening cross-border competition may cause a fall in interest rates with an impact on the banking sector's earnings. The likelihood of this actually happening is low, however. The macroeconomy is regarded as stable and the direct negative consequences of the reform of public finances should not be substantial. Nor is the country's accession to the EU expected to be accompanied by any step increases in prices.

⇒ *In the corporate sector…*

Owing to their negative experience in the past the banks are not currently willing to accept the heightened risk attaching to lending to the corporate sector and are therefore turning their attention to households and other less risky business activities.

The financial condition of the corporate sector is improving slightly…
The financial condition of the corporate sector, as expressed by return on capital and assets, share of external funds in production financing and other indicators, is steadily improving. The high level of intercompany debt is not falling, but the proportion of past-due intercompany debts is decreasing. The financial characteristics of the individual corporation types do vary, though.

Year-on-year labour productivity growth in industrial corporations and falling unit wage costs suggest a possible improvement in loan repayment in the future. This presumption is also supported by the low level of interest rates (3.5% for new credits in mid-2003), which is increasing companies' ability to repay bank credit. The price factor is not a limiting barrier for obtaining credit, as indicated by calculated maximum interest rate indicators and loan repayment indicators.[4] As regards the recoverability of lent funds, at the end of 2002 the maximum interest rate (still bearable) for corporations in public and private domestic ownership was 7.8% and that for foreign-controlled corporations was 16.7%. However, banks are very conservative in their approach to assessing companies' creditworthiness and so loans to corporations are more or less flat. Domestic public non-financial corporations are two-thirds financed from own funds. Domestic private non-financial corporations are applying for bank credit, but do not always satisfy the conditions for efficient financing, especially at a time of falling demand on foreign markets. The category of foreign-controlled non-financial corporations (which would meet with a positive response to a request for credit) is not applying for loans owing to low investment activity and generation of own funds. Its share of total loans is flat at 13.8%.

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[4] According to the methodology from an MIT CR financial analysis:
Maximum interest rate = (EBIT/assets)/((equity+bank loans+bonds)/assets);
Condition of debt by credit EBIT/assets > (interest/(bank loans+bonds))*(equity+ bank loans + bonds/ assets)

Box 1

Corporate Sector Financing Alternatives

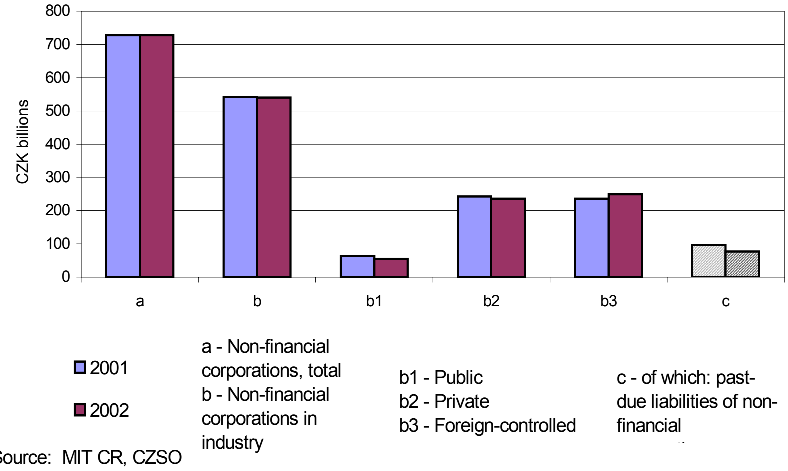
Bank loans are just one of the corporate sector's financing options. The others are:

- ***own funds**, the level of which is determined by the performance of corporations themselves. According to company managers, a shortage of own funds is the second most important factor limiting company performance. In terms of frequency, this tendency is decisive in manufacturing (which accounts for one-third of all companies) and construction (one-quarter of all companies). Over the last three years the proportion of manufacturing firms recording a shortage of own funds has been around 33%. The total number of firms constrained in their investment activity by a shortage of own funds is falling steadily, but nevertheless stood at 49.4% in the first half of 2003.*
- ***foreign direct investment**, the volume of which was CZK 68.8 billion in the first half of 2003 (and CZK 304.6 billion in 2002 as a whole) according to the financial account of the balance of payments. Major sales of corporate assets abroad took place during 2002. This situation was not repeated in 2003. Reinvested earnings of foreign-owned corporations accounted for much of the foreign direct investment inflow.*
- ***intercompany debts –** totalling CZK 727 billion in 2002 in corporations with 100 or more employees – exceed by 68% the volume of bank loans extended to corporations in the Czech Republic. Intercompany debts are long-term and short-term corporate liabilities, including past-due liabilities, which usually constitute forced trade credit and also comprise funds obtained from abroad. Positive phenomena include a year-on-year stagnation in their volume and a reduction in past-due liabilities.*
- ***financial leasing** is chiefly geared to the enterprise sector (only around 10% of the volume goes to natural persons). In 2003 Q1, leased property reached CZK 218 billion (increasing by CZK 63 billion during 2003 Q1), representing a ratio of 24% in relation to loans.*
- ***issues of corporate bonds and shares** are not used all that much owing to the underdevelopment of the capital market, insufficient size of companies and also to the subdued investment activity at present. The total volume of new securities issues was CZK 34 billion as of 31 December 2002.*
- ***factoring and forfaiting,** these alternatives supplement the market and do not generally compete with bank credit. Turnover of purchased debts was CZK 52.5 billion in 2002, 14% up on a year earlier.*

Banks are involved in providing other forms of financing to the corporate sector through their subsidiaries within banking financial groups. This applies particularly to leasing transactions (44.5%) and factoring transactions (61.7%).

Intercompany debts

(non-financial corporations with 100 employees or more)



Source: MIT CR, CZSO

The situation is worst in small and medium-sized enterprises…
Small and medium-sized enterprises (SMEs) with less than 250 employees constitute the largest number of companies in the corporate sector. According to the definition used in the EU, 99.8% of all domestic enterprises belong to this category, creating jobs for 60.9% of the employed and accounting for 51.4% of the output of the economy. In some industries SMEs are pushing home their advantages, which according to productivity indicators are most in evidence in services, transport, and wholesale and retail trade, i.e. industries and branches that in many cases are not associated with high organisational and administrative burdens and are of a service nature. The enterprises themselves combine various forms of financing. A large number of SMEs use some form of leasing, while a certain number also take out mortgage loans (without state support). Small corporations and natural persons are also recipients of consumer credit, which they use to finance their business activities.

On the one hand SMEs act as a stabiliser of macroeconomic equilibrium, chiefly by mitigating the negative effects of structural changes, creating new job opportunities and enhancing development in the regions. On the other hand they are very risky. Although no SME bankruptcy figures are available for the Czech Republic, the European statistics can be used by way of illustration. These show that a full 90% of newly established firms fail within five years and one-third go under within one year of opening for business. Most in danger are small companies with up to five employees, which make up 70% of all SMEs in the Czech Republic. The situation is complicated in the Czech Republic by the fact that this segment has a high proportion of newly established firms compared with EU member states owing to the economic transformation. The high riskiness of SMEs can also be inferred from the share of non-performing loans in total loans in individual industries. Industries which have a higher proportion of SMEs generally have more non-performing loans, for instance hotels and restaurants (29.7%), wholesale and retail (12.1%) and construction (11.7%).

Banks are changing strategy and intend to lend more to SMEs while remaining cautious…
Given the high risk of the segment, banks are highly cautious in their approach to SMEs.[5] Their lending will be selective with putative year-on-year growth. Selection will be based on assessments of clients' creditworthiness, future cash flows, guarantors and collateral. An important part of credit risk management is the launch of credit registers in 2002, the drafting of a register of leasing and hire-purchase company debtors, and considerations of setting up a similar register in the insurance company segment (integration of such registers is, however, currently prevented by the laws regulating each area of the financial market – see legal risks). Companies from industries and branches which for years have been recording high non-performing loan ratios (hotels and restaurants, metal product manufacture, etc.) will find it hard to obtain bank credit. Given their representation and role in the economy the state aims to support SMEs. Banks accept loan guarantees provided by the state in the form of support from specialised institutions and funds (e.g. CMZRB and PGRLF).

[5] Commercial banks' data are not suitable for the purposes of comparison. The definition in the banking statistics is not unified and banks have created their own company-size marketing categories based on various criteria, most notably turnover.

Box 2

Credit Registers

Credit registers allow banks to efficiently exchange information on clients' overall debt levels and the quality of that debt. Banks use this information mainly for credit risk management, in their loan-approval procedures, for monitoring their clients' credit commitments, for assessing client creditworthiness, for client scoring, and for assessing economically linked groups. Two credit registers were launched in the Czech Republic in 2002.

Mid-2002 saw the launch of a commercial register of the loans of natural persons. Operated by CBCB, a company founded by banks, this register brings together banks' claims on natural persons (households and sole proprietorships). Five banks are currently involved in the project (Česká spořitelna, Komerční banka, Československá obchodní banka, GE Capital Bank and HVB, namely, banks that account for the bulk of loans extended to households). Building societies and some other banks are currently in talks on joining the register. This register currently contains the receivables of 1.9 million natural persons.

On 1 January 2002 the Central Register of Credits (CRC) operated by the CNB went live. This contains the loan and other similar receivables (balance sheet and off-balance sheet) of legal persons and natural-person entrepreneurs. All banks and branches of foreign banks are involved in the project, as is the Czech Consolidation Agency. Each entry contains the client's identification data (identification number of the organisation or another identification code, legal form, address) and data on the bank's claim on the client (receivable type, original amount, balance, synthetic account, purpose of the loan, origination date and maturity date, number of days and amount past due, NACE category, collateral type).

Around 250,000 bank debtors are currently registered in the CRC. Some 200,000 receivables are processed each month. As of 31 July 2003, 1,313 users were registered. Most users come from Česká spořitelna (304), Československá obchodní banka (246) and Českomoravská hypotéční banka (103). The number of users depends on the organisation of work within the banks, the size of their branch networks and so forth. Some banks prefer all lending staff to have individual access, while in other banks this work is centralised in a selected group of workers, which in turn affects the number of users in the bank. Banks obtain on-line outputs from the CRC almost instantaneously.

Each bank has access to a monthly report on the credit commitments of all its clients. Besides this report, between 1 January and 31 July 2003 banks submitted a total of 7,816 enquiries on external clients, i.e. on those clients who approached the bank with a loan application and were not yet clients of that bank, and obtained 2,720 outputs on their credit commitments (for the others there were no active receivables registered as of the enquiry date). The CRC is used most often by Československá obchodní banka, Českomoravská hypotéční banka, Česká spořitelna and Raiffeisenbank.

The level of credit risk in the corporate sector depends on the evolution of the economy…

Given their experience of the past evolution of loan portfolio quality, banks are cautious in lending to corporations. The result is a stagnation of loans to corporations. Neither the current trend in corporations' financial condition nor the outlook for economic growth provides a sufficient signal for a significant increase in lending to the corporate sector. Assuming a pick-up in economic growth we can expect a modest increase in loans to corporations, especially those under foreign control, which in turn could foster stability of banks' interest income.

The selective approach to lending, which is based on ever improving credit risk management systems (thanks primarily to parent banks' experience), coupled with the expected economic recovery, supports continued banking sector stability. Conversely, a further stalling of economic growth, especially in European countries, could lead to a deterioration in the financial condition of the corporate sector and would have a negative effect on companies' ability to repay their loans and a knock-on impact on the banking sector's profits. Insufficient investment activity would cause a continuing stagnation of corporate loans, which would in turn impinge adversely on both the lending activity and the profitability of the banking sector.

⇒ *In property price movements…*

Property prices are rising buoyantly…
Property prices have been showing continuous growth in the long term, and not just on the domestic market. This growth reflects, among other things, people's higher demands as regards their standard of living, a tendency that is also apparent on the EU market. In the second half of the 1990s property prices surged by around 50% in the Czech Republic. Even within single states, though, the trend is patchy, being affected also by infrastructure preparedness, conditions for regional development, expected movements on the labour market and so forth. One factor having an extraordinary and one-off effect at the moment is the Czech Republic's impending accession to the EU. According to representatives of the Association of Estate Agents there is no reason to expect a shock increase in property prices on accession. The termination of exemption from EU rules resulting from the harmonisation of VAT rates on construction work for housing purposes from the current 5% to a probable 22% will mark something of a turnaround in the expected evolution of prices – this is expected in the medium term, sometime around 2007.

The changes in property prices will chiefly affect mortgage loans…
The trend towards meeting housing needs on one's own account will continue. An increase can be expected in the percentage of people who go into debt in order to purchase a home. Housing is specific in nature and only few people can afford to finance it from their current savings. Credit financing is becoming ever more prevalent, chiefly in the form of mortgage loans and building savings loans. National housing support policy is affecting the price of loans, as the price of funds (for financing, banks primarily use long-term funds in the form of mortgage bonds and building society deposits) is modified by state contributions.

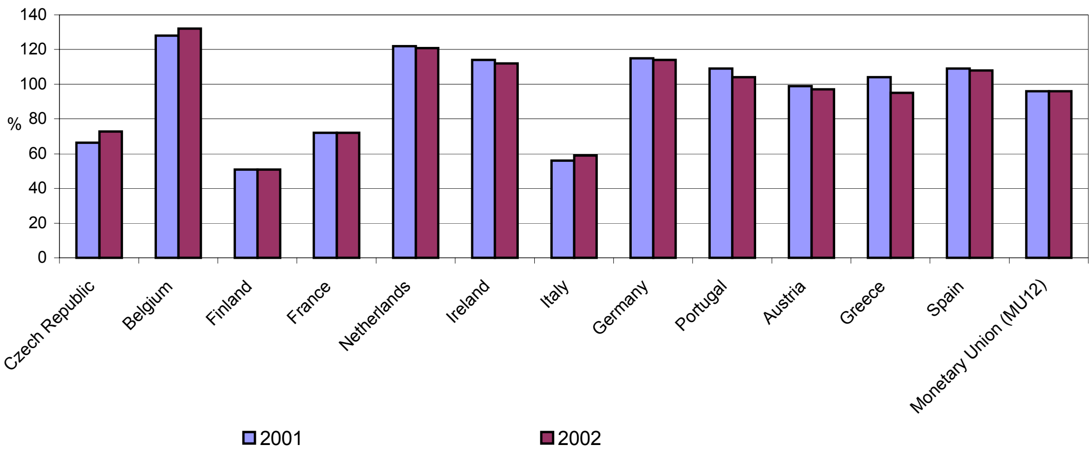
A fall in property prices will manifest itself in the banking sector as a fall in asset prices and the value of mortgage loan collateral and will generally prompt a need for more provisions and reserves, which in turn will affect profits. There will be a risk of non-coverage of losses from unpaid receivables from the sale of loan-financed property. This is of key importance in the case of newly extended mortgage loans; the risk decreases over time as loans are repaid. The price of property is related to the loan in a decreasing ratio. Under the contractual terms a fixed rate is set usually for five years and after revaluation again remains unchanged for a further five years. A factor increasing the risk to banks is a fall in property prices amid falling demand, or the opposite as a reaction to an overheating of the market. Other potential sources of risk for the banks include an undermining of confidence in a continuing positive trend on the market, unfulfilled expectations of an appreciation in the value of future investments in the form of residential property, and a downturn in economic activity impacting on debtors' income situation in conditions of rising interest rates. Price movements of commercial properties display greater sensitivity to the economic cycle and affect banks' risks to a greater extent.

No major change in property prices is expected in the near future…
Neither the present economic outlook nor the forecast impacts of the Czech Republic's accession to the EU suggest any fundamental changes in trend or major changes in prices impinging on financial stability. According to the forecast, the predicted gradual price changes and the moderate upturn in economic performance should not translate into a fundamental increase in banking sector risks in the short run. A potential risk from a fall in property prices (e.g. increased competition from foreign developers' entry) to the banking sector's financial stability can be contemplated in the longer run, especially were there to be an unexpected and sudden movement in property prices combined with other adverse factors affecting clients' ability to repay loans.

⇒ *In the financing of the banking sector's activities…*

Funds are not constraining banks' business activities…
The stagnation on the client deposit market is for the time being not generating any shortage of funds to finance banks' business activities. At present banks have a much greater volumes of deposits than client loans (in mid-2003 the banks' liabilities to clients amounted to 176% of their claims on clients). In the EU the reverse is true, owing to banks' greater credit exposure. The ratio of interbank deposits in the Czech Republic is broadly comparable with the EU member states. But the ratio of client deposits to overall GDP in the Czech Republic is well below the EMU level (0.73 in the Czech Republic as against 0.96 in the EMU at the end of 2002; only Finland and France were below the Czech Republic, with ratios of 0.51 and 0.72 respectively).

Comparison of client deposits as a percentage of GDP



Note: The ratios for Luxembourg are far higher (1015% and 906% respectively), so are not shown in the chart.
Source: CNB - BSIC, CZSO, ECB

Alternative investments to bank deposits are on the increase…
The process of disintermediation – the move away from bank deposits – is closely bound up not only with the various forms of state contributions and tax allowances for households' non-banking investments, but also with the current very low interest rates on bank deposits. Moreover, the differences in bank-deposit interest rates with regard to deposit duration are

minimal. Consequently, the level of interest does not provide a stimulus for growth of long-term deposits. Banks' clients usually do not renew their long-term deposits after maturity, preferring to replace them with shorter time (or demand) deposits or – if interested in longer-term investment – to choose from the wide range of non-banking products available. Banks' current fee-charging policies – which place client deposits at an even further disadvantage by reducing real returns – also speak in favour of non-banking financial products. In contrast, non-banking financial institutions have gone down the path of reducing fees. This, together with the exemption of yields on certain capital market investments from income tax and national policy in the areas of life insurance and private pension schemes, is making alternative non-banking allocation of households' funds in particular very attractive by comparison with the banking sector. On the other hand, non-banking products have their disadvantages, too (see Box 3).

Box 3

Advantages and Disadvantages of Alternative Products to Bank Deposits

Alternative products to bank deposits chiefly include life and annuity insurance, private pension schemes, and investments in mutual fund shares and other securities. The disadvantage of insurance products from the holder's perspective as compared to bank deposits is to some extent their illiquidity, as people have to decide to save at a particular level for an extended period. Moreover, these products become far less advantageous in the event of a reduction in contribution or withdrawal from the contract. As for the risks involved, all alternative products are offered by entities that are to some extent regulated by relevant laws and overseen by regulatory institutions. Nevertheless, the level of risk does vary, being higher in particular for securities investments. A major disadvantage of alternative products relative to bank deposits is that they are not usually insured.

A large proportion of funds remain in the banking sector via banking financial groups, which generally contain pension funds, insurance companies and investment companies and funds. On the life insurance market the share of banking financial groups has risen to 23.3% thanks to increased interest in the products of insurance company Česká spořitelna. The fall in banking financial groups' share of the private pension scheme market to 35.7% at the end of 2002 from 58% in the previous period was caused by enlargement of the financial groups of insurance companies and multinational financial corporations.

The alternative products have some other advantages over bank deposits, for instance:
- *mutual fund shares can be attractive to natural persons not only because of their yields as compared to time deposit rates, but also due to the taxation rules applying to them;*
- *pension schemes are attractive thanks to the state contribution and tax deduction;*
- *life and annuity insurance premiums are tax deductible under certain conditions.*

Allocation of households' deposits and savings in CZK billions
(increases in given year)

	2000	2001	2002	30 June 2003
Total - of which:	60,6	185,4	73,6	54,0
increases in cash in households	11,6	4,1	13,2	13,1
life and annuity insurance policies	22,8	28,4	34,0	n.a.
private pension schemes	12,1	13,5	14,7	n.a.
net sales of mutual fund shares	-6,0	-11,9	19,3	13,2
shares, bonds and mortgage bonds	-3,6	6,9	-3,2	-0,9
building savings	18,2	24,2	45,1	20,8
time and demand deposits in banks	5,5	120,3	-49,4	8,0

Source: CNB, CZSO, UNIS

Market shares of banking financial groups in per cent

	1999	2000	2001	2002
Pension schemes (capital funds)	58,6	58,1	35,2	35,7
Life insurance (gross premiums)	24,0	19,5	18,6	23,3
Leasing (leased property)	45,4	45,6	45,1	44,5
Factoring (debt turnover)	63,0	66,8	64,9	61,7

Source: APF CR, CAP, ALS, AFS.

The option of allocating funds into government securities will continue…

In an environment of low interest rates, banks find investing in low-risk/zero-risk government securities a good fund-allocation alternative. With their guaranteed, albeit none-too-high, yields these securities contribute to the sector's profitability. In mid-2003 banks held almost 70% of the total volume of government securities in their portfolios. Despite the government's initiatives to put public finances in order and reduce the state budget deficits, the rising national debt means that a sufficient supply of zero-risk investment opportunities will remain on the market. Only after the final version of the reform of public finances has been approved will it be possible to determine the foreseen turning point and expect a reduction of the state budget deficit.

One risk factor would be the adoption of an excessively soft reform of public finances and the continuation of the current rising debt trends to the brink of insufficient funds to finance the debt at home, growth in the risk premium, and currency turmoil.

Box 4

Excess Liquidity

Commercial banks' zero-risk repos with the CNB are used to manage liquidity and steer short-term interest rates on the interbank market. Hence they do not restrict the funds that the banking sector can allocate in the form of lending transactions to finance the corporate sector and they are not a risk factor inhibiting required economic growth. The causes of the lack of availability of credit, especially to particular corporations, and the inhibition of economic growth must be sought in other risk factors.

Like many advanced central banks the CNB operates a system of inflation targeting. To achieve its price stability targets it uses a transmission mechanism based on management of the aforementioned short-term interest rates. It does not operate a system of managing the quantity of money in the economy. The CNB executes repos on the money market with two-week maturity. The upshot of this is almost absolute control of short-term money market interest rates.

The process of absorbing liquidity in order to steer interest rates was based on developments in the 1990s, when foreign exchange reserves recorded steady growth both in the fixed rate period (up to mid-1997) and thereafter (when the fluctuation band was abandoned). The central bank buys foreign currencies in order to prevent sharp appreciation swings in the exchange rate. This money, which increases the central bank's total assets, is automatically absorbed from the money market in repos directed at steering short-term nominal interest rates.

However, in no event does the absorption of liquidity lead to a containment of commercial bank lending. The central bank is forced to enter the money market and withdraw the excess supply of money; in the opposite case there would be a change (fall) in interest rates to a level inconsistent with its monetary policy targets.

A shortage of funds should not be a barrier to a rise in lending…
Given the current adequate volume of funds a stagnation of primary deposits is not a limiting factor for banking business and does not endanger the banking sector's financial stability. The expected modest increase in interest rates should stimulate bank deposits to some extent, and unused interbank funds would be made ready for financing. Banks would have no problems in the short term obtaining secondary funds from the capital markets via mortgage and other bonds. In the longer term this risk factor could manifest itself in the banking sector in a situation where banks would encounter sufficient effective demand for loans from creditworthy clients.

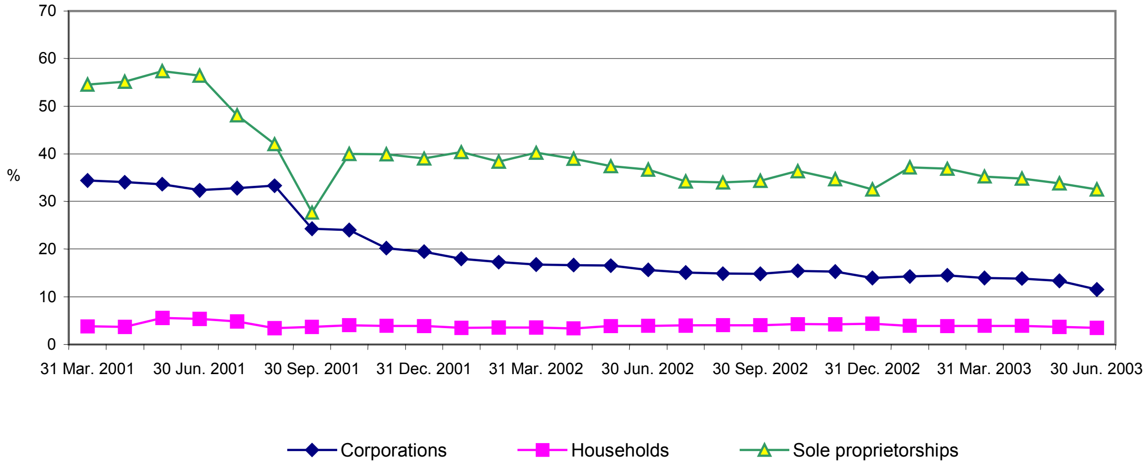
A build-up of factors ensuing from the economic risk scenarios of economic development – based on negative evolution of households' disposable incomes, tensions on the labour market and higher unemployment growth amid excessive household debt – would present a risk to financial stability as regards sources of financing regardless of any increase in interest rates. A fall in bank deposits and an inability on the banks' part to find other funds would give rise to an increase in liquidity risk. At the moment, however, the current estimates of future developments do not suggest that this will happen, although the forecast of a fundamental turnabout towards rapid growth of primary deposits has not been confirmed either.

⇒ *In the evolution of interest rates…*

The low interest rate environment is reducing the banking sector's returns…
Interest profit is the main source of profit from banking activities. Banks' ability potentially to absorb higher business risks is predicated on achieving sufficient profits. In mid-2003 average interest rates on new loans to the corporate sector reached all-time lows and were close to the 10-year government bond yield (3.80%). Yields on shorter bonds fell further. Looking at the evolution of domestic FRA rates, the forecast interest rate stability and the only slight increase at the short time horizon of 2005 one can conclude that banks will remain exposed to pressure of low returns and margins on loans to corporations. The higher interest on loans to households reflects the specific conditions of this segment. They tend to involve small amounts, high transaction costs and poorer knowledge of client background, etc.

The sector's profitability is being driven by profit from fees and high rates on household loans…
The banking sector is attaining the required profit by actively changing its earnings structure, i.e. by strengthening the less volatile component of fees and commissions relative to interest income. The decline in lending activity and limited interest returns vis-à-vis corporations are being offset by a business expansion vis-à-vis households. Banks have thus managed to withstand the fall in interest rates so far. Loans to households have provided an opportunity to achieve higher margins with a lower level of risk (non-performing loan ratio: 3.5%) relative to loans to corporations (11.5%) or loans to sole proprietorships (32.5%). The high concentration of banks' interest in this segment of the market may lead both to reducing prices of products and to exposure of the banking sector to the risk of default if the competition for clients causes some banks to underestimate caution and households' rising indebtedness.

Share of non-performing loans in total loans by debtor type
(for banks with licences as of the given date, including the CNB)



Source: CNB - ARAD

The low interest rates are improving debtors' ability to repay loans…
The evolution of interest rates on new loans to corporations can be viewed as a favourable factor as regards future repayment of loans. One potential repayment risk factor would be a deterioration of corporate sector performance caused by non-fulfilment of the economic growth forecasts in the Czech Republic, insufficient recovery of the EU member states' economies in the relatively short term, and the emergence of negative profitability tendencies in particular sectors of the economy and particular categories of companies. The forecast modest rise in interest rates should not have any fundamental effect on stability.

An increase in interest rates is a potential risk factor…
The banks' direct sensitivity to major changes in interest rates may increase slightly over time owing to a rising proportion of demand deposits on the liabilities side and an increasing proportion of long-term loans and fixed income securities on the assets side. Overall, though, the sector has a good level of resilience to direct interest rate risk.[6] A sharper-than-expected rise in interest rates would also have an indirect negative effect on the riskiness of newly extended loans to the corporate sector. Coupled with a negative unemployment trend, a higher-than-expected rise in interest rates would curtail lending to households. In combination with the debt they have already taken on, households faced with their negative financial prospects would resist any further rise in indebtedness and the default risk would increase. The mortgage market's sensitivity to relatively higher interest rates is reduced by the time shift caused by the usually 5-year fixed rate. The risk would translate into lower volumes and a lower frequency of new mortgage loans. For banks this would chiefly imply impacts on earnings owing to higher costs for the creation of provisions and reserves. The probability of this high-risk scenario materialising is nonetheless low. The forecast is for a stable interest rate level.

[6] See M. Čihák's research paper: *Designing Stress Tests for the Czech Banking System*, CNB Internal Research and Policy Notes, 2003 (in print).

⇒ *In the Czech Republic's accession to the European Union…*

The Czech Republic's accession to the EU does not increase the risk of a stability threat…
As from May 2004 the Czech banking sector will be part of the EU's single internal market and administratively will also become part of European banking structures. The experience from the period of establishment of the single market cannot be applied in full to identifying the possible risks, as the present situation is fundamentally different. The changes resulting from entry into an already established and functioning single market will also have different consequences and corresponding potential risks. Their scope and depth have been deliberately limited by the pre-accession harmonisation process. The banking sector will also not face post-accession shocks to the full extent because of its constant adjustments to conditions at the microeconomic level as a result of the actions of foreign banks and strategic investors in the Czech banking sector.

Foreign investors are already involved in shaping the domestic banking market…
Foreign entities accounted for 81.9% of the total registered capital of the banking sector at the end of 2002. Foreign capital is even more dominant when one takes into account both direct and indirect control of the sector's total assets. At the end of 2002 foreign shareholders exercised control of 93.3% of the sector's total assets.

The positive influence of foreign investors predominates…
The stabilising effect of foreign owners stems on the one hand from their involvement in the relevant market and on the other hand from qualitative benefits, most notably reputational, prudential and knowledge benefits. The core elements acting positively on the stability of the banking sector are improvements in risk management and the internal control environment and an expansion of banking services, products and distribution channels. These result from the possibility of direct application of the know-how of foreign parent banks.

High involvement generates potential contagion risks…
In certain circumstances, excessively high involvement of the banks of a single state can pose a risk of greater instability, especially at times of economic swings and insufficiently diversified portfolios.[7] In the Czech Republic's case it is fair to say that the potential for contagion through European banking systems in EU countries operating the single licence principle is not high given the diversified geographical orientation of the strategic owners and foreign banks operating on the Czech market. None of them exert an influence over a decisive segment of the market.

The single banking licence principle will not induce fundamental changes…
On accession to the EU the single banking licence principle will apply in the Czech Republic. EU banks will be able to operate in the Czech Republic and any other member state as a branch without further licensing. Under the home country supervision principle, responsibility for banking supervision will fall to the country in which the bank's head office is located. The domestic supervisory authority will, under its powers, supervise the branch with regard to liquidity and money laundering. In addition, the supervisor will assess the branch's influence on the development of the banking sector, its financial stability and suchlike.

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[7] One example is the involvement of Japanese banks, which at the start of 1997 were the largest joint creditor of numerous Asian economies and in response to the depreciation of the Thai baht reined back their lending activities in Asia, thereby exacerbating the crisis throughout the region (Kaminsky and Reinhart, 2000).

As a result of the close links between the Czech banking sector and foreign banks and branches of foreign banks we do not envisage any fundamental and destabilising change in the penetration of foreign competition on the market, but rather a gradual evolution based on strengthening competition, consolidation, mergers, etc. On the other hand the foreign entities operating in the Czech Republic may use the domestic market as a stepping stone to penetrate further into the markets of Central and Eastern Europe. Czech banks will probably not expand their branch networks into EU markets owing to their specific orientation and insufficient size, which prevents them from succeeding in a tough competitive environment.

The competition on the banking market will continue to strengthen…

The reason for this lies in the depth of financial intermediation by the Czech banking sector, which is still relatively low, even though it looks favourable by comparison with other EU candidate countries. On the other hand the depth of banking intermediation as measured by the ratio of bank assets to GDP is incomparably lower than in selected EU member states. The entry strategies of the investors in the large Czech banks were moreover based in all cases on the previously untapped growth potential from retailing opportunities in particular. Following the privatisation of the state's shares in these banks we are seeing a secondary division of the market, with more investors establishing themselves on the market in a post-privatisation wave. The competition is concentrated on products for the retail client segment. The aim is to establish commercial ties between the bank and its existing clients and to acquire new clients. Banks are offering the internal know-how developed in their parent companies, and the products on offer reflect the latest trends in banking.

Banking sector assets in the Czech Republic and selected countries as a percentage of GDP

	1999	2000	2001	2002
Czech Republic [1)]	111,0	113,6	114,9	110,0
Hungary	68,6	68,1	68,4	68,3
Poland	59,2	60,4	63,0	62,6
Slovakia	94,4	95,5	96,3	85,5
Slovenia	75,7	81,4	94,2	87,2
Euro area weighted average	245,0	251,0	258,0	257,0

1) Excluding Konsolidační banka and banks in conservatorship

Source: ECB, CEC5

⇒ *In the legal environment…*

Given the high degree of harmonisation of the Czech regulations with those in the EU, this is not a primary risk area.

CNB Banking Supervision performs supervision of consolidated units…

As regulator, the CNB is required from 2003 to perform banking supervision on a consolidated basis to the full extent. In the Czech Republic in the middle of last year there were nine regulated consolidated units falling within the competence of CNB Banking Supervision. Given the banks' majority representation (at least 80% of the total assets of the unit) their stability can be affected by the other members of the group to only a limited extent. An analysis from last year reveals that the profits and expenses of consolidated units are comparable to those of the stand-alone banks. For both regulator and regulated entities this is a radically new approach, one that also places certain demands on non-banking group members, especially entities controlling a bank in the position of a financial or mixed-activity holding company. Experience has shown that holding companies have problems complying with the prescribed rules. Consolidated supervision also relies on co-operation with domestic and foreign regulators. A transposition of EC Directive on the supplementary supervision of financial conglomerates - an additional oversight of sectoral supervision on a consolidated basis facilitating consolidation of groups having a significant share both of insurance and banking business[8] - to Czech law should be carried out by August 2004. The supplementary supervision of financial conglomerates should be launched from 1 January 2005.

Comparison of regulated consolidated units and banks in per cent

	Regulated consolidated units		Stand-alone banks	
	2002	30 June 2003	2002	30 June 2003
ROA	1,3	2,7	1,3	2,3
Return on Tier 1	21,0	57,4	19,7	43,9
Profit from financial activities/assets	3,7	5,0	3,7	4,5
Admin. expenses/profit from fin. activities	56,7	47,6	55,4	46,4
Admin. expenses/assets	2,0	1,8	1,9	1,7
Ratio of assets to consol. unit's assets	100,0	100,0	93,6	94,0

Note: The figures represent the non-weighted averages of the following nine banks: Česká spořitelna, ČSOB, Komerční banka, HVB Bank, Citibank, J&T Banka, Raiffeisenbank, Živnostenská banka and První městská banka.
Source: CNB - BSIC

Implementation of the New Basel Capital Accord (Basel 2) should bolster stability…

The New Accord responds to the rapid development of the financial markets. It aims to promote safety and soundness in financial systems; introduce more accurate and more sensitive rules for risk management and the calculation of regulatory capital; bring the regulatory capital requirements closer to the risk management methods of banks themselves; introduce ongoing review of banks' management (especially risk management); and promote wider disclosure of banks' risk exposures so that the market can play a partial role as regulator. These objectives translate into a more sensitive approach to measuring risk in relation to each particular bank's risk profile and into more accurate methods for quantifying its regulatory capital. The new capital adequacy rules are expected to take effect in 2007.

The impact of the new approach on banks' capital adequacy was investigated in a major international project organised by the Basel Committee on Banking Supervision (BCBS). For the Czech Republic this showed there will be a fall in capital adequacy of around 1–4 percentage points compared to the current approach. The fall will be due primarily to the introduction of a capital requirement for operational risk and also to stricter measurement of credit risk. The banks' current high capital adequacy level lays the groundwork for the absorption of this fall without any threat to the sector's stability.

Problems with debt recovery persist…

There has been something of an improvement in the area of debt recovery, but many problems still remain. Newly adopted creditor protection legislation (amendments to the Civil Code,

[8] Banking rules of consolidated supervision " do not know" how to set requirements regarding a calculation of capital adequacy and performance with an inclusion of the insurance company.

Civil Procedure Code and the Bankruptcy and Composition Act, and the new Execution Code and Public Auctions Act, etc.) has not brought about any major reduction in credit risk. This has occurred thanks to the more prudent behaviour of banks. Banks consider the work of the courts and other authorities to be the most problematic area. The problems are caused primarily by lengthy trial deadlines, rules of procedure that allow debtors to delay legal proceedings, ineffectiveness of fast-track legal proceedings, and long time limits for making entries in the Companies Register and the Land Register.

The lien is generally one of the most certain and widely used means of securing loans. It has proved to be highly ineffective in the Czech Republic, mainly because of shortcomings in the legislation. For example, there is no way of establishing a lien against a corporation.

One problem in the credit risk area is bankruptcy law. Satisfaction of creditors' unsecured claims in bankruptcy is below the one-sixth level. It seems necessary to draw up a new bankruptcy act and provide for effective protection against unreasonably long insolvency proceedings.

Abbreviations:

AFS	Association of Factoring Companies
AKAT	Capital Market Association
ALS	Association of Leasing Companies
APF CR	Association of Pension Funds of the Czech Republic
BCBS	Basel Committee on Banking Supervision
BSIC	Banking Supervision Information Centre
CAP	Czech Insurance Association
CBCB	Czech Banking Credit Bureau, a.s.
CEC5	five Central European Countries entering the EU (Czech Republic, Hungary, Poland, Slovenia, Slovakia)
CKA	Czech Consolidation Agency
CMZRB	Českomoravská záruční a rozvojová banka, a.s. (the Czech-Moravian Guarantee and Development Bank, a.s.)
CNB	Czech National Bank
CR	Czech Republic
CRC	Central Register of Credits
ČS	Česká spořitelna, a.s.
ČSOB	Československá obchodní banka, a.s.
CZK	Czech crown
CZSO	Czech Statistical Office
EBIT	earning before interest and taxes
EC	European Communities
ECB	European Central Bank
EMU	European Monetary Union
EU	European Union
FSAP	Financial Sector Assessment Program
FRA	forward rate agreement
GE Capital Bank	GE Capital Bank, a.s.
GDP	Gross domestic product
HVB	HVB Bank Czech Republic, a.s.
J&T	J&T BANKA, a.s.
KB	Komerční banka, a.s.
KBC	KBC Bank, a.s.
MF CR	Ministry of Finance of the Czech Republic
MIT CR	Ministry of Industry and Trade of the Czech Republic
MU	Monetary Union
NACE	sectoral classification of economic activities
p.b.	percentage point
PGRLF	Farming and Forestry Relief and Guarantee Fund
ROA	return on assets
SG	Société Genérale, a.s.
SME	small and medium enterprises
UNIS	Union of Investment Companies
UNIVYC	UNIVYC, a.s. (universal settlement centre)
VAT	value added tax