



Crisis-proofing financial integration: Czech Republic

Abstract

During the financial crisis of 2008, banking failures in Europe and the United States posed a major threat to finance across the world. Most believe that financial integration with the west made banking systems in emerging Europe more vulnerable to external shocks. Yet, banks in some countries such as Czech Republic did better than others during recent global economic crisis. In 2009, Czech banks recorded sound profits: return on equity amounted to 26.4 percent, and the return of assets stood at 1.5 percent. This resilience reflected timely policy actions, a sound regulatory system, and prudent bank lending. First, the financial sector benefitted from a consolidation program that the central bank initiated in the mid-1990s, closing many small banks. Second, the process of financial sector prudential oversight was also consolidated. Since 2005, the Czech central bank has had the authority to oversee all segments insurance markets and commercial and investment banking. Third, the banking sector has a strong retail deposit base and benefitted from prudent lending practices—nonperforming loans were lower in the Czech Republic than in most other Central and Eastern European economies. No country is crisis-proof, but Czech financial sector practices and policies have been a source of stability during the financial crisis.

During 2008–2010, banking failures in Europe and the United States threatened the stability of the world’s financial system. Most believe that financial integration with the west made banking systems in emerging Europe more vulnerable to external shocks. Yet banks in some countries did better than others during recent global economic crisis. The Czech Republic provides an example.

Surviving the storm

Despite the financial turmoil, in 2009 Czech banks recorded sound profits: return on equity (ROE) amounted to 26.4 percent and the return of assets (ROA) stood at 1.5 percent (figure 8). Credit default swap spreads for Czech Republic were among the lowest in the CEE region. While European banks lost their high rankings in the Global Competitiveness Report ratings in 2008–2011, the score of Czech banks remained practically unchanged.¹ It is interesting to note that this stability was accompanied by a high level of banking sector integration with the rest of Europe; as of January 2010, 96 percent of bank assets were foreign owned.

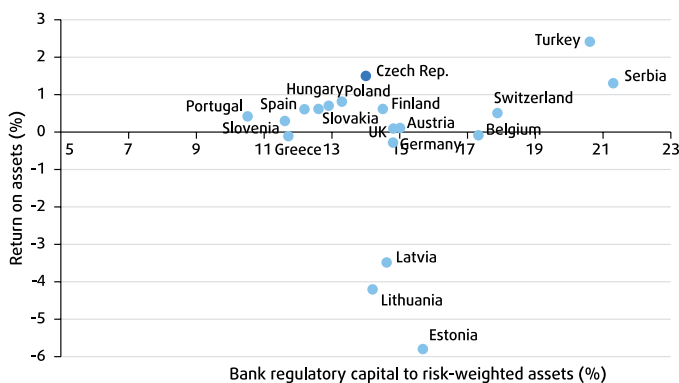
During the crisis, the Czech banking system remained a source of liquidity for enterprises. Between 2007 and 2009—with the exception of the fourth quarter of 2008—the cross-border interbank lending exceeded the borrowing. There were some signs of distress as banks became more reluctant to lend and the maturity structure of the loans shifted toward long-term borrowing. Some banks faced downgrades in their ratings. But banks did not require bailouts, they managed to remain profitable, and their engagement in mortgage-back securities was limited. Given the magnitude of the financial turmoil in Europe, how did Czech banks manage to stay relatively immune?

Early lessons

One of the main reasons why Czech banks survived the crisis is that they were able to learn from previous financial difficulties that the country experienced in the 1990s. After the reintegration

with Europe, in 1991 the government launched a consolidation process to help banks deal with undercapitalization and the burden of bad loans from the socialist times.² After 1991, the banking sector experienced a boom; between 1990 and 1993, 53 new banks were set up. Due to relaxed rules on banking licensing in 1990–91, many new banks lacked adequate capital and/or staff with relevant expertise.³ In the absence of adequate supervision of the sector, these small banks took on substantial risks, usually associated with venture capital enterprises.

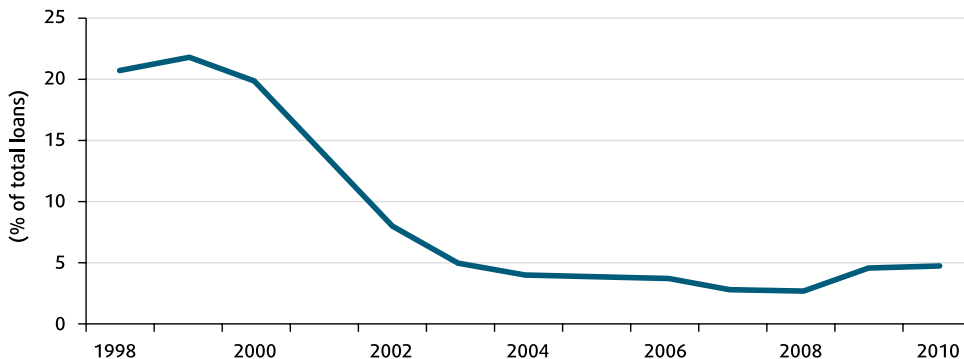
Figure 8: Return on assets and bank regulatory capital to risk-weighted assets in selected economies in 2009⁴



Source: IMF FSI.

In the beginning of 1996, the Czech National Bank (CNB) launched a consolidation program for small banks that resulted in revoked licenses for some institutions. The authorities also started the Stabilization Program to maintain stability within the sector. This initiative proved to be unsuccessful: five out of six banks were excluded from the program. Nevertheless, thanks to all measures undertaken by the CNB, the situation in the sector improved significantly, and the ratio of nonperforming loans to total loans dropped from above 25 percent in 1995 to below 10 percent after 2001 (figure 9).

Figure 9: Nonperforming loans to total loans in the Czech Republic, 1998-2010



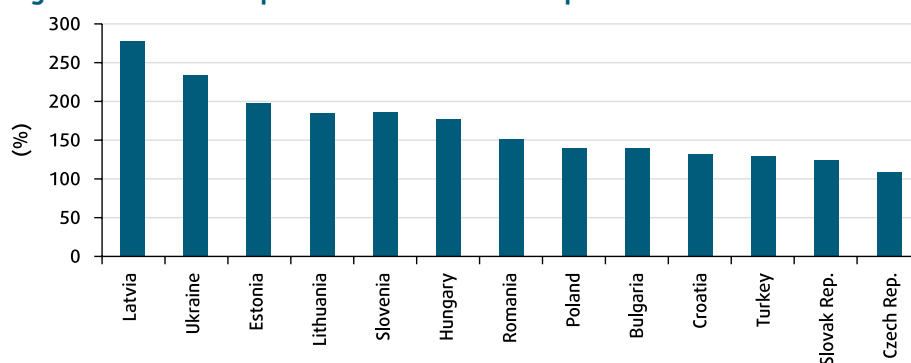
Source: IMF FSI.

Although successful, the consolidation process was difficult for banks and their customers. The costs of banking sector restructuring amounted to 9.7 percent of GDP in 1992, 4.2 percent in 1998, and 2.8 percent in 2002.⁵



There were several other factors that contributed to the resilience of the financial sector. Banks had a strong retail deposit base with supplementary bonds issuance: in the last quarter of 2009 bonds accounted for nearly 19 percent of retail deposits. According to Mitra et al. (2010), in 2010 Czech banks had the strongest loan-to-deposit ratio in the region (figure 10).

Figure 10: Loans to deposits ratio in Eastern Europe in 2009



Source: Mitra et al. (2010).

Lending may have been more prudent in the Czech Republic than in other countries in the CEE region: the ratio of nonperforming loans to total loans in 2009 was 4.9 percent, compared with 5.3 percent in the Slovak Republic, 6.7 percent in Hungary, and 7.6 percent in Poland. During the crisis, banks were also able to improve their performance, reducing the cost-to-income ratio below 40 percent in 2009.

Households did not take loans denominated in foreign currencies to as great extent as did households in other countries. There was no increase in the ratio of foreign exchange loans to total loans between 2000 and 2007. The main reasons behind the limited presence of foreign loans were moderate interest rates in the country, lower than those set by the European Central Bank. Thanks to the credibility of the Czech National Bank and fiscal consolidation after 2004, low local currency yields (of the koruna) discouraged households from borrowing in foreign currencies.

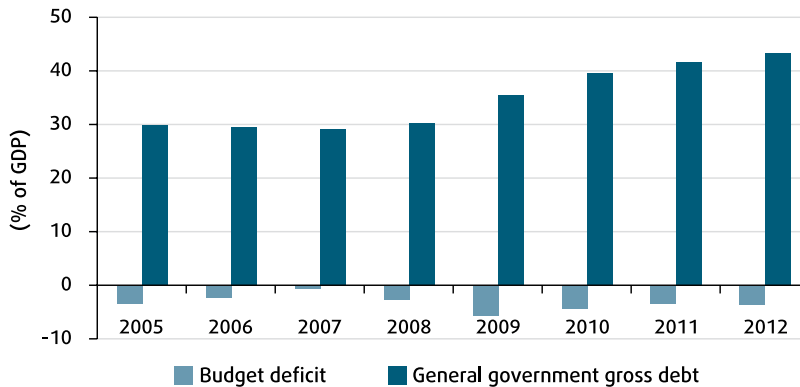
Finally, the legal framework for financial sector supervision was strengthened during the crisis. The CNB has the sole authority for bank supervision and, together with the Ministry of Finance, prepares primary financial sector legislation. When a bank engages in undesirable or destabilizing activities, the CNB can amend the bank's license or impose conservatorship. Moreover, since the consolidation of financial supervision in 2005, the CNB has been responsible for overseeing banks, capital markets, and insurance and cooperative banking.⁶ Centralized supervision allows for synergies: greater information flows, coordinated decisions, and coherent communication. New legislation established the Financial Market Committee that advises the CNB on supervision strategies, new trends in the financial sector, and supervision practices. The system underscores strong ties between financial institutions: at least one out of five members of body managing the Deposit Insurance Fund is chosen from the CNB.

Looking ahead

During the recent crisis, Czech banks did face challenges. In 2009 the ratio of nonperforming loans to total loans (4.6 percent) was higher than in most of Western Europe.⁷ Although the

banking system survived the crisis, the Czech export-led economy was affected by the global downturn, mainly due to falling demand from Western Europe. A plunge in external demand contributed to a decline in GDP as well as a surge in unemployment. The budget deficit amounted to 5.8 percent of GDP in 2009 (4.7 percent in 2010) and public debt grew after 2008 to nearly 40 percent in 2010 (figure 11).

Figure 11: Budget deficits and government debt as percentage of GDP in the Czech Republic, 2005-12 (forecast after 2010)



Source: IMF WEO, Czech National Bank.

During the crisis Czech households engaged in mortgage lending that led to housing bubbles in bigger cities. During the crisis, the CNB provided the market with additional liquidity. But current ratios of highly liquid assets to total assets may not be enough to meet new Basel III liquidity regulations. Czech banks have also a surprisingly high return on equity (26.4 percent in 2009), indicating that they might be too profitable, at the cost of consumers.⁸

No country is crisis-proof, but Czech financial sector practices and policies have been a source of stability during the financial crisis. The GDP is projected to grow by nearly 3 percent in 2012 and the government budget for 2011 included the consolidation of public finances.⁹ Naturally, the recovery in a small, open economy like the Czech Republic depends on the economic performance of other European economies. Yet, when the recent crisis hit, changes in the regulation of the financial sector together with improvements in monetary policy proved to be of great value.



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Notes

- 1 Measure 8.07: Soundness of the Banking Sector.
- 2 So-called Consolidation Plan I.
- 3 Until April 1991 regulators required the minimum subscribed equity capital of only CZK 50 million (US\$2 million).
- 4 Data on return on assets for German banks is from 2008.
- 5 The Czech National Bank provides data for each year between 1992 and 2004. See Bárta and Singer (2006).
- 6 Leasing companies and nonbank credit institutions are not subject to the supervision.
- 7 With exceptions of Greece (7.7 percent), Iceland (61.2 percent), Ireland (9.0 percent), Italy (7.0 percent), and Spain (5.1 percent).
- 8 In comparison to 7.6 percent in the Slovak Republic, 10.7 percent in Poland, and 9.8 percent in Hungary.
- 9 Although consolidation measures have been passed, the Constitutional Court stated that some of the procedures were not appropriate and need to be voted on once again in order to be implemented in the budget. In order to be effective, consolidation measures need to be passed through the end of 2011.