Report on Banking Supervision in the Czech Republic

CZECH NATIONAL BANK

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Contents

I. THE ROLE AND PRINCIPLE AIMS OF BANKING SUPERVISION

The primary function of the banking sector in a market economy consists in accumulating and distributing savings and in making payments. The quality and reliable functioning of the banking sector thus has a fundamental influence on the financial and overall economic stability of the state and receives attention from the public, international institutions and investors. The specific and exclusive standing of banks in the economy places great importance on their soundness as regards the stability of the banking system as a whole. In countries with functioning market economies, the requirements placed on the banking system have led to an awareness that the banking sector must be regulated in some way. This was the driving force behind the emergence of banking supervision, which has evolved over time into an important and standard component of the institutional structure of the market economy.

Banking supervision in developed countries has been built up over several decades. During this time, banking supervisory authorities have acquired expertise and experience, they have standardised the majority of their procedures and have established parameters for the regulatory framework within which banks function. The significance of the existence of banking supervisors and their work has been closely connected with the rapid expansion of the financial market and modern financial services. This process has increased the exceptionally demanding nature and complexity of conducting banking supervision, and the pressure from society for it to be efficient and effective has also risen.

In this context, it should be stated that the role of banking supervision in any country is not and cannot be to prevent the collapse of individual banks, nor to take over the responsibility of management and shareholders for a particular bank's financial situation. Despite the high standard of newly acquired expertise and its transmission into practical banking supervision procedures in countries with developed market economies, individual banks still fail and there are still crises and turbulence, just as there occur deep and systemic crises in their banking sectors, usually linked to negative developments in those countries' economies.

The role and importance of the banking system in the economy also determines the central aim of banking supervision. Internationally, this aim has been expressed in the "Core Principles"[1], which *inter alia* stipulate that quality banking supervision is a "public good" that may not be fully provided in the marketplace and whose key objective is to maintain stability and confidence in the banking system. Banking supervisors should also encourage market discipline and competitiveness and promote good corporate governance.

Act No. 6/1993 Coll. on the CNB in essence reflects this internationally recognised approach to banking supervision and defines the mission of the CNB's banking supervision as follows: "The CNB shall perform supervision of the execution of banking operations and take care of the prudential and purposeful development of the banking system in the Czech Republic".

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1 In co-operation with experts from the banking supervisory authorities of member and non-member states, the Basle Committee on Banking Supervision at the Bank for International Settlements (BIS) has drawn up a set of 25 Core Principles for Effective Banking Supervision. The principles clearly and comprehensively define banking supervisory responsibilities and at the same time indirectly indicate which matters do not fall within the remit of supervisors (bank management, substituting for the law enforcement authorities or regulators of institutions other than banks). The implementation of the "Core Principles" and their incorporation into legal regulations will be monitored by the BIS and other international institutions. The fulfilment of the "Core Principles" in a given country will form the basis for international assessment of the quality of banking supervision in that country.

Although this legislative formulation is very terse, it concisely expresses the banking supervisor's principal mission. To fulfil this objective, the CNB banking supervisory body is authorised by law to stipulate the basic regulatory conditions for entry into the banking sector and the regulations for prudential banking conduct with the aim of limiting the risks which banks take on; to conduct subsequent checks of their compliance with these regulations by means of audits of the financial data recorded by banks ("off-site surveillance") and inspections directly in banks ("on-site supervision"); and, in the event that any shortcomings are detected, to demand that banks take steps to eliminate and remedy them.

In accordance with the "Conception for the further development of banking supervision" (1998-2001) approved by the CNB Bank Board in 1998, the medium-term strategic objective for banking supervision is **to contribute to creating a stable and competitive banking sector, which will be the outcome of a dynamic balance between banking regulation and supervision, market discipline and good governance of individual banks.** The basic implementation principles for the Conception include:

- **a high degree of harmonisation of the regulatory framework, methods and procedures** with the European Union's prudential principles and best international practice, as set out in the European Union's banking directives and the Core Principles;
- **a comprehensive, standardised and balanced system for regulating and supervising banks,** based on an appropriate combination of off-site surveillance and on-site supervision, making use of external auditors as an important source of information, strict criteria for banks to enter and leave the sector, and international co-operation with the home supervisors of foreign bank branches and subsidiaries;
- **effective communication between CNB banking supervisors and the banking sector** via the Banking Association and directly with individual banks in elaborating prudential regulations and in further cultivating the banking services market by means of standards and codes issued by the Banking Association.
- **a system for co-operation in regulating and supervising "banking financial groups",** focusing on the harmonisation of licensing policy and prudential regulations for the members of a group, on information sharing between regulators and on the procedures for supervising members of the group.

In this context, it is also necessary to define those responsibilities which do not pertain to banking supervision and those expectations which it cannot fulfil.

In the first place, banking supervision cannot replace the role of individual banks' shareholders, governing bodies or senior managers, who are exclusively responsible for a bank's financial results and, as part of that, for the quality of its management, the identification and investigation of risks associated with banking transactions and the functioning of control mechanisms. They are also obliged to comply with the relevant legal and banking supervision regulations and to see that shortcomings in a bank's operations are remedied as required by banking supervisors.

Banking, by its very nature, cannot be conducted without objective risks, ensuing particularly from lending business, as otherwise banks would not be able to fulfil their fundamental economic role, i.e. the allocation of free funds. The banking supervisor, as the regulatory and controlling authority, can only limit this risk and work for the sound functioning of the banking system as a whole. It cannot, however, prevent banks and their governing bodies from taking on excessive risks that might lead them into serious financial difficulties which they and their shareholders are not able to eliminate. Nor can supervisors be expected to prevent banks from failing as a consequence of illegal activities and fraud because of decisions made by their managers. In this context, it must be emphasised that it is not the role of the banking supervisory authority to substitute for the law enforcement authorities and identify, clarify and prove that crimes have been committed in banks.

Although the banking supervisory authority cannot prevent individual banks from failing, its work should enable it to recognise banks in jeopardy in good time and adopt appropriate measures to maintain the stability of the banking system. The aim is not, however, to prevent individual banks from failing at all costs, as this would be at odds with the principles of a functioning market. Nor, in the event of a crisis in the banking sector, is the banking supervisor the only authority which can (or must) resolve that crisis. Nevertheless, it must have its place in the system for resolving situations that might jeopardise the functioning of the entire economy.

The situation in the banking sector and the workings of banking supervision are at the same time heavily influenced by macroeconomic stability, developments in the real economy, the conditions circumscribed by the legislative framework, the enforceability of the law and the overall environment for ethical business conduct in all spheres of the economy, including market discipline founded on transparent and truthful information on the financial situation in individual businesses.

II. THE DEVELOPMENT OF BANKING SUPERVISION IN THE CZECH REPUBLIC

A. Introduction

Prior to 1990, i.e. under the centrally planned economy, banking supervision was an unknown institution in what was then Czechoslovakia. Banking was subject to central management and banks' functions were considerably limited. The State Bank of Czechoslovakia (CSSB) was not only the bank of issue responsible for monetary policy and managing the circulation of money, but it also directly extended credit to economic organisations, maintained their accounts and thus fulfilled the functions of a commercial bank. Decisions on the distribution of credit were subject to the tasks and priorities stipulated by the state plan. Other state banks fulfilled set tasks for the foreign trade plan (Československá obchodní banka), kept the public's savings (Česká státní spořitelna and Slovenská štátna sporiteľňa), or operated in specific areas within a very narrow framework (Živnostenská banka and Investiční banka).

In 1989, preparations were made to abandon the CSSB mono-bank system and its interconnection of the central bank's issuing and allocating functions. Komerční banka and Všeobecná úvěrová banka were established on 1 January 1990, taking over the CSSB's commercial activities in the Czech and Slovak Republics. One of the first steps in the economic reforms that followed November 1989 was the creation of a standard two-tier banking system. This was a highly complicated and risky manoeuvre involving the reconstruction of the institutional and legislative framework.[2]

The emergence of a two-tier banking system, which created conditions for a rapid expansion of commercial banking and an increase in the range of banking services and products, was the fundamental spur towards establishing a banking supervision system.

B. The starting conditions for the development of the banking sector and the establishment of banking supervision

The economic environment

The transformation of the economy was commenced in a situation where the emerging and expanding banking sector was heavily burdened by the deformations of the preceding era. The existing state banks and the banks formed by split-offs from the CSSB were strongly undercapitalised, carried considerable volumes of bad loans and suffered from unbalanced funds (a large number of the earlier-extended loans were long-term and lacking in adequate coverage). Banks lacked the appropriate technology, and their management and decision-making processes were being established only gradually. They were understaffed, and those staff they did have lacked the necessary expertise and experience.

The process of establishing a market environment coupled with the emergence of thousands of new businesses brought a sharp increase in the demands placed on individual banks and the banking sector as a whole. Demand for all kinds of banking services rose significantly (there was a massive surge in the number of accounts opened and an increase in payments and clearing). The banking market responded both with an expansion of existing banks' business networks and products and with interest from newly established banks in entering the market. The emergence of new banks with Czech capital was to a considerable extent a forced reaction to this rising demand, which the state banks were not able to satisfy, and was simultaneously in line with thinking at the time on the need for greater competition in the banking sector. The entry of foreign capital into the banking sector was not an option at that time, as foreign banks were very cautious in their approach to this new and non-standard environment and continued to focus on select and solvent clients.

Given the non-existence of a capital market, demand for banking services was increasingly oriented towards credit, with mounting pressure on banks to finance the ever-greater needs of the business sphere and new business plans as part of the "small" and "large" privatisation schemes. Assessing loan applicants' financial situations was seriously hampered by a non-existence of historical data (for new clients) and the limited usefulness of the existing data. The banking sector also began to be confronted with the negative consequences of the rapid expansion of the banking market, including financial crime. In retrospect, it is clear that only very prudent conduct could have guaranteed the banks' long-term existence without the need for massive state assistance. Nevertheless, these banks were long criticised for their "insufficient support for the transformation of the economy".

2 The emergence of commercial banking was linked to the adoption of Act No. 158/1989 Coll. on Banks and Savings Banks, which entered into force on 1 January 1990. Act No. 130/1989 Coll. on the State Bank of Czechoslovakia entered into force on the same day.

Legislative conditions

Drafting new laws and adapting original legislation to the requirements of a market economy is a demanding and time-consuming process. In practice, changes in legislation often lagged behind the speed of reform. At the beginning of the transformation process, banking legislation was one of the most backward areas – for obvious reasons it did not provide any legal basis for reputable and prudent banking, nor for the effective supervision of bank governance. The domestic economy also lacked other important legal norms governing business relations between entities (particularly relations between creditors and debtors), regulations for the creation, existence and closure of enterprises, market-oriented accounting and tax laws, laws governing auditors, etc.

For banking legislation, the foundation-stone was the creation of a two-tier banking system on 1 January 1990, which was related to the adoption of Act No. 130/1989 Coll. on the State Bank of Czechoslovakia. In Article 17 of that Act, the central bank was made responsible for supervision of areas which it regulated by means of binding legal regulations, i.e. monetary planning; the issuance, circulation, exchange and withdrawal of cash; treasury and foreign exchange operations; the information system of the CSSB, banks, savings banks and other legal entities; and remuneration for financial services rendered. It is evident that this conception did not include the typical tasks of banking supervision, but rather empowered the central bank to demand that the entities concerned (by no means only banks) complied with the generally binding regulations. The aim of such supervision was to support the CSSB's main functions in the area of issuing cash and managing the circulation of money and the payment and clearing system.

On the same date, Act No. 158/1989 Coll. on Banks and Savings Banks also entered into force, allowing banks to exist in the form of state financial institutions, joint-stock companies, co-operatives or joint ventures. Foreign entities were also allowed to participate (under Act No. 173/1988 Coll. on Companies with Foreign Ownership). The CSSB issued authorisations for banks or savings banks to be established and for other acts (mergers, splits, reductions in capital, etc.) in agreement with the Federal and Republican Ministries of Finance, depending on the bank's location. Banks' activities were subject to state supervision by the Federal Ministry of Finance, with savings banks subject to supervision by the appropriate Republican Ministry of Finance. Supervision included checks on banks to ensure they met their commitments, adhered to the generally binding regulations and complied with their licences. It also included the right to request documents on operations and financial statements and to participate in the meetings of banks' and savings banks' governing bodies.

It emerges from the above that at the time Acts No. 130/1989 and 158/1989 were in force, the CSSB was not charged with supervising prudent business conduct by banks and savings banks. It should be added that the Act on Banks and Savings Banks regulated the state supervision of banks – entrusted to the Ministries of Finance – very imperfectly, as it did not give the supervisory authorities the power to issue binding legal regulations to control banking risks, nor to regulate the banks in any other way.

C. First steps towards banking supervision in the CSSB

1990

Banking supervision was mentioned in Act No. 130/1989 Coll. on the State Bank of Czechoslovakia as one of the functions of the central bank, but its content did not correspond to the true conception and purpose of banking supervision, namely the systematic reduction of the risks inherent in banking and the protection of the safety and soundness of the banking sector. The gradual development of expertise and intensive negotiations with international institutions led to an identification of shortcomings in the existing legislation and an awareness of the lack of institutional arrangements for activities which directly concerned the exercise of banking supervision, together with an awareness of the importance of its proper functioning.

The need to establish standard banking supervision found increasing support within the CSSB. One reason was that the Federal and Republican Ministries of Finance displayed practically no interest in developing state oversight, which was at that time represented by just one institution whose role it was to supervise the activities of banks and savings banks. In 1990, the CSSB therefore commenced steps to establish banking supervision, with the aim of filling the clear gap in the newly established institutional structure for the market economy. The main reasons at that time for bringing banking supervision within the CSSB were its regular contacts with banks, its material and technical arrangements, the possibility of developing automation and information technology, and the limiting of political influences.

At the same time, so that the CSSB could meet the essentially formal requirements of Act No. 158/1989 Coll. on Banks and Savings Banks for licensing new banks, it created the first set of requirements for bank founders. These requirements corresponded to the level of knowledge at the time and included requirements for depositing capital of at least CZK 50 million, the submission of draft founders' deeds and business plans, the inclusion of persons with banking expertise in the management (at the start of the transformation process, when experience in banking under the previous regime was at the very least debatable, this requirement was not always realistic), for the organisation of the bank, etc. Checking individual founders' compliance with these requirements was already complicated at the stage of assessing a project for a new bank, particularly with respect to the origin of funds for paying up capital, the evaluation of founders and their relations, etc. Moreover, once a bank had started up, the CSSB had no further powers to check its activities.

Under these terms, in addition to the five existing state banks, thirteen new banks[3] were established that year in the Czech Republic, with the CSSB issuing licences after agreement with the Federal and Republic Ministries of Finances. Of those thirteen, nine had Czech capital and four had foreign ownership. As the new private banks were launched on what was in essence a monopolistic market and with no funds of their own, the CSSB provided them with refinancing credits to allow them to commence operations.

3 Data on the founding of banks in individual years in the text of this report is based on data on the provision of licences, i.e. this data may differ from the number of banks active at that time.

1991

At the beginning of 1991 a new group was established in the CSSB with the task of preparing the necessary conditions for developing banking supervision with attributes similar to those in developed countries. This group, composed of CSSB staff, employed a total of seven desk officers and one manager. By mid-1991 a document had been produced containing a plan for the exercise of banking supervision as a true regulatory authority within the CSSB, including working methods, banking supervision methods and an organisational structure. Following its approval by the CSSB Bank Board, work commenced immediately on incorporating these proposals into legal norms.

As regards organisational structure, in view of the existence of the Czechoslovak Federation the CSSB was split into a federal headquarters and ”main institutions” for the Czech and Slovak Republics. Both republican institutions worked to establish their own banking supervisory bodies. Of the two options for the organisational arrangement for banking supervision – centralised supervision (as supported by the IMF adviser) or decentralised supervision – it was decided, under the pressure of circumstances, to introduce a decentralised model for banking supervision in the Czech and Slovak Federal Republic (CSFR). Separate banking supervision groups were set up at the main institutions for the Czech Republic and Slovak Republic within the CSSB organisational structure, with no direct management links to banking supervision at the federal headquarters. As part of the process of drafting new acts on the CSSB and on banks, the Banking Supervision Group at the federal headquarters drafted an analysis of the basic aspects of bank regulation – matters relating to banks' universality and specialisation, the work of foreign bank branches, ownership interests by banks and restrictions on them, etc. Simultaneously, work began in co-operation with a foreign adviser on drafting the central bank's first set of prudential regulations to mitigate banking risks, so that they could be available from the moment the new set of banking laws entered into force. In this context, work also began on drafting entirely new requirements for establishing banks.[4]

As part of the preparations for banking supervision, a draft “Banking Supervision Development Action Plan” was produced, including a detailed timetable for work on regulations, the use of a permanent IMF expert within the CSSB as a banking supervision adviser, the gaining of practical experience for supervisory staff by means of direct co-operation with foreign experts in supervisory activities, and training for supervisory staff. The CSSB supervisory body gradually reached a stage at which it could actively participate in international co-operation. In March 1991, it became a co-founder of the Group of Banking Supervisors from Central and Eastern Europe.[5]

The growing importance of banking supervision entailed increasingly frequent involvement in activities relating to decisions on the future direction of the banking sector. The

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4 Drafting the new banking supervision regulations was unusually complicated. Each type of risk involved an entirely new subject matter which had not been clearly classified in any foreign regulations. As foreign banking supervisors in developed countries are not generally familiar with the form of separate regulations (known as ”provisions”), the CSSB's approach to drafting such regulations represented a progressive element, with its focus on a specific type of risk and on transparency. This is also true of the provision dealing with the requirements for establishing banks. The CSSB's best supervisory staff worked on the draft provisions, taking away a substantial part of the capacity for the actual performance of supervision.

5 The main purpose of the Group of Banking Supervisors from Central and Eastern Europe is to promote the exchange of experience and information on policy application and practical supervisory issues and to organise joint training events with the aim of making procedures consistent with practice in developed countries and with the recommendations of the Basle Committee. The group has no executive powers and the conclusions from conferences of the supervisory authorities' main representatives are not binding. It was decided to hold regular conferences, and a method for changing the Group's chairman and a range of other organisational and technical aspects of the Group's work were also agreed.

Banking Supervision Group participated in the first wave of privatisation of banks, assessing banks' draft privatisation projects and elaborating privatisation parameters. It co-operated with the banks and central institutions concerned in "Consolidation Programme I". This included establishing Konsolidační banka, transferring selected assets from commercial banks to Konsolidační banka, increasing the large banks' capital with state subsidies for their reserve funds and improving the quality of banks' portfolios by means of government bonds. This was the first (and, the government declared at the time, the last) mass action by the government to clean up and capitalise the banking sector, with the objective of improving the situation for the large Czech and Slovak banks.

In 1991 the Banking Supervision Group commenced work, in the first phase taking over responsibility for dealing with requests for banking licences, which had until then been covered by other CSSB departments. It also commenced preparation of the information arrangements for its analytical functions, particularly with regard to the receipt of regular information and data from banks. An important condition for the performance of banking supervision was co-operation with the Federal Ministry of Finance on transforming the chart of accounts for banks, including basic accounting records, and initiating contacts with bank auditors. Communications were likewise opened with the Federal Ministry of Finance on the taxation aspects of banking, as there was no legislation governing the creation of reserves for banking risks. The Federal Ministry of Finance subsequently stipulated a limit for the annual creation of reserves from banks' expenses at a level of 1.5% of their loans as at 30 June 1991.

The rapidly increasing demands on banking supervision put great pressure on the Banking Supervision Group's capacity. Staff numbers, structure and qualifications represented a significant limiting factor for the effectiveness of the Department's work. Moreover, at that time the CSSB was facing a marked outflow of capacity into the banking sector and private enterprise, and the labour market did not provide a quality response to the Banking Supervision Group's recruitment efforts.

The banking sector in 1991 was influenced by the "small" privatisation process underway at the time, which was financed mainly from bank loans. To ensure sufficient funds for such financing, the CSSB provided banks – and especially the new banks – with considerable refinancing loans. At the same time, it oversaw the construction of a monetary plan for the privatisation boom then underway. The forecast volume of loans for the "small" privatisation was recorded separately from standard loans, with these funds sterilised following payment to the National Property Fund (NPF) for the units auctioned.

In the course of the year, the CSSB, with the agreement of the Federal and Republican Ministries of Finance, licensed thirteen new banks in the Czech Republic, as in the preceding year. Six of these were banks with Czech capital, one was a state bank (Konsolidační banka) and six were banks with foreign ownership (mainly subsidiaries of foreign banks).

D. Creating the basic regulatory environment

1992

On 1 February, the new banking acts – Act No. 22/1992 Coll. on the CSSB and Act No. 21/1992 Coll. on Banks – entered into force. This entailed an important change in the legal basis of banking supervision and the framework for such activities. The content of the work of banking supervision was defined as follows:

- assessing applicants for banking licences in accordance with the Act on Banks,
- overseeing compliance with the terms of banking licences in accordance with the Act on Banks and of licences in accordance with special acts,
- checking compliance with regulations issued by the CSSB and compliance with laws in cases where it is authorised to do so,
- imposing remedial measures and fines when shortcomings are detected.

The Act on Banks was based on the German model, with certain provisions based in part on the wording of the European Commission's banking directives. At the time they entered into force, the new banking acts appeared to be a sufficient instrument for the central bank to impose discipline and transparency in banking. The shortcomings in the Act on Banks (entry of and changes to banks' shareholders and managers, the establishment of prior consent, remedial measures, the establishment of conservatorship, the exit of a bank from the sector, etc.) were not so evident at the time it began to be used.

Methodological work

From the beginning of the year, the supervisory authority focused chiefly on implementing the new laws. The main work and priorities were directed towards issuing prudential regulations for banks and improving licensing procedures. The CSSB Bank Board gradually approved "provisions" (regulations) on capital adequacy, credit exposure, liquidity and limits for banks' open foreign exchange positions, and provisions stipulating the requirements for establishing new banks (e.g. the requirement for depositing capital was increased to CZK 300 million, including for banks already in existence). Banking supervisors also concentrated on formulating supervisory procedures for on-site inspections in banks, which had gained support under the new legislation.

The Banking Supervision Group contributed to other activities which were important for running banks and conducting banking supervision. Following discussions with the Federal Ministry of Finance, a CSSB and FMF Directive was approved which included principles for creating reserves and provisions for banks' risk assets (receivables and securities). The principles classified banks' assets according to their quality (standard, substandard, doubtful and loss), recommended provisioning levels for specific assets at 20%, 50% and 100%, and stipulated accounting procedures for classified loans. At the same time, the FMF issued a statement that banks could create reserves up to a level of 2% of their assets as of 31 December 1992. The legislation for this area was established by Act No. 593/1992 Coll. on Reserves for Determining the Income Tax Base, of 20 November 1992, which set out the maximum limits for creating bank reserves. The approved wording of the Act was in force in unaltered form from January 1993 to July 1995. The Banking Supervision Group continued to work towards greater co-operation with banks' auditors and commenced mapping out the options for codifying this co-operation under the directives for conducting audits issued by the newly established Chamber of Auditors. The thematic areas for auditing the accounts and financial results of large Czech and Slovak banks were elaborated in co-operation with Phare. Following a series of discussions with bank representatives, a tender was organised at the CSSB and the selected auditors began work in the autumn.

The Banking Supervision Group also worked on promoting awareness, arranging training for commercial banks on the new set of prudential regulations (conducted in the Czech Republic with the participation of around 400 bank representatives and in the Slovak Republic with the participation of around 200 bank representatives). The publication "Banking Supervision Communication" was launched as an information and communication medium for commercial banks and other interested parties. The Banking Supervision Group initiated a number of consultations on money laundering and financial crime with representatives from the departments and authorities concerned. In its international activities, the Banking Supervision Group organised an international conference for the Group of Banking Supervisors from Central and Eastern Europe.

Control and analytical work

Control work at that time was objectively aimed at acquiring experience in this area of supervision. Several controls were carried out and during some of them experts from the Federal Reserve Bank of New York relayed their experience to the staff of the Banking Supervision Group. The quality and frequency of the supervisory work was very limited owing to capacity constraints. The results corresponded to the level of expertise and experience of the supervisors at that time. The Banking Supervision Group attached great importance to commencing active analytical work, especially work with bank reports. As a new body, the Banking Supervision Group had not, however, yet achieved a sufficiently high standing within the CSSB, and IT support for its work was inadequate. The analytical work was therefore developed under very difficult conditions. Supervisors concentrated nevertheless on improving the construction of bank reporting and linking prudential reports to the chart of accounts for banks. Alongside this, they worked to improve information flows between banks and the Banking Supervision Group. Despite the complications, during the year reports began to be produced on the situation in the banking sector and in individual banks, including development trends. These reports were regularly submitted to members of the Bank Board (with quarterly reports the objective).

Organisational arrangements for banking supervision

The exercise of banking supervision was affected by the federal arrangements within the CSSB, i.e. the efforts by both republics to transfer as many powers as possible to the CSSB's republican headquarters. On the basis of a document discussed by the Bank Board, the work of the Banking Supervision Group was split so that the department at the federal headquarters was responsible for methodology and the republican departments for licensing and control work. The result was that licensing work for new banks was transferred to the republican banking supervision groups, including a complicated management mechanism via the management of both main institutions. The dividing line for supervisory work was not entirely clear and did not provide adequate possibilities for the effective performance of banking supervision.

A constant problem for banking supervision was the lack of staff with the required expertise and experience, although total staff numbers did gradually increase. The federal headquarters' Banking Supervision Group came to employ 21 people in the course of the year, with the republican departments having ten and seven staff respectively, but on the other hand a number of more experienced staff left the supervisory structures.

The banking sector

With the agreement of the Federal and Republican Ministries of Finance, the CSSB licensed seventeen new banks in the Czech Republic, of which six were branches of foreign banks, six were banks with foreign ownership and five were banks with Czech capital. The rapid expansion of the banking sector thus continued. The ”small” privatisation was proceeding at full speed and work was also commenced on privatising the large banks, which first of all acquired the status of joint-stock companies. Banks with Czech capital played a relatively important role in financing privatisation. The large banks began establishing investment privatisation companies and funds for the first wave of voucher privatisation.

1993

Methodological work

The CNB Bank Board approved revisions to the prudential regulations on capital adequacy, credit exposures and liquidity regulations.[6] Following an assessment of the results of audits of large banks, financed by Phare, the Banking Supervision Group produced minimum requirements for the content of bank performance reports. After discussions with banks and their auditors, these were distributed to banks and their branches in the form of recommendations for audit work on the 1993 results. The Department also worked with the Czech Chamber of Auditors on establishing basic auditing standards targeted at verifying the most important and risky areas – especially banks’ systems of risk management.

The Banking Supervision Group also contributed to work on legal norms to introduce building savings and a new act on mortgage banking. This act proposed establishing specialised banks for mortgages. Although the act was not passed in the proposed form, passages on definitions and security parameters for mortgage banking were incorporated into the Act on Bonds. On 1 January, the Act on Reserves for Determining the Income Tax Base entered into force, allowing banks to create reserves for loan receivables and for guarantees provided within stipulated limits as a tax expense. Despite warnings from the Banking Supervision Group, the issue of provisioning for securities remained unresolved. The Banking Supervision Group co-operated on devising laws to establish a state export support institution (EGAP) and worked its insurance terms into the prudential regulations.

There was increasing awareness of the Banking Supervision Group among specialists, including at international level. The Department took part in a number of discussions with rating agencies and missions from the OECD, IMF, etc. The CSSB Banking Supervision Group was charged with the presidency of the Group of Banking Supervisors from Central and Eastern Europe.

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6 The provision on capital adequacy made the calculation of banks’ capital adequacy more strict by deducting credit exposures vis-à-vis related parties and uncovered losses from capital, including capital investments in legal entities in which a bank had control. At the same time, EGAP was classified as an institution with government support under the category of assets with a 20% risk weighting. The capital adequacy limit (the ratio of capital to risk-weighted assets) was set at 6.25% and banks were required to achieve it by 31 December 1993, with a limit of 8% to be met by 31 December 1996. The credit exposure provision introduced a duty for banks to set limits for economic sectors and geographical territories, and the liquidity provision established the duty to submit a preliminary report for the elapsed calendar year by the thirtieth day of the following calendar year.

Control and analytical work

This area of the Banking Supervision Group's work gradually became more dynamic. A detailed analysis of developments in the banking sector in 1990–1992 was produced and discussed in the CNB Bank Board. Producing the report was demanding owing to a lack of data, missing time series and technical problems. The Banking Supervision Group therefore proposed and produced a more modern method for comparative analyses of banks in the form of a uniform appraisal system based on dividing banks into comparable groups and assessing selected absolute and relative indicators for banks' financial results.

The development of on-site inspections in banks continued, with completed inspections resulting in increasing pressure on banks in the form of recommendations and remedial measures. However, the number of banks and the limited capacity of the Banking Supervision Group remained an obstacle to more frequent inspections and to concentrating on resolving the more serious problems facing individual banks. Nevertheless, problems were identified and resolved concerning banks' credit portfolios, commitments to closely related parties, machinations with the payment of capital and banks' accounting.

Organisational arrangements for banking supervision

The CSFR was dissolved and the CNB (and SNB) were established. The new national arrangements were also apparent in the splitting of banking supervision in the Czech Republic and Slovakia. The Banking Supervision Group participated in preparing and implementing the division of the federation (communications with banks, splitting balance sheets and exchanging shares between the National Property Funds, the Konsolidační banka portfolio, etc.). As regards the organisational arrangements for banking supervision, the existing department at the CSSB headquarters (or CNB) merged with the republican department. The Banking Supervision Group now had three divisions – methodology, licensing, analyses and inspection. The total number of staff did not exceed thirty (around 25–27) and supervisory work was limited by the given capacity and considerable overloading, particularly in management positions.

The banking sector

The first significant difficulties became apparent in the banking sector. This chiefly concerned Kreditní a průmyslová banka, where acute shortcomings in liquidity and capital led to the introduction of conservatorship. This case also pointed to the risk of banks being negatively influenced by shareholders and management.

Stricter rules for banks' access to CNB refinancing and the interbank market had a negative affect on the liquidity of several small banks with weak capital. These banks suffered from a considerable imbalance in the time structure of their assets and liabilities. This situation led to a series of talks with banks' management, shareholders and auditors. A liquidity team was set up at the CNB at Vice-Governor level. Banks' cash flow was monitored in detail and remedial measures were proposed and implemented.

Konsolidační banka's conduct and financial situation did not correspond to the supervisory requirements, and the Banking Supervision Group put pressure on the bank and the Ministry of Finance as its founder. This pressure resulted in the Ministry of Finance issuing a guarantee for the bank's finances and its capital was increased from NPF funds.

There was a decline in issuing of licences and establishing of new domestic universal banks in 1993. Of the ten banks newly licensed that year, four were building savings banks, four were branches of foreign banks and two were banks with foreign ownership.

E. The expansion of banking supervision

1994

Methodological work

Negative trends in the small banks subsector and practical experience in eliminating banks' shortcomings revealed gaps in the legislation (notably the Banking Supervision Group's limited powers in cases where it had detected temporary or persistent shortcomings in banks' activities, where they had negative financial results, where there was obvious fraud, etc.). The response was a revision of the Act on Banks, which strengthened the CNB's remedial measures and powers and included the option of reducing a bank's capital. The conception of conservatorship was refined and insurance was introduced for deposits of natural persons.

The greater activity by the CNB in the legislative area also resulted in the regulatory framework being supplemented. Work continued on improving licensing procedures, which became substantially stricter and limited access to the sector, including an increase in the minimum level of capital to CZK 500 million.[7] Banks were approached concerning the timetable for increasing capital to the prescribed level. New CNB provisions were issued forbidding banks from providing certain kinds of loans or making certain investments in ownership interests. There were new regulations on classifying loan receivables and the method for creating reserves and provisions. A commission was established to appraise bank managers' professional and management skills. The Banking Supervision Group also produced a methodology for assessing the quality of work of auditing companies, together with a new CNB provision stipulating the minimum requirements for bank performance reports. The CNB subsequently revised and issued new official communications on registering the representations of foreign banks and financial institutions in the Czech Republic and on Article 17 of the Act on Banks (banks' ownership interests in other companies).

Methodological work also focused on the Banking Supervision Group's internal procedures, especially those concerning inspection work, administrative proceedings and the introduction of conservatorship in a bank.

The Banking Supervision Group devoted its attention to the draft Act on Preferential Export Financing (establishing Česká exportní banka) and, as part of work on revising the Act on Reserves for Determining the Income Tax Base, to legislation for banks to create tax deductible reserves and provisions from expenses.

[7] Approved by the CNB Bank Board in January 1994.

Control and analytical work

The year commenced with discussion in the Bank Board of an analysis of developments in the banking sector in 1993, with the Board raising a requirement for a deeper analysis of the financial health of the small banks subsector. Staff from other CNB departments were temporarily attached to the Banking Supervision Group for this purpose, and the Group organised short-term inspections of a selected group of banks, focusing on the quality of their credit portfolios, the management of lending procedures, liquidity, management quality and information systems. The results of these inspections, which revealed a number of fundamental shortcomings in banks' activities, became the subject of a series of talks with the management of the banks concerned, including measures by the Banking Supervision Group to remedy these shortcomings, which in some cases meant restricting banks' activities or producing consolidation programmes for their overall recovery. The Banking Supervision Group also carried out ten comprehensive and partial inspections in banks and a series of information visits to banks.

Organisational arrangements for banking supervision

After assessing developments in the banking sector, the Bank Board decided to enhance the standing of the Banking Supervision Group and reorganise it. For the first time, banking supervision was made the direct responsibility of a member of the CNB Bank Board – a senior director – and was split into two departments: the Banking Supervision Policy Department, which included the Methodological and Licensing Divisions, and the Bank Analyses and Inspection Department. The latter department was divided into three inspection divisions (for small, large and foreign banks) and one analytical division. Extensive staff recruitment was commenced, with a wide-ranging training programme for new staff devised in co-operation with the Federal Reserve Bank of New York. The number of supervisory staff increased to approximately 60 during the year.

The banking sector

Owing to fraudulent financial transactions by Banka Bohemia that directly jeopardised its existence, it was decided to introduce conservatorship. The bank's activities were subsequently terminated by a decision taken at the general meeting. In view of the non-existence of deposit insurance, the situation of the bank's clients was resolved with the deposits being taken over by ČSOB. The CNB and the state, represented by the Ministry of Finance, undertook to cover ČSOB's losses and expenses from this operation.

The Banking Supervision Group, in agreement with the Ministry of Finance, also commenced administrative proceedings to revoke AB Banka's licence owing to serious problems with liquidity and insufficient capital. On the basis of a statement by the bank's shareholders and its largest creditor, Česká spořitelna, on the bank being taken over by Česká spořitelna (confirmed at the bank's general meeting), these administrative proceedings were halted. In this case, the CNB and the state, represented by the Ministry of Finance, again undertook to cover ČS's losses and expenses from this operation.

Only two buildings savings banks, one foreign bank and one foreign bank branch were licensed in this year, although the number of active banks in the banking sector peaked at 55, of which 32 had Czech capital, 15 were dominated by foreign capital and 8 were branches of foreign banks.

1995

Methodological work

In August 1995, a amendment to Act No. 593/1992 Coll. on Reserves for Determining the Income Tax Base entered into force. This newly defined categories and limits for provisioning, in particular in accordance with a classification of individual receivables (see the CNB provision on classification).[8] This revision was in force up to the end of 1997.

In this year, the Banking Supervision Group carried out its first aggregate appraisal of co-operation with banks' auditors. It assessed individual auditors' activities and results for 1993 and 1994 in relation to the CNB provision from the end of 1994 stipulating the requirements for bank performance reports.

In view of the expertise and experience gained, especially from inspection work, the basic prudential regulations were substantially revised, as they had ceased to correspond to conditions in the banking sector (the provision stipulating the limits and terms for banks' open foreign exchange positions, the capital adequacy provision, the credit exposure provision and the provision on bank performance reports).

As the legal norms reflecting the needs of mortgage banking had been revised with effect from the beginning of July 1995, the Banking Supervision Group prescribed criteria and procedural aspects for granting licences to banks for the issuance of mortgage bonds (i.e. mortgage banks).

Control and analytical work

At the end of each quarter, a supplemented and expanded aggregate analysis of developments in the banking sector, including trends and ratings for individual banks, classified according to uniform criteria into five groups, was submitted to the CNB Bank Board for discussion. In 1995, the Banking Supervision Group's inspection work became much more intensive. In total, 15 comprehensive and partial inspections were carried out in banks, together with 17 information visits. The on-site inspections revealed that banks had inadequate valuations of their credit portfolios and their provisions needed to be significantly increased, which in several cases meant a loss of capital to create them. On the basis of the inspections, the Banking Supervision Group demanded that individual banks remedy this situation (by reclassifying loans, creating additional provisions and increasing capital as part of consolidation programmes).

Following an appraisal of trends in the banking sector in the first three quarters of 1995, especially in the small banks subsector, the CNB Bank Board discussed and approved the basic principles of Consolidation Programme II. This programme signified a more strict approach by the Banking Supervision Group to those banks which failed to meet the fundamental prudential regulation – real capital adequacy of 8% – and required the implementation of recovery programmes with the support of the shareholders of banks under threat. The programme was

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8 The total level for provisioning was limited to 3% of the average level of receivables for the tax year.

oriented primarily towards the small domestic banks subsector and was based on the requirement for banks to fully cover risks from their assets in accordance with auditors' valuations at the end of 1995.

Organisational arrangements for banking supervision

In connection with the stricter supervision of banks and the greater volume of work, the CNB Bank Board discussed issues connected with optimising the structure and activities of banking supervision and the prospects for its future development. The outcome of these discussions was support for proposals by the banking supervision organisational units and a decision to continue recruiting supervisory staff, in particular to strengthen the supervisory work. In the Bank Analyses and Inspection Department, the overburdened Small Banks Inspection Division was split into two divisions.

Training programmes for supervisory staff continued, with the most important ones carried out with the assistance of regulators in developed countries, especially the USA and EU countries (the UK, France, Belgium), in the form of short-term attachments. The number of staff working in all the banking supervision organisational units rose to a total of approximately seventy.

The banking sector

The number of banks was in essence constant in 1995. Only one licence was issued, to Česká exportní banka, established by the state under a special legislative act.

In the second half of the year, the CNB Bank Board decided to revoke the licences of Kreditní a průmyslová banka, AB Banka and Česká banka owing to serious long-term shortcomings in their activities. These decisions by the CNB Bank Board (dating from December 1995 for AB Banka and Česká banka) were a feature of the implementation of Consolidation Programme II.

1996

Methodological work

The provision on banking secrecy in Article 38 of Act No. 21/1992 Coll. on Banks was supplemented with a reporting duty in this year in connection with the issuing of Act No. 61/1996 Coll. on Some Measures Against Money Laundering and on the Amendment of Related Acts.[9]

The CNB Banking Supervision Group continued implementing fundamental modifications and changes to the prudential rules for banks, which had commenced in 1995. Entirely new provisions were issued on the principles for creating portfolios of securities and holdings by banks and covering the risk of the depreciation of securities and holdings through provisioning

Revisions were made to the provision on banks' credit exposures, where the concepts of debtor and credit exposure were newly defined, and to the provision on capital adequacy. New

9 A Financial Analysis Unit (FAU) was set up at the Czech Ministry of Finance in connection with the issuing of Act No. 61/1996 Coll.

risk weightings were introduced for Konsolidační banka, the NPF and EGAP, i.e. entities with state guarantees. A revision was also made to the liquidity provision from April 1993. After an aggregate evaluation of reports and the quality of work by bank auditors in 1995 (as in the preceding year), a new provision was issued setting out the requirements for banks' performance reports.

Control and analytical work

Aggregate analyses of developments in the banking sector were submitted to the CNB Bank Board at the end of each quarter. The methodology for rating individual banks was refined, signal information was processed for a warning system based on monthly changes to a group of selected financial indicators for banks, procedures for on-site inspections were refined and information outputs for evaluating individual banks within off-site surveillance were standardised. The Banking Supervision Group also produced and published its first report on banking supervision and the banking sector in the Czech Republic for 1995. Inspection work was to some extent influenced by the priority usage of banking supervision capacity to implement Consolidation Programme II, which meant appraising the results of all small banks for 1995 in accordance with the stipulated criteria, holding repeated talks with banks' managers, shareholders and auditors, preparing consolidation programmes for individual banks, and adopting a range of remedial measures, including administrative proceedings where recovery for banks was not possible. Nevertheless, there were eight comprehensive and partial inspections and seventeen information visits to banks.

The implementation of Consolidation Programme II led to a clarification of the negative financial situation facing a number of small domestic banks. The Banking Supervision Group reacted (after a period in which various solutions were tested) with uncompromising interventions in accordance with its legal powers in those cases where banks' shareholders rejected or were not able to accept an appropriate solution and where prolonging those banks' negative financial situation was unjustifiable. Of the total of 18 small banks, 15 were treated under the consolidation programme, with 9 of them receiving a radical solution consisting in the revocation of their licences or the introduction of conservatorship following a reduction in capital. In other cases there was co-operation with the existing shareholders or new investors in increasing capital to cover the banks' potential losses.

The consolidation programme did not go ahead without the public's confidence in the banking sector falling and an increased threat to small banks in the form of deposits being withdrawn, which those banks would not have been able to withstand. To reduce the risk of a liquidity crisis for small banks and to promote the overall stabilisation of the banking sector, a Czech Government Decree of 16 October 1996 adopted as a systemic solution a "Programme to improve the stability of the Czech banking sector" (the "Stabilisation Programme"), which was intended for the thirteen small banks in existence at the time. The Stabilisation Programme entailed Česká finanční s.r.o.[10] purchasing insolvent receivables from banks at their nominal value, up to a maximum of 110% of the banks' capital. This was done on the basis of returnability, with the banks obliged to gradually create a reserve to repay their dues to Česká finanční after seven years had elapsed.

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[10] A wholly-owned subsidiary of the CNB.

The Stabilisation Programme was based on the level of knowledge of the small banks' situation at that time and was intended to create conditions for them to become financially stable again. Its success depended, however, on a number of other conditions, especially on the banks' true initial situation, developments in the country's economic and legislative environment, and the ability of shareholders and management to make use of this option.

The Stabilisation Programme was therefore by no means a guarantee that the risks to the banks would subsequently be eliminated. On the contrary, in the event of failure to comply with the prescribed terms, it envisaged terminating banks' operations.

To implement the Stabilisation Programme, the Banking Supervision Group elaborated conditions for banks to be included in the programme, working with other specialised CNB units on the procedures for Česká finanční to purchase assets from the banks and establishing uniform economic parameters for evaluation purposes.

Organisational changes

During 1996, the CNB Bank Board approved the formation of a team within the Banking Supervision Group focusing on financial crime in banking, the role of which was to make contacts with the law enforcement authorities to secure their methodological and professional assistance. The Banking Supervision Group ensured participation at a number of seminars for representatives from the law enforcement authorities and commercial courts. At these seminars, on the basis of its practical experience, it presented and clarified the economic basis and context of fraudulent practices within banks. The team's activities were also aimed at lodging complaints against banks in which suspicious transactions had been detected. A total of sixteen complaints were lodged (e.g. against Kreditní a průmyslová banka, Banka Bohemia, První slezská banka, Ekoagrobanka, Banka Skala, Podnikatelská banka, Realitbanka, Evrobanka, Agrobanka and Foresbank). There were consultations on the fraudulent practices uncovered in banks with FBI specialists, who proposed setting up a specialised team to focus on crime in the financial sector. In line with this recommendation, the CNB wrote to the Ministers of Finance, the Interior and Justice with a proposal to set up a specialised interdepartmental group and a recommendation for specialisation within the law enforcement authorities. These activities received no immediate response.

The total number of supervisory staff was now just over eighty.

The banking sector

The outcome of the greater pressure on the Banking Supervision Group to remedy shortcomings in banks was a painful but ultimately purgative process, the postponing of which would only have harmed the economy further. In the first half of 1996, První slezská banka's licence was revoked and conservatorship was introduced in Ekoagrobanka, COOP banka and Podnikatelská banka. Conservatorship in Ekoagrobanka was terminated in the second half of the year in connection with a capital investment by Union banka, which subsequently purchased part of the bank. In the second half of the year, conservatorship was introduced in Realitbanka, Velkomoravská banka and Agrobanka, while Kreditní banka Plzeň's licence was revoked.

There were further changes in the banking sector. Two new licences were issued, one for the subsidiary West Deutsche Landesbank (CZ) a.s. and one for a branch of Midland Bank plc. At the beginning of the year, the Bayerische Vereinsbank branch was transformed into the subsidiary Vereinsbank (CZ) a.s. Three banks which no longer had licences went into liquidation (AB Banka, První slezská banka and Kreditní banka Plzeň) and one into bankruptcy (Česká banka).

1997

Methodological work

In 1997 the Banking Supervision Group started work on revisions to Act No. 21/1992 Coll. on Banks, designated the “small” and “large” amendments. These responded to shortcomings in banking legislation on the basis of practical experience and an identification of potential weaknesses, especially in terms of the causes underlying the failure of several banks and the Banking Supervision Group’s options for dealing with such cases. They also reflected the requirements of the Government’s "packages" for correcting economic policy and cultivating the legal framework of the Czech economy.

At the same time, the Banking Supervision Group continued its work to supplement and refine the prudential rules for banks. There were revisions to the CNB provision on capital adequacy, the provision stipulating restrictions and conditions for banks for certain kinds of loans and investments in ownership interests, the provision on the principles for creating portfolios of securities and holdings and covering the risk of the devaluation of securities and holdings through provisioning, and the provision setting out the principles for classifying loan receivables and provisioning for those receivables After an evaluation of performance reports and the quality of bank auditors’ work for 1996 (as in previous years), a new provision was issued stipulating the requirements for bank performance reports.

In view of the need for various risk factors in banks’ financial positions to be better assessed, the Banking Supervision Group commenced work in 1997 on a new provision on capital adequacy, which would, in accordance with newly adopted international standards, incorporate market risk, and on a provision to monitor capital adequacy on a consolidated basis. In international relations, the CNB Banking Supervision Group was asked by the Basle Committee on Banking Supervision to participate in an expert group producing international banking supervision standards (the Core Principles for Effective Banking Supervision).

Control and analytical work

Aggregate analyses of developments in the banking sector, including ratings for individual banks, were submitted to the CNB Bank Board at the end of each quarter. The Banking Supervision Group also produced and published a report on banking supervision and the banking sector for 1996. In addition to these aggregate reports, analyses of individual banks requiring greater attention from the Banking Supervision Group were produced. In this year, the Banking Supervision Group conducted 12 comprehensive and partial on-site inspections and 18 information visits to banks.

The implementation of the Stabilisation Programme was important for the Banking Supervision Group’s work. Six banks – Banka Haná, Zemská banka (now Expandia banka), Pragobanka, Moravia banka, Universal banka and Foresbank – expressed an interest in joining the programme and subsequently submitted their individual stabilisation programmes, gradually joining the programme in the course of 1997. This entailed them starting to sell their bad receivables to Česká finanční. Programmes for Pragobanka, Moravia banka and Banka Haná were ready in January and were subsequently approved by the CNB Bank Board for inclusion in the stabilisation programme. During the first half of the year, admittance was negotiated for Foresbank, Universal banka and Zemská banka (after granting consent to the entrance of a new investor – the Expandia group – into Zemská banka). Once the conditions had been met, these banks were also included in the Stabilisation Programme.

1997 also saw ongoing work to complete Consolidation Programme II. The CNB Bank Board discussed concrete proposals by the Banking Supervision Group for banks under conservatorship. In the case of Podnikatelská banka, the court, at the proposal of the conservator, approved a settlement process and the subsequent approach proposed was sale to a new investor. The solution for Agrobanka was highly complicated, with the most viable approach being to split the bank up and sell only the sound part to a new investor. Despite intensive negotiations by the conservators, no suitable investors could be found for Velkomoravská banka or COOP banka.

Organisational arrangements for banking supervision

In March 1997, the CNB Bank Board discussed a document entitled "The institutional classification of banking supervision in the Czech Republic", and, after weighing up the arguments submitted, it opted to keep banking supervision within the CNB. In the course of the year, the Bank Board then approved a proposal to reorganise the Banking Supervision Group in the CNB with effect from December 1997.[11] The Bank Analyses and Inspection Department was split into two banking supervision departments, of which each had two inspection divisions and two inspection teams. The Banking Supervision Policy Division had two departments – methodological and analytical, while the licensing department was closed. A separate Nonstandard Activities Division, aimed at the issue of banks whose licences had been revoked and matters relating to crime in the banking sector, was created. It was also decided to increase the number of supervisory staff. The changes made in this year led to the total number of supervisory staff increasing to 86.

The banking sector

In the first half of the year, it was decided to revoke the licences of three banks (Bankovní dům Skala, Ekoagrobanka and Evrobanka), whose activities were taken over by Union banka as part of the integration process. It was also decided to revoke the licence of Realitbanka, which was declared bankrupt by the court at the proposal of the conservator.

11 Prior to the implementation of these changes, the Foreign Exchange Control Division was brought within the Bank Analyses and Inspection Department.

F. The standardisation of banking supervision

1998

Methodological work

At the beginning of the year, the CNB Bank Board approved a ”Conception for the further development of CNB banking supervision”, which outlined the strategic medium-term objective for banking supervisory work. This was intended to contribute towards creating a stable and competitive banking sector which would be the result of a dynamic balance between banking regulation and supervision, market discipline and the good governance of individual banks.

The Czech Parliament approved the small and large amendments to the Act on Banks, on the basis of which licensing terms became stricter, the approvals process for acquiring a holding in an existing bank was modified, restrictions were put on links between banks and the business sector, investment and commercial activities were organisationally separated, remedial measures for banks were made stricter, the procedures against shareholders adversely influencing a bank were modified and the deposit insurance scheme was improved (by increasing the maximum amount for deposit disbursement and extending insurance to legal entities).

At the start of the year, the most recent revision to Act No. 593/1992 Coll. on Reserves for Determining the Income Tax Base entered into force. This reduced the limit for provisioning from 3% to 2% of average valid loan receivables for the year, i.e. compared with the previous legislation it limited banks’ options for creating a sufficient level of provisions in the form of tax deductible expenses.

In January the Czech Government decided to increase funding for the Stabilisation Programme by CZK 5 billion, and then in June it decided to terminate the Programme.

In the course of the year, there were revisions to the CNB provision on classifying loan receivables and provisioning for them. This gave a more realistic view of the returnability of loss-making and long overdue loans secured by real estate. The provisioning requirements for these loans were also made stricter. This CNB provision was a response to the fact that shortcomings in the legislation to protect creditors in recovering receivables and exercising lien, in the work of the courts and the land registry offices, in the status of experts and asset appraisers and in the underdeveloped real estate market were preventing banks in practice from realising real estate pledged as collateral. In practice, the provision means that if a bank cannot realise lien on real estate within one year of the day the loan was due for repayment and the loan is rated as a loss loan, the bank must also provision for that part of the loan covered by the lien. If the conditions for realising lien change so much that banks can do so in good time, the regulation will cease to affect banks’ financial results.

To ensure that the public is informed of important data on banks (basic information on a bank as legal entity, information on its shareholders, activities and financial results), the CNB issued a provision stipulating the minimum requirements for information published by banks and branches of foreign banks. A bank is obliged to publish the information stipulated on a quarterly basis at all of its premises which are open to the public.

The Banking Supervision Group also responded to the special problem of adapting information systems and other automatic systems for the change from 1999 to 2000 by issuing a CNB provision which is only in force up to the end of the year 2000. This provision stipulates basic requirements for banks with the aim of limiting the Y2K risk in relation not only to the banks themselves, but also to their clients and business partners.

In view of the passing of the Securities Commission Act, an Agreement on Co-operation in the Performance of Banking Supervision and State Oversight was signed between the CNB, Securities Commission and Ministry of Finance. This agreement forms the basis for the co-operation essential for the regulation and supervision of financial conglomerates and groups comprising not only banks, but also other types of financial companies.

Control and analytical work

Aggregate analyses of developments in the banking sector, including ratings for individual banks, were submitted to the CNB Bank Board at the end of each quarter. The Banking Supervision Group also produced and published a report on banking supervision and the banking sector for 1997. In addition to these aggregate reports, analyses of individual banks and evaluations of signal information were produced for the banking supervision management, with proposals for further progress and measures for banks displaying negative tendencies. Where banks had more serious problems, documents were produced for the CNB Bank Board with proposals for adopting fundamental measures for individual banks (Podnikatelská banka, Agrobanka, Velkomoravská banka, Foresbank, Banka Haná and Universal banka). Audits of the fulfilment of the Stabilisation Programme were carried out quarterly, including the production of an aggregate evaluation as of 31 March and 30 September 1998 for the Czech Government. In the course of the year, Pragobanka and Universal banka were taken out of the Stabilisation Programme owing to their failure to meet the set criteria, as was Banka Haná for the reasons specified below.

The Banking Supervision Group conducted seven comprehensive on-site inspections in the following banks and foreign bank branches: Universal banka, Všeobecná úverová banka, Banka Haná, Moravia banka, První městská banka, Erste Bank Sparkassen and BNP-Dresdner Bank. These inspections focused more on appraising the banks’ risk management systems and internal audit systems, even though the main weight of the inspection teams’ work remained the evaluation of the quality of their assets, especially credit portfolios. Information visits, usually at the level of the appropriate divisional director and inspector, took place at a total of 30 banks and foreign bank branches.

Organisational arrangements for banking supervision

The CNB Bank Board decided to make changes to the central bank’s organisation and management. These took effect on 1 June 1998. There were no fundamental changes in banking supervision, as those had already been carried out under the reorganisation of the Banking Supervision Group at the close of 1997. However, the original two departments were merged into the Banking Supervision Department[12], which now includes four bank inspection divisions and

[12] Under the reorganisation of the CNB, the Czech-language designation of the CNB's organisational units was changed; however, to avoid confusion, the system for naming these organisational units (departments and divisions) has been kept uniform throughout the English version of this report.

the Nonstandard Activities Division. The plan to establish four inspection teams (one in each division) could only be partially fulfilled, despite repeated recruitment drives to raise the number of supervisory staff, and during the year inspection work was carried out by only two teams instead of the planned four.

The banking sector

Compared with 1997, the number of banks and foreign bank branches in the banking sector fell by 5 to 45. The licences of COOP banka, Velkomoravská banka, Agrobanka and Pragobanka were revoked owing to failure to comply with the prudential rules. Owing to mergers, the licences of Bank Austria (merger with Creditanstalt) and HYPO Bank (merger with Vereinsbank) expired. The licence of West Deutsche Landesbank (CZ) was also revoked owing to its failure to commence operations. GE Capital Bank, which took over Agrobanka’s network and the main part of its balance sheet, received a licence. Similarly, on the basis of an agreement on the sale of part of the company, Investiční a Poštovní banka (IPB) at the end of the year took over the main part of Banka Haná’s assets and liabilities, including its commitment to Česká finanční, and Banka Haná’s stabilisation programme was terminated.

Following a judicial settlement under conservatorship, a new investor for Podnikatelská banka was approved. The bank now operates under the name J&T banka. Société Génerale Praha a.s. was transformed from a subsidiary into a branch. The privatisation of IPB was completed with the NPF selling its holding to the Japanese company Nomura, and a decision was taken on the state’s advisers for the privatisation of the remaining banks with state ownership (ČSOB, KB and ČS).

1999

Methodological work

The supervisory work in 1999 was governed by the plan approved by the CNB Bank Board at the beginning of the year. This plan was an elaboration of the medium-term conception adopted in the preceding year.

Two key CNB provisions were issued in July – one on banks’ capital adequacy, including credit and market risks, which will enter into force on 1 April 2000, and one stipulating the terms for supervising banks on a consolidated basis. In view of their importance, great attention was paid to the drafting of both provisions, including consultations with banks and the Banking Association. The two provisions mean a qualitative change in banking supervision methodology. A CNB provision and decree were also issued regulating the procedures for licence applications and for requests for permission to acquire bank shares.

The Banking Supervision Group actively contributed to the drafting of amendments to the Act on Banks and the Act on the CNB to harmonise them with EU law, and commented on revisions to other acts concerning the financial market and the banking sector (revisions to the Act on Securities, the Act on Bonds, the Bankruptcy and Composition Act, the Public Auctions Act and the Commercial Code).

In shaping the structure of the banking sector, the Banking Supervision Group contributed to preparing the privatisation of large banks and the restructuring of transformation institutions in accordance with the decisions of the Czech Government (Konsolidační banka, Česká exportní banka, Českomoravská záruční a rozvojová banka and Česká finanční).

In 1999, the Twinning Programme[13] for banking supervision was launched. This is aimed at bringing regulatory methodology (market risk, supervision on a consolidated basis, capital requirements based on a bank's risk profile) and the practical implementation of supervision (analyses of banks' financial positions, procedures for on-site inspections) into line with the standards usual in the EU.

In international relations, an agreement was concluded on co-operation in banking supervision between the CNB and the Slovak National Bank, while negotiations on co-operation with the banking supervisory authorities in Germany, Holland, Austria and Poland are at an advanced stage. The fundamental obstacle to closer co-operation with our partners is, however, the fact that the Czech legislation does not allow the home banking supervisor to carry out on-site inspections in branches or subsidiaries of foreign banks in the Czech Republic.

International appreciation of our banking supervisory work was reflected in an invitation for representatives from the Czech Republic, and a number of selected countries outside the G10, to participate in work on a new framework for capital adequacy and on an evaluation of the Core Principles within the Basle Committee on Banking Supervision. In addition to this co-operation, intensive contacts continued with the World Bank, the International Monetary Fund and the Bank for International Settlements (BIS), and with banking supervisors in Central and Eastern Europe.

Control and analytical work

Supervisory activities that had proved their worth in previous years were retained. The Banking Supervision Group produced aggregate analyses of developments in the banking sector each quarter, paying greater attention to evaluating banking risks and including ratings for individual banks. The Banking Supervision Group also produced and published a report on banking supervision and the banking sector for 1998. In addition to these aggregate reports, analyses of individual banks and evaluations of signal information were produced for banking supervision management, with proposals for subsequent approaches and measures for banks displaying negative tendencies. Where banks had more serious problems, documents were produced for the CNB Bank Board containing proposals to adopt fundamental measures for individual banks (Universal banka, Foresbank and Moravia banka).

The Banking Supervision Group carried out five comprehensive on-site inspections in Živnostenská banka, Česká Spořitelna, J&T banka, Investiční a poštovní banka and Credit Lyonnais Bank. This lower number of comprehensive on-site inspections was the result of the capacity demands for inspections in large banks; owing to the size of their balance sheets and the complexity of their management mechanisms, such inspections must by carried out by at least two teams (e.g. around 15–20 inspectors worked for eight weeks on the inspection of Česká spořitelna). In view of the situation in the Czech Republic, the main weight of the inspection teams' work consists in assessing the quality of assets, above all the credit portfolio, as credit risk

[13] Under the programme, countries wishing to join the EU are allocated a partner country which assists in preparations for accession. The Czech Republic's partner for supervising banks and insurance companies is Germany, with Greek experts participating in parts of the programme.

remains the most significant risk for banks. However, in line with international trends, inspections are focusing more on appraising banks' risk management and internal audit systems.

In addition to comprehensive inspections, there was a series of information visits aimed at individual areas of banks' activities. In addition to ordinary banking activities, considerable emphasis was placed in 1999 on preparing banks for problem-free transition to the year 2000 (the Y2K problem). The Banking Supervision Group therefore visited all banks and branches of foreign banks at least once to ascertain their readiness and to implement the relevant CNB provision for this issue.

Organisational arrangements for banking supervision

There were no changes to the organisational arrangements for banking supervision. Unfortunately, it was not possible to fulfil the plan to establish four inspection teams, so the inspection work was carried out by three teams. The average number of supervisory staff was just under ninety during the year.

The banking sector

The number of banks and branches of foreign banks operating in the Czech banking sector fell further to 42. At the beginning of the year, Universal banka's licence was revoked – in 1998 it had been taken out of the Stabilisation Programme and administrative proceedings had been commenced against it owing to its capital adequacy falling to below one third of the prescribed limit. At the end of March, Foresbank's general meeting decided to terminate its activities. Following its partial sale to Union banka, Foresbank had not conducted any further activities and had settled its payables due to depositors. In November, Moravia banka's licence was revoked owing to persistent serious shortcomings in its activities.

The ongoing economic decline and the related worsening in the economic situation of debtors continued to adversely affect banks' financial results and the quality of their assets. Persistent shortcomings in the legal environment preventing banks from recovering receivables from debtors, together with the diminishing creditworthiness of the business sector, contributed to a decline in lending and the maintenance of a relatively high ratio of classified loans to total loans. These negative trends also affected large banks. The state, as main shareholder, contributed to strengthening Česká spořitelna and Komerční banka's capital and cleaning up their balance sheets.

Significant in terms of the future of the banking sector was the progress made in the privatisation of the large banks. The Belgian KBC Bank became the majority owner of ČSOB, while exclusive discussions are underway on Česká spořitelna with the Austrian Erste Bank. An advertisement for the sale of the state's holding in Komerční banka was published and an information memorandum is being produced. According to forecasts, the sale of both banks should be completed by mid-2000. Several private banks were also looking for strategic partners – without a transfer of know-how and capital, these banks have no prospects in the increasingly competitive banking market.

III. The consolidation and stabilisation programme

A. The consolidation programme for the small banks subsector

The initial phase of economic transformation was characterised by high risks for businesses. Owing to the general lack of capital in the Czech economy, the transformation and privatisation were financed by loans. This made banks heavily dependent on economic developments and the success of the transformation process. At this time, however, these banks provided a significant stimulus for economic growth and privatisation and in this sense their problems represented a certain price paid for the rapid economic reform. The risks in the new environment became fully apparent in subsequent years, especially in the poor quality of credit portfolios. This jeopardised the existence of small banks, which had, as a consequence of their activities not being fully developed, limited capacity to absorb such a high risk.

The CNB Banking Supervision Group had observed signs of negative developments in certain banks since 1993. Using the options available under the legislation at that time, it had tried to resolve the situation by means of measures and consolidation programmes for individual banks. Despite all its efforts, in the majority of cases it was not possible to halt the negative developments. In a number of cases, this was due to shareholders' unwillingness to resolve the bank's problems; in other cases, the bank's problems, right from the start of its activities, were too great for its shareholders to remedy. It was in this situation that the CNB produced a comprehensive programme for consolidating small banks (Consolidation Programme II) at the end of 1995, with implementation commencing at the beginning of 1996. Its aim was to prevent a domino effect in the small banks sector, which could have led to a loss of confidence in the banking system as a whole.

The starting point for Consolidation Programme II was the projection of potential risks from asset operations into banks' real losses based on the external audits of 1995 financial results. This provided the basic legislative support for interventions by the Banking Supervision Group in accordance with the Act on Banks. The results of the external audit for 1995 – when in accordance with a CNB provision the auditors carried out a fundamental audit of banks' portfolio quality and specified the required volume of provisions and reserves – created the conditions for tougher action by the Banking Supervision Group aimed at solving problems in the banks which had recorded insufficient reserves and whose capital could not cover their losses. The Banking Supervision Group's basic approach to these banks consisted in attempts to prompt existing shareholders, or new investors, to increase the banks' capital as required, leading to their recovery.

In consequence of this more realistic overview of the potential risks and their projection into the accounts, capital adequacy fell in practically all banks. Banks whose capital adequacy was under 8% were instructed to produce consolidation programmes for future activities which would ensure that the target of 8% would be met by 31 December 1996. The CNB placed particular emphasis on improving banks' profitability, management systems and shareholder base. The consolidation programmes submitted were then assessed in terms of how realistic they were and whether they were sufficient to halt the negative developments, and were discussed with the individual banks. The measures adopted were based on an appraisal of the specific situation in each bank – the extent of its losses, its development options, and the willingness of the bank's shareholders and management to participate in the recovery process.

The measures adopted for individual banks under Consolidation Programme II can be divided into four basic groups:

a) Reducing the bank's capital and introducing conservatorship

This solution was adopted for banks with substantial losses, which had to be covered in part with funds from existing shareholders in the form of reducing capital and transferring it to reserves. Conservatorship was introduced in cases where there was a chance of revitalising a bank, but where management and the main shareholders were not able to deliver this process or their actions actually jeopardised the bank's position. Further negotiations and measures were based on an assessment of the possibility of reviving the bank by means of increasing its capital through new investors or merging with another bank; alternatively, the bank's activities were terminated through bankruptcy or liquidation (COOP banka, Velkomoravská banka, Podnikatelská banka, Ekoagrobanka and Realitbanka).

b) Terminating a bank's activities

Revoking a bank's licence was used in cases where there were high losses, minimal opportunities for continued existence of the bank and where shareholders or new investors were unwilling or unable to contribute towards covering losses from the bank's earlier activities (První slezská banka and Kreditní banka Plzeň).

c) Selling a bank with the expectation of a future merger

In cases where another bank was interested in taking over the business network and the majority of assets and liabilities, the CNB supported selling to that bank, with the expectation that the acquisition would subsequently be incorporated into the buyer's structure (Ekoagrobanka, Bankovní dům Skala and Evrobanka).

d) Increasing capital by existing shareholders or a new investor

This method was selected in cases where the existing shareholders or new investors were willing to implement a consolidation programme for the bank and increase capital to cover the losses identified (Banka Haná, Moravia Banka and Universal banka).

Of the total of 18 small banks, 15 were included in Consolidation Programme II, with radical solutions (revocation of licences, introduction of conservatorship or take-over by another bank) adopted for nine of them. In the other cases, there was co-operation with the existing shareholders or new investors to increase capital, which covered the potential losses identified.

In order to avert a systemic crisis, the CNB provided guarantees in individual cases for deposits to be paid out and guaranteed the pay-out of deposits in excess of the Deposit Insurance Fund framework up to CZK 4 million (the maximum payment under deposit insurance at that time was CZK 100 000). The level of payment beyond the framework of the Deposit Insurance Fund was constructed so as to satisfy as many clients as possible – not only natural persons, but also legal entities (smaller companies), which were excluded from the deposit insurance scheme. The pay-out of deposits up to CZK 4 million satisfied more than 99% of the total number of clients, while in terms of volume the payments covered approximately 66% of total deposits.

The gross[14] level of funds issued by the CNB under Consolidation Programme II, i.e. without taking repayments and other revenues into account, was CZK 32.9 billion (of which deposit compensation was CZK 2.9 billion, loans and ownership interests were CZK 12.2 billion and gross expenses for integration support was CZK 17.8 billion). As not all the assets that the CNB or Česká finanční acquired under the programme have yet been realised, it is not possible to specify the total nonreturnable expenses of Consolidation Programme II, nor the other transformation expenses for the banking sector. It can, however, be stated that the banking sector's problems and the costs of resolving them as a percentage of GDP are comparable with other transformation economies, although each country has dealt with such problems in different ways and at different times.

The situation in Agrobanka Praha a.s. was resolved outside the consolidation programme for the small banks subsector, although within the same time frame. This was the sixth largest bank in the Czech Republic and its collapse could have negated everything that had been done up to that time in the small banks subsector, with a potential impact on the banking sector as a whole. To ensure the stability of the banking sector, it was therefore decided to preserve the bank's operations in full during conservatorship and to promote client confidence by issuing a guarantee for their deposits.

Agrobanka had already in 1993 voluntarily enumerated its potential losses and projected them into its accounts. In co-operation with the Banking Supervision Group, it had then relatively successfully implemented a programme up to the end of 1995 aimed at improving its situation. However, the situation changed dramatically when it was taken over by new investors – the group around Motoinvest a.s. The bank ceased to comply with the agreed programme, conducted risky transactions, especially in securities, and the quality of its credit portfolio deteriorated. The bank did not comply with the remedial measures imposed and found itself in an insupportable liquidity situation, which climaxed in a need for the introduction of conservatorship.

In the end, the bank's situation was resolved by selling part of the company to a strategic investor, who took over all of the bank's commitments to its clients and part of its assets. The CNB supported the strategic investor by compensating[15] it for its losses from taking over the part of the bank with negative value (the value of commitments to depositors and other creditors on the liabilities side was considerably higher than the value of the assets taken over). In addition, the CNB contributed towards increasing the bank's capital[16] and provided it with bridging loans.

The solution implemented was aimed above all at protecting depositors and ensuring the

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[14] For individual items, gross expenditure means:

a) for loans and receivables, the level under bankruptcy or liquidation,
b) for ownership interests, the purchase price,
c) for integration support, the amounts which were specified and expended either to buy risk assets or as compensation to the purchasing bank under guarantees or compensation pledges issued in connection with integration support.

[15] This compensation took the form of a subscription of shares with a high premium.

[16] Česká finanční subscribed and paid CZK 9 billion, but the increase in capital was not recorded in the Commercial Register owing to a legal dispute over the validity of the general meeting which decided in favour of the increase. Česká finanční has the CZK 9 billion as a receivable due from Agrobanka.

stability of the banking sector, and was supported by the entry of a quality investor with banking expertise. Given the level of the bank's losses ascertained following the introduction of conservatorship, this approach minimised costs, quelled the public's fears and strengthened the banking sector.

B. The Stabilisation Programme

The consolidation of the small banks subsector in 1996 led to a fundamental change in its structure. Banks which were insolvent on the basis of a statement by the auditors and an analysis by the Banking Supervision Group were taken out of the banking sector. The consolidation process did not take place without a decline in the public's confidence in the banking sector. Small banks were threatened with a gradual outflow of deposits which they would not have been able to withstand. To reduce the risk of a liquidity crisis in these small banks and the overall destabilisation of the banking sector, with significant impacts on banks' depositors, the Czech Government adopted a programme to enhance the stability of the banking sector (the Stabilisation Programme) as a systemic solution in a decree dated 16 October 1996.

The essence of the Stabilisation Programme was the purchase of insolvent receivables from banks at their nominal value by Česká finanční s.r.o., up to a maximum of 110% of their capital and on the basis of returnability. Banks were obliged to issue a guarantee to Česká finanční for the recoverability of the receivables transferred, and after the end of the seven-year programme they will be obliged to remunerate Česká finanční for that part of the receivables which it is not able to realise during the Stabilisation Programme. For this purpose, banks have had to create an annual reserve of at least one-seventh of the value of the receivables sold. Konsolidační banka ensured the refinancing of Česká finanční with the proviso that the National Property Fund would reimburse Česká finanční for the refinancing costs and any related losses. The duration of the programme and the level of assistance was based on knowledge at the time of the quality of the banks' assets, potential risks and estimates of future economic trends.

The scope envisaged for the programme was based on the value of 110% of the capital of 13 small banks as of 31 August 1996. On this basis, Česká finanční was allowed to purchase receivables at a level of CZK 13.7 billion. After assessing the negative impacts on banks of the economic stagnation, exchange rate turbulence, flooding and companies' worsening financial situation in 1997 and the exhausting of funds to implement the Stabilisation Programme, on 29 January 1998 the Czech Government decided to increase the funding of the Stabilisation Programme by CZK 5 billion. The total funds released for the programme were now CZK 18.7 billion. After evaluating the first phase of the programme, the Czech Government decided in decree of 24 June 1998 to terminate further drawing of funds, with the exception of purchases of bank receivables by Česká finanční that had already been approved. Under the Stabilisation Programme, the drawing of a total of CZK 14.9 billion was approved.

Six banks (Banka Haná, Zemská banka [now Expandia banka], Pragobanka, Moravia banka, Universal banka and Foresbank) expressed an interest in joining the Stabilisation Programme and subsequently submitted their individual stabilisation programmes, gradually joining the Programme in the course of 1997 and commencing the sale of their bad assets to Česká finanční.

The banks which had volunteered to join the Programme were obliged to comply with the general prudential limits (for capital adequacy, credit exposure, open foreign exchange position) and also had to meet specific indicators prescribed under the Stabilisation Programme. These indicators regulated banks' activities (limiting risks, cutting costs) and at the same time served as indicators of the Programme's success. The indicators and their limits were stipulated in a banking supervision regulation for all banks and were assessed each quarter. The basic indicators included:

Capital adequacy:	min. 8%, within two years 10%, target 12%
Ratio of risk-weighted assets to total assets:	maximum 75%
Ratio of variable-yield securities to assets:	maximum 5%
Ratio of quick assets to total assets:	minimum 15%
Ratio of assets and liabilities due within 1 month:	minimum 60%
Ratio of earning assets to total assets:	minimum 60%
Ratio of operating costs to assets:	maximum 3%
Ratio of operating costs to profit from banking operations:	maximum 60%
Creation of reserves for guarantee to Česká finanční	1/7 annually

The Stabilisation Programme could not in itself ensure the viability of small banks in the face of the increasing competition on the banking market, nor could it eliminate general problems due to economic stagnation and the existing legislative environment. It did, however, allow them to survive a critical phase in their development in terms of liquidity and created a breathing space for them to restore their financial stability and preserve their business networks for clients. A fundamental precondition for the success of the individual small banks' stabilisation programmes was either to find a strategic investor in the form of existing or new shareholders who would ensure the essential capitalisation of the bank and secure changes in its management based on a clearly formulated business strategy, or to find a solution to the unfavourable situation in the form of an amalgamation with another bank with stronger capital. In the event of the prescribed parameters and prudential rules not being met, the Stabilisation Programme envisaged terminating a bank's activities.

A worsening in the quality of loans in connection with the economic decline in 1998 and 1999 and the financial difficulties facing many companies resulted in additional and large-scale provisioning compared with the Programme's targets and, in a number of cases, in failure to meet the prescribed limits, bringing individual banks' stabilisation programmes into jeopardy. In some cases the need for additional provisioning was due to the overvaluing of the quality of a bank's assets by the bank and its auditors at the time of joining the Stabilisation Programme, i.e. the true situation was worse than the bank had stated. The CNB was forced to respond in 1998 with remedial measures for the banks in question. Owing to the unwillingness or inability of banks and their shareholders to eliminate the shortcomings detected, the CNB terminated the stabilisation programmes for Pragobanka and Universal banka in 1998 and their licences were subsequently revoked.

The stabilisation programme for Banka Haná was also terminated at the end of 1998.

Here, however, after the IPB group increased its capital, part of the bank was sold to Investiční a Poštovní banka, which also took over the commitment to Česká finanční under the stabilisation programme. Likewise, Foresbank, after a part of it was sold to Union banka, repaid its commitment to Česká finanční (at a discounted value) and the stabilisation programme for that bank was terminated at the beginning of 1999. Subsequently, the Foresbank general meeting decided, with the consent of the CNB, to terminate banking operations, as Union banka had taken these over in full. In September that year, the CNB decided to take Moravia Banka out of the Stabilisation Programme owing to its failure to meet the Programme’s parameters and because of ongoing shortcomings in its activities; the CNB commenced administrative proceedings to revoke its licence, which came into force in November. At present, the only bank remaining in the Stabilisation Programme is Expandia banka, which is now making preparations to receive a strategic partner.

IV. Summary

Three basic stages can be distinguished in the relatively short history of banking supervision in the Czech Republic (in comparison with countries with mature market economies), as follows:

Creating the legislative framework and conditions for banking supervision (1991 – 1993)

- The banking supervisory authority as an institution incorporated into the central bank was established in 1991, but the legislation at that time did not furnish it with the corresponding activities or powers. The supervision of banks and savings banks was entrusted to the Ministries of Finance.
- New “banking” legislation which entered into force in February 1992 defined the content and conception of banking supervision and enabled standard activities. Up to that time, we can talk only of a preparatory period in which the fundamental features of banking supervision were formulated. 1992 saw a change to the federal structure of the central bank’s Banking Supervision Group and a period of formulation and introduction of the first set of prudential rules for banks.
- 1993 was characterised by the gradual expansion of inspection and analytical activities, which uncovered the first serious shortcomings in the Czech banking sector.

The development of banking supervision (1994 – 1997)

- 1994 brought major organisational and legislative changes which were a turning point for banking supervision. Supervisors now focused more on auditing and investigating banks’ activities. The number of banks stopped growing that year – the banking sector had been in essence formed at a time when banking supervision was defined and conceived but when no activities had been developed.
- In 1995, the knowledge acquired from supervisory activity began to be used to a greater extent in drafting and modifying prudential rules and there were increasing demands for banks’ shortcomings to be remedied.
- In 1996 and 1997 the Banking Supervision Group brought systematic pressure to bear for prudent conduct by banks. In view of the profound changes in part of the banking sector, this

led to radical interventions in individual banks and to the formulation of a Government programme to support the stability of the Czech banking system.

The standardisation of banking supervision (1998 – 1999)

- 1998 saw a further milestone in the work of the Banking Supervision Group with the adoption of a medium-term conception for CNB banking supervision in January of that year. One of the top supervisory priorities became harmonising the banking legislation and prudential rules with EU standards as part of the preparatory process for EU accession.
- Banking supervisors concentrated on standardising procedures in the areas of licensing, off-site surveillance and on-site inspections in banks based on the practical experience acquired and on the standard procedures used by foreign banking supervisory authorities. The focus of banking supervision shifted to comprehensive inspections targeted at banks' risk management and internal audit systems.