Basic Trends in the Banking Sector

(excerpt from an in-depth report written by the CNB's Banking Regulation Department and discussed by the CNB Bank Board on 5 December 2002)

A competitive banking sector is one of the prerequisites for successful integration into European financial market structures with respect to stability, performance, profitability and legislative and regulatory harmonisation. A stable and competitive banking sector has a decisive effect on the quality of the entire financial sector. The domestic banking sector is developing in line with trends in European and international banking. It is being affected by economic developments both in the Czech Republic and in our trading partner countries.

Our analysis of the Czech banking sector leads us to expect a strengthening of the sector's stability in the medium term. Alongside improvements to the regulatory framework, the groundwork has been laid for the sound development of the banking sector, free of any major problems of a systemic nature. From the macroeconomic point of view, the Czech Republic is expected to record relatively low economic growth rate in 2003, owing to a sluggish growth rate of aggregate domestic demand and household consumption. The favourable conditions will include the expected low-inflation trend. However, considerable uncertainty surrounds the expected recovery in foreign demand, and this might negatively affect the corporate sector and the lending process.

In the medium term, we foresee the following trends in the domestic banking sector:

Dominance of foreign capital in the Czech banking sector

The shortage in Central and Eastern Europe of strategic investors endowed with sufficient capital has led to a situation where the banks in this region are for the most part owned by foreign banks or other foreign entities. Now that the privatisation of the large Czech banks have been completed, the ownership structure of the sector has stabilised. The domestic banking sector is becoming integrated into European banking structures via supranational financial groups of large-bank owners. In the Czech Republic, almost 95% of the banking sector's assets are either directly or indirectly controlled by foreign banks. The situation is similar in the other Central European candidate countries. More foreign businesses can be expected to penetrate the domestic market, although from now on solely through mergers or sales of ownership interests or by establishing branches. Given the Czech Republic's expected accession to the EU and the current scope for further development of the sector and for improvements in its performance, we can expect EU countries such as Austria, Germany, Belgium, France, Italy and the Netherlands to show continued interest in entering the sector. The main benefits will be the acquisition of high-quality know-how, which will in turn generate improvements in banking risk management, and a wider range of sophisticated products as used successfully by parent banks.

A continuing process of concentration of the banking sector

The process of concentration through mergers and acquisitions is governed by the need to be competitive and to cut costs. Most active in this respect in the EU are Italian, German and French banks. EU banking markets are, in the main, controlled by a small group of the largest entities. In the individual countries, the share of the five largest banks in total banking sector assets ranges from 20% (Germany) up to 82% (the Netherlands). Over the last ten years, the number of credit institutions in the EU has fallen by 35%, equating to an average decrease of 440 institutions a year. Small and medium-sized banks usually take advantage of gaps in the market and specialise in particular banking products or specific groups of customers. In Central and Eastern Europe, concentration is closely bound up with the privatisation process.

The concentration process in the Czech Republic is visible mainly in the growing significance of medium-sized banks, which are gradually expanding their activities. The results of the concentration process in the EU countries is also affecting the Czech banking sector, via mergers and acquisitions of banks that are now part of the domestic banking sector.

The development of new products and services

The trend towards offering clients a widening range of products and services is becoming a significant factor of competition in the banking sector. Non-banking financial and non-financial companies, intermediaries and sellers are competing with banks in some products and services. In expanding the range of products and services they provide, banks are relying on financial groups and are making use of economies of scope and increased market segmentation and offering combined products. The product range derives from the life cycle, the changing needs of clients and the economic conditions. In the EU countries, emphasis is placed on offering a wide range of products from the areas of asset management and private banking, products associated with the ageing of the population, and risk-mitigation products. As for specific products, bancassurance continues to develop apace. However, the range of products and services offered differs from one country to another according to the level of development of its banking sector and to the traditional behavioural patterns of clients.

Despite developing dynamically in recent years, the domestic market has yet to take full advantage of the current possibilities. On top of the traditional range of banking products and services, we can expect to see new investment-banking products as well as financial insurance and consultancy products and combinations thereof. In retail banking, new innovated banking services in the credit, deposit and payment instrument areas will be introduced. The new strategic owners of the large banks are expected to play an active role. The development of banking products on the basis of knowledge transfer will be an important factor as regards competition in the sector.

New technologies in distribution networks

The development of distribution networks varies from country to country, depending on how conservative clients are and how able they are to embrace new technology. A convenient around-the-clock service is becoming the general standard. Direct (electronic) banking offers the advantages of cost savings and the acquisition of target client groups. However, branch networks will remain indispensable, especially in retail banking.

In the Czech Republic, most clients use a telephone connection with the bank for their direct banking. In the future, greater use of mobile telephone networks and, in particular, the Internet can be expected. Banks are encouraging their clients to use the new distribution channels mainly by means of their pricing policies. The rapid development of electronic banking is creating conditions that will allow the domestic banking sector to converge towards the level in the European Union in the use of diversified distribution networks. This convergence is conditional on increased Internet accessibility in the medium term and the elimination of concerns about data being misused when banking transactions are performed via the new distribution channels.

A continued leading position of the banking sector in the financial sector

The banking sector plays the most important role in the overall financial sector in the Czech Republic, accounting for around 80% of total assets of the financial sector. Although the non-bank financial sector is displaying dynamic growth, it is still underdeveloped by comparison with the EU. Relative to the other candidate countries, the Czech non-bank financial sector has a fairly high share, but here too there is considerable room for growth.

The second most important segment in most of the candidate countries' financial sectors is the insurance industry, which accounts for around 7%–8% of the financial sector's total assets. The market as a whole is insufficiently developed. The use of insurance products in the EU countries is significantly higher, but there are big differences across the individual countries. In Portugal and Spain, insurance companies account for 20% of financial sector assets, whereas in Austria the figure is close on 30% and in Germany it is almost 50%. Greece with its 6% is comparable with the candidate countries. The growth potential in the Czech Republic lies chiefly in bancassurance, life insurance and a diversified range of life-cycle-related insurance products.

Despite the dynamic development of the non-bank financial sector, the banking sector can be expected to continue its dominance of the Czech financial sector. This can also be deduced from the low ratio of banking assets to GDP relative to the average in the EU (117% in the Czech Republic, as against 270% in the Euroarea).

Continuing development of financial groups

As elsewhere around the world, there exist financial groups in the Czech Republic. They are led, as a rule, by banks that are already part of supranational financial groups. These banking financial groups generally comprise an insurance company, a pension fund, an investment company, a building societies, unit trusts, a leasing company, a factoring company and suchlike. In some cases, these companies are among the most significant on the relevant domestic market. In this way, banks can increase their effectiveness, make use of retail networks within the financial group, increase the benefits for clients by providing a comprehensive service and offering combined products, and develop cross-selling of the group members' products. Banks thus have a share in the results of other financial market entities. By being part of financial groups, banks can diversify both their activities and their risks.

Continued dominance of the three large banks

Notwithstanding a slight decline in their share of the domestic market (connected with privatisations and associated clean-up operations), the large banks still occupy the leading position in the banking sector and in the financial sector as a whole. They head banking groups, but on the other hand they themselves have become an integral part of foreign groups and their future activities will be determined by the foreign owner's strategy. This concerns also most of other banks operating in the Czech banking sector which, as a rule, are foreign bank subsidiaries or foreign bank branches.

The primary objective of strategic investors in the large banks will be to increase the value of their investments in the medium-to-long term, and not to make short-term profits and sell the bank on. Another source of cost savings and risk mitigation will be centralisation and the sharing of activities within parent-bank financial groups at a level that is not in contradiction with the valid legal rules. As regards adapting to the EU environment, the acquisition of high-quality know-how – which will lead to improvements in internal procedures in banks, especially for banking risk management – will be particularly useful. Clients will be offered a wider range of sophisticated products as used successfully by the parent bank.

Prudent lending to corporate clientele

The only modest growth in lending expected in the period ahead is due not to a shortage of funds, but primarily to continuing cautious behaviour of banks. This takes the form of a rigorous selective approach to lending based on the soundness of corporate clients. This development has been fostered in part by the slowdown in economic growth and by the banks' continuing problems with recovering debts. Banks have been unable to find sufficient opportunities on the lending market with acceptable credit risk. The Central Register of Credits of entrepreneuring entities operated by the CNB should help to improve the assessment of clients' soundness. As regards sources of financing for the corporate sector, borrowing has been supplemented with high volumes of intercompany debts, foreign investment inflow and other alternatives to bank loans. The capital markets still play an insignificant role in financing the corporate sector.

In the Czech Republic, the total volume of credits granted stands at 45% of GDP, compared to around 97% in the Euroarea. Although the figure for the Czech Republic is the highest of all the Central European candidate countries, the comparison with the EU countries suggests considerable growth potential. However, the increased demands of Czech banks with regard to the soundness and financial strength of enterprises as a guarantee that loans will be repaid are considerably hampering the growth in lending.

Growth in retail banking

The lack of opportunities for effective allocation of loans to corporates and the strengthening effect of non-bank competition, along with the relatively low indebtedness of the population, has led banks to offer a wider assortment of loans to individuals. However, despite vigorous growth in recent years, their share of the total volume of loans granted remains relatively low (14.3% as at 30 June 2002). Household indebtedness in the Czech Republic (9.4%) is much lower than in the EU countries (50%). This suggests considerable room for further growth, something that an ever-growing number of banks on the Czech banking market are declaring in their strategies. Providing loans to private individuals is generally considered less risky than lending to corporate clientele.

In the area of consumer credits, banks are facing quite stiff competition from financial and commercial companies offering personal loans, instalment sales, credit cards and so on. The key factor in this competition is the on-the-spot availability of such loans. The lending process is being streamlined, among other things, by a commercial register of loans provided to private individuals, through which banks can exchange information on the payment histories of their clients. A significant factor in standardising the terms and conditions for granting consumer credit is the new Consumer Credit Act, which requires lenders to state their annual percentage rates.

Improvements in loan portfolio quality, leading to a reduced need for provisioning

The stability of the banking sector has been considerably enhanced by a marked improvement in loan portfolio quality. Although the decline in the volume of classified credits is mainly due to past transfers of bad debts from the banks being privatised to Konsolidační banka (now called the Czech Consolidation Agency), the improved quality of new loans resulting from the banks' cautious approach is also starting to have a positive effect. Despite the many improvements, loan portfolio quality remains the biggest risk to the domestic banking sector and remains below the EU countries average. The share of classified credits in total credits fell from 29% in end-2000 to 17.9% in mid-2002. However, the still relatively high share of classified credits is largely due to a stricter classification methodology in the Czech Republic, a low level of write-offs against provisions for tax reasons, and by the slow process of enforcing collateral. The potential risk from classified credits is currently fully covered by provisions and reserves. Any further lowering of the volume of bad loans will depend on an increase in the level of write-offs of loss loans against already existing provisions and in particular on the banks' ability to provide recoverable loans. Portfolio quality and loan recoverability are also likely to be affected by comprehensive new procedures for managing lending transactions and credit risk.

Involvement of banks in financing state debt and in transactions with the CNB

The limited lending by banks to risky corporate clientele in recent years has resulted in a relatively large surplus of funds, for which banks are seeking profitable, low-risk applications. This situation is evidenced in particular by the ratio of client credits to client deposits (government institutions excluded). In the Czech Republic the volume of deposits significantly exceeds that of credits (by around 46%), whereas in the EU countries the opposite applies, owing to the greater involvement of the banks there in lending.

Banks are investing their surplus funds in medium and long-term government bonds. These instruments are one of the most frequently used risk-free alternatives for the investment of banks' funds, as they guarantee profits. In their portfolios, banks hold around 62% of the total volume of government securities issued, while government bonds account for 9.5% of their total assets. Banks can make almost the same profit from government debt, with virtually zero credit risk, provided that the bonds are held to maturity. Banks are also actively involved in transactions with the central bank.

Banks have minimal involvement in securities trading on the stock and bond markets (except in the case of government securities). This is chiefly due to the low volume of non-government bonds on the market and the high risk associated with shares. Another investment option is to allocate assets abroad, and in particular to deposit them at non-resident banks. However, the decline in interest rates is gradually reducing the profitability of this type of investment.

Given the expectations of limited lending activity, the banks' current fund-allocation preferences will persist in the period ahead.

A reduction in the growth rate of primary funds

In 2002, the banking sector faced growing competition on the client deposit market. Up until mid-2002, the banking sector's funds stagnated while non-banking forms of investment of households' income, in particular in life insurance, pension schemes or possibly the capital market, displayed steady growth. The main advantage of banking products is their greater liquidity. Against this, the alternative forms of investment generally offer higher returns, owing to lower taxation, state contributions and suchlike.

Despite the development of alternative products, bank deposits still constitute the primary form of investment for the public, mainly because of the ease with which they enable payments and other transactions to be performed and because of a certain conservatism among part of the population. However, the effect of disintermediation is strengthening because of increasing returns on investment of households' funds and the public's growing knowledge of new products. This trend can be expected to continue.

Improved banking sector profitability

The stability of banks is conditional on their ability to generate sufficient profits. In 2002, banks carried on their activities against a background of low and still-falling interest rates on the inter-bank market, which considerably affect the interest rates announced by the banks. The main sources of profit from financial activities – interest and fees and commissions – are a stable component of profitability. Profit from financial market operations – which may bring in an immediate profit or loss, but is not a stable long-term source of earnings – is a volatile component. The increase in profit again compared to 2001 is partly attributable to growth in interest profit, particularly from transactions with banks. Growth in non-interest profit, of which fees and commissions were the most significant component, was the decisive factor. The stable growth in profit from fees and commissions caused its share of the total profit from financial activities to increase to around one quarter, although this is still below the EU average (30%). The reduced requirements to set aside provisions and reserves, coupled with the slower growth in administrative costs, led to relatively high net profitability of the banking sector.

In comparison with the EU countries, the Czech Republic exhibits greater diversification of margins (i.e. the difference between the interest rate and the market reference rate) on particular products, while the overall margin is only slightly lower than in the EU. Banks in the Czech Republic enjoy margins on credits granted to households which are roughly three times higher than in the EU (thanks to high demand and a willingness on the part of the public to accept market conditions). Conversely, they achieve lower margins on credits granted to businesses. Deposit margins are at roughly the same level as in the EU. The return on average assets (ROAA) of the banking sector´s net profit increased annually from 0.9% to 1.32%, which is more than double the usual level of the banking sector in the European countries (0.53%).

The domestic banking sector is expected to record rising profitability. It will achieve this by taking advantage of the potential for cost cutting and by generating new income based on expansion of business activities and on risk management. These developments will be driven by the desire of investors to increase the value of their investments.

Pressure to control administrative costs

The pressure to increase efficiency in the current climate of a slowdown in economic growth and stiff competition on the banking market is focused primarily on the cost components of banking business. Cost management – via further staff cuts, optimisation of cost-benefit ratios and higher returns on capital – is the order of the day. Although administrative costs are growing in absolute terms, the growth rate is gradually slowing. Owing to the increases in efficiency and the introduction of new technology, more employees will be laid off from the banking sector, although this might be offset in part by growth in banking business. Organisational structures will be simplified and focused on banking business. In addition to ancillary and supplementary activities, risk management is now starting to be outsourced. There will be major organisational changes with regard to client services in branches.

In the Czech Republic, the ratio of administration costs to profit from financial activities is lower than the EU average. Conversely, administrative costs on assets are higher in the Czech banking sector. The situation is much the same in the other Central European candidate countries. This shows that the EU countries are able to manage a markedly higher volume of total assets with comparable operating costs, despite the fact that the candidate countries have an advantage in lower wages.

Maintenance of sufficient capital coverage

Capital adequacy, which is an indicator of a bank's financial stability, stood at 15.4% in mid-2002. This suggests that there currently exists considerable capital potential for the development of banking transactions. The overall level of capital adequacy in the Czech Republic is around 4 percentage points higher than in the EU. This is due mainly to the depressed lending activity and because banks are investing their free funds in T-bills and CNB-bills depositing them at other banks, i.e. in products with a lower risk weight.

The ever-expanding range of products and services bearing specific risks is generating a need for continuous strengthening of banking regulation. The "New Basel Capital Accord" (NBCA) represents a change in the approach used to regulate banking risks. It emphasises individualised procedures for measuring and managing risk and for assessing the risk profile of each bank (the "risk-based approach"). The existing approach to prudential regulation, which covers credit risk and market risks, has been expanded to include operational risk. The NBCA bolsters the role of market discipline and includes enhanced information disclosure requirements for banks. It also envisages the application of far more sophisticated supervisory methods and procedures, where these are warranted by the scope of a bank's activities or its risk profile. This will exert considerable pressure on regulators, as they will have to learn new skills and take on greater responsibilities. The New Accord is expected to take effect in 2006. A qualitative shift in the performance of supervision can also be expected in the development of co-operation between regulators across the financial sector as a whole. The core banking legislation has been harmonised with EU law, and the regulatory framework is evolving towards the application of appropriate capital requirements covering all risks.