

Transformation Costs of the Recovery and Consolidation of the Banking Sector

1. Methodological approach

The precise quantification, or at least qualified estimation, of these costs runs into a series of methodological problems, and the resulting data may thus differ significantly depending on the methodology applied.

- First problem: identification of activities that the term “consolidation” can encompass.

For the purposes of this document, “consolidation operations” are only those transactions which were expressly aimed at improving the situations of individual banks or at mitigating the losses of their creditors and which are unambiguously quantifiable. Operations whose primary objective was to aid the corporate sector and whose favourable impact on banks was only a side effect are not included.

The series of operations undertaken at the start of the 1990s has a special position. These operations have to be considered in the context of the establishment of the banking sector and the ensuing need to create the basic conditions for the viability of the banks split off from the State Bank of Czechoslovakia (SBCS). Since these operations took place in the federal state, the calculated costs comprise only that part demonstrably borne by the institutions of the Czech Republic.

The consolidation operations chiefly involve capital increases, asset purchases, lending, payment of deposit compensation above and beyond the deposit insurance framework, and support for integration processes (compensation for property losses, etc.).

Given the purpose of this document, we only provide a quantification of those operations borne by the public sector, i.e. by the state budget, the CNB and by transitional institutions: the National Property Fund (NPF), Konsolidační banka Praha (KoB), Česká inkasní (ČI) and Česká finanční (ČF). For this reason, payments from the Deposit Insurance Fund, for example, are not included, as they are ultimately covered from insurance contributions.

- Second problem: avoidance of potential duplicate recording.

The approach chosen is based on the concept of two consolidated units: “the banking sector” (banks excluding KoB, ČMZRB and ČEB) and “the public sector” as defined above. Only the relationships between these two units are quantified (for example, within the Stabilisation Programme, KoB will provide a loan to ČF, which will use it to purchase assets from banks, while the NPF covers KoB’s losses; for calculating the costs, the amount ČF is able to get back is the deciding factor).

- Third problem: the method for cost calculation.

Only principal, not interest, is taken into account; this means that refinancing costs are not included unless they are an inseparable part of the transaction. Indirect costs (e.g. lower tax revenues) and indirect or potential incomes (e.g. prevention of greater losses) are not included. The time value of money is not explicitly considered, and only the nominal values of individual amounts are used.

Net costs are presented as the difference between direct gross costs (e.g. capital increases, amounts paid for asset purchases, settlement of losses, credits granted and not yet repaid, etc.) and direct revenues (e.g. dividends, proceeds from privatisation, repayments of loan principal or receivables, revenues from asset realisation). For this reason, returnable financial assistance such as credits is not included, provided it has been repaid.

The following are not considered direct consolidation costs:

- a) payments of deposit compensation from the Deposit Insurance Fund or from the funds of non-public sector entities, e.g. Česká pojišťovna's payment of deposit compensation above and beyond the framework of deposit insurance to the clients of Kreditní banka Plzeň;
- b) the deposit losses of institutions linked to the state budget or administering public funds in cases of bank collapses;
- c) the settlement of banks' losses in connection with the provision of social loans (loans for newlyweds and co-operative housing loans), since this aid is not linked to the consolidation of the banking sector but to the social policy of the state and is earmarked for loan recipients.

The return on the assets administered by Česká finanční is measured using the repayments of the credits through which these assets are financed (the CNB – Consolidation Programme, KoB – Stabilisation Programme). This means that nonmonetary payments accepted by Česká finanční are not considered revenues until they are realised and recorded as repayments of credits accepted. In the case of the Stabilisation Programme, however, the asset yields are also used for interest payments, so that the realised assets are higher than the corresponding fall in credits.

As for guarantees, these are presented in terms of the level of the estimated payment and not at nominal value.

- Final problem: the method for estimating future revenues and costs.

Some items (e.g. yield on assets) are based either on audited values (e.g. items in the ČF portfolio), or on expert estimates ensuing from the rather bad experience with debt recovery. If there is no auditor's estimate or if the estimate is not based on examination of a specific set of assets, the yield is generally estimated at 10% of their nominal value.

II. Operations carried out within Consolidation Programme I

Consolidation Programme I includes operations associated with the clean-up of the balance-sheets of Komerční banka (KB), Česká spořitelna (ČS), Investiční banka (IB) and the State Bank of Czechoslovakia (SBCS) of bad loans extended before 1990, operations to strengthen the capital of state-owned banks (KB, ČS and IB), and the clean-up of the balance sheets of other banks in the periods both before and after the division of Czechoslovakia. These operations are as follows:

- a) the transfer of assets to KoB,
- b) the write-off of loss loans from NPF funds,

- c) the topping up, by means of NPF bonds, of the capital of the banks split off from the SBCS (in this case the nominal value of the bonds is considered to be the cost)
- d) the capital increase in ČSOB,
- e) the transfer of credits and guarantees from ČSOB to ČI (the costs of this operation are measured using the NPF subsidy for the payment of the principal and interest of the ČSOB loan for ČI's refinancing).

III. Adjusted definition of the costs associated with Consolidation Programme II

For aggregation purposes, the costs of Consolidation Programme II also include the costs associated with resolving the problems at Kreditní a průmyslová banka, AB Banka, Banka Bohemia and Agrobanka Praha.

In the case of AB banka and Banka Bohemia, the costs were partly covered from the state budget¹.

Part of the CNB's losses associated with banking sector consolidation are covered by a state guarantee. The amount of the applicable state guarantee is given for information in the table below.

IV. Conclusions

The level of the costs associated with the recovery of the banking sector is presented in aggregated form in the table below. Owing to a lack of preparation time, it was not possible to obtain updated figures from all the institutions involved; however, the time differences have no major effect on the level of the costs.

Aggregated unit	Net costs	Expected net revenues	State guarantee
Consolidation Programme I ^{a)}	101.6	-14.5	
Consolidation Programme II ^{b)}			
- balance sheet	102.2	7.4	22.5
- off-balance sheet	3.3		
Stabilisation Programme ^{c)}	14.7	7.6	
Privatisation preparation ^{d)}	51.4	17.1	
Income from share holdings ^{e)}	- 47.8		
Total	225.4	17.6	

a) According to data as of 31 August 1999. The expected costs ensue from repayments of the credit drawn by ČI from ČSOB.

b) According to data as of 31 December 1999.

c) According to data as of 31 August 1999.

d) Neither the planned expenses for Komerční banka's clean-up (purchase of assets with a maximum nominal value of CZK 60 billion for a maximum price of CZK 36 billion) nor the potential payments arising from

¹ For example, payment of the state guarantee vis-à-vis ČS on the basis of the Government Decree No. 370/1998; this guarantee was issued in connection with the resolution of the situation of AB banka.

guarantees issued in connection with the sale of Česká spořitelna are included. The expected revenues depend on the realisation of the assets purchased from the banks.

- e) The expected revenues from the sale of Česká spořitelna shares are not included, as the purchase price depends on the audit as of 31 December 1999, which has not yet been completed; the revenues from the sale of Komerční banka are not included either.

The final level of the costs will be affected by the net effect of the sale of Česká spořitelna and Komerční banka. The actual yield on assets may also differ from the estimate. The above values, however, give a good idea about the order of the current nominal level of the costs associated with the recovery of the banking sector in line with the methodology described in part I. This methodology enables an international comparison to be made. Nonetheless, it partially underestimates the impact on public budgets, mainly because it does not take into account refinancing costs². The fact that the time value of money is not taken into account is also misleading with respect to the precise expression of the costs as percentage of GDP, owing to the relatively long period of consolidation and the relatively high level of inflation.

² In the case of the CNB, this means the costs of sterilising the excessive liquidity of the banking sector.