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DIPLOMOVÁ PRÁCE

State Aid to the Czech Banking Sector in the Context of Transition and EU Accession

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Prohlášení

Prohlašuji, že jsem diplomovou práci o rozsahu 278 062 znaků (včetně mezer) vypracoval samostatně a použil pouze uvedené prameny a literaturu.

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Abstrakt

První část této diplomové práce se zabývá faktory, které vyústily v propuknutí krize bankovního sektoru, pravými příčinami a řešením této situace, mezinárodním srovnáním přijatých opatření a aktuální výkonností tohoto sektoru. Autor dospívá k závěru, že na rozdíl od krizí bank ve vyspělých tržních ekonomikách, kde příčinami ztrát jsou obecně faktory specifické pro konkrétní banku (navíc do značné míry související s agresivní obchodní a úvěrovou politikou této banky), byla krize českého bankovního sektoru způsobena faktory nikoliv specifickými pouze pro dané banky, ale specifickými i pro celou tranzitivní ekonomiku.

Ve druhé části autor zkoumá efekty státní pomoci na úroveň hospodářské soutěže v bankovním sektoru. Z analýzy vyplývá, že udělení přiměřené (tzn. nikoliv nadměrné) státní pomoci k překonání nedostatků uvedených v první části této diplomové práce bylo pro tranzitivní ekonomiky nezbytné a že principiálně by na tato opatření nemělo být nahlíženo jako na pomoc narušující hospodářskou soutěž ve finančním sektoru. Naopak, tato pomoc přispěla k vytvoření náležitého rámce hospodářské soutěže mezi domácími i zahraničními bankovními institucemi. Dále se autor zaměřuje na původ, právní rámec a výsledek posuzování státní pomoci Evropskou komisí v rámci tzv. *interim procedury*, která byla iniciována v souvislosti se vstupem České republiky do Evropské unie.

Abstract

The first part of this thesis is concerned with triggers, causes and resolution of the banking sector crisis as well as with international comparison of adopted solutions and current performance of the banking sector. The author has concluded that on the contrary to crises of banks in well-functioning market economies, where the reasons for the bank's losses are generally specific to each particular bank (and related to a large extent to its aggressive commercial and credit policy), the crisis in the Czech banking sector was caused mainly by factors not only specific to each bank, but specific also to the economy in transition.

In the second part, the author analyzes effects of aid measures on the level of competition in the banking sector. The analysis concludes that incurrence of adequate

(i.e., not excessive) aid measures to overcome deficiencies presented in the first part of this thesis has been inevitable for the transition countries and in principle should not be viewed as state aid distorting competition in the financial market. On the contrary, such aid has contributed to creation of a level playing field allowing just competition between both domestic and foreign banking institutions. In addition, the author focuses on background, legal framework and outcome of the review of pre-accession aid measures by the European Commission within the framework of so-called *interim procedure*, which has been initiated in the context of accession of the Czech Republic into the European Union.

Motto

"*As regards the applicant countries, it is quite true that they start with situations characterised by enormous and certainly non-transparent State aids, in view of the nature of their economic systems. Great care should be devoted to the work done with them in the sphere of preaccession on this aspect, as well as on competition policy more generally. One of the points which I have already earmarked as worthy of great attention and determination is recovery, that is recovery of illegal state aid. I and my departments will consider further procedures and instruments for effective enforcement in this sphere.*"

Mario Monti[1]

[1] *Verbatim Report of Hearing of Commisioners-designate at the European Parliament.* European Parliament, 1999, p.7. [On-line]. [Cit. 2004-12-02].
URL: <Http://www.europarl.eu.int/hearings/com/pdf/monti.pdf>.

Contents

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Abbreviations

AGB	Agrobanka Praha, a.s.
BdN	Banco di Napoli
BIS	Bank for International Settlements
CAR	Capital adequacy ratio
CDR	Consortium de réalisation
CEE	Central and Eastern European
CF	Česká finanční, s.r.o.
CI	Česká inkasní, s.r.o.
CIS	Commonwealth of Independent States
CKA	Czech Consolidation Agency
CL	Credit Lyonnais
CNB	Czech National Bank
Commission	European Commission
CS	Česká spořitelna, a.s.
CSOB	Československá obchodní banka, a.s.
CZK	Czech Crown
DG	Directoriate General
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EC Treaty	Treaty Establishing the European Community
EPFR	Etablissement public de financement et de restructuration
EU	European Union
EUR	Euro
FRF	French Franc
FSU	Former Soviet Union
GECB	GE Capital Bank, a.s.
GECC	General Electric Capital Corporation
IB	Investiční banka, a.s.
IMF	International Monetary Fund
IPB	Investiční a Poštovní banka, a.s.
ITL	Italian Lira

KB	Komerční banka, a.s.
KBC	Belgian Kredietbank
KOB	Consolidation Bank
MoF	Ministry of Finance of the Czech Republic
NPF	National Property Fund
NPL	Non-Performing Loans
OECD	Organization for Economic Cooperation and Development
ROAA	Return on average assets
ROAE	Return on average equity
SBCS	State Bank of the Czechoslovakia
SI	Slovenská inkasní, s.r.o.
TOZ	Working capital requirement funding
OPC	Office for the Protection of Competition
VUB	Všeobecná úverová banka, a.s.
WB	World Bank

Introduction

The issue of state aids into the banking sector has emerged during the negotiation of the Accession Agreement between the Czech Republic and the EU and was further boosted by the third party complaints directed to the European Commission, with respect to pre-accession state aids granted to the Czech banking sector. This thesis aims to shed light on the relevant aspects of this highly sensitive issue by focusing on the development of the crisis, its triggers and causes, adopted solution, its implications on the level of competition in the banking sector, as well as the background and outcome of the review of aid measures by the European Commission (so-called *interim procedure*). Each of these issues could be certainly analyzed in more detail, however, given the limited scope of the thesis, the selection of particular issues and aspects which are raised in this thesis, as well as the depth of the analysis pursued, is subordinated to the primary goal of this paper**: to show the logic link between the status of the banking sector at the beginning of transition, the necessity of its rescue and restructuring and the desired outcome of of the review of aid measures by the European Commission.**

The thesis consists of two parts. The first part is concerned with triggers, causes and resolution of the banking sector crisis as well as with international comparison of adopted solutions and current performance of the banking sector. All transition countries have experienced banking crises during the process of transition and a number of factors caused these adverse developments. A key factor that contributed to distress in banking sector in these countries was a **large debt burden inherited from the previous centrally planned economy regime, a lack of experience doing business in the market economy**, **underdeveloped regulation and weak corporate governance**. Moreover, **large banks were the main providers of liquidity to businesses and as such, they bore the majority of the risks and burdens of the transition by funding undercapitalized companies during their privatizations**. From their nature, such problems may have been considered as inevitable costs of transition, as both banks and enterprises were learning to operate in a completely new environment, while bearing debts from the old era. Therefore, **on the contrary to crises of banks in well-functioning market economies, where the reasons for the bank's losses are generally specific to each particular bank (and related to a large extent to its aggressive**

commercial and credit policy), the crisis in the Czech banking sector was caused mainly by factors not just specific to each bank, but specific also to the economy in transition.

In the second part, called Competition Policy Considerations, the author analyzes effects of aid measures on the level of competition in the banking sector. It is obvious that *"[b]y giving certain firms or products favoured treatment* ***to the detriment of other firms or products****, state aid seriously disrupts* ***normal competitive forces."***[2] Therefore, the author analyzes whether aid measures granted to Czech banks in context of transition and privatization were provided to the detriment of their competitors and whether "normal" competitive forces were actually in place when the measures were implemented.

Firstly, impact of the unique characteristics of domestic banking sector in transition on competition and on competition policy is discussed. Then, the question of aid proportionality is tackled and, subsequently, also foreign banks are incorporated into the competition analysis. The main conclusion of this analysis is that the **incurrence of some fiscal costs to overcome the crisis is inevitable for the transition countries and should not be principially viewed as state aid distorting competition in the financial market.** Although the Czech Republic has spent quite substantial fiscal costs in the process of banking sector consolidation, these costs are fully in line with its CEE peers when controlled for the size of the banking sector. In addition, **the result is a sounder, competitive and more efficient banking system, ready for the competition in the international context, without a threat of destabilizing banking sector in the Common Market.**

Finally, the author focuses on background, legal framework and outcome of the review of aid measures by the European Commission within the framework of so-called *interim procedure*, which has been initiated in the context of accession of the Czech Republic into the European Union. **The autor argues that taking into account the specific circumstances (i.e. transition economy context, nature of the aid measures and purpose of the interim mechanism) and the level of flexibility in a number of major decisions by the European Commission, the expected outcome of the review of aid measures by the Commission within the framework of the *interim procedure* would be (i) a proper economic**

[2] *DG Competition Web Page*. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/competition/citizen/citizen_stateaid_en.html>.

assessment of each aid measure, and (ii) no objections from the European Commission to a vast majority of aid measures .

PART I

Triggers, Causes and Resolution of the Banking Sector Crisis

1. Uniqueness of the Banking Sector

The main area of banks' business is allocation of resources, intermediating between savers and borrowers seeking external finance for investment projects. However, some may argue that this function is not exclusively pertinent to banking sector as such and that the financial intermediation role can be also played by securities markets.[3] But such thought would have been unrealistic in the Czech Republic due to the following reasons[4]:

- Historically, banks have played a dominant role among financial institutions in this region;
- The formerly command economies lacked the preconditions for the development of active and efficient securities markets;
- The legal and institutional prerequisites for efficient securities markets are more demanding;
- Proximity of Western Europe, where financial systems are based mainly on banks.

As such financial intermediation activity is conducted in an environment of asymmetric information, there are **three major implications:**

- "*Because banks issue liquid liabilities to finance illiquid activities, they bear significant illiquidity risks, they themselves generate risks and are **vulnerable to risks originating elsewhere in the economy**. Also, due to their large intrasector and inter-sector open positions, **banks may transmit shocks across the economy**.*"[5] Therefore, depositors' confidence in banking sector is essential for its operation. If, for any reason, the depositors' confidence diminishes, such situation can result in situation in which banks are unable to meet their obligations. This is further exacerbated by

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[3] See for example: Bossone, B.: *What Makes Banks Special? A Study on banking, finance, and economic development*. WB Working Paper 2408, Washington D.C.: World Bank, 2000, p. 6. [On-line]. [Cit. 2004-15-01]. URL: <Http://econ.worldbank.org/docs/1163.pdf>.

[4] Based on: *Transition Report 1998: Financial Sector in Transition*. London: European Bank for Reconstruction and Development, 1998, p. 92.

[5] Bossone, B.: What *Makes Banks Special? A Study on banking, finance, and economic development*. WB Working Paper 2408, Washington D.C.:The World Bank, 2000, p. 30. [On-line]. [Cit. 2004-12-02]. [Emphasis added].
URL: <Http://econ.worldbank.org/docs/1163.pdf>.

"… the sequential-service constraint under which banks operate (demands for funds are met on a first-come, first-served basis) ***gives creditors an incentive to liquidate their deposits at the first sign of trouble****."*[6] In addition, the fragility is even heightened by the **adverse selection** problem.[7] Therefore, **even failure of a single bank may trigger widespread contagious effect, having devastating effect on the whole banking sector and the economy as such**.

- As banks may decrease **information asymmetries** through monitoring and reduce lending risks portfolio through diversification, in times of disruption of banks' activities, this advantage of banking system cannot be utilized fully and thus, such disruptions have a devastating impact on the level of economic activity.
- **Banks' portfolios are not fully transparent.** It is difficult for auditors, supervisors and even for bank's management to assess the real financial condition of a bank.[8] Therefore, banks in difficulties will face troubles to raise liquidity needed to restructure, increasing the probability that adverse shocks will result in failure.

These implications are particularly prevalent in transition economies, which have been facing the process of financial liberalization. The experience of many countries demonstrate that financial liberalization involves inherent risks as banks and other financial

[6] Eichengreen, B., Rose, A.: *Staying Afloat When the Wind Shifts: External Factors and Emerging-Market Banking Crises*. NBER Working Paper 6370, Cambridge: National Bureau of Economic Research, 1998, p. 8. [On-line]. [Cit. 2004-10-02]. [Emphasis added].
URL: <Http://www.nber.org/papers/w6370>.

[7] Adverse selection dilemma under asymmetric information is caused by the fact that only those investors with high-risk projects will be willing (or declare to be willing) to pay high interest rates. As these risky investors are highly vulnerable to changing economic conditions, adverse selection dilemma may significantly contribute to vulnerability of the banks.

[8] *"In many emerging economies, auditors, management and supervisory authorities face considerable difficulties in adequately measuring the value of individual instruments and therefore of an institution's portfolio as a whole. These difficulties have considerably hampered the ability of managements to assess adequately their institution's financial status and to make changes in investment priorities when needed; also hampered are market discipline and the ability of regulators to recognize developing problems before they become serious."* (*Financial Stability in Emerging Market Economies: A strategy for the formulation, adoption and implementation of sound principles and practices to strengthen financial systems*. Report of the Working Party on Financial Stability in Emerging Market Economies, Basel: Bank for International Settlements, 1997, p. 3. [On-line]. [Cit. 2004-15-01].
URL: <Http://www.bis.org/publ/gten02.pdf>).

institutions adjust to new, unfamiliar environment in which they are confronted with substantial risk. ***"Emerging market economies are particularly subject to these risks****, not only because of financial liberalisation but also because of the limited development of their financial systems and the pressures created by the internationalisation of financial markets*."[9] **Thus, the banking sectors of transition countries are even "more unique" than in developed market economies.**

Therefore, having in mind the above-mentioned features, we may conclude this section by stressing the **necessity for special attention to banking sector stability especially with a view to averting systemic consequences.**[10] Naturally, this holds also for competition policy considerations, as there is a trade-off between the objectives of minimizing the systemic risk associated with the failure of an individual bank and accountability of management for bank's performance. "***However, striking the right balance can be exceedingly difficult, particularly in periods of financial panic***."[11]

[9] *Financial Stability in Emerging Market Economies: A strategy for the formulation, adoption and implementation of sound principles and practices to strengthen financial systems.* Report of the Working Party on Financial Stability in Emerging Market Economies, Basel: Bank for International Settlements, 1997, p. 47. [On-line]. [Cit. 2004-15-01]. [Emphasis added].
URL: <Http://www.bis.org/publ/gten02.pdf>.

[10] This has been recognized by the European Commission: "*The Commission is aware of the* ***particular sensitivity of the banking sector****, which calls for special attention on the part of the national and Community authorities to ensure that serious difficulties in a major financial institution do not disrupt financial links between institutions in the sector and create a more widespread crisis*." (*The XXVth Report on Competition Policy.* Brussels: European Commmission, 1995, p. 217-218. [On-line]. [Cit. 2004-15-01]. [Emphasis added].
URL: <Http://europa.eu.int/comm/competition/ publications/ra9501en_en.pdf>).

[11] *Transition Report 1998: Financial Sector in Transition*. London: European Bank for Reconstruction and Development, 1998, p. 131. [Emphasis added].

2. Banking Sector Evolution Between 1990-1996

2.1 Creation of the Two-tier Banking System and Transition to a Market Economy

As other post-communist countries, the Czech Republic faced a challenge to reform its banking sector in order to prevent a systemic crisis and subsequent collapse of the economy. The banking sector reform was perceived as an engine of the whole transformation. After the formation of the two-tier banking system in early 1990s, we may identify the following negative characteristics:

- The lack of capital;
- High amounts of bad loans;
- Unbalanced funding structure;
- Insufficient technical equipment;
- Poor management and inexperienced employees.

Therefore a project called **Consolidation Programme I** was undertaken in order to reduce the large debt burden from socialist regime and to create the basic conditions for the viability of the strongly undercapitalized commercial banks after their split-off from the State Bank of Czechoslovakia (SBCS).

This included operations associated with the clean-up of the balance sheets of Komerční banka, a.s. (KB), Česká spořitelna, a.s. (CS), Československá obchodní banka, a.s. (CSOB) and Investiční banka, a.s. (IB) of the bad loans extended before 1990, operations to strengthen the capital of KB, CS, CSOB and IB, and the clean-up of the balance sheets of some other banks in the periods both before and after the division of Czechoslovakia.

Specifically[12],

- Consolidation Bank (KOB) acquired from CS, CSOB, KB and IB their "revolving inventory loans" (so called TOZ[13]) inherited from the previous socialistic regime at their nominal value in 1991;
- Loss and non-recoverable loans were written-off from CS, CSOB, KB and IPB with the National Property Fund (NPF) coverage in 1991;
- NPF recapitalized CS, KB, IB and Všeobecná úverová banka, a.s. (VUB);
- NPF increased CSOB's share capital in 1993;
- Česká finanční (CF) and Slovenská inkasní (SI) bought CSOB's inherited export credits and guarantees in 1993-94;
- KOB bought NPLs from Agrobanka Praha, a.s. (AGB), IB and CSOB at 80% of their nominal value in 1992 and 1994;
- KOB bought NPLs from CS at their nominal value in 1994.

In the meantime, licenses were granted quite freely to newly created banks, and the market was opened to foreign bank branches in 1992 in order to increase competition in the banking sector quickly. As demonstrated in Exhibit 1, the number of banks had reached 55 by the end of 1995.

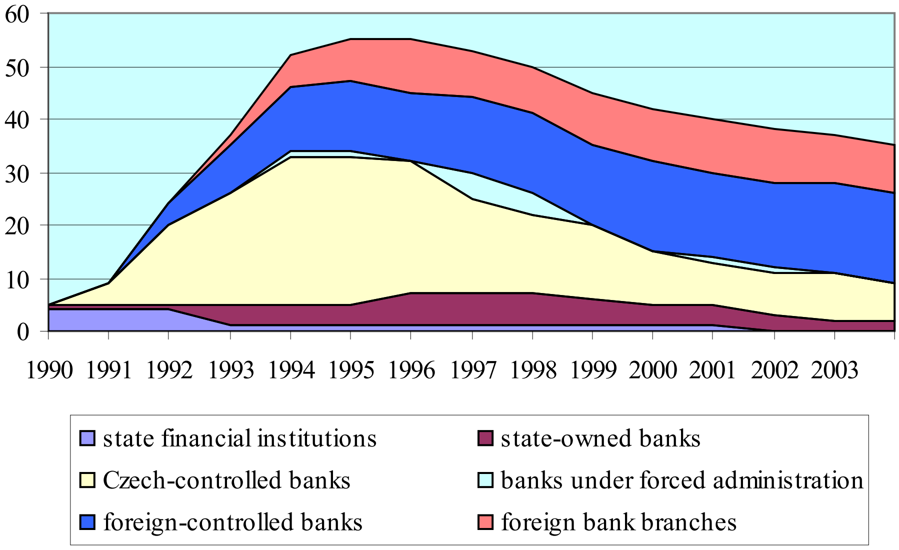
Živnostenská banka, a relatively small but well-established bank, was sold off 100 % to private investors in 1992.[14] The large Czech banks were transformed into joint-stock companies in 1992 and partially privatized within the first wave of "voucher privatization".

[12] Based on Annual Reports of National Property Fund, 1991 – 1993, Dubská, D.: Banky nás nakonec přijdou na 300 až 400 miliard korun. *Ekonom*, 2/2000, p. 22 and the Czech National Bank study: *Transformation Costs of the Recovery and Consolidation of the Banking Sector*. Prague: Czech National Bank, 1999. [On-line]. [Cit. 2004-15-01].
URL: <Http://www.cnb.cz/en/pdf/transfor.naklady.pdf>.

[13] Working capital requirement funding.

[14] German BHF-BANK took up a 40% shareholding in Živnostenská banka, the International Finance Corporation took a 12 % stake and the remaining 48 % was taken up by private individuals and Czech investment funds.

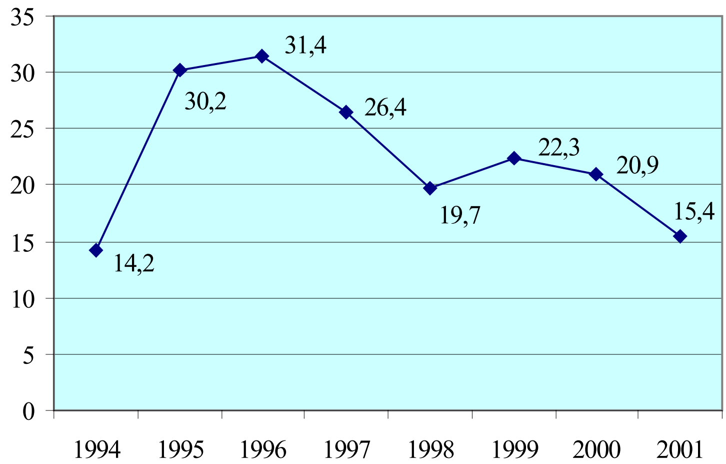
Exhibit 1 Number of banks



Source: Czech National Bank

Due to general lack of capital in the economy and unability of the newly established Czech capital markets to provide the necessary liquidity (this is reflected in the relative size of the Prague stock exchange capitalization - see Exhibit 2), the Czech Government decided to ensure that the banking sector had the capacity to support major state-owned industrial enterprises as well as the non-bank privatized companies which were heavily dependent on bank loans financing.

Exhibit 2 Czech stock market capitalization (in % of GDP)



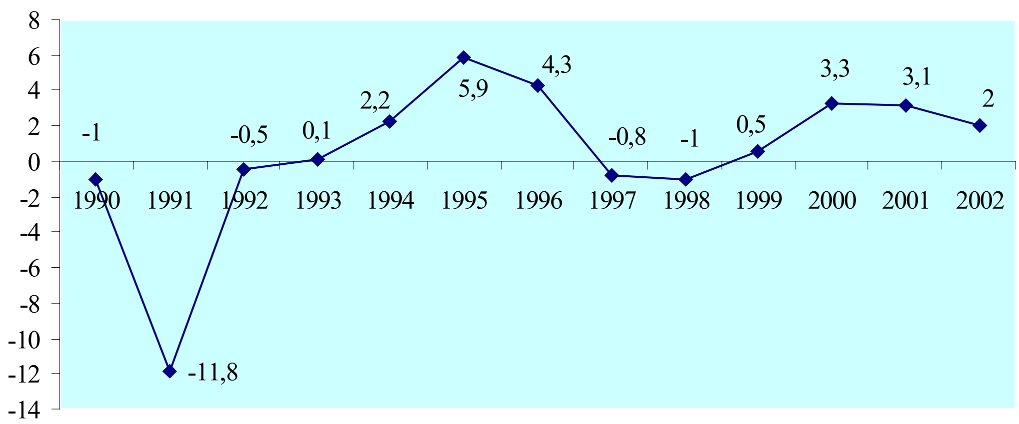
Source: European Bank for Reconstruction and Development

Therefore, the State kept controlling stakes in these banks (over 50% in CS and CSOB, 47.4% in IPB and 44% in KB) and put the large bank privatization on hold until 1997. **This obviously resulted in a biased corporate governance structure**, as the state appointed management was indirectly liable to politicians and, therefore, state vested interests were often in conflict with principles of prudential banking.[15] As a result, banks' portfolios were heavily dependent on the success of the transformation process. Given the political constellation, the outcome of which was the voucher privatization, **banks provided a significant stimulus for economic growth and prevented collapse of the economy while putting their portfolios at substantial risk.**

2.2 Macroeconomic Situation Between 1990-1996

The Czech Republic experienced a shorter and less severe transition recession in the first half of the 1990s than many other transitive countries. The decline in output lasted three years and by 1995, real GDP had returned to its 1989 level (see Exhibit 3).

Exhibit 3 Real GDP growth (% change year-on-year)

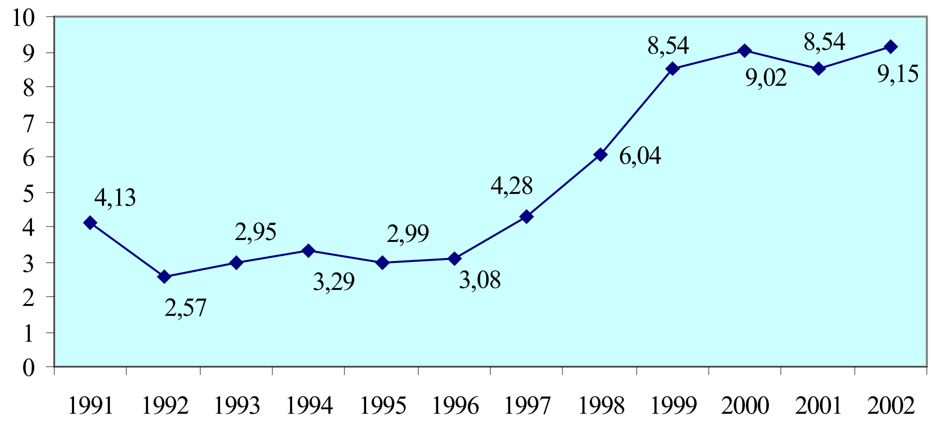


Source: Czech Statistical Office

The country enjoyed low unemployment, averaging less than 3% in 1990-95 (see Exhibit 4).

[15] See e.g. Mejstrik, M. at al.: *The cultivation of the Czech financial market*. Prague: Karolinum Press, forthcoming 2004, chapter 2.

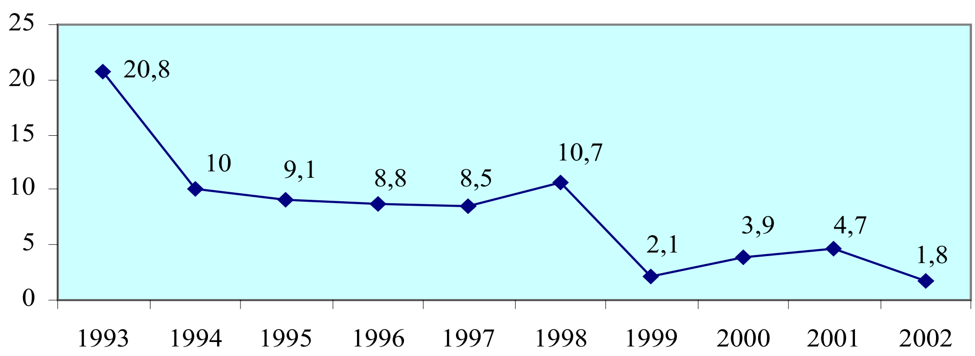
Exhibit 4 Unemployment rate (%, average)



Source: Czech Statistical Office

Fast reduction in inflation to single-digit levels was reached by fixing and devaluation of the exchange rate, tight fiscal and monetary policies, and initial wage discipline (see Exhibit 5). The process of price, wage and trade liberalization was launched as well as the process of mass privatization.

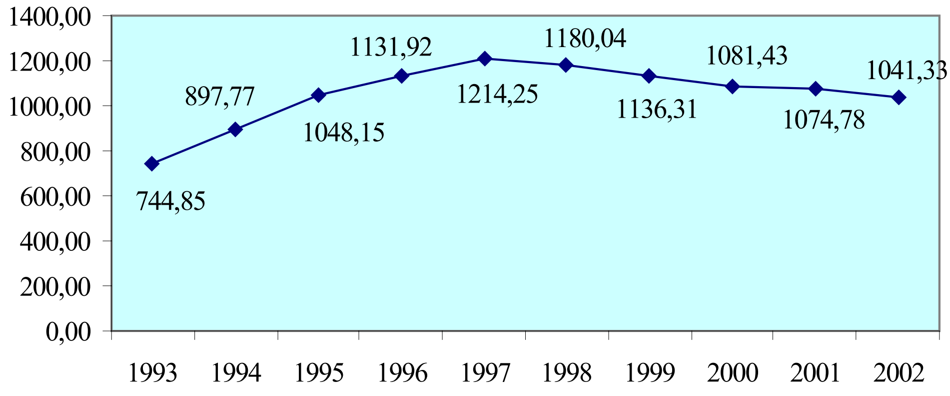
Exhibit 5 Inflation (%, year-on-year, average)



Source: Czech Statistical Office

In addition, the period between 1994-1996 was characterized by sharp credit growth (see Exhibit 6).

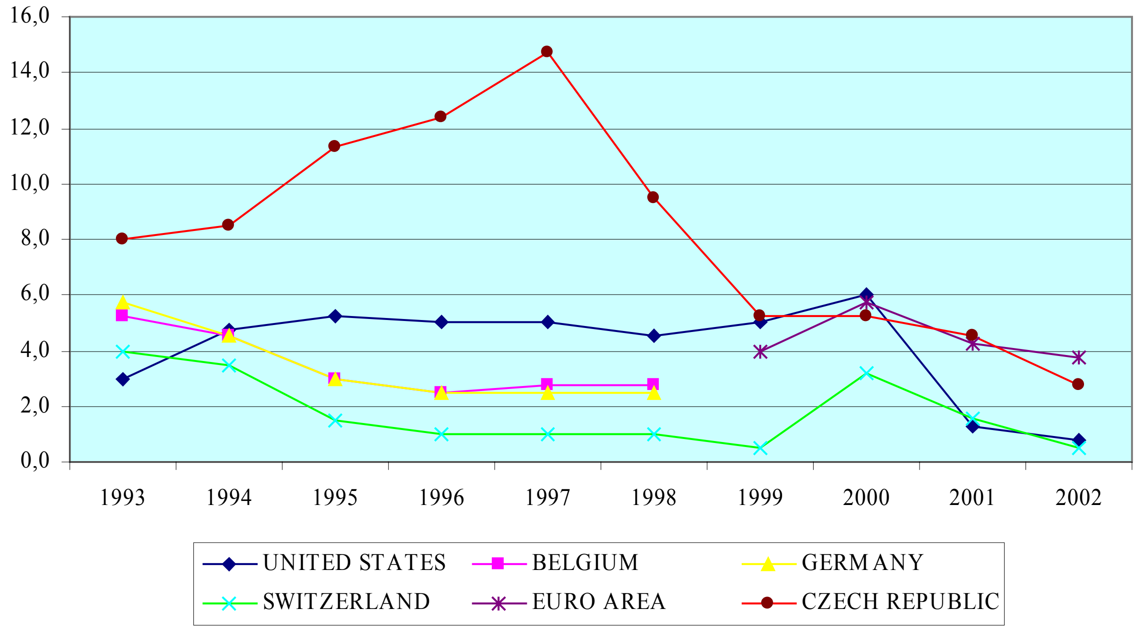
Exhibit 6 Domestic credit (CZKbn)



Source: International Financial Statistics (IMF)

Czech banks were borrowing abroad to increase their disposable funds and because of lower foreign interest rates (see Exhibit 7).

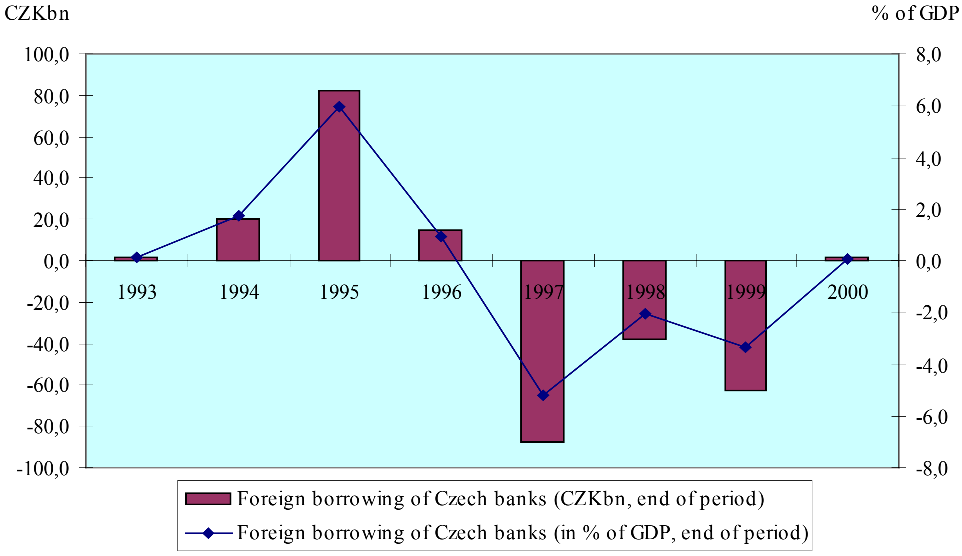
Exhibit 7 International comparison of discount rates (end of period)



Source: International Financial Statistics (IMF)

The foreign borrowing of Czech banks peaked at 6% of GDP at the end of 1995 (see Exhibit 8).

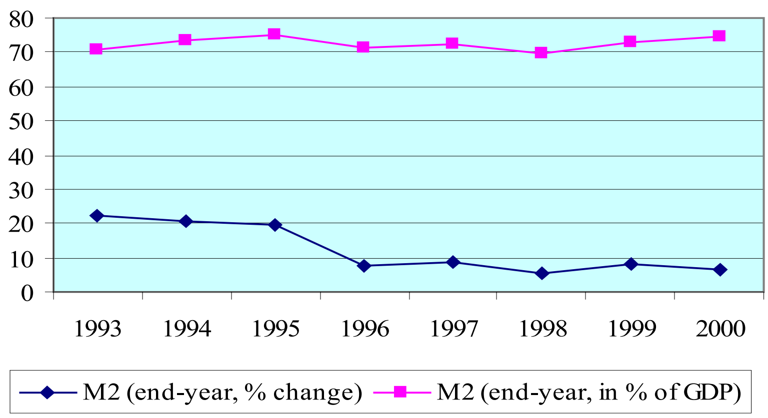
Exhibit 8 Foreign borrowing of the Czech banking sector



Source: International Financial Statistics (IMF)

However, such development exposed banks to a substantial exchange-rate risk: eventual devaluation of the Czech currency would lead to increased indebtedness, while the value of the banks' assets would not rise.[16]

Exhibit 9 M2 (% change and in % of GDP)

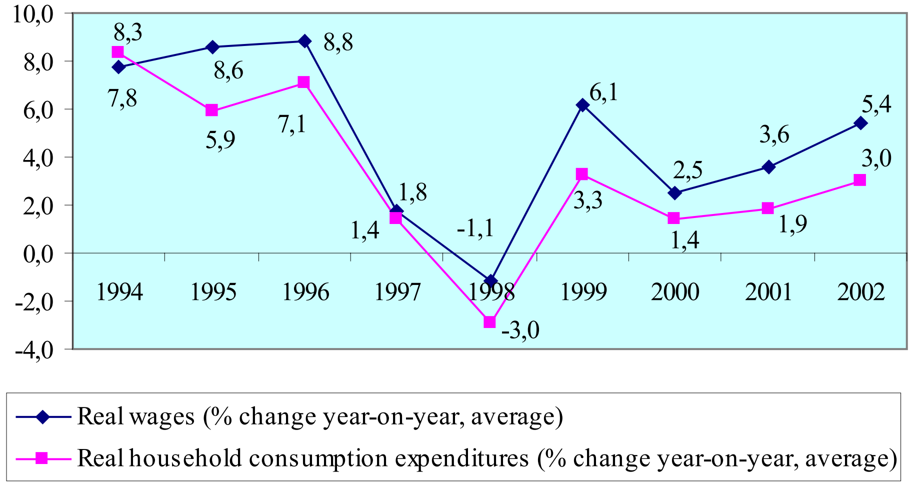


Source: European Bank for Reconstruction and Development

[16] "*The resulting deterioration in banks' equity capital can lead to substantial declines in bank lending because the resulting drop in bank capital results in a failure of banks to meet capital standards, such as the Basle requirements. The decline in bank capital then requires banks to shrink their lending until they can raise new capital to meet the capital standards.*" (Mishkin, F: *The Causes and Propagation of Financial Instability: Lessons for Policymakers*. NBER Working Paper No. 7364, New York: National Bureau of Economic Research, 1999, p. 69. [On-line]. [Cit. 2004-15-01].
URL: <Http://www.worldbank.org/wbi/banking/finsecpolicy/finsecissues/pdf/mishkin_lessons.pdf>).

As a consequence, money supply growth substantially exceeded the CNB's targets every year between 1993 and 1995 (see Exhibit 9). Moreover, the Czech economy experienced quickly growing wages and household spending (see Exhibit 10).

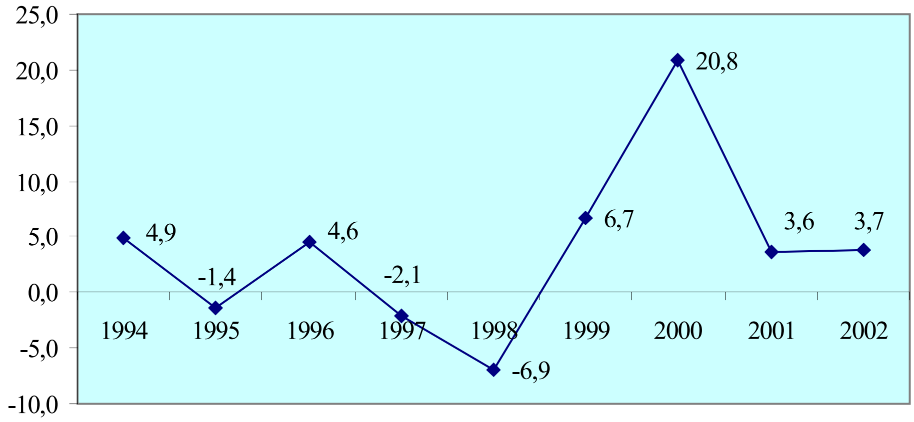
Exhibit 10 Real wages (% change year-on-year, average) and real household consumption expenditures (% change year-on-year)



Source: International Financial Statistics (IMF)

Surprisingly, fiscal policy was rather pro-cyclical in this period, as supported by Exhibit 11.

Exhibit 11 Real government consumption expenditures (% change year-on-year)



Source: International Financial Statistics (IMF)

These factors caused a fast economic growth between years 1994-1996. However, considering the institutional and supply side weaknesses of the Czech economy, the actual growth rate exceeded potential, and thus, the economy was overheated by 1996.[17]

2.3 Consolidation of Agrobanka[18]

Since its establishment in 1990, AGB experienced significant growth of its business and by the end of 1995 it had developed into the fifth largest bank in the Czech Republic in terms of deposits and credit volume, and it became the largest privately owned bank. In its activities, AGB focused mainly on extending credit to the agricultural sector, one of the weakest sectors of the Czech economy. To finance such credits, AGB offered generous deposit interest rates, which attracted deposits even from public and semi-public institutions. This relatively aggressive strategy, combined with substantial insufficiencies on field of risk management and the lack of internal controls, resulted in the gradual deterioration of bank's loan portfolio.

In 1993, AGB suffered a loss of CZK 2 billion and ended up with a negative equity, and the bank was technically bankrupt.[19] However, CNB ordered AGB to develop a Consolidation Programme ("AGB's Consolidation Programme"), consisting of series of measures based on grounds of closer supervision and utilization of AGB's own resources and resources of its shareholders aimed to achieve the financial recovery of AGB. The AGB's Consolidation Programme did not consist of any measures granted by the CNB or State and was accepted by CNB in June 1994 (for more details refer to Box 1).

[17] See Schneider, O., Krejdl, A.: *Strukturální schodky veřejných rozpočtů v ČR* [*Structural deficits of public budgets in the Czech Republic*]. Finance a úvěr, 3/ 2000, Prague 2000, p. 160–174 or Tůma, Z.: *Banking Sector Development in the Czech Republic*, Prague: Czech National Bank, 2002, p. 4. [On-line]. [Cit. 2004-15-02].
URL: <Http://www.cnb.cz/en/pdf/tuma_vien_nov_2002.pdf>.

[18] Based on *Banking Supervision in the Czech Republic*. Prague: Czech National Bank, 1999. [On-line]. [Cit. 2004-15-01].
URL: <Http://www.cnb.cz/en/bd_publikace_op.php> and *Annual Reports on Banking Supervision* 1994-1999. Prague: Czech National Bank. [On-line]. [Cit. 2004-15-01].
URL: <Http://www.cnb.cz/en/bd_publikace_rz.php> and Bank's Annual Reports.

[19] See bank's 1993 Annual Report.

Box 1 AGB's Consolidation Programme

Concretely, the AGB's Consolidation Programme was based on the following steps:

- Gradual increase of the capital adequacy to meet key target income statement and balance sheet indicators (total assets; equity; loans from CNB; general reserves; risk weighted assets; capital adequacy ratio; net interest margin and net income through increase of AGB's equity capital (through capitalization and new shares subscription);
- Shift of AGB's assets into less risky ones (such as treasury bills);
- Reduction of AGB's dependence on financing from other banks;
- Improvement in efficiency of loan collection and lending processes;
- Review of all AGB's internal measures;
- Scaling down the capital expenditures for building new branches;
- Stabilization of existing IT system and its integration;
- Assessment of efficiency of organization structure of AGB and strict segregation of duties among existing departments.

After the capital increase by IPB (one of the main AGB's shareholders) in 1994, AGB's registered capital had been in compliance with the terms of the AGB's Consolidation Programme. However the quality of bank's portfolio had further deteriorated and a new capital increase (again from IPB) had to be carried out to comply with the AGB's Consolidation Programme basic measures.

In autumn of 1995, IPB sold its stake in AGB to the Motoinvest group companies, which practically gained control over AGB.[20] As a result, AGB strayed from the AGB's Consolidation Programme strategy and engaged in risky operations.[21]

In 1996, CNB inspections revealed that the bank did not comply with the remedial measures imposed by CNB. It became apparent that AGB's Consolidation Programme would not be fulfilled nor would be sufficient for resolution of the escalating problems. Therefore,

[20] For more details see *Banking Turbulence in the Czech Republic and the "Bad Boys" from Motoinvest*. Transition Newsletter, Volume 7, Number 9-10, September-October 1996, Washington, D.C.: World Bank, 1996. [On-line]. [Cit. 2004-15-01].
URL: <Http://www.worldbank.org/html/prddr/trans/so96/art2.htm>.

[21] *Report on Banking Supervision in the Czech Republic*. Prague: Czech National Bank, 1999, p. 31. [On-line]. [Cit. 2004-15-01].
URL: <Http://www.cnb.cz/en/bd_publikace_op.php>.

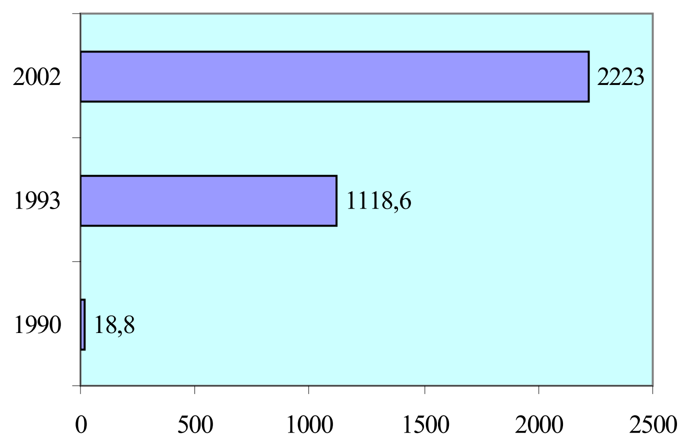
taking into account that AGB was the biggest bank in difficulties so far and considering the risk of potential contagion, CNB imposed a forced administration on AGB on September 17, 1996.[22]

2.4 The Crisis of Small Banks

2.4.1 Consolidation Programme II[23]

In the course of economic transition, a key role was played by the newly-established small and medium-sized enterprises (see Exhibit 12 showing a rapid increase in number of registered economic units), which needed fast access to bank funds and services.

Exhibit 12 Number of registered economic units (thousands, end of year)



Source: Czech National Bank, Czech Statistical Office

However, small and medium-sized enterprises sector involves a high degree of risk even in highly developed economies. In circumstances where the large banks, created upon the break-up of the former SBCS, held onto their long-term client base, and the role of the foreign banks at that time was limited to monitoring the situation and financing companies

[22] The intervention followed the collapse of the medium-size Kreditní banka in August. The main reason for Kreditní banka's failure is widely considered to be incompetent management and fraud.

[23] Based on *Annual Reports on Banking Supervision 1994-1999*. Czech National Bank, Prague. [On-line]. [Cit. 2004-15-01].

URL: <Http://www.cnb.cz/en/bd_publikace_rz.php> and on *Report on Banking Supervision in the Czech Republic.* Prague: Czech National Bank, 1999. [On-line]. [Cit. 2004-15-01].

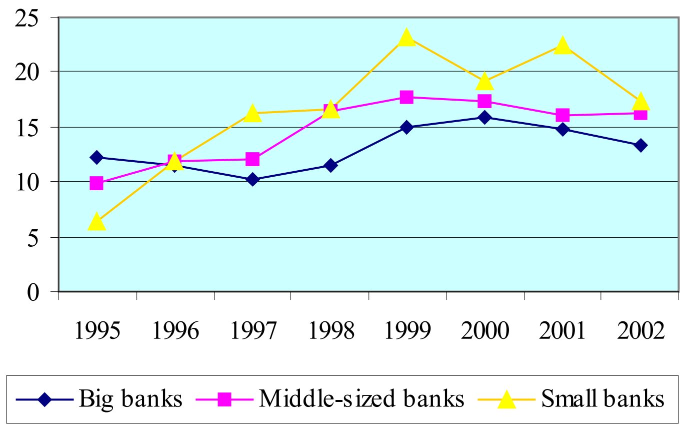
URL: <Http://www.cnb.cz/en/bd_publikace_op.php>.

with foreign shareholders based in their country of origin, the newly-established small and medium-sized enterprises became clients of the small banks.

The risks in the new environment became fully apparent in subsequent years, when the business failure of many small and medium-sized businesses meant they were unable to repay the loans granted to them by small banks, which constituted virtually the only source of finance for the newly-established small and medium-sized enterprises. As a general rule, this failure become apparent in the poor quality loan portfolio of small banks, established with a relatively low registered capital at the very beginning of the transformation of the Czech economy and without experience doing business in the market economy.[24]

Furthermore, the period after 1995 in the banking industry is characterized by high level of classified loans (see Exhibit 23), insufficient capital adequacy (see Exhibit 13), non-transparent ownership structure and asset stripping. Already during a period of optimism and large credit expansion, serious problems started to emerge in the sector of small banks. Especially banks with private Czech capital were lacking experience in banking business and were unable to cope with the risky transition environment.[25]

Exhibit 13 Capital adequacy (in %)



Source: Czech National Bank

[24] For more detailed analysis of banks' critical features see Section 3.2 *Real Causes of the Crisis*.

[25] The impact of of the transition environment specifics is analysed in Exhibit 24 and in Section 3.2 *Real Causes of the Crisis.*

All these factors jeopardized the existence of small banks and therefore, CNB introduced a Consolidation Programme II, the **comprehensive** series of measures intended to consolidate the problematic small bank sector, **with implementation commencing at the beginning of 1996** (for more details on the Consolidation Programme II see Box 2). **The main goal of this programme was to avoid a domino effect in the small banks sector, which could have resulted in a loss of confidence** in the small bank sector. An unmanageable crisis in the small bank sector would damage depositors and would have a negative impact on the development of private enterprise overwhelmingly financed by bank loans. Last but not least, due to eroded confidence of depositors, the crisis of the small banks could easily spread **in the banking system as a whole.** Hence the whole future of the transformation process was at stake.

Box 2 Consolidation Programme II

Under the regime of the Consolidation Programme II, CNB would demand that a bank with a capital adequacy (assessed pursuant to external audits) below 8% filed a consolidation programme, the aim of which was to:

- Increase capital adequacy[26];
- Improve profitability and
- Establish a management system for the bank affected.

The individual bank would be obliged by a CNB regulation or decision to reach the indicators set out in the applicable consolidation programme within a specified time limit. Depending on each particular bank's capacity to comply with the CNB measures, as well as the particular circumstances of each case (especially the extent of its losses, its development options, and the willingness of the bank's shareholders and management to participate in the recovery process), CNB would initiate various steps:

- Reduction in capital and introduction of forced administration[27];
- Termination of the bank's activities[28]**;**

[26] Regulatory minimum of 8% had to be be met by 31 December 1996.

[27] In cases where there was a chance of revitalizing the bank, but where the management and 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).

- Sale of the bank with the expectation of a future merger[29]; and
- Capital increase by existing shareholders or a new investor[30].

Furthermore, „*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.*“[31] [32]

The result of the Consolidation Programme II was following:

- Of the total of 18 small banks, 15 were included in Consolidation Programme II,
- Revocation of licenses was adopted in 2 cases;
- Forced administration was introduced in 5 cases;
- Increase of initial capital in 6 cases;
- Take-over by another bank was realized in 3 cases.[33]

Exhibit 14 shows components of he gross level of funds[34] issued by the CNB under Consolidation Programme II[35], totaling CZK 32.9 billion.[36]

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[28] 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).

[29] 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).

[30] 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).

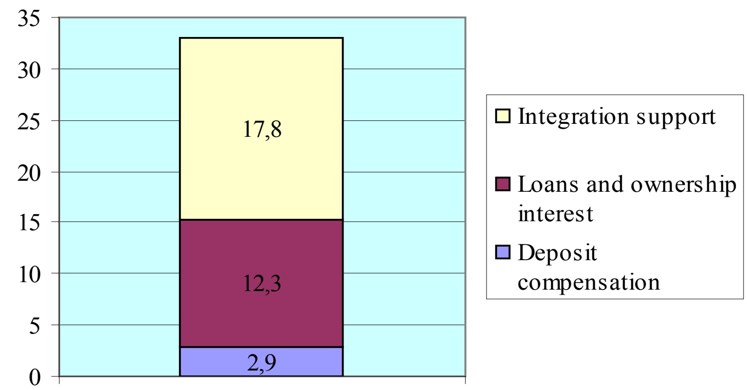
[31] Report *on Banking Supervision in the Czech Republic.* Prague: Czech National Bank, 1999, p. 30. [On-line]. [Cit. 2004-15-01].
URL: <Http://www.cnb.cz/en/bd_publikace_op.php>.

[32] 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 individuals, 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.

[33] The total numer of banks included into the Consolidation Programme II does not equal the total of individual methods because two methods have been combined in one case.

[34] Gross expenditure means:
a) for loans and receivables: the level under bankruptcy or liquidation,
b) for ownership interests: the purchase price,

Exhibit 14 Gross level of fund expended under Consolidation Programme II (CZKbn)



Source: Czech National Bank

However, in the majority of cases it was not possible to stop further deterioration of banks' assets. In some 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.

2.4.2 Stabilization Programme[37]

Given the fact that the consolidation process did not take place without a decline in the public's confidence in the banking sector (due to further deterioration of small banks' assets and elimination of insolvent banks from the banking sector), it was crucial to find a solution to avoid the two threats:

- Destabilization of the entire (not just the small) banking sector; and

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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.

[35] Without taking repayments and other revenues into account.

[36] See *Report on Banking Supervision in the Czech Republic.* Prague: Czech National Bank, 1999, p. 31. [On-line]. [Cit. 2004-15-01].
URL: <Http://www.cnb.cz/en/bd_publikace_op.php>.

[37] Based on *Annual Reports on Banking Supervision 1994-1999.* Prague: Czech National Bank. [On-line]. [Cit. 2004-15-01].
URL: <Http://www.cnb.cz/en/bd_publikace_rz.php> and on *Report on Banking Supervision in the Czech Republic*. Prague: Czech National Bank, 1999. [On-line]. [Cit. 2004-15-01].
URL: <Http://www.cnb.cz/en/bd_publikace_op.php>.

- Destabilization of the small and medium-sized enterprises, which were heavily dependent on small banks as these constituted virtually the only source of their finance.

Therefore, the Czech Government adopted in a decree[38] dated October 16, 1996 the Stabilization Programme to strengthen the stability of the banking sector in the Czech Republic (for more details on the Stabilization Programme see Box 3).

Box 3 Basic principles of the Stabilization Programme

The Stabilization Programme was based on the following principles:

- Voluntary participation of bank;
- 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 CF for the recoverability of the receivables transferred,
- KOB ensured the refinancing of CF with the provison that the NPF would reimburse CF for the refinancing costs and any related losses.
- Aid was provided in one go with subsequent detailed monitoring to ensure compliance with the general prudential limits[39] and specific indicators prescribed under the Stabilization Programme and in the strict individual stabilization plan[40];
- After the end of the seven-year programme they will be obliged to remunerate CF for that part of the receivables which it is not able to realize during the Stabilization Programme.

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[38] *Government Resolution no. 539*, approved on 16 October 1996.

[39] For capital adequacy, credit exposure, open foreign exchange position.

[40] 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 CF 1/7 annually.

It is clear that the Stabilization Programme was designed to allow the small banks to survive a critical stage in their development in terms of liquidity and to restore their financial stability rather than eliminate general problems due to economic stagnation and the existing legislative environment. However, in this regard it should be noted that the Stabilization Programme was set to deal with existing problems by introducing measures aimed at changing a bank's operation, rather than simply to artificially extend a bank's existing critical position. The programme never intended to rescue banks, which had reached the stage where their continued existence could not be justified economically. "*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*."[41]

A public offer of the opportunity to participate in the Stabilization Programme was made to all small banks (at that time 13 banks), 6 banks[42] expressed an interest in joining the Stabilization Programme and subsequently submitted their individual stabilization programmes, gradually joining the Programme in the course of 1997 and commencing the sale of their bad assets to CF.

"*A worsening in the quality of loans in connection with the economic decline in 1998 and 1999*[43] *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*

[41] *Report on Banking Supervision in the Czech Republic*. Prague: Czech National Bank, 1999, p. 33. [On-line]. [Cit. 2004-15-01].
URL: <Http://www.cnb.cz/en/bd_publikace_op.php>.

[42] Banka Haná, Zemská banka (now Expandia banka), Pragobanka, Moravia banka, Universal banka and Foresbank.

[43] For details, please see the next section.

into jeopardy."[44] The overall detailed results of the Stabilization Programme are summarized in Box 4.

Box 4 Results of the Stabilization Programme

- Owing to the unwillingness or inability of banks and their shareholders to eliminate the shortcomings detected, the CNB terminated the stabilization programmes for Pragobanka and Universal banka in 1998 and their licenses were subsequently revoked.
- The stabilization 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 IPB, which also took over the commitment to Česká finanční under the stabilization 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 stabilization 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.
- On 31 July 1997 Expandia a.s. acquired in Zemská banka, a.s. However, Expandia failed to comply with the binding indicators. This led to negotiations with potential strategic investors, which eventually resulted in a take-over of Expandia by Česká pojišťovna, a.s. Since May 2001 the bank has operated under name eBanka, a.s. In December 2001, the bank and the CNB executed settlement of their mutual obligations and thus, ceased to participate in the Stabilization Programme.
- In September 1999, the CNB decided to take Moravia banka out of the Stabilization 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 license, which came into force in November.

Under the provisions of the Government Resolution no. 539, a total of CZK 13.7 billion[45] was dedicated for the above purpose. "*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*

[44] *Report on Banking Supervision in the Czech Republic*. Prague: Czech National Bank, 1999, p. 33. [On-line]. [Cit. 2004-15-01].
URL: <Http://www.cnb.cz/en/bd_publikace_op.php>.

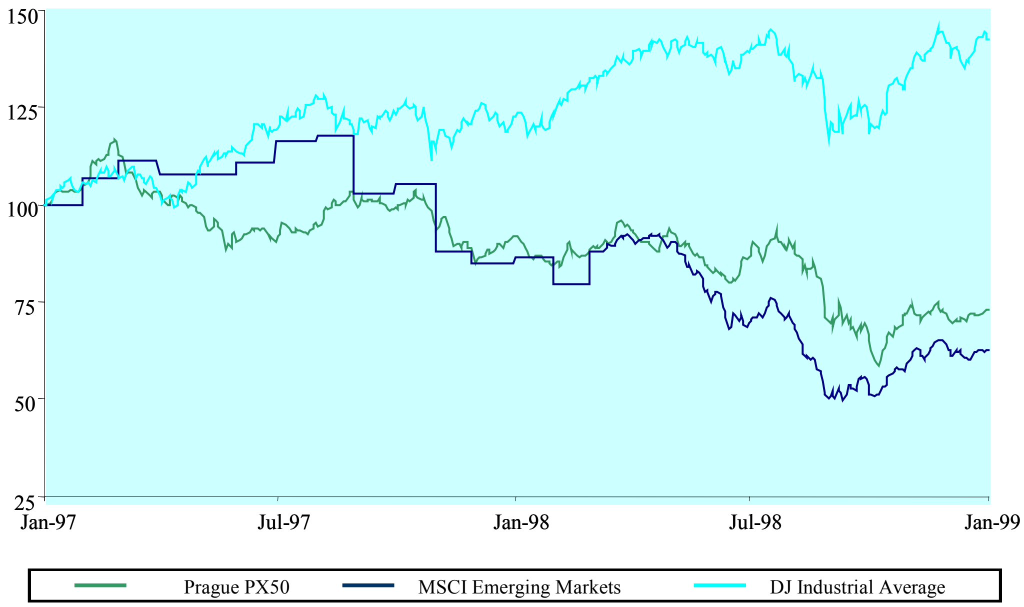
[45] Based on the value of 110% of the capital of 13 small banks as of 31 August 1996.

the Stabilisation Programme by CZK 5 billion."[46] However, after assessing the first stage of the programme, the Czech Government decided[47] on June 24, 1998 to terminate further drawing of funds, with the exception of purchases of bank receivables by CF that had already been approved. As a result, the drawing of a total of CZK 14.9 billion was approved under the Stabilization Programme.

2.5 The Emerging Market Crisis

In 1997, the Czech economy suffered from both negative external and internal factors. After the currency crisis in South-East Asia, investors' confidence was undermined (see Exhibit 15) and thus, the crisis spread to Central and Eastern Europe.

Exhibit 15 Stock Market Indices



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[46] *Report on Banking Supervision in the Czech Republic*. Prague: Czech National Bank, 1999, p. 32. [On-line]. [Cit. 2004-15-01].

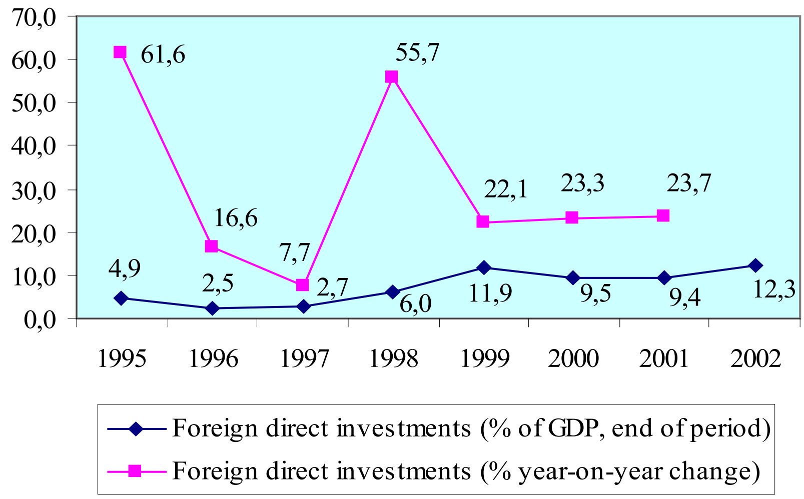
URL: <Http://www.cnb.cz/en/bd_publikace_op.php>.

[47] *Government Resolution no. 449* of 24 June 1998.

Source: DataStream

As a result, we observed a significant decrease in FDI inflow (see Exhibit 16) and a liquidity crisis ensued. The situation was further exacerbated by the Russian crisis, which contributed to even higher uncertainty of the Czech economy and its banking sector.

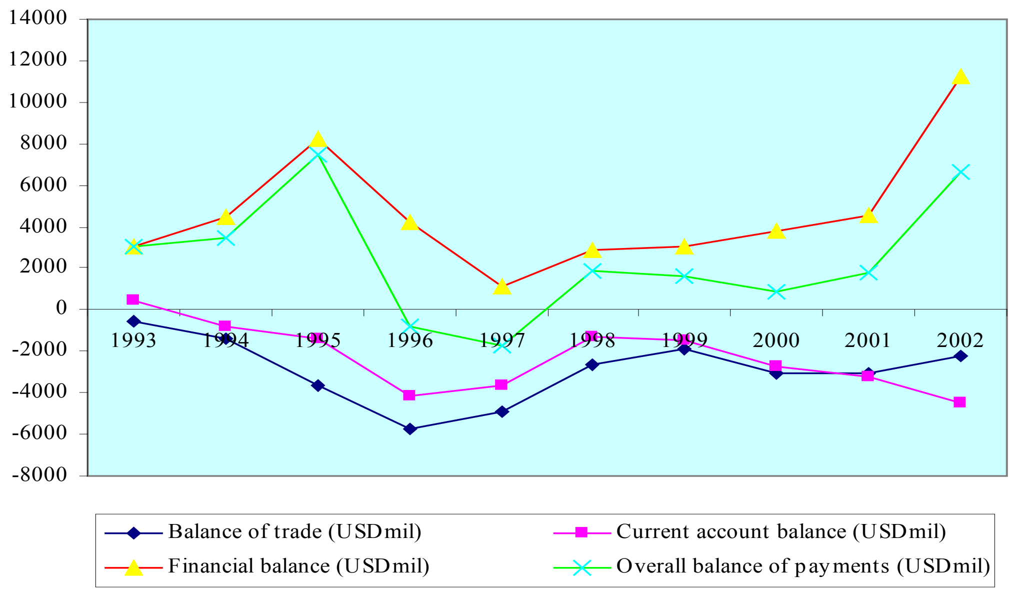
Exhibit 16 Foreign direct investments



Source: International Financial Statistics (IMF), International Monetary Fund

Moreover, the Czech Republic experienced a balance of payment crisis in 1997 (see Exhibit 17).

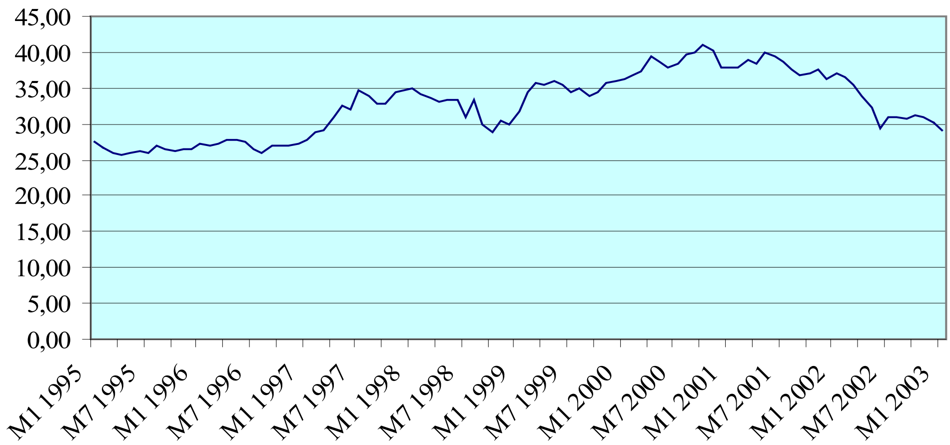
Exhibit 17 Balance of payment accounts (USDmil)



Source: International Financial Statistics (IMF), International Monetary Fund

All these factors resulted in speculation against the Czech Crown. CNB responded by huge intervention to defend the currency. Afterwards, two policy packages were introduced to stabilize the currency and increase market confidence. Fixed exchange rate regime was abandoned in May 1997, resulting in a devaluation of the currency of approximately 10% (see Exhibit 18).

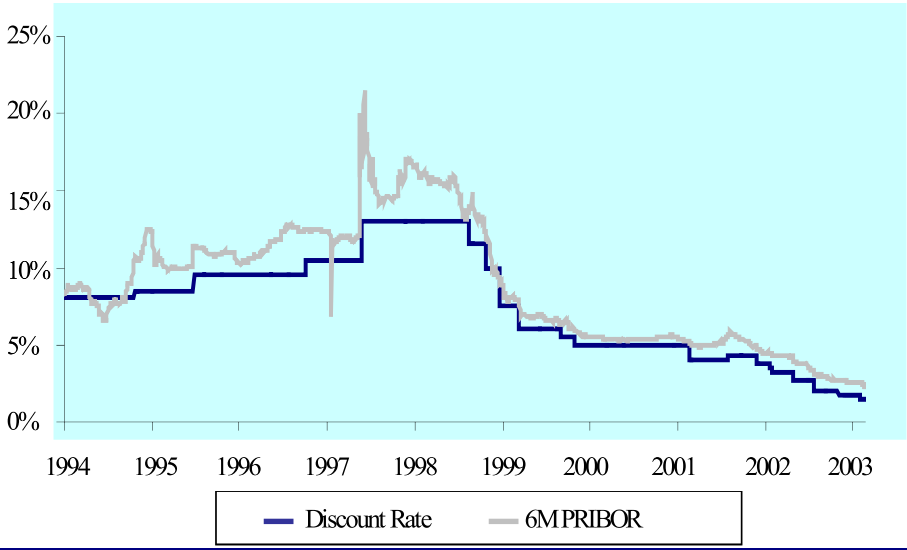
Exhibit 18 Exchange rate - CZK/USD



Source: International Financial Statistics (IMF)

Consequently, interest rates rose considerably (see Exhibit 19), and thus further increased the burden of past debts on the corporate sector as there was no market instrument available to hedge the interest rate risk. As a result, Czech economy entered into a period of stagnation and recession (see Exhibit 3).

Exhibit 19 Interest Rates

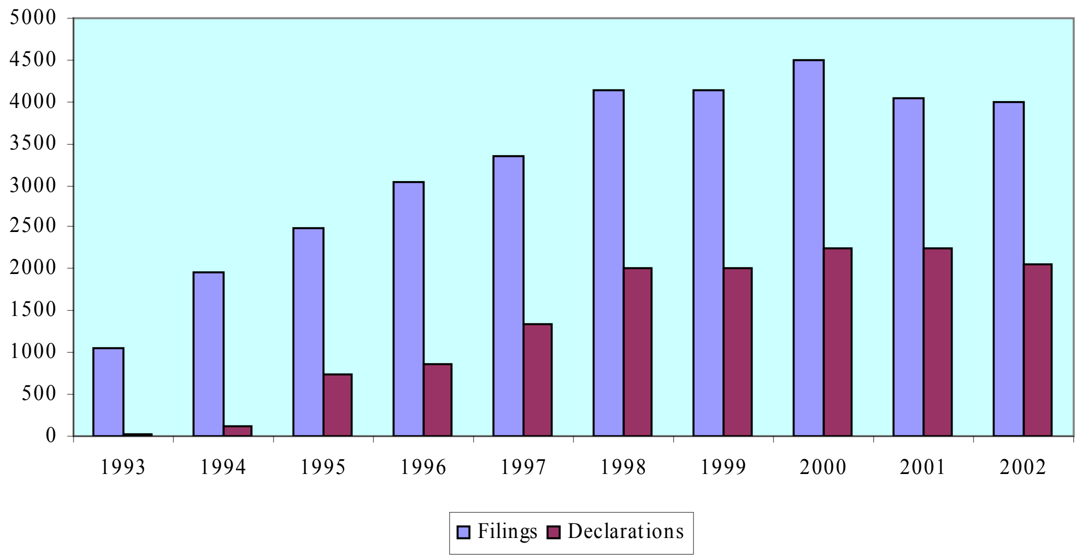


Source: DataStream

2.6 The Crisis of Big Banks

Naturally, the above-mentioned problems reached also the biggest banks. After the economic boom, **economic recession between 1997 and 1999 deteriorated financial conditions of Czech companies and accelerated the number of bankruptcy proceedings** (see Exhibit 20).

Exhibit 20 Bankruptcy Statistics

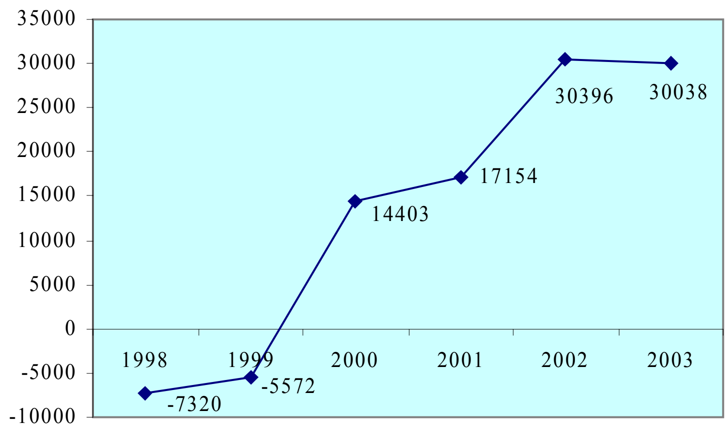


Source: Ministry of Justice of the Czech Republic

This was reflected in the development of loan portfolios of major Czech banks (see Exhibit 23). In addition, **owing to the problems with enforcing collateral, the CNB tightened regulations on the classification and provisioning of loans in 1998.**[48] The main reasons for the stricter rules were problems associated with exercising liens on real estate because of imperfect general legislation in this area.[49] The present provision stipulates mandatory additional provisioning for loss loans secured by real estate which are more than one year past due. In effect, according to CNB, in 1998 alone the total extra provisions of the entire banking sector amounted to approximately CZK 25 billion. Over the following three years this increased to approximately CZK 46 billion.

These two factors caused the significant part of operating profits to be allocated to additional reserves, which made two major banks – CS and KB - to record accounting loss (CZKbn 6.9 and CZKbn 9.6 respectively). The banking sector in general generated losses of CZKbn 12.9 in 1998 and 1999 (see Exhibit 21).

Exhibit 21 Net profit of the banking sector (CZKmil)



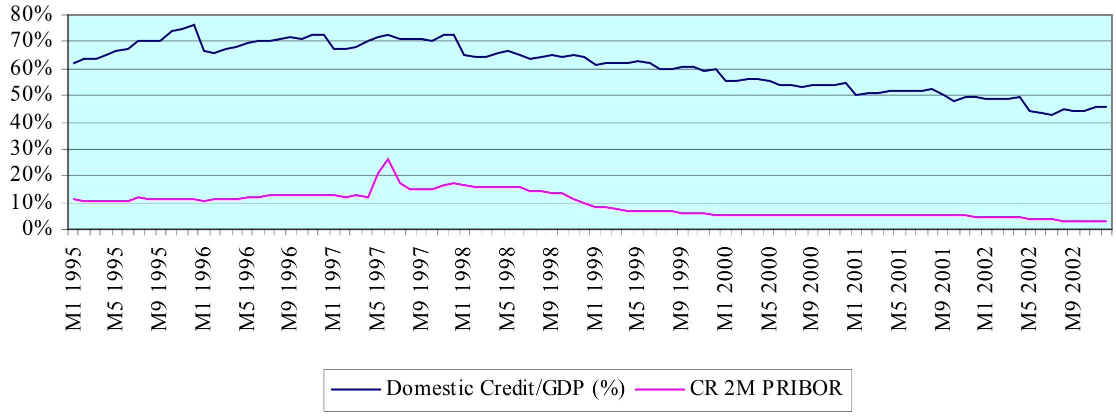
Source: Czech National Bank

[48] CNB Provision No.193/1998 Coll.

[49] *Annual Report 1998*, Prague: Czech National Bank, 1999, p. 72. [On-line]. [Cit. 2004-15-01]. URL: <Http://www.cnb.cz/en/ocnb_vyrocnizpravy.php>.

In the same time, banks stopped more risky operations, which resulted in credit crunch despite a significant fall in interest rates (as demonstrated in Exhibit 22).[50]

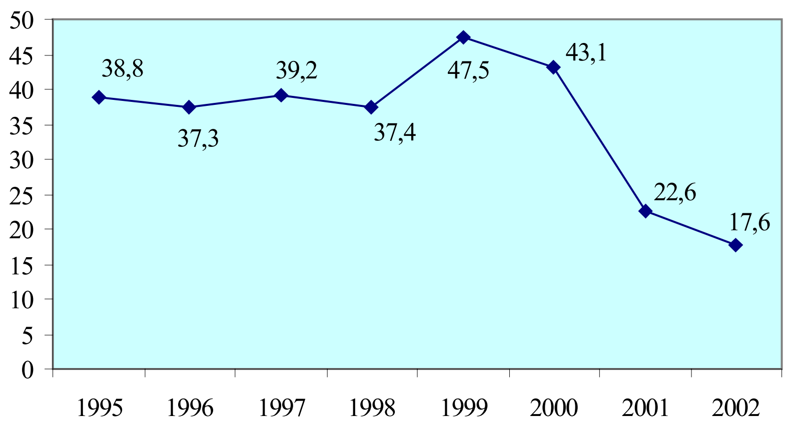
Exhibit 22 Domestic Credit/GDP (%), CR 2M PRIBOR



Source: International Financial Statistics (IMF), own calculations

As a result, the stock of classified loans in the balance sheets of commercial banks and special transformation institutions (see Exhibit 23) amounted to almost one half of total loans, one of the highest ratios in the region.

Exhibit 23 Classified loans as % of total loans



Source: Czech National Bank

[50] In a standard economy, the problem would have been overcome through a greater reliance on the securities market. However, in the Czech Republic, the financial markets were not fully developed (see Exhibit 2) due to constraints in effective corporate governance and due to the historical role of the banking sector.

It is clear that the above-mentioned situation could cause contagion, destroy credibility of all banks and lead to runs on the banking sector, regardless of the soundness of individual banks.[51]

[51] See e.g. Mishkin, F: *The Causes and Propagation of Financial Instability: Lessons for Policymakers*. NBER Working Paper No. 7364, New York: National Bureau of Economic Research, 1999, p. 61. [On-line]. [Cit. 2004-15-01].

URL: <Http://www.worldbank.org/wbi/banking/finsecpolicy/finsecissues/pdf/mishkin_lessons.pdf>.

3. Triggers and Causes of the Crisis

3.1 Triggers of the Crisis

As in many other countries, the main triggers of the Czech banking crisis were mainly macroeconomic in origin:

- **Economic recession between 1997-1999** deteriorated financial conditions of Czech companies and accelerated the number of bankruptcy proceedings;
- **Currency crises** in South-Asia and Russia undermined investors' confidence;
- **Speculation against Czech Crown resulted** in a devaluation of the currency of approximately 10% and substantial increase in interest rates;
- **Eroded confidence of retail depositors** in the banking system after the crisis of small banks;
- **CNB tightened regulations** on the classification and provisioning of loans.

The effect of these triggers has been further amplified by the relatively high level of sensitivity of transition economies to macroeconomic shocks. "***Emerging market economies*** *[…] have tended to be less diversified and* ***less able to absorb shocks than more mature industrial economies***." [52] However, **weak performance of the Czech economy after 1997 alone and adverse macroeconomic shocks were not sufficient condition for banking crisis to emerge. The failure lies internally and inevitably within the process of transition.**

3.2 Real Causes of the Crisis

Inconsistency between a macroeconomic stabilization and a sound microeconomic policy appears as a driving force of the crisis. Country's apparent success at output and macroeconomic stabilization in the early phase of transition distracted from addressing fundamental problems of the banking sector and corporate governance issue on the

[52] *Financial Stability in Emerging Market Economies: A strategy for the formulation, adoption and implementation of sound principles and practices to strengthen financial systems*. Report of the Working Party on Financial Stability in Emerging Market Economies, Basel: Bank for International Settlements, 1997, p. 3. [On-line]. [Cit. 2004-15-01].
Http://www.bis.org/publ/gten02.pdf>.

microeconomic level. To be more specific, the main constraints that made the process of transition difficult were the following:

- A large number of commercial banks in the transition economies were carved out from former state banks. As a result, they **inherited nonperforming loans extended under the central planning system to state-owned enterprises**;
- The country avoided a high rate of inflation during the early stage of transition. Therefore, **the real value of banks' inherited bad debts was not significantly reduced and the pre-transition bad loans remained a burden on the banking system**;
- The state-owned enterprises had not been subject to hard budget constraints under the previous regime and did not have the habit of repaying debts. Moreover, **enterprises lacked experience doing business in the market economy**, with a profit-oriented approach;
- **Removal of enterprise subsidies, internal and external liberalization and collapse of exports to the former Soviet Union** cut enterprises profitability in many sectors of the economy and **reduced their ability to repay loans**;
- Banks lacked managerial and supervisory know-how and thus, they were not able to assess credit risk properly. The problem of **poor risk assessment** concerned both large and small domestic banks, while foreign banks by possessing the know-how attracted the top-tier clientele. **No market history of potential borrowers caused even greater uncertainty regarding the outcome of entrepreneurial projects**. The ranking of bank groups obviously reflected an **adverse selection problem**. Foreign banks served the best customers because they were able to supply the demanded product. On the other hand, large state banks financed projects with poorer, but still of a more-or-less standard quality while small banks often captured very doubtful projects;
- **Bank restructuring was not coupled with enterprise restructuring**. "*Incumbent banks were thus often left financing companies with no prospects*"[53];
- Unwillingness to signal their own poor financial condition and a desire to gamble for resurrection[54], amplified by **weak *ex ante* monitoring capability**, **led banks to**

[53] Hanousek, J., Němeček, L., Hájková, D.: *The Czech Republic's Banking Sector: Emerging From Turbulent Times.* CERGE Discussion Paper No. 2002-83, Prague: CERGE, 2002.

[54] Such behavior was possible due to significant undercapitalization of Czech banks.

passively roll over loans in default. In addition, "*because of the immense size of such loans on banks' balance sheets, these banks were locked-in and maintained credit links to these companies despite their obvious inefficiency.*"[55] As a consequence, banks continued to lend to bankrupt enterprises, which further worsened their financial positions;

- The recapitalizations in the early 1990s often did not significantly change the behavior of the banks. In contrast, "… ***repeated government interventions created a perception of soft budget constraints and led to moral hazard behavior.***"[56] Thus, a feedback effect led to further deterioration of bank balance sheets;
- **Gradual establishment of an effective banking supervision**.[57] This was not put in place until 1991. It had not been possible to base the new system on any earlier experience of banking supervision in a market economy. The gradual nature of the development of this supervision caused the establishment of **regulatory and inspection-related activities to lag behind actual developments in the banking sector**;
- **No adequate institutional framework in the financial sector.** Countries with less developed institutions (property rights, rule of law, political openness, high corruption, etc.) are more likely to suffer from systemic crises in banking sector.[58] For example, poor bankruptcy laws and enforceability of collateral resulted in weak creditors' rights. **These problems intensified the information asymmetries that are**

[55] Hanousek, J., Němeček, L., Hájková, D.: *The Czech Republic's Banking Sector: Emerging From Turbulent Times.* CERGE Discussion Paper No. 2002-83, Prague: CERGE, 2002.

[56] Wagner, N., Iakova, D.: *Financial Sector Evolution in the Central European Economies: Challenges in Supporting Macroeconomic Stability and Sustainable Growth*. IMF Working Paper No. 01/141, Washington D.C.: International Monetary Fund, 2001, p. 22. [On-line]. [Cit. 2004-15-01]. [Emphasis added].
URL: <Http://www.imf.org/external/pubs/ft/wp/2001/wp01141.pdf>.

[57] "*Informational asymmetries [...] are* ***more likely to be relevant in the context of transition economies*** *where the institutions for evaluating and disclosing the credit-worthiness of both firms and banks are inherently weak*." (Aghion, P., Bolton, P., Fries, S.: Optimal Design of Bank Bailouts: The Case of Transition Economies. *Journal of Institutional and Theoretical Economics*, Vol. 155, 1999, p. 54. [On-line]. [Cit. 2004-15-01]. [Emphasis added].
URL: <Http://www.princeton.edu/~pbolton/optdesi.pdf>).

[58] See Beck, T., Demirguc-Kunt, A., Levine, R.: *Bank Concentration and Crises*. Washington D.C.: World Bank, 2003, p. 21. [On-line]. [Cit. 2004-15-01].
URL: <Http://www.worldbank.org/research/interest/confs/042003/banking_crisis_beck.pdf>.

inherently present in the financial sector. Moreover, "*heightened uncertainty during the transition made the information asymmetries greater, while the lack of know-how, problems with the use of collateral and insufficient public regulation reduced the effectiveness of their standard solutions*"[59];

- The government failed to cultivate **underdeveloped institutional and legal frameworks**, which are necessary conditions for effective corporate governance. Namely, **the failure to protect minority shareholder ownership rights led to the distrust of foreign portfolio investors**[60];
- **Both banks and enterprises also lacked strategic owners who would have higher incentives to exercise control over their management and promote sound corporate governance**. The state as an owner lacked both incentives and capacity to meet this task;
- In addition, **widespread ownership structures** of privatized companies **did not allow effective control of companies** in the hands of the existing managements, which had no motivation or ability to formulate promising business strategies. As a result, the financial situation of enterprises and banks further worsened;
- **Biased corporate governance structure of banks**, as the state appointed bank management was indirectly liable to politicians and, therefore, state vested interests were often in conflict with principles of prudential banking.[61] As a result, **banks were viewed as an automatic source of financing for the take-off of the domestic economy**;[62]
- **Banks managed the largest investment funds and therefore became indirect holders of their own shares and partial owners of many of their loss-making enterprise clients**. "*As a result, **soft lending continued** and future rounds of*

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[59] Tůma, Z.: *Banking Sector Development in the Czech Republic.* Prague: Czech National Bank, 2002, p. 5. [On-line]. [Cit. 2004-15-01].
URL: <Http://www.cnb.cz/en/pdf/tuma_vien_nov_2002.pdf>.

[60] See e.g. Mejstrik, M. et al.: *The cultivation of the Czech financial market*. Prague: Karolinum Press, forthcoming 2004, chapter 2.

[61] *Ibid*.

[62] See for example *Transition Report 1998: Financial Sector in Transition*. London: European Bank for Reconstruction and Development, 1998, p. 93: "*Governments have been able to use financial institutions as their quasi-fiscal agents…*" or Ibid, p. 132: "*[t]here have been strong political pressures placed on banks to sustain large state-owned enterprises…*"

recapitalization followed, as both banks and enterprises had little incentive to restructure and improve their operations"[63]*;*

- Unlike in other countries in transition (e.g. Poland and Hungary), **the state was a majority owner of the incumbent banks for too long**. This was mainly due to the fact that a comfortable fiscal position at the beginning of the 1990s did not necessitate bank privatization.

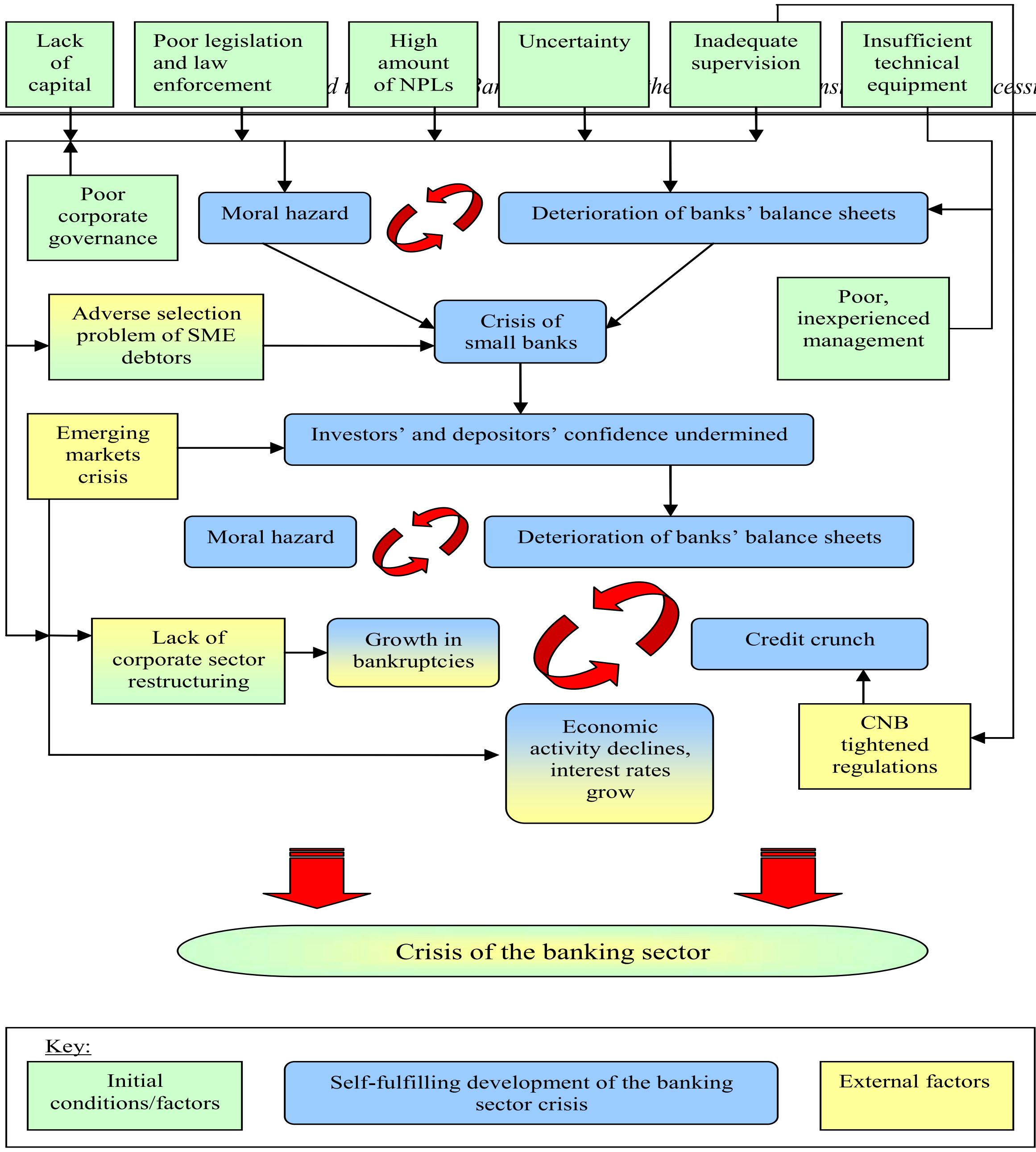
From this perspective, it is evident that **on the contrary to crises of banks in well-functioning market economies, where the reasons for the bank's losses are generally specific to each particular bank**[64] and related to a large extent to its aggressive commercial and credit policy, **the crisis in the Czech banking sector** was caused mainly by factors not just specific to each bank, but **also specific to the economy in transition.**[65] **Exhibit 24 shows the impact of these factors on the development of the crisis.**

Exhibit 24 Triggers, causes and development of the banking sector crisis

[63] Wagner, N., Iakova, D.: *Financial Sector Evolution in the Central European Economies: Challenges in Supporting Macroeconomic Stability and Sustainable Growth*. IMF Working Paper No. 01/141, Washington D.C.: International Monetary Fund, 2001, p. 56. [On-line]. [Cit. 2004-15-01]. [Emphasis added]. URL: <Http://www.imf.org/external/pubs/ft/wp/2001/wp01141.pdf>.

[64] For more details on reasons of banks's losses in well-established market economies see *Annex III* or e.g. *Commission Decision of 29 July 1998 giving conditional approval to the aid granted by Italy to Banco di Napoli*, C(1998) 2495, p. 48.

[65] See for example *Transition Report 1998: Financial Sector in Transition*. London: European Bank for Reconstruction and Development, 1998, p. 105. [Emphasis added]: "*In transition economies, the challenge has been to build the principles and practices of sound finance in step with the expansion of financial activity.* ***Such synchronisation is undoubtedly difficult to achieve; and not surprisingly there have been banking crises in transition economies***."


Lack of capital
Poor legislation and law enforcement
High amount of NPLs
Uncertainty
Inadequate supervision
Insufficient technical equipment
Poor corporate governance
Moral hazard
Deterioration of banks' balance sheets
Adverse selection problem of SME debtors
Crisis of small banks
Poor, inexperienced management
Emerging markets crisis
Investors' and depositors' confidence undermined
Moral hazard
Deterioration of banks' balance sheets
Lack of corporate sector restructuring
Growth in bankruptcies
Credit crunch
Economic activity declines, interest rates grow
CNB tightened regulations
Crisis of the banking sector
Key:
Initial conditions/factors
Self-fulfilling development of the banking sector crisis
External factors

4. Crisis Resolution

We will now turn to the issue of handling the crisis, once it has erupted. We will start with a short theoretical overview of possible actions, and then, we will focus on the international comparison of adopted strategies. Then, we will turn to the European Commission, International Monetary Fund, European Bank for Reconstruction and Development and World Bank recommendations of resolving the crisis and finally, we will describe the adopted solution.

4.1 Policy Responses to Banking Distress

There are many possible policy responses to banking distress, and the right decisions depend on factors such as the causes of the crisis, institutional factors and political constraints. Regarding political constraints, it should be mentioned that "*[t]he government itself may face credibility problem because it may have been partly to blame for the crisis, and in general faces many time-consistency problems-such as how to avoid large bailouts while also restarting the economy.*"[66]

We should also note that managing a banking sector crisis is much different in developed countries than in transition economies due to weaker institutions[67], and different initial circumstances. Therefore, the best practices cannot be easily transferred from developed countries to transition economies. In addition, even in developed countries, opinions on what constitutes the best practice differ widely.

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[66] Claessens, S., Klingebiel, D., Laeven, L.: Financial Restructuring in Banking and Corporate Sector Crises: Which Policies to Pursue? In: Claessens, S., Klingebiel, D.: Laeven, L., Honohan, P., Caprio, G.: *Managing the Real and Fiscal Effects of Banking Crises*. WB Discussion Paper No. 428, Washington D.C.: World Bank, 2002, p. 2. [On-line]. [Cit. 2004-15-01].
URL: <Http://wbln0018.worldbank.org/html/FinancialSectorWeb.nsf/(attachmentweb)/Fsdp8rv5/$FILE/Fsdp8rv5.pdf>.

[67] Such as weak disclosure and accounting rules, poor equity and creditor rights, inefficient judiciary, as well as no history of corporate and banking sector restructuring.

However, we can identify three schools of thoughts[68] on whether to use liquidity support and guarantees to resolve the crisis:

- The first one argues that "*crisis conditions make it almost impossible to distinguish between solvent and insolvent institutions, leaving the authorities with little choice but to extend liquidity support.*"[69]
- The second one emphasizes the moral hazard dilemma by claiming that liquidity support provides more time for insolvent institutions to gamble on resurrection, facilitates continued financing of loss-making borrowers, and allows owners and managers to engage in looting. Furthermore, a government guarantee on banking institutions' liabilities reduces large creditors' incentive to monitor banking institutions. Therefore, the managers of the bank may continue gambling on the insolvent bank and increasing the fiscal costs of the crisis. Moreover, such guarantees limit government maneuverability in allocating losses. This leads to a situation where the government incurs most of the costs of the crisis.[70]
- The third one stresses the role of political economy. Supporters of this view argue that granting of government guarantees is the outcome of political economy circumstances, and so is often a foregone conclusion.[71]

Therefore, the issue of selecting the best strategy for handling the crisis once it has erupted is extremely difficult and complex.

[68] Based on Claessens, S., Klingebiel, D., Laeven, L.: *Financial* Restructuring in Banking and Corporate Sector Crises: Which Policies to Pursue? In: Claessens, S., Klingebiel, D.: Laeven, L., Honohan, P., Caprio, G.: *Managing the Real and Fiscal Effects of Banking Crises*. WB Discussion Paper No. 428, Washington D.C.: World Bank, 2002. [On-line]. [Cit. 2004-15-01].
URL: <Http://wbln0018.worldbank.org/html/FinancialSectorWeb.nsf/(attachmentweb)/Fsdp8rv5/$FILE/Fsdp8rv5.pdf>.

[69] Ibid, p. 4.

[70] See e.g. Sheng, A., ed.: *Bank Restructuring: Lessons from the 1980s*. Washington, D.C.: World Bank, 1996.

[71] See e.g. Dooley, M., Sujata, V.: *Rescue Packages and Output Losses Following Crises*. NBER Working Paper No. 8315, Cambridge: National Bureau for Economic Research, 2001. [On-line]. [Cit. 2004-15-01].
URL: <Http://papers.nber.org/papers/w8315.pdf>.

4.2 International Comparison

In this section, we will briefly describe strategies adopted by other countries in a similar position.[72] Firstly, we will focus on the countries in transition, namely other Central and Eastern European countries (CEEs), the three Baltic countries and selected countries from the Commonwealth of Independent States (CIS). Secondly, we will concentrate on strategies pursued by the Nordic countries.

4.2.1 CEEs, CIS and Baltic States

In principle, countries of each region adopted a different set of the crisis resolution strategies:

- CEEs countries have generally undergone extensive recapitalization and restructuring of banks[73];
- most CIS countries pursued large-scale liquidation of banks[74]; and
- Baltic countries generally adopted a combination of bank liquidation and restructuring.[75]

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[72] Detailed analysis goes beyond the scope of this paper.

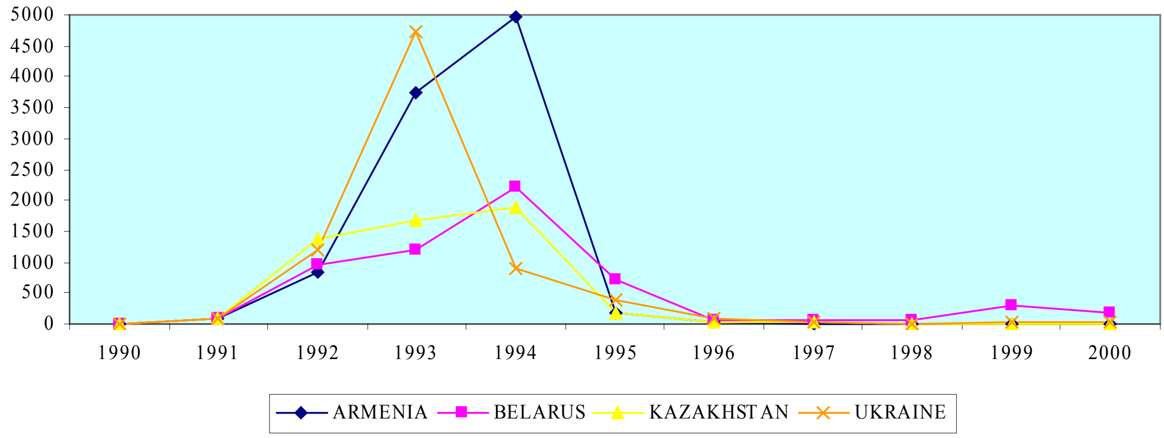
[73] For more details on strategies adopted in **Hungary**, see e.g. Szapary, G.: *Banking Sector Reform in Hungary: Lessons Learned, Current Trends and Prospects*. NBH Working Paper, Budapest: National Bank of Hungary, 2001, p. 11. [On-line]. [Cit. 2004-15-01].
URL: <Http://english.mnb.hu/dokumentumok/fuz2001_05_hu.pdf> or Gaspar, P.: *Restructuring and Development of the Hungarian Banking Sector: The Experiences and the Lessons for Bulgaria*. Budapest: Budapest University of Economics, 2001. [On-line]. [Cit. 2004-15-01].
URL: <Http://www.epi-bg.org/_en_/projects_link_28_2.html>. For more details on strategies adopted in **Poland**, see e.g. Balcerowicz, E., Bratkowski, A.: *Restructuring and Development of the Banking Sector in Advanced Transition Countries: Lessons for Bulgaria: The Case of Poland*. Conference on Restructuring and Development of the Banking Sector in Central and South-Eastern European Countries: Mutual Lessons from Practical Experience in Transition, Sofia, June 22, 2001. [On-line]. [Cit. 2004-15-01].
URL: <Http://www.epi-bg.org/_en_/projects_link_28_3.html>.

[74] For more details on strategies adopted in **Baltic countries**, see e.g. Zoli, E., Tang, H, Klytchnikova, I.: *Causes of Banking Crises: Banking crises in transition economies, fiscal costs and related issues*. WB Policy Research Working Paper 2484, Washington D.C.: World Bank, 2000. [On-line]. [Cit. 2004-15-01].
URL: <Http://econ.worldbank.org/files/1294_wps2484.pdf>.

[75] For more details on strategies adopted in **CIS region**, see e.g. Castello-Branco, M., Kammer, A., Psalida, E.: *Financial Sector Reform and Banking Crises in the Baltic Countries*. IMF Working Paper No. 96/134, Washington D.C.: International Monetary Fund, 1996.

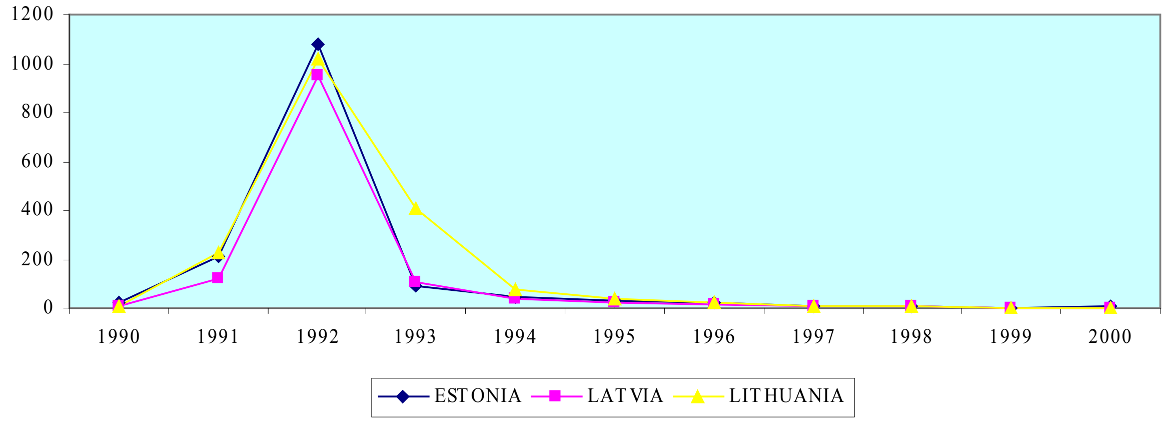
There appear to be two key factors, determining the choice of particular strategy pursued by the relevant authorities: **macroeconomic conditions at the beginning of transition and banking system development.** Regarding macroeconomic conditions, the crucial factor was the development of **inflation**. "*Hyperinflation in the countries of the former Soviet Union (FSU) - the CIS and the Baltics - at the beginning of transition drastically reduced the real value of their inherited bad debts.*"[76] This is demonstrated in Exhibit 25 and Exhibit 26.

Exhibit 25 Consumer prices – CIS countries (% change year-on-year, average)



Source: International Financial Statistics (IMF), EBRD

Exhibit 26 Consumer prices – Baltic countries (% change year-on-year, average)

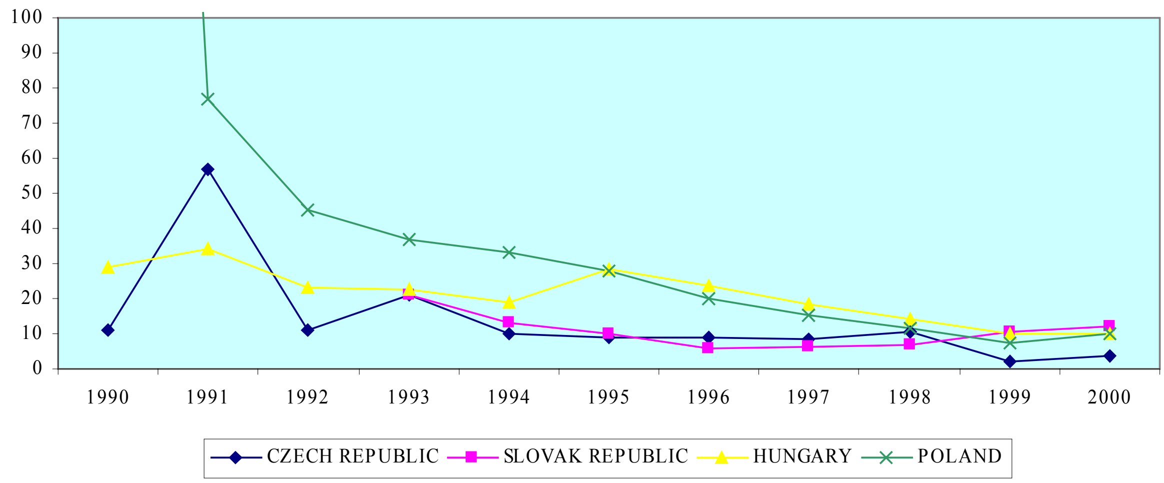


Source: International Financial Statistics (IMF), EBRD

[76] Zoli, E., Tang, H, Klytchnikova, I.: *Causes of Banking Crises: Banking crises in transition economies, fiscal costs and related issues*. World Bank Policy Research Working Paper 2484, Washington D.C.: World Bank, 2000, p. i. [On-line]. [Cit. 2004-15-01].
URL: <Http://econ.worldbank.org/files/1294_wps2484.pdf>.

"By contrast, inflation never reached the same hyper levels in the CEEs, and the pre-transition bad loans remained a burden on the banking system"[77] (see Exhibit 27).

Exhibit 27 Consumer prices – CEE region (% change year-on-year, average)



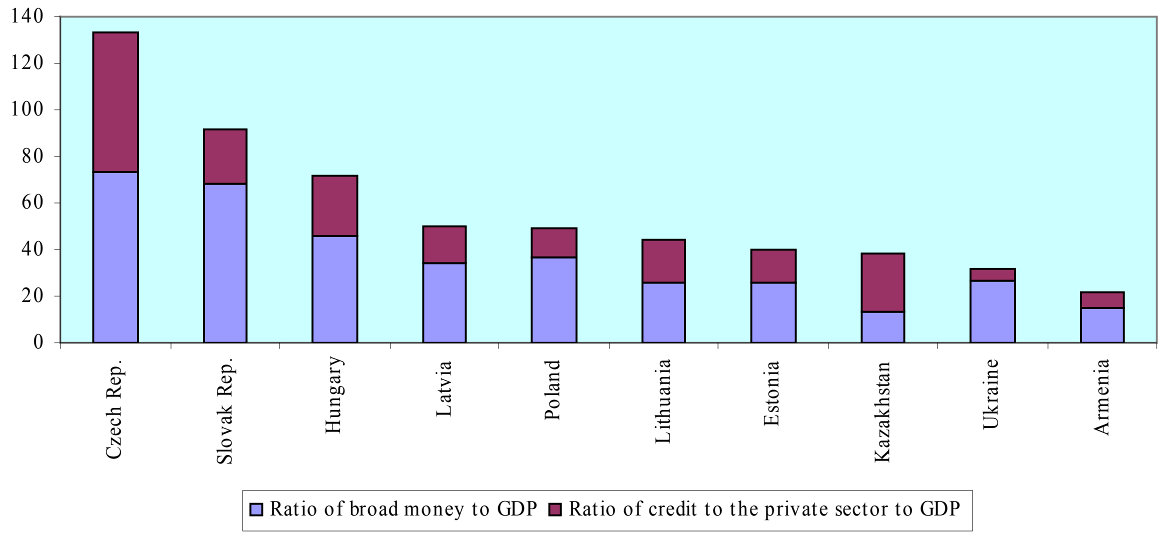
Source: International Financial Statistics (IMF), EBRD

As far as the banking system development is concerned, we may observe different paths of development of the banking systems in each region. There was much larger increase in the number of banks in the Baltic countries and CIS countries than in the CEEs in the early transition years. "*The new banks in the countries of FSU were generally of poorer quality, being small, undercapitalised and not engaged in much financial intermediation. As a result, banks could be closed in the FSU countries with limited economic and social impact.*"[78] **On the contrary, due to relatively deep financial intermediation in CEEs** (see Exhibit 28), **the liquidation of low quality banks was not feasible without huge economic, political and social costs.** For these reasons, the Baltics and CIS countries pursued bank liquidation on a much larger scale than the CEE countries, while the latter generally followed restructuring and recapitalization of the banking sector.

[77] Zoli, E., Tang, H, Klytchnikova, I.: *Causes of Banking Crises: Banking crises in transition economies, fiscal costs and related issues.* World Bank Policy Research Working Paper 2484, Washington D.C.: World Bank, 2000, p. i. [On-line]. [Cit. 2004-15-01].
URL: <Http://econ.worldbank.org/files/1294_wps2484.pdf>.

[78] Zoli, E., Tang, H, Klytchnikova, I.: *Causes of Banking Crises: Banking crises in transition economies, fiscal costs and related issues.* World Bank Policy Research Working Paper 2484, Washington D.C.: World Bank, 2000, p. i. [On-line]. [Cit. 2004-15-01].
URL: <Http://econ.worldbank.org/files/1294_wps2484.pdf>.

Exhibit 28 Scale of deposit taking and lending in selected transition economies as of 1994 (in %, end of year)



Source: International Financial Statistics (IMF), EBRD

4.2.2 Nordic Countries

In many aspects, both triggers and causes of the Nordic banking crisis are similar to the triggers and causes of the Czech crisis. The negative factors, which led to the crisis in the Nordic countries, were the following[79]:

- Bad banking (including excessive risk taking, poor governance, poor risk management, lack of internal controls and distorted incentives for bank owners who may not have enough capital at stake, and for bank managers, who carry little personal responsibility for the excessive risks they are taking);
- Inadequate market discipline (result of poor transparency and disclosure, poor accounting and auditing practices and weak legal, judicial and institutional frameworks for dealing with failing banks and companies);
- Weak banking regulation and supervision (including inadequate loan valuation that overstate bank profits and capital, incompetent management, etc.); and
- Adverse macroeconomic development (to certain degree caused by inadequate macro policies). Such a negative macroeconomic environment may be characterized by

[79] Based on: *The Nordic Banking Crisis from an International Perspective*. Oslo: Banking, Insurance and Securities Commission of Norway, 2002. [On-line]. [Cit. 2004-15-02]. URL: <Http://www.imf.org/external/np/speeches/2002/091102.htm>.

lending booms, slowdown in GDP growth and/or exports, or the loss of export markets, growing excess capacity, falling profitability in the real sector, lower overall investment, rising fiscal and/or current account deficits, weakened public debt sustainability, sharp changes in exchange rates and real interest rates, etc.;

- Premature financial liberalization due to inadequate preparation among bankers and supervisors, possibly resulting in pure ignorance about the risks involved among relevant parties.

To solve the crisis, Finland chose a model of mixed actions, which consisted of:

- Central bank takeover of the main institution of the savings banks (Skopbank Ltd). This also included the transfer of bad assets (equity and property investments, major industrial loan stock) to asset management companies owned by the central bank;
- General capital injection to the whole banking sector by the government (to avoid a potential credit crunch or reduction in the supply of loans[80]);
- Special Crisis Support in the form of share capital, capital notes and guarantees to the savings bank sector by the government;
- Actions of the banking sector itself to strengthen the capital basis.

In Sweden, the following steps were taken to resolve the crisis:

- The Government issued an **unlimited guarantee**[81], ensuring that all banks would meet all their commitments on a timely basis.
- The mandate to implement the support policies was given to a new agency, the Bank Support Authority accountable to the Government.
- Nordbanken, a very large bank whose asset base equalled 23% of GDP, was nationalized and recapitalized.[82]
- The extensive use of Asset Management Corporations (AMCs), splitting an ailing bank into a good bank and a "bad part" and transferring the bad assets to the AMC at strictly assessed market values. The assets transferred to AMCs were regrouped and improved in order to become attractive to potential buyers.
- Finally, the state sold its stakes in the intervened institutions.

[80] One of the conditions for this support was a zero interest rate for the first three years.

[81] Shareholders were not covered by the government guarantee.

[82] The initial cost of recapitalizing Nordbanken equaled to 3 percent of GDP.

As we demonstrated, both triggers and causes of Nordic Banking Crisis were very similar to triggers and causes of the Czech crisis. However, in the Czech case, these problems were even magnified by the economic transition. We will describe the steps taken to resolve the Czech crisis in the following chapters. However, we will firstly turn to recommendations of reputable international organizations regarding the strategies the Czech Republic should pursue.

4.3 Recommendations of Reputable and Respected International Organizations

Almost from the beginning of transition, the Czech banking sector has been under constant review of reputable and highly respected international organizations, which have formulated their recommendations and their reports from the international perspective.

4.3.1 European Commission Recommendation

The European Commission exerted significant pressure on the Czech Republic to clean up and privatize its banking sector at a time when this sector, as the European Commission recognized, was undergoing a serious crisis. This can be demonstrated by the Progress Reports issued between 1998 and 2001.

The basic benchmark was set by the *Commission Opinion on the Czech Republic's Application for Membership of the European Union* (1997) where the Commission reported that *"[t]he formal reform of the banking sector is essentially complete, but **further restructuring is both necessary and expected**. ... **[The Czech] banking system cannot be considered sufficiently efficient or able to compete**.*"[83]

[83] *Agenda 2000 - Commission Opinion on the Czech Republic's Application for Membership of the European Union*. Brussels: European Commission, 1997, p. 26. [On-line]. [Cit. 2004-5-03]. [Emphasis added]. URL: <Http://europa.eu.int/comm/enlargement/dwn/opinions/czech/cz-op-en.pdf>.

In Progress Report of 1998[84], the Commission stated that *"[s]ignificant problems still remain in the financial sector, especially in the banking sector, which suffers from an acute problem of bad loans.*"

In 1999, the Czech economy was still in the last phase of transition to a functioning market economy, and had some serious structural problems as was recognized by the Commission: *"The [Czech] banking sector continues to be seriously over-burdened by bad loans, with some banks more badly affected than others; classified credits form around one third of the loan portfolio. The build up of a large number of classified loans in the past was partly due to the passive attitude that state-owned banks adopted towards bad debtors. ... [Classified credits continue to be accumulated due to the poor health of the economy. The privatisation of the remaining state-controlled banks, improvements in bankruptcy legislation, and increased separation between the commercial and investment arms of banks should improve the situation further, whilst also improving the framework for corporate governance.] The capital market is still largely illiquid, does not encourage strong corporate governance, and is a negligible source of finance for commercial and industrial enterprises. The continued presence of divergent prices for the same stock due to the fragmented organisation of the securities market remains an important problem. ...* ***Priorities for reform should include the completion of the bank privatisation process; a cleaning up of banks' portfolios…"***[85]

However, the Commission recognizes that at the same time, it will be important to closely **monitor government policy to ensure compliance with EU requirements**, particularly in the area of state aids.[86] In the same document, the Commission also stresses that **unless the Czech Republic continues reform of the financial markets, it should not**

[84] *1998 Regular Report from the Commission on Czech Republic's Progress towards Accession*. Brussels: European Commssion, 1998, p. 17-18. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/enlargement/report_11_98/pdf/en/czech_en.pdf>.

[85] *1999 Regular Report from the Commission on Czech Republic's Progress towards Accession*. Brussels: European Commssion, 1999, p. 24. [Emphasis added]. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/enlargement/report_10_99/pdf/en/czech_en.pdf>.

[86] *Ibid*, p. 40. [Emphasis added].

be able to cope with competitive pressures and market forces within the European Union in the medium term.[87]

In Progress Report of 2000, the Commission noted that *"[a] crucial task for the Government is to overcome the* ***cycle of dependency among state-owned banks, bank -owned funds and only nominally-privatised companies owing large sums to the banking sector****."*[88]

In 2001, the Commission acknowledged that *"****[b]anking restructuring has made considerable progress*** *…[P]rivatisation of the banking sector was completed.*"[89]

4.3.2 International Monetary Fund Recommendation

In its 2000 Country Report, the International Monetary Fund (IMF) stipulated the close links among bank restructuring, corporate sector restructuring and legal reforms. "*Bank and corporate restructurings reinforce each other, while the legal reforms should provide an environment conducive to the smooth progress of the overall restructuring process****. It is therefore important that efforts be made to strengthen reforms in all three areas.***"[90] Regarding bank restructuring, the IMF noted that a large amount of NPLs was transferred from the banking sector to KOB. "***However, the transfer has been a prerequisite for privatization, and hence real reform.***"[91]

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[87] *1999 Regular Report from the Commission on Czech Republic's Progress towards Accession*. Brussels: European Commssion, 1999, p. 26-27. [Emphasis added]. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/enlargement/report_10_99/pdf/en/czech_en.pdf>.

[88] *2000 Regular Report from the Commission on Czech Republic's Progress towards Accession*. Brussels: European Commssion, 2000, p. 73. [On-line]. [Cit. 2004-03-02]. [Emphasis added].
URL: <Http://europa.eu.int/comm/enlargement/report_11_00/pdf/en/cz_en.pdf>.

[89] *2001 Regular Report from the Commission on Czech Republic's Progress towards Accession*. Brussels: European Commssion, 2001, p. 36. [On-line]. [Cit. 2004-03-02]. [Emphasis added].
URL: <Http://europa.eu.int/comm/enlargement/report2001/cz_en.pdf>.

[90] *Czech Republic: Staff Country Report for the 2000 Article IV Consultation*. IMF Staff Country Report No. 00/96, Washington D.C.: International Monetary Fund, 2000, p. 35. [On-line]. [Cit. 2004-03-02]. [Emphasis added].
URL: <Http://www.imf.org/external/pubs/ft/scr/2000/cr0096.pdf>.

[91] Ibid, p. 36. [Emphasis added].

In this regard, IMF also argued that additional actions were needed to facilitate the disposal of NPLs. "*In general, **a multi-track approach to asset resolution** provides the greatest likelihood of success. This might involve banks working out the better quality bad loans (substandard and doubtful categories, for example), bundled sets of loans sold at auction or open tender, and an AMC [Asset Managements Companies] to work out more complex loans*."[92]

It was also stressed that assistance for weak banks needs to be designed to avoid a recurrence of problems-notably by reducing incentives for moral hazard behavior. "*When banks cannot simply be closed, due to their systemic role, **sufficient recapitalization, combined with measures to address sources of weakness, is needed to provide a sound basis for future operations.***"[93]

4.3.3 European Bank for Reconstruction and Development Recommendation

According to the European Bank for Reconstruction and Development, (EBRD), **resolving the intertwined problems of bank insolvency and enterprise reform is one of the key problems** east European governments faced and should be accompanied by privatization of the banking sector. "*The wider private ownership of banks is thus [...] key policy challenge in transition banking...*"[94] In this context, the EBRD acknowledged the **specific nature of transition economies which calls for a special treatment**. "*Traditional approaches to enterprise reform and bank restructuring have been tested and designed in circumstances rather different from those one encounters in post-transition Eastern Europe. In the West, the enterprise problem typically is much smaller compared with GDP and in*

[92] Wagner, N., Iakova, D.: *Financial Sector Evolution in the Central European Economies: Challenges in Supporting Macroeconomic Stability and Sustainable Growth*. IMF Working Paper No. 01/141, Washington D.C.: International Monetary Fund, 2001, p. 20. [On-line]. [Cit. 2004-03-02]. [Emphasis added].
URL: <Http://www.imf.org/external/pubs/ft/wp/2001/wp01141.pdf>.

[93] Ibid, p. 21. [Emphasis added].

[94] *Transition Report 1998: Financial Sector in Transition*. London: European Bank for Reconstruction and Development, 1998, p. 129.

terms of claims on the budget of the unreformed enterprises. And banking distress will also typically extend to a subsection of banks, rarely to the banking system as a whole.“ [95]

Troubled banks in transition economies should not be cured by means of forced administration as such framework is unlikely to function properly in countries with not fully developed bank supervision as banks' managers are able to mis-report and hide the real condition of troubled bank. Instead, *”it would be desirable to move to a system for bank recapitalisation that gives troubled banks an incentive to reveal their asset quality problems (rather than to hide them) and to recover on bad loans and other non-performing assets.* ”[96] Due to moral hazard dilemma of banks' managers, **a “sufficient” level of capital should be injected into troubled banks to reduce such managers' behavior**. “*Bank managers cannot be made responsive to capital value of the bank if there is no capital to begin with. Thus an essential element of banking reform is recapitalisation of the banks with enough income-earning assets to leave a prudential capital base in place after provisioning for bad loans.*“[97]

In its 1998 Transition Report[98], the EBRD acknowledged the importance of competition in the banking sector. However, it also stressed that **competition considerations must not jeopardize stability of the overall banking system in transition**.[99]

[95] Wijnbergen, S.: *Bank Restructuring and Enterprise Reform*. EBRD Working Paper No. 29, London: European Bank for Reconstruction and Development, 1998, p. 17. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.ebrd.com/pubs/econ/workingp/29.pdf>.

[96] *Transition Report 1998: Financial Sector in Transition*. London: European Bank for Reconstruction and Development, 1998, p. 134.

[97] Wijnbergen, S.: *Bank Restructuring and Enterprise Reform*. EBRD Working Paper No. 29, London: European Bank for Reconstruction and Development, 1998, p. 1. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.ebrd.com/pubs/econ/workingp/29.pdf>.

[98] *Transition Report 1998: Financial Sector in Transition*. London: European Bank for Reconstruction and Development, 1998.

[99] “*A key policy challenge in transition banking is thus to **foster competition while maintaining stability of the overall banking system**.”* (*Transition Report 1998: Financial Sector in Transition*. London: European Bank for Reconstruction and Development, 1998, p. 129. [Emphasis added]).

4.3.4 World Bank Recommendation

According to the World Bank[100] ("WB"), the successful completion of the restructuring task and privatization of the banking sector in the Czech Republic required progress in two broad areas:

- Design and implementation of a strategy to transfer the classified claims to the agents with the best incentives and skills for working them out;
- Implementation of further legal reforms designed to promote restructuring of viable enterprises through informal and formal channels, to transfer the assets of unviable enterprises to alternative users, and to promote new lending by reducing the uncertainty to banks and other creditors.

Regarding the workout challenge, the WB suggested the adoption of a mixed private sector/state strategy[101] with diversified, multi-track approach, under which the heavy burden of debt workout is distributed among many players in the economy. WB also proposed a centralized component to deal with large and complex workout cases, and several decentralized components to deal with the very large number of medium and small enterprises.

According to the WB, further legal reforms were necessary to remove legal obstacles to the restructuring of viable enterprises, as well as the prompt liquidation of non-viable enterprises. "*The implementation of a coherent package of legal reforms would also increase investor interest in classified claims and should be seen as a pre-condition for developing a secondary market for these claims.*"[102] WB proposed the following major reforms:

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[100] *A World Bank country study No. 21440, Czech Republic - Completing the transformation of banks and enterprises.* Washington D.C.: World Bank, 2000. [On-line]. [Cit. 2004-03-02].
URL: <Http://www-wds.worldbank.org/servlet/WDSContentServer/
WDSP/IB/2001/01/06/000094946_00121906020354/Rendered/PDF/multi_page.pdf>.

[101] In principle, the mixed strategy relies in substantial sales of assets to third parties, as well as substantial outsourcing of asset management.

[102] *A World Bank country study No. 21440: Czech Republic - Completing the transformation of banks and enterprises*. Washington D.C.: World Bank, 2000, p. x. [On-line]. [Cit. 2004-03-02].
URL: <Http://www-ds.worldbank.org/servlet/WDSContentServer/
WDSP/IB/2001/01/06/000094946_00121906020354/Rendered/PDF/multi_page.pdf>.

- Improving further debt enforcement mechanisms outside bankruptcy, including more efficient and summary judicial procedures for obtaining judgments and executions/sale for collateral and by ensuring that the new Law on Public Auctions produces the intended effects;
- Strengthening further the bankruptcy framework, by introducing further improvements in the liquidation track, and by improving the institutional and regulatory framework for bankruptcy; and
- Introducing other complementary changes in other legislation to remove remaining obstacles to workouts and enterprise restructuring.

4.4 Adopted Solution

As stipulated in earlier sections, resolution of the crisis without state aid was not considered as a viable option, mainly for the following reasons:

- **Necessity for the special attention to banking sector stability especially with a view to averting systemic consequences** (as discussed in section *Uniqueness of the Banking sector*); and
- **No credible strategic investor was willing to accept huge risks connected with privatization of banks without proper guarantees and indemnities.**

As the private sector was not willing to take the huge risks, the state implemented a series of state aid measures in order to avert a systemic crisis, which would have, given the level of banking sector intermediation, a detrimental impact on the Czech economy.

However, as mentioned earlier, "*[t]he recapitalizations in the early 1990s often did not significantly change the behavior of the financial intermediaries. In the Czech Republic and Slovakia, repeated government interventions created a perception of soft budget constraint and led to moral hazard behavior.*"[103] State control over the banking sector distorted the economy through non-commercially based lending, delaying restructuring,

[103] Wagner, N., Iakova, D.: *Financial Sector Evolution in the Central European Economies: Challenges in Supporting Macroeconomic Stability and Sustainable Growth*. IMF Working Paper No. 01/141, Washington D.C.: International Monetary Fund, 2001, p. 22. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.imf.org/external/pubs/ft/wp/2001/wp01141.pdf>.

restricting competition, allowing bad loans to accumulate and postponing bankruptcy particularly of the largest companies.

Slow progress of legal reforms and poor law enforcement on the fields of collateral recovery, bankruptcy law, protection of creditors instead of debtors, regulatory and supervisory policy, etc., resulted in further intensification of the information asymmetries and hence led to further worsening of banks' position. Furthermore, due to lack of progress in enterprise restructuring, feedback effect led to further deterioration of banks' balance sheets. As a result, next rounds of recapitalization and bail-outs followed.

In addition, the carved-out loans were managed by three centralized state-owned asset management agencies (KOB, CI and CF), which, initially, did not use market mechanisms for asset recovery very extensively and achieved very low recovery rate.[104]

The originally adopted *ad hoc* measures, lacking any systemic vision, allowed problems to reach the brink of banking sector collapse as "*authorities tried to minimize costs through incomplete recapitalization, avoiding market-based work-outs, preserving insolvent institutions of non-systemic importance, and postponing major changes in the legal and institutional framework.*"[105]

It became evident that instead of inefficient *ad hoc* approach, a decisive and comprehensive approach needs to be taken. Such approach would combine:

- Rescue, restructuring and privatization of state-owned banks;
- More efficient methods of NPLs recovery;
- Corporate sector restructuring; and
- Legal reforms.

[104] However, part of the reason for the low recovery rate stems from the inadequate legal framework which, for example, did not allow sale of real estate collateral unless the debitor gives the creditor permission.

[105] Wagner, N., Iakova, D.: *Financial Sector Evolution in the Central European Economies: Challenges in Supporting Macroeconomic Stability and Sustainable Growth*. IMF Working Paper No. 01/141, Washington D.C.: International Monetary Fund, 2001, p. 19. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.imf.org/external/pubs/ft/wp/2001/wp01141.pdf>.

We will tackle each issue subsequently, starting with rescue, restructuring and privatization of each major bank.

4.4.1 Rescue, Restructuring and Privatization[106]

Agrobanka

Agrobanka, the largest private Czech bank in the mid-1990s, was placed under the forced administration in September 1996 (as described in chapter *Consolidation of Agrobanka*). *"The CNB has announced that it will honor Agrobanka's financial obligations; all deposits, including interest, registered at Agrobanka as of September 17 are guaranteed."*[107] The aim of the guarantee was to stop a run on the bank during the forced administration, which had the potential to destabilize AGB further, weaken the credibility of AGB and increase the outflows of capital.[108] Moreover, in order to secure the necessary liquidity of the bank and its compliance with the regulatory requirements in force, the CNB established a credit line to AGB. The amount of credit extended reached more than CZK 22 billion in February 1998.[109]

The CNB split Agrobanka into a good bank and bad bank, with the healthy part, AGB 1, expected to be sold to a strategic investor. To gain control over AGB 2, the unhealthy part, after the forced administration period, CNB instructed Česká finanční ("CF") to increase the registered capital of AGB through subscription of a new issue of AGB shares by CF. As a

[106] For more information on background of the privatization process, see Havel, J.: Bank privatization, critical look at privatization procedures. In: *Proceedings from the International Conference Future of the banking after the year 2000 in the world and in the Czech Republic – Privatization of the banking sector*. Opava: Silesian University, October 2001. [On-line]. [Cit. 2004-03-02].
URL: <Http://info.opf.slu.cz/kfi/pb2000/sbornik2001/index.htm> or Juchelka, J.: The National Property Fund view on the banking sector privatization. In: Ibid.

[107] *Banking Turbulence in the Czech Republic and the "Bad Boys" from Motoinvest.* Transition Newsletter, Volume 7, Number 9-10, September-October 1996, Washington, D.C.: World Bank, [On-line]. [Cit. 2004-03-02].
URL: <Http://www.worldbank.org/html/prddr/trans/so96/art2.htm>.

[108] However, no payments have ever been made by the CNB under this guarantee.

[109] Based on Kalina, P.: Nebyla pomoc nadměrná? *Ekonom*, 9.10.2003, p. 37. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.cnb.cz/media_ot_arch_41_2003_031009d.php>.

result, CF subscribed the new shares for a consideration of CZK 9 billion.[110] Subsequently, AGB correspondingly reduced its liability to the CNB arising from the credit line.[111] However, as this capital increase was successfully challenged by some minority shareholders, the injected capital turned into debt of the AGB towards CF.[112]

The public tender for a strategic investor for the sale of AGB was launched in April 1997. In November 1997, CNB approved General Electric Capital Corporation (GECC) as a winner of the tender. As a part of the transaction agreement, the CNB increased the registered capital of the bank by CZK 19.7 billion.[113] In addition, CNB provided indemnity to GECC limited by amount of CZK 2 billion in respect of losses resulting from disputes over the validity or constitutional legitimacy of the sale of AGB 1 to GECC. Moreover, GE Capital Holding Corporation (GECHIC) holds a put option, allowing the investor to return its shares in GE Capital Bank (GECB) for a fair market price to CNB.[114] In June 1998, GE bought 100 percent of Agrobanka 1 and took over all of its commitments to its clients and all its assets on June 22 for CZK 500 million.

Investiční a Poštovní banka

The Government launched a tender for the sale of its 36.3 % stake in IPB in March 1997. In order to facilitate the bank's privatization, the portfolio of loans for co-operative housing construction subsidized by the State, with nominal value of CZK 16.1 billion CZK, was transferred to the KOB in April 1998.[115] In March 1998, the State's share was sold to Nomura International for a consideration of CZK 3 billion. "*However, the investor treated its acquisition as a portfolio investment, selling off part of its assets and leaving the existing*

[110] See e.g. Smith, P.: Central bank puts fresh stock in Agrobanka. *The Prague Post*, April 1, 1998. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.praguepost.cz/archive/busi40198h.html>.

[111] Therefore, the amount of outstanding liabilities of AGB resulting from this credit facility equals to CZK 13.3 billion. See e.g. Kalina, P.: Nebyla pomoc nadměrná? *Ekonom*, 9.10.2003, p. 37. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.cnb.cz/media_ot_arch_41_2003_031009d.php>.

[112] See e.g. CNB znovu bojuje s Tykačem. Catania.*cz Newsletter*, Catania.cz s.r.o., April 4, 2002. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.catania.cz/20020404.html>.

[113] See e.g. Páral, P., Mydlář, A.: Bruselská zpověd. *Euro*, January 13, 2003, p. 20.

[114] *Ibid*.

[115] The main reason of this transfer was the low profitability of these loans for the bank.

management procedures in place. The sale had not involved any balance sheet clean up, and the bank's situation continued to deteriorate although for a while the extent of this deterioration was not apparent."[116]

On June 16, 2000, CNB put IPB into a forced administration with the intention of subsequently selling the business to CSOB as a strategic investor[117], after Nomura failed to improve its bad loan portfolio, increase the capital to meet capital adequacy requirements or offer a viable solution to resolve the situation. "*The supervisor's examination revealed serious shortcomings in the bank's activities, especially in the area of classified receivables and asset valuation. It was discovered that the bank had violated the regulations by recording artificially overvalued assets. The supervisory group calculated the need for additional provisions and reserves at CZK 40 billion for the examined asset sample only. IPB's results were therefore distorted by at least this amount, if not more.*"[118] The bank was effectively insolvent.[119] The same day, in order to reduce the substantial outflow of deposits from the bank[120] and to prevent further destabilization of the financial markets, the CNB issued an irrevocable guarantee for creditors of IPB.[121] [122] In addition, the CNB granted a short-term credit to IPB to raise the bank's liquidity.

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[116] *Czech Republic: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes*. IMF Country Report No. 01/113, Washington D.C.: International Monetary Fund, 2001, p. 19.

[117] The potential investors interested in taking over IPB were Alianz-Unicredito and CSOB who differed fundamentally in terms of the manner and speed of the takeover. Given the urgency of the problem, the CSOB's immediate solution was preferred.

[118] *Report for the session of the Chamber of Deputies of the Parliament of the Czech Republic on the situation at and course of action for stabilising Investiční a Poštovní banka, a.s.* Czech National Bank, Prague: Ministry of Finance, June 2000, p. 3-4. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.cnb.cz/en/pdf/zprava_ipb-en.pdf>.

[119] Nomura is alleged to have tunneled assets from the investment funds held by IPB and made significant returns on selling the IPB's equity holdings.

[120] CZK 34 billion between February 2000 and the start of June 2000.

[121] For more details see e.g. *Guarantee for IPB creditors*. Prague: Czech National Bank, June 19, 2000. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.cnb.cz/en/bd_info_ipb_guarantee.php>.

[122] According to the Office for the Protection of Competition, the maximum amount guaranteed was CZK 219 billion as of 16 June 2000. However, this guarantee was not utilized and was later in principle replaced by other guarantees. (Based on Páral, P., Mydlář, A.: Bruselská zpověď. *Euro*, January 13, 2003, p. 20).

On June 19, 2000, IPB's assets and liabilities were sold immediately to CSOB on NAV principle for the adjusted purchase price set at CZK 1, with state guarantees and promises of indemnity granted by the Ministry of Finance (MoF) and the CNB to CSOB. "*This quick action protected the banking sector from potential destabilizing effects and preserved the stability of the resolved bank's clientele.*"[123]

The state guarantees, in particular, include:

- The Agreement and State Guarantee provided CSOB with a guarantee for the relevant net asset value (not covering off-balance-sheet items) according to the state of the bank's accounting, up to CZK 154.5 billion.[124] The agreement also includes a put option allowing the CSOB to transfer NPLs to KOB (CKA).
- The Agreement and Indemnity executed between the CNB and CSOB sets out the various indemnities granted by the CNB to reimburse CSOB for losses and damages it may incur arising from contingencies and commitments in connection with the purchase of IPB;
- The Promise of Compensation concluded between the MoF and CSOB sets out a level of net compensation CSOB is to pay for the state guarantee. It is based upon the total risk weighted assets of IPB, which CSOB intends to keep in its portfolio.

In November 1997, the Czech government decided to commence preparations for the sale of the remaining State shares in CS, CSOB and KB.[125] The failure of IPB privatization served as a lesson to policymakers for the future privatizations - in contrast to IPB privatization, the later privatizations have all involved carve out of non-performing loans. The failure of IPB privatization proved right the recommendations of both the World Bank and European Bank for Reconstruction and Development: for that to reduce the moral hazard problem some form of recapitalization is necessary. This was mainly done by allowing the banks to transfer their non-performing loans to the state-owned KOB.

[123] Dědek, O.: Bank consolidation in the Czech Republic. In: *The banking industry in the emerging market economies: competition, consolidation and systemic stability*. BIS Papers No. 4, Basel: Bank for International Settlement, 2001, p. 69. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.bis.org/publ/bispap04e.pdf>.

[124] Based on Páral, P., Mydlář, A.: Bruselská zpověd. *Euro*, January 13, 2003, p. 20.

[125] See *Government Resolution No. 732* of November 19, 1997.

Československá obchodní banka

The bank was extensively cleaned from the old debt coming from the socialistic era in 1991 and 1994 by the NPF, CF, CI and the KOB and also recapitalized in 1993 by the NPF. Since then it did not receive any additional state support for covering new NPLs. As mentioned in chapter *Banking Sector Evolution Between 1990-1996*, as part of bank's restructuring, CF and Slovenská inkasní ("SI") bought CSOB's inherited export credits and guarantees in 1993-94. Specifically, CSOB provided SI with a loan for a period of 10 years to finance the bailout. However, in 1996, the Slovak government decided not to repay the loan.[126] As a result, given the size of the receivable[127], the CSOB would not fulfill the basic regulatory capital adequacy ratio without external assistance. Therefore, in order to prevent the adverse economic consequences of the situation, the Czech state mitigated the risks by a state guarantee which covers not collected amount of receivable against Slovak Republic.[128]

In June 1998, the Government announced its intention to sell the state-owned share in CSOB and in June 1999, prior to absorbing IPB's assets, the Government sold controlling interest (66%) in CSOB to Belgian Kredietbank for a consideration of CZK 40 billion.[129] "*CSOB's sale at a good price to the Belgian Kredietbank (KBC) is an example of a successful privatisation resulting in the entry of a reliable and strong investor into the Czech banking sector.*"[130]

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[126] In April 1997, CSOB initiated arbitration proceedings against the Slovak Republic before the International Centre for the Settlement of Investment Disputes in Washington D.C.

[127] Approx. CZK 20 billion.

[128] See e.g. Havel, J.: *Bank* privatization, critical look at privatization procedures. In: *Proceedings from the International Conference Future of the banking after the year 2000 in the world and in the Czech Republic – Privatization of the banking sector*, Opava: Silesian University, October 2001, p. 14. [On-line]. [Cit. 2004-03-02].
URL: <Http://info.opf.slu.cz/kfi/pb2000/sbornik2001/index.htm>.

[129] For more information on the privatization process, see Juchelka, J.: The National Property Fund view on the banking sector privatization. In: *Proceedings from the international conference Future of the banking after the year 2000 in the world and in the Czech Republic – Privatization of the banking sector.* Opava: Silesian University, October 2001, p. 26-27. [On-line]. [Cit. 2004-03-02].
URL: <Http://info.opf.slu.cz/kfi/pb2000/sbornik2001/index.htm>.

[130] Dědek, O.: Bank consolidation in the Czech Republic. In: *The banking industry in the emerging market economies: competition, consolidation and systemic stability*. BIS Papers No. 4, Basel: Bank for International Settlement, 2001, p. 69. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.bis.org/publ/bispap04e.pdf>.

Česká spořitelna

Due to expected loss, the CS was at the brink of collapse at the end of 1998. Without aid measures, the bank would most likely not meet the capital adequacy requirements and CNB would have to initiate administrative procedure to revoke CS's license. Therefore, taking into account the significance of the bank for the stability of the Czech economy, in December 1998, CS issued a subordinated debt amounting to CZK 5.5 billion, which was underwritten by KOB.[131] In addition, credits with a nominal value of CZK 10.4 billion were transferred to KOB for a consideration of CZK 6.9 billion in order to ensure criteria of capital adequacy.[132] These measures gave CS time to prepare for its privatization.

In April 1999, the Government officially informed potential strategic investors about its intention to sell the control block of CS's shares. In order to comply with the capital adequacy ratio and create sufficient reserves, CS's capital was increased by CZK 7.6 billion[133] in September 1999, to which the NPF contributed by CZK 4.495 billion. The state share in authorized capital of CS increased from 45% to 52.07%. On September 23, 1999, the only strategic investor, Erste Bank, submitted its indicative offer for the first round of the selection procedure. In light of this development, the Government decided to grant a time-limited exclusivity for negotiations on purchase of state block of shares in CS to Erste Bank. This initiated the second round of the selection procedure and due diligence of Erste Bank in CS. Erste Bank submitted its binding offer to purchase state share in CS on October 29, 1999.

Because of the unfavorable macroeconomic situation, further deterioration in the quality of the CS loan portfolio and persisting doubts about CS's stability, it was apparent that these factors might jeopardize CS's privatization. Therefore, NPLs with a nominal value of CZK 32.975 billion were transferred to KOB for a consideration of CZK 19.872 billion in November 1999. On February 2, 2000, the Government decided to sell its 52.07% share in CS to Erste Bank for a consideration of CZK 19.381 billion.

[131] The maturity of this debt was set to ten years; however, the bank was allowed to repay the debt after five years, in December 2003.

[132] See *Government Resolution No. 834* of December 9, 1998 and no 870 of December 16, 1998.

[133] See *Government Resolution No. 195* of March 10, 1999.

However, due to persisting uncertainty on the Czech banking market and doubts about the quality of the CS's loan portfolio, the valuation problem arose. These doubts could not be eliminated by due diligence in the short time span of the privatization, given the large number of receivables in the portfolio and the limited access to information subject to banking secrecy pursuant to the Czech Act on Banks. Therefore, as part of privatization agreement, the Czech government granted CS a net asset value guarantee for a portfolio of assets with CNB classification 3 to 5, so-called ring-fencing agreement. The total nominal value of all assets finally included under the guarantee was CZK 32.6 billion and the total net asset value was estimated to CZK 25.04 billion. Transferable assets from this portfolio can be transferred once a year until 2005 to KOB/CKA, while the length of guarantee for nontransferable assets is determined by the maturity of these assets.

In addition, the State agreed to compensate CS for administration of social loans (as these formed part of State's social policy from 1973 until 1998) in order to bring the interest on outstanding loans in line with the market practice.

Komerční banka

In order to meet the capital requirements stipulated by the CNB, the State decided to increase KB's capital in 1999. The capital increase was carried out in two phases:

- In the first round only the then existing shareholders were allowed to subscribe to new shares in proportion of their shareholdings.[134]
- In the second round, based on KB's General Meeting decision of May 31, 1999, only the major shareholder, NPF, was authorized to subscribe the remaining shares.[135]

As a result, NPF invested during the two runs total amount of CZK 6.8 billion and increased its shareholding of KB from 48.7% to 60% between December 1999 and January 2000.

However, given the fact that the capital increase was actually implemented later than expected (due to some minority shareholders' challenges), there was a period when KB faced a non-compliance with capital adequacy requirements. *"Given the urgency of the situation, the Czech authorities on 28 July 1999 approved a bail-out involving certain non-performing*

[134] As a result, investors' proportionate share of KB's shareholding remained unchanged.

[135] Therefore, private shareholdings were diluted and some minority shareholders challenged the capital in crease on various grounds. However, the Czech Supreme Court ruling finally confirmed that the capital increase was carried out in line with the Czech law.

assets of KB."[136] A portfolio of NPLs with a total nominal value of CZK 23.1 billion and a total net asset value of CZK 4.1 billion was transferred to KOB, for a consideration of CZK 13.6 billion.

Despite the capital increase and the first bail-out, a further deterioration of KB's balance sheet resulted in KB's non-compliance with the capital adequacy requirements. Thus, on February 16, 2000 the Czech authorities decided to transfer a portfolio of NPLs with nominal value of CZK 60 billion and a net asset value of CZK 29 billion from KB to KOB, for a consideration of CZK 36 billion.

In March 1999, the Czech government decided to sell the KB in an open tender. However, given the amount of KB's NPLs, the Government feared that this could undermine the privatization process. Therefore, on December 18, 2000, the Czech government decided to provide KB a State guarantee on a ring-fenced portfolio of NPLs, limited to a maximum amount of CZK 20 billion, valid for losses realized between December 31, 2000 and December 31, 2003.

In addition, to offset the higher tax liability resulting from the reduction of provisions in 2000, the KB requested the tax authority to allow a one-off restatement of tax deductible provisions of CZK 4 billion for fiscal year 2000, having effect of reducing KB's tax liability by CZK 1.2 billion. The tax relief was granted by the Czech tax authority in July 2001.

From five potential investors that expressed interest by means of preliminary bid, only two submitted final bid. Finally, KB was sold to the winning bidder, Société Générale S.A. for a consideration of CZK 40 billion in October 2001.

The last state financial institution, KOB, terminated its activities in 2001 when its assets were transferred to its direct successor, the Česká konsolidační agentura (CKA). Although the Government was late to recognize the importance of attracting strategic foreign investors for its large voucher-privatized banks, all major banks in the Czech Republic have

[136] *See EC Decision on Komerční banka, a.s., State aid CZ 15/2003 – Czech Republic*. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/secretariat_general/sgb/state_aids>.

become foreign controlled by mid-2001, when foreign banks assets as share of commercial banks assets reached almost 90% (see Exhibit 46).

4.4.2 Methods of NPLs Recovery

In accordance with the EC, IMF, EBRD and WB recommendations, the resolution of the banking crisis was based on transformation agencies, which acquired non-performing assets from banks to improve their balance sheet. For the small banks, these asset transfers were a prerequisite for liquidation or consolidation of virtually all of those banks that had experienced difficulties.[137] For the larger banks, the asset transfers contributed to much higher transparency of the banks assets, reduced credit risks substantially and, thus, allowed faster and more efficient privatization.

As in most transition economies, the Czech Government-owned centralized asset management agencies have not been very successful in the recovery of assets, mainly due to the following reasons:

- Lack of clear mandate;
- Lack of legal powers to dispose of assets or to force restructuring; and
- Vague timeframe for winding down operations, which may have increased moral hazard.

The KOB initially functioned as a bank and was subject to all prudential regulations for banks, including capital adequacy requirements. In addition, it was used for government-directed lending, and for many years was simply a passive collection agency instead of an active manager of its asset portfolio. However, KOB started to auction its assets more extensively since 1999. KOB’s banking license was revoked in 2001, and thus, Česká konsolidační agentura (CKA) - former KOB – could concentrate more on the NPLs recovery function.

Regarding NPLs recovery, the Czech Republic started to use a multi-faceted approach to non-performing asset resolution. This is in line with the IMF and WB suggestions mentioned earlier. As a result, burden of debt workout is better distributed across a broader range of participants.

[137] Please refer to the section *Crisis of Small Banks*.

4.4.3 Legal Reforms

As regards legal reforms, **the amended Act on Bankruptcy and Settlement and the Act on Public Auctions** became effective on May 1, 2000. "*The new legislation aims at accelerating bankruptcy proceedings and balancing creditors' and debtors' rights by allowing specialised firms or legal persons to act as trustees in bankruptcy proceedings and by offering the possibility to negotiate out-of-court settlements. It is expected that the changes in legislation will strengthen creditors' rights, reduce debtors' opportunities to dispose of property during the bankruptcy procedure and give incentives for the restructuring of enterprises rather than their liquidation*."[138] Moreover, **the amendment of the Act on Banks**, which came into effect on May 1, 2002, further **strengthened central bank's ability to conduct consolidated supervision over financial sector**. However, *"[d]espite the legislative improvements, including new banking and investment funds laws which have been implemented, enforcement remains the key to achieving tangible results, as the justice system is overly bureaucratic and slow*."[139]

4.4.4 Corporate Sector Restructuring

In line with the IMF and EBRD recommendation, certain progress had been made in the **restructuring of the corporate sector**. However, *"[m]uch of it was spontaneous since tighter budget constraints had increased the number of bankruptcies* [see Exhibit 20] *and also voluntary debt restructuring.*"[140]

The Czech Government also adopted measures to stop unfavorable development and launched a recovery scheme aimed at selected Czech industrial companies in difficult economic circumstances. To deal with this problem the Revitalization Agency Ltd. was set up

[138] Dědek, O.: Bank consolidation in the Czech Republic. In: *The banking industry in the emerging market economies: competition, consolidation and systemic stability*. BIS Papers No.4, Basel: Bank for International Settlement, 2001, p. 4. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.bis.org/publ/bispap04e.pdf>.

[139] *Transition Report 2000: Employment, skills and transition*. London: European Bank for Reconstruction and Development, 1998, p. 154.

[140] *Czech Republic: Staff Country Report for the 2000 Article IV Consultation*. IMF Staff Country Report No. 00/96, Washington D.C.: International Monetary Fund, 2000, p. 37.
URL: <Http://www.imf.org/external/pubs/ft/scr/2000/cr0096.pdf>.

by the KOB in May 1999. However, the activity of the Revitalization Agency did not deliver the expected turn round in the undesirable development. Therefore, the agency merged with KOB in February 2001 to streamline revitalization efforts and in April 2001 the Government adopted[141] a new scheme called *Support Strategy for Growth of the National Economy*. The strategy is based on standard restructuring and recovery measures. They are incorporated in two programmes called *EXIT* and *BALANCE*.

Nevertheless, the main driver of corporate sector restructuring will have to be a proper incentive framework for private sector agents to allow and encourage market-based, sustainable solutions. Unfortunately, this is heavilly dependent on the efficiency of the judicial system, which is still low in the Czech Republic.

4.5 Costs of the Banking Sector Reform

The costs of banking system restructuring have become a very attractive issue. However, there are a number of constraints, which make this issue extremely difficult. The main constraints are following:

- There is no universal methodology:
  - Problem of identifying items that fall into the category of banking system restructuring and eliminating items that fall into the category of State social policy (e.g. social and housing loans);
  - Time-value of money should be taken into account;
  - Problem of the method of future costs and revenues estimates;
- Obtaining all necessary data is problematic as some are perceived as confidential;
- Measuring indirect costs of banking system restructuring (usually proxied by losses in GDP) is even more difficult than measuring of direct fiscal costs of aid measures (e.g. bail-outs, capital increases etc.).

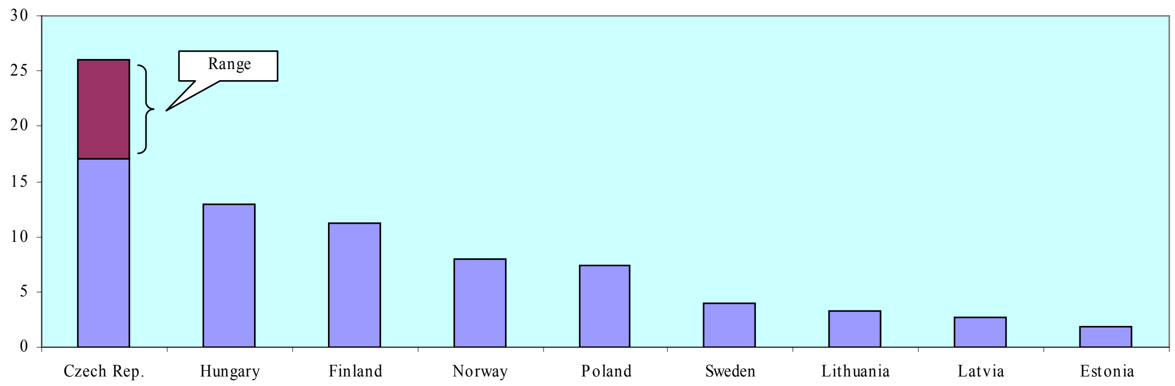
Hence, to tackle this issue correctly, we would need to pursue a very detailed and complex analysis, which goes beyond the scope of this paper.[142] Therefore, we will use the

[141] *Government Resolution No. 306*, April 2001.

[142] For a detailed analysis of these costs see e.g. Čuda, P.: *Vyčíslení transformačních nákladů na restrukturalizaci a konsolidaci bankovního sektoru.* [Calculation of banking sector restructuring and

analyses of the MF, CNB, IMF, OECD and WB, which estimated the total amount of net fiscal costs to 17% - 26% of 2003 GDP, depending on the methodology used. Exhibit 29 presents the range of these estimates as well as some cross-country estimates.

Exhibit 29 Direct fiscal costs of banking crisis in selected countries (in % of GDP)



Source: Ministry of Finance; Czech National Bank, International Monetary Fund, OECD, World Bank, Zoli, E., Tang, H, Klytchnikova, I.[143]

Direct fiscal costs of banking sector stabilization turned out to be relatively high in the Czech Republic in comparison with the Nordic countries (where the direct costs ranged from 4% to 11% of GDP) and also with other countries in transition. However, **cross-country comparisons of costs incurred to resolve financial crisis should be viewed with some degree of caution** given:

- **Differences in methodology** (as indicated above);
- **Initial conditions** (as discussed in chapter *International Comparison*);
- **Elimination of indirect costs from the analyses**. Many countries in transition also suffered enormous indirect costs due to decline in output and higher unemployment. Therefore, to compare total costs of banking sector stabilization, we should add direct and indirect costs together;
- **Size of the banking sector.** "*As long as financial institutions and formal financial markets are underdeveloped, non-financial firms depend on financial intermediaries*

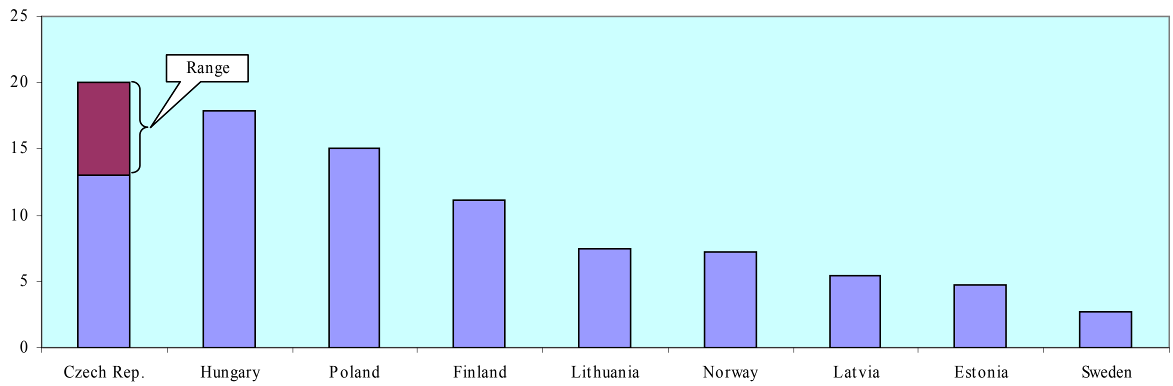
consolidation costs]. 2004, *forthcoming*. Master's Thesis, Institute of Economic Studies, Charles University. Tutor: Havel, J.

[143] Zoli, E., Tang, H, Klytchnikova, I.: *Causes of Banking Crises: Banking crises in transition economies, fiscal costs and related issues*. World Bank Policy Research Working Paper 2484, Washington D.C.: World Bank, 2000, p. i. [On-line]. [Cit. 2004-03-02].
URL: <Http://econ.worldbank.org/files/1294_wps2484.pdf>.

only to a limited extent. This leaves them less vulnerable to disruption by turbulence in financial markets. ***But as credit markets deepen*** *and external finance grows in importance,* ***the effects of banking crises are likely to be more severe****.*”[144]

Therefore, we will express the direct fiscal costs of banking crises in % of size of the financial sector, measured as a sum of broad money and credit to private sector. The results are presented in Exhibit 30.

Exhibit 30 Direct fiscal costs of banking crisis as % of the financial sector size[145]



Source: Ministry of Finance; Czech National Bank, International Monetary Fund, OECD, World Bank; Zoli, E., Tang, H, Klytchnikova, I.[146]; own calculations

From this perspective, the costs of Czech crisis resolution appear to be fully in line with its CEE peers. The difference between CEE and Baltic countries can be explained by different initial conditions, mainly by hyperinflation at the beginning of transition that drastically reduced the real value of inherited bad debts (as depicted in Exhibit 26). The difference between CEE countries and Nordic countries accounts mainly for **the much weaker institutions in the CEE region, which tend to aggravate the fiscal costs of**

[144] *Transition Report 1998: Financial Sector in Transition*. London: European Bank for Reconstruction and Development, 1998, p. 100.

[145] Measured as a sum of broad money and credit to private sector in each country as of 1994.

[146] Zoli, E., Tang, H, Klytchnikova, I.: Causes of Banking Crises: *Banking crises in transition economies, fiscal costs and related issues*. World Bank Policy Research Working Paper 2484, Washington D.C.: World Bank, 2000, p. i. [On-line]. [Cit. 2004-03-02].

URL: <Http://econ.worldbank.org/files/1294_wps2484.pdf>.

crises[147] and for the fact that CEE "*[g]overnments have been able to use financial institutions as their quasi-fiscal agents…*"[148] by strong political pressures placed on banks to sustain large state-owned enterprises.

From the above analysis, we may conclude that although the Czech banking system restructuring has not been not very efficient, the costs spent are in line with its CEE peers and comparable with costs expound by Nordic countries, taking into account the difference in institutional backgrounds. The question whether aid measures granted to the Czech banking sector were excessive (i.e. causing unnecessary advantage for aid recipients) or not will be further discussed in chapter called *Was Aid Limited to the Strict Minimum Necessary?* in Part II of this paper.

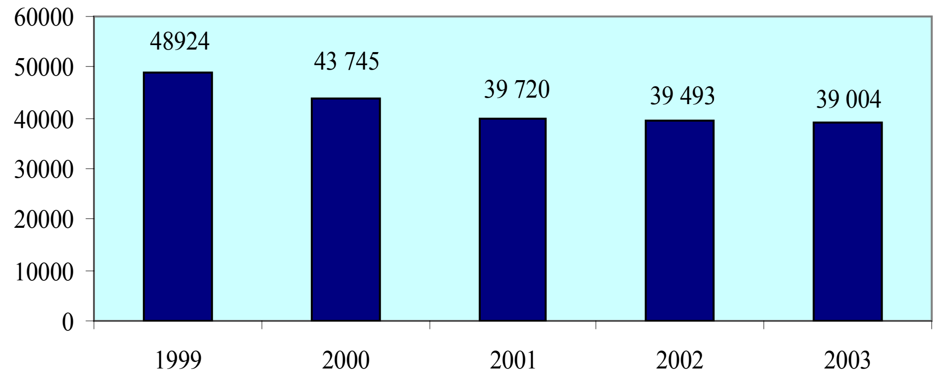
[147] See Honohan, P., Klingebiel, D.: Controlling the Fiscal Costs of Banking Crises. In: Claessens, S., Klingebiel, D.: Laeven, L., Honohan, P., Caprio, G.: *Managing the Real and Fiscal Effects of Banking Crises*. World Bank Discussion Paper No. 428, Washington D.C.: World Bank, 2002, p. 22-24. [On-line]. [Cit. 2004-03-02].
URL: <Http://wbln0018.worldbank.org/html/FinancialSectorWeb.nsf/(attachmentweb)/Fsdp8rv5/$FILE/Fsdp8rv5.pdf>.

[148] Transition *Report 1998: Financial Sector in Transition.* London: European Bank for Reconstruction and Development, 1998, p. 93.

5. Assessment of the Current Performance of the Banking Sector

As of December 31, 2003, the banking sector achieved a net profit of CZK 30.038 billion, representing a ROA 1.20%. According to the European Central Bank, "*the profit was, moreover, achieved in a highly competitive environment characterised by lowering interest rates and narrowing banks' margins.*"[149] In addition, this level of profit was achieved in the steadily declining volume of employment (see Exhibit 31), which shows the considerable restructuring efforts undertaken by large banks.

Exhibit 31 Number of employees in the banking sector

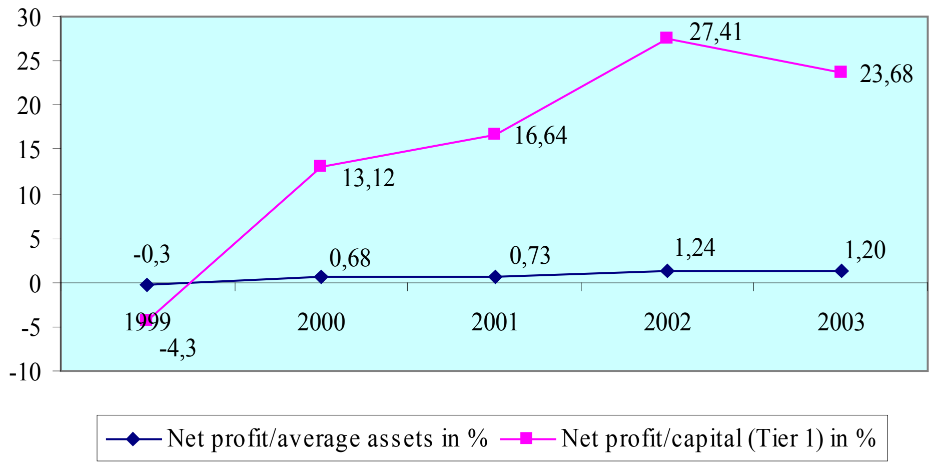


Source: Czech National Bank

As indicated in Exhibit 32 and Exhibit 33, the year 1999 was the last one when the banking sector recorded a fall in profit, caused predominantly by the group of big banks. Since then, bank profitability relative to assets and capital has risen sharply, classified and nonperforming loan ratios have declined and capital adequacy ration remains adequate.

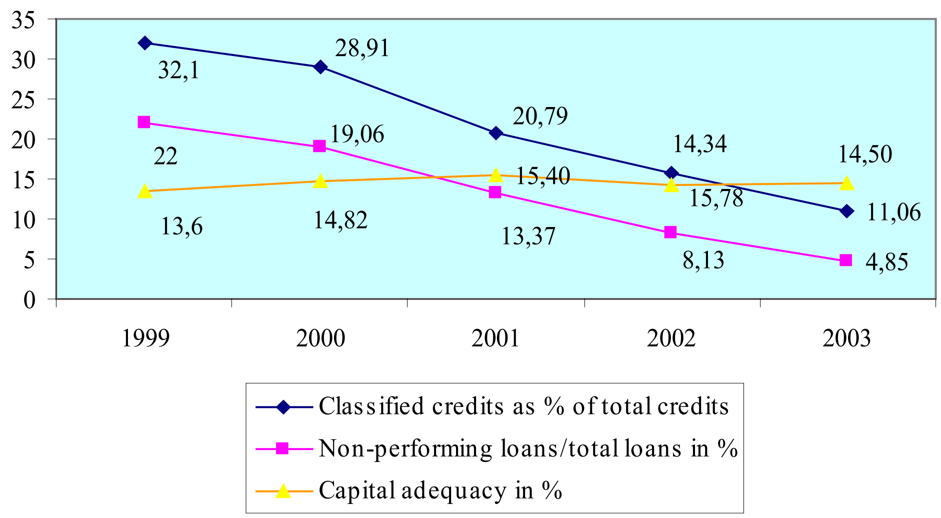
[149] Ihnat, P., Procházka, P.*: Financial Sectors in EU Accession Countries: The financial sector in the Czech Republic: an assessment of its current state of development and functioning*. Frankfurt: European Central Bank, 2002, p. 76.

Exhibit 32 Selected indicators of banking sector profitability



Source: Czech National Bank

Exhibit 33 Selected prudential indicators



Excludes loans on the books of KOB, banks in forced administration and the loan of CSOB to SI.

Source: Czech National Bank

As the Commission stated in case of Banco di Napoli, which, after implementation of rescue and restructuring (see Annex III), also exceeded the expectations of profitability, "*in view of these results, it can be concluded that the restructuring plan is capable of producing the anticipated results and even improving on them over the next few years.*"[150] This statement fully holds also for the Czech banks.

[150] *Commission Decision of 29 July 1998* giving conditional approval to the aid granted by Italy to Banco di Napoli, C(1998) 2495, p. 51.

In April 2001, the International Monetary Fund and World Bank mission conducted a Financial Sector Assessment Programme in the Czech Republic. The mission concluded that **the Czech financial system is near the completion of a fairly rapid phase of restructuring and reform, with particularly considerable progress achieved in improving the legislative and regulatory framework.**[151] It also concluded that the "***resilience of the Czech financial system to macroeconomic shocks and structural weaknesses has strengthened considerably***." Moreover, the mission also confirmed that **the competition for creditworthy clients is intense**.[152]

According to European Central Bank 2002 study, "***negative trends among the large commercial banks were suppressed successfully thanks to their privatisation, the clean up of banking operations and radical actions taken against unsound practices of Investiční a Poštovní banka***." [153] Since then, banking system soundness has been further consolidated. The amendment of the Act on Banks, which came into effect on May 1, 2002, further strengthened central bank's ability to conduct consolidated supervision over financial sector. In addition, in Progress Report of 2002, the European Commission noted that *"[p]rivatisation and consolidation have laid the foundations for a* ***solid financial sector which is able to fulfil its intermediation role.*** *"*[154]

Hence, we may conclude that the result of transformation and privatization of major banks is a sounder and more efficient banking system, ready for the competition in the Common Market.

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[151] *Czech Republic: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes*. IMF Country Report No. 01/113, Washington D.C.: International Monetary Fund, 2001, p.18.

[152] Ibid.

[153] *Financial Sectors in EU Accession Countries: The financial sector in the Czech Republic: an assessment of its current state of development and functioning*. Frankfurt: European Central Bank, 2002, p. 76.

[154] *2002 Regular Report from the Commission on Czech Republic's Progress towards Accession*. Brussels: European Commssion, 2002, p. 43. [On-line]. [Cit. 2004-03-02]. [Emphasis added].
URL: <Http://europa.eu.int/comm/enlargement/report2002/cz_en.pdf>.

PART II

Competition Policy Considerations

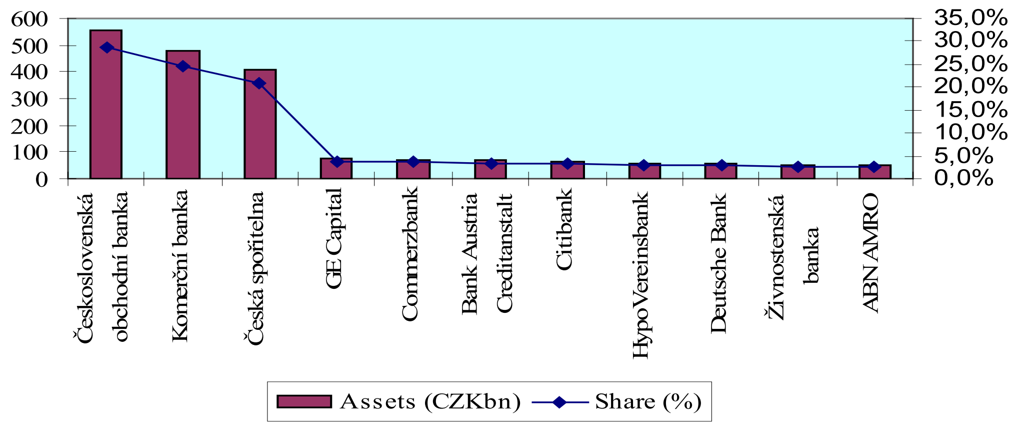
This part is organized as follows: In the first section, called *Banking Sector in Transition and Competition Policy Considerations*, the impact of the specific features of banking sector in transition[155] on competition and on competition policy will be discussed. The second section of this part, called *State Aid in Context of the EU Accession*, focuses on the issue of state aids into the banking sector, which has emerged in the negotiation of the Accession Agreement between the Czech Republic and the EU.

1. Banking Sector in Transition and Competition Considerations

Competitive banking market is essential for financial sector to function properly. Lack of competition limits the ability of stakeholders to shun poorly run banks, substantially undermines incentives for sound corporate governance and seriously impairs market discipline.

Some authors argue that the level of competition is reflected by the market structure. Exhibit 34 ranks 11 largest banks operating on the Czech market[156] by their asset size as of June 2001. In addition, Exhibit 35 illustrates that the concentration of overall banking assets in the four largest Czech banks is in-line with that observed in European and other CEE countries.

Exhibit 34 Czech banks by asset size as of June 2001

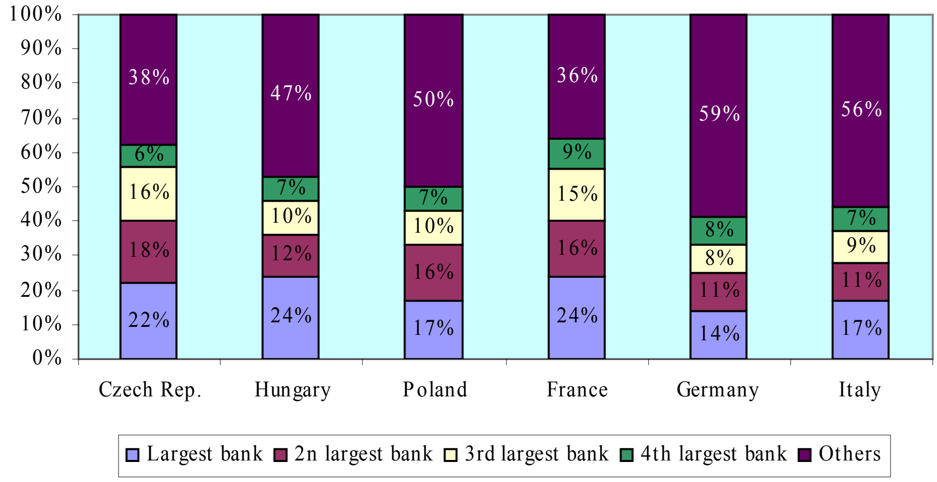


Source: Czech Banking Association

[155] As presented in chapter *Triggers and Causes of the Crisis*.

[156] Without KOB.

Exhibit 35 Concentration of Overall Banking Assets in 2001 (in %, end of period)



Source: Central Banks, Banks' Annual Reports

Nevertheless, *"[a] competitive financial market does not necessarily require a large number of institutions, nor exclude the presence of institutions with substantial market share: however, the market must be contestable in that market shares and prices are market-driven competitive outcomes and there is liberal entry and exit.*"[157] In addition, the banking market should not suffer from excessive state aid.

There is no doubt that even the financial sector should be subject to competition rules, including those relating to state aid. However, regarding the many specifics of the banking industry, there are many disputes over the level of sensitivity of the competition policy in this particular sector. The main specifics of the state aid regulatory policy in the banking sector can be summarized as follows:

- In contrast to non-financial companies, even poorly performing bank may be allowed to survive by state interventions because it is perceived *too big to fail*[158];

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[157] *Financial Stability in Emerging Market Economies: A strategy for the formulation, adoption and implementation of sound principles and practices to strengthen financial systems*. Report of the Working Party on Financial Stability in Emerging Market Economies, Basel: Bank for International Settlements, 1997, p. 37. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.bis.org/publ/gten02.pdf>.

[158] This is due to huge spillover effects that failure of such a bank can have on the rest of the banking sector. See e.g. *Commission Decision of 29 July 1998* giving conditional approval to the aid granted by Italy to Banco di Napoli, C(1998) 2495 or *Commission Decision of 20 May 1998* concerning aid granted by France to the Credit Lyonnais group, C(1998) 1454 and Commission *Decision 95/547/EC*.

- In case of financial distress of several banks, the State may initiate rescues of such institutions regardless of the size of individual banks.[159] This phenomenon is called *too many to fail*[160]*;*
- *"The regulator does not have full information regarding banks' financial states at the point where he chooses a policy."*[161]

Therefore, there is no doubt that state interventions in the form of state aid into troubled banks tend to distort the competitive process in developed economies and should be largely avoided. However, such conclusion may be questionable in transition economies taking into account the initial conditions and specific features of the post-communist banking sector that make restructuring of troubled banks particularly difficult to achieve.

At the beginning of transition, the "monobank" system inherited from central planning represented **the highest possible level of distortion of competition** in the banking market. After the formation of the two-tier banking system in early 1990, banking industry suffered from the lack of capital, high amounts of bad loans, unbalanced funding structure, insufficient technical equipment, poor management and inexperienced employees (as described in the first part of this paper). Moreover, **the process of entry into the banking sector was often poorly regulated**, with many newly established private banks lacking the necessary capital and skills to compete effectively with the dominant state-owned and privatized banks. Furthermore, *"[g]iven that banks are prone to runs and that bank failures can precipitate a financial crisis [...]* ***a simple hard budget constraint is not appropriate for banks even in mature market economies****, so it is likely that* ***bank restructuring will be even more difficult***

[159] Besides transition countries, such widespread rescues were carried out e.g. in Norway, Sweden, Japan or Chile.

[160] See e.g. Mitchell, J.: *Strategic Creditor Passivity, Regulation, and Bank Bailouts*. Working Paper No. 46, Michigan: William Davidson Institute, 1997, p. 2.
URL: <Http://eres.bus.umich.edu/docs/workpap-dav/wp46.pdf>.

[161] Mitchell, J.: Strategic *Creditor Passivity, Regulation, and Bank Bailouts*. Working Paper No. 46, Michigan: William Davidson Institute, 1997, p. 4-5. [On-line]. [Cit. 2004-03-02].
URL: <Http://eres.bus.umich.edu/docs/workpap-dav/wp46.pdf>.

***in transition** than the restructuring of enterprises for which uncompromising bankruptcy rules make more sense*."[162]

As the banking sector was unable to address these problems on its own, state financial injections became inevitable. It will be demonstrated that, based on assumption that such injections were limited to the strict minimum necessary and were not spent on predatory behavior to gain additional market share from their competitors[163], **this aid in context of transition (based on the EC, WB, EBRD and IMF recommendations) to all major banks, should not be principially viewed as aid distorting competition. On the contrary, taking the "monobank" system as a benchmark, these measures contributed to reduce such distortions of competition, as they were essential to build a sounder, competitive and more efficient banking system, ready for the competition in the international context, without a threat of destabilizing banking sector in the Common Market after the EU accession.**

1.1 Was Aid Limited to the Strict Minimum Necessary?

One of the conditions that must be fullfiled in order to assess state aid as compatible with acquis communautaire is that each aid measure must be limited to the strict minimum necessary to allow viability of an ailing company.[164] It is evident from previous chapters that the adopted solution of restructuring from a "monobank" system into the competitive banking sector was not very efficient. Most likely, by e.g. earlier direct privatizations, and faster and more complex legal reforms, the costs of banking system restructuring could have been substantially reduced. Therefore, from this broad view, the answer would be no, the costs of series of aid measures were not limited to the strict minimum necessary in the Czech Republic and, most likely, nowhere in the world. However, from the competition policy view, **we do not judge the method, sequence or the overall efficiency of the restructuring.**

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[162] Fries, S., Neven, D., Seabright, P.: *Bank Performance in transition economies*. Working Paper No. 76, London: European Bank for Reconstruction and Development, 2002, p. 1. [On-line]. [Cit. 2004-03-02]. [Emphasis added].

URL: <Http://www.ebrd.org/pubs/econ/workingp/76.pdf>.

[163] See chapter *Was Aid Limited to the Strict Minimum Necessary?* for analysis of these assumptions.

[164] For more details see *Annex II - Acquis Communautaire related to State aid control.*

Instead, we apply a narrow view and assess individual aid measures as proposed by the aid grantor to decide whether they cause unnecessary distortions of competition. Therefore, a measure that is limited to the strict minimum necessary from the competition policy view may not be limited to the minimum from a broader view.

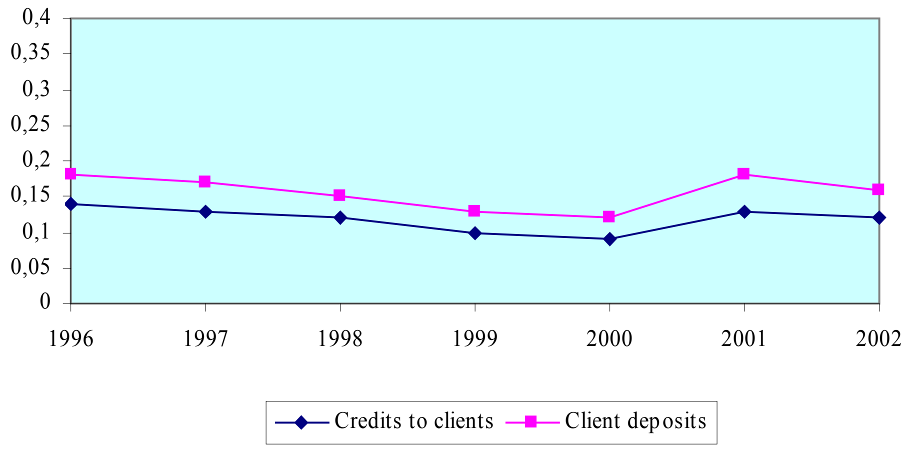
To test whether aid in question is proportional and hence does not cause unnecessary distortions of competition, we would need to collect very detailed data about each aid measure and its impact on the banking sector. However, a large portion of such data contains business secrets and thus, it is classified.[165] Moreover, in case of aid to small banks, it is extremely difficult to trace the impact of the aid measures on the banking sector without precise data. Hence, the analysis carried out in this chapter is limited only to aid measures granted to big banks (CSOB/IPB, CS, KB) and to the publicly available data and, thus, it is not comprehensive but rather indicative.

In chapter *Uniqueness of the Banking Sector* as well as in the previous chapter, we stressed the **necessity for sensitive application of competition policy to banking industry.** Specifically, in applying state aid rules in this industry, we should bear in mind that **depositors' confidence in banking sector is essential for its operation**. If, for any reason, the depositors' confidence diminishes, such situation can result in situation in which banks are unable to meet their obligations and such situation might jeopardize the stability of the whole economy. **Therefore, state aid to rescue bank in difficulties should on one hand be sufficient to ensure depositors' confidence, and, on the other hand, it should not be excessive.** Obviously, it is extremely difficult to determine the precise amount that fulfills the above-mentioned criteria. However, the author benefits from the fact that he pursues an *ex post* analysis and therefore, for the purposes of this paper, the actual reflection of aid measures on the level of competition in the banking sector is being tested. This approach deviates from the approach of the national competition authority and the Commission, who are required to pursue standard analysis as of the date the measures were granted or notified. However, their statutory access to all relevant data regarding the aid measures and the banking sector allows them to test proportionality of aid by means of economic projections and hence, we should arrive to similar results.

[165] All relevant information has been, however, collected by the grantors of aid measures in question and available to both OPC and Commission for their assessments.

By analyzing development of various indicators (Herfindahl indices, market shares, net interest margins, capital adequacy ratios and portfolio quality indicators) in the following section, we will seek for evidence showing that aid measures were misused by the beneficiaries in order to gain higher market shares. Exhibit 36 shows one of the measures of market competition - Herfindahl indices[166] to depict the level of market competition in the banking sector.[167]

Exhibit 36 Herfindahl indices of market competition (end of period)



Source: Czech National Bank

The Herfindahl index of market competition for two groups of banking transactions – client loans and client deposits - suggests a further intensification of market conditions until end of 2000. It is worth mentioning that even the collapse of IPB and its subsequent sale to CSOB did not result in an overall increase of the indices. The rise of the indices between end of 2000 and end of 2001 is caused partly by conversion of KOB into a non-bank institution (effect on credit market) and by the merger of HypoVereinsbank CZ and Bank Austria Creditanstalt Czech Republic (effect on both credit and deposit markets). In 2002 the Herfindahl index on the credit market decreased, mainly as a result of decline in lending by

[166] The Herfindahl index of market competition can take values in the range of 0 to 1, where 1 represents a totally uncompetitive environment. Competition on the market increases with decreasing Herfindahl index value. Please note that KOB was included into the calculation of Herfindahl index.

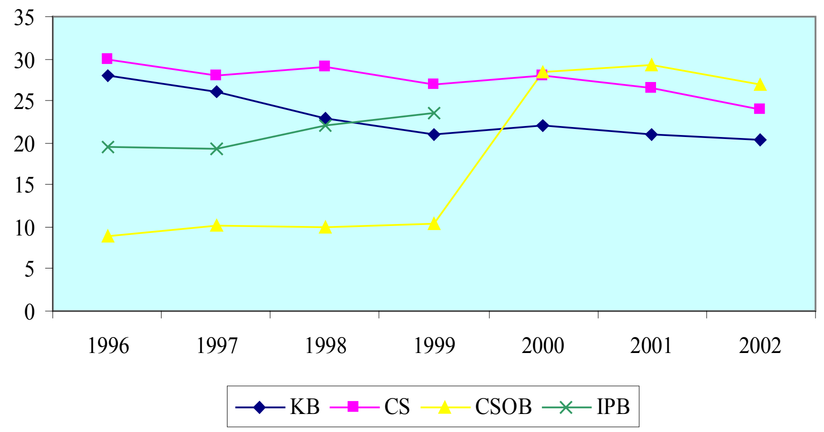
[167] Based on *Banking Supervision in the Czech Republic 2002.* Prague: Czech National Bank, 2002. [On-line]. [Cit. 2004-03-02].

URL: <Http://www.cnb.cz/en/pdf/bd_2002_a.pdf>.

several of the large banks. There was also a decrease in the index on the deposit market, where the large banks and, in particular, the foreign bank branches retreated from their previous positions. Therefore, this test does not provide us with evidence that state aid resulted in a decrease in the level of competition.

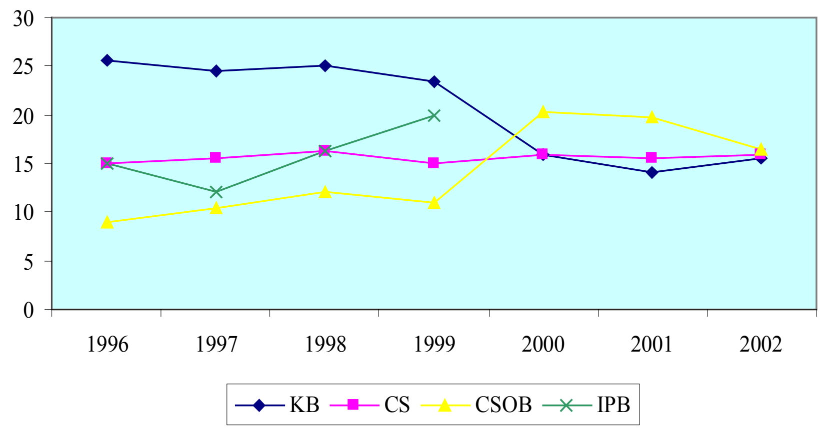
Neither the following graphs (Exhibit 37 and Exhibit 38) provide us with such evidence, as the market shares on the both main relevant markets (client deposits and client loans) of banks in question have been relatively stable or decreased since the aid measures were implemented.

Exhibit 37 Market shares - Client deposits (%)



Source: Banks' Annual Reports, own calculations

Exhibit 38 Market shares - Client loans (%)

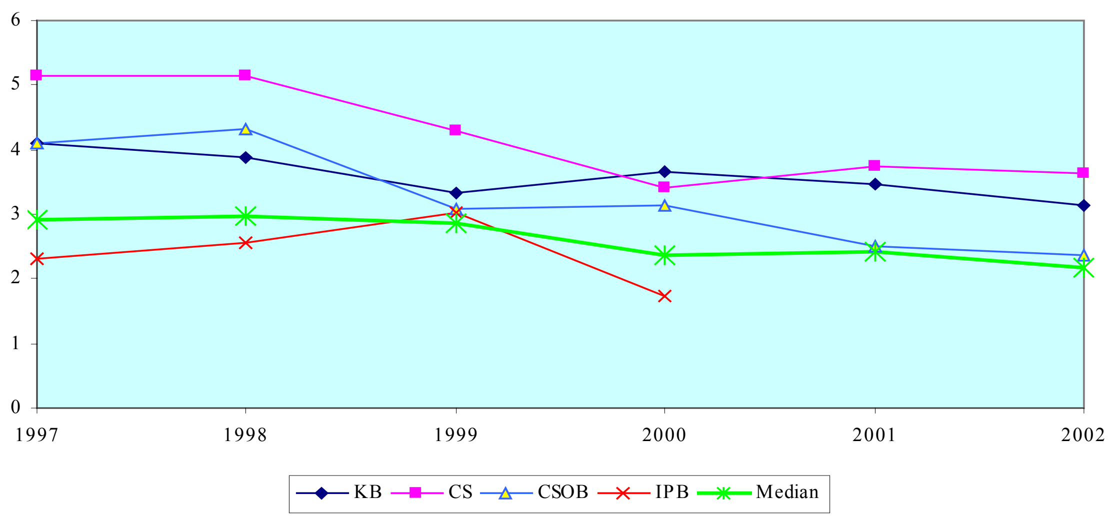


Source: Banks' Annual Reports, own calculations

We will now focus on the development of banks' net interest margins. There are at least two possible effects of state subsidies on banks' net interest margins in the short/medium run. The first effect is based on the empirical finding that highly capitalized banks tend to have higher margins, which is consistent with theories stressing that highly capitalized banks can charge more for loans and pay less on deposits because they face lower bankruptcy risks. However, according to the recent World Bank regression results[168], controlling for macro, regulatory, and institutional environment of the Czech Republic, even a 100 % increase in bank equity divided by total assets induces a boost in the net interest margin only of 0.1 of a percentage point.

Therefore, we will turn to the second effect, which assumes that a bank benefiting from a state subsidy may in the short/medium run engage in predatory lending practices (e.g., charging less for loans). Exhibit 39 demonstrates that CS, CSOB and KB were above the median of the whole Czech banking sector during the whole period analyzed (1998-2002), whereas the IPB was almost exclusively bellow the median (with one exception in 1999, when IPB's net interest margin was 0.17 p.p. above the median). These data do not support a hypothesis that banks in question (CS, CSOB or KB) mis-used aid measures granted to them in order to gain higher market shares by predatory lending practices.

Exhibit 39 Net interest margins (%, end of period)



Source: Bankscope

[168] Based on Demirguc-Kunt, A., Laeven, L., Levine, R.: *The Impact of Bank Regulations, Concentration, and Institutions on Bank Margins*. World Bank Policy Research Working Paper 3030, Washington D.C.: World Bank, 2003. Bank-level data across 72 countries and over 1,400 banks are analyzed in this study.

We will now focus on the development of capital adequacy ratio. "*Bank capitalization is positive and significantly associated with the real growth in customer loans. On the surface, this association suggests that those banks that are more financially sound are attracting the resources that enable them to expand their customer loans.*"[169]

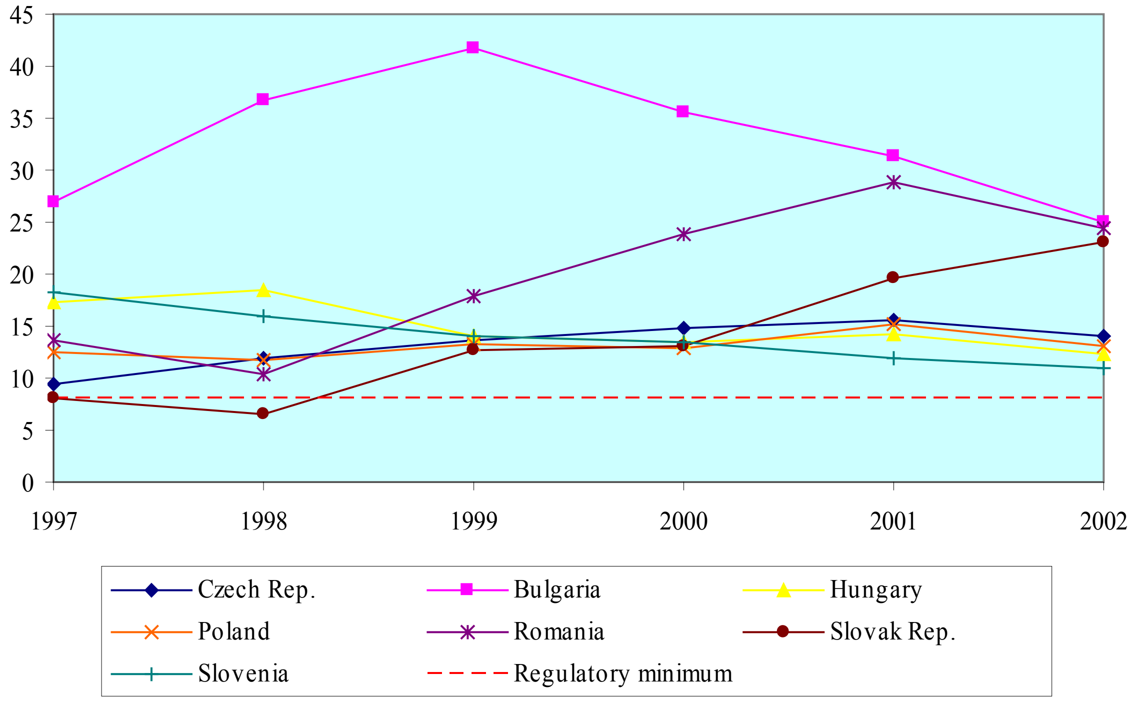
As demonstrated in Exhibit 40, capital adequacy ratios in excess of the minimum regulatory requirement of 8% established under the Basel Accord are common features of CEE banks. "*However, the existing capital adequacy regulation does not address market, interest rate, exchange rate, and trading risk, which are becoming increasingly important with the internationalization of the Czech economy and the development of new financial instruments. […] As a cushion against these risks, the* ***BIS recommended in 1997 that the capital adequacy ratio in emerging and developing countries be held above 12 percent.***"[170]

The average capital adequacy ratio of the Czech banking sector was at 14.1% at the end of 2002, which is higher than Eurozone average (9.5%), though at the lower end of CEE peers. Given the specific features of transition economies, this essentially reflects the additional risk associated with operating in these economies rather than the aid granted was excessive. Moreover, taking into account the regional market practice (as demonstrated in Exhibit 40), the privatization process and uncertainty on future provisioning needs, **we cannot consider the level of capital adequacy higher than regulatory minimum and lower than CEE average peer as evidence that aid measures have been excessive**.

[169] Bokros, L., Fleming, A., Votava, C.: *Financial transition in Europe and Central Asia: challenges of the new decade*. Washington D.C.: World Bank, 2001, p. 180. [On-line]. [Cit. 2004-03-02]. [Emphasis added].
URL: <Http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2001/12/11/
000094946_01112204191337/Rendered/PDF/multi0page.pdf>.

[170] *Czech Republic: Selected Issues*. IMF Staff Country Report No. 98/36, Washington, D.C.: International Monetary Fund, 1998, p. 86-87. [On-line]. [Cit. 2004-03-02]. [Emphasis added].
URL: <Http://www.imf.org/external/pubs/ft/scr/1998/cr9836.pdf>.

Exhibit 40 Capital Adequacy Ratio development in CEE countries (%, weighted average, end of period)

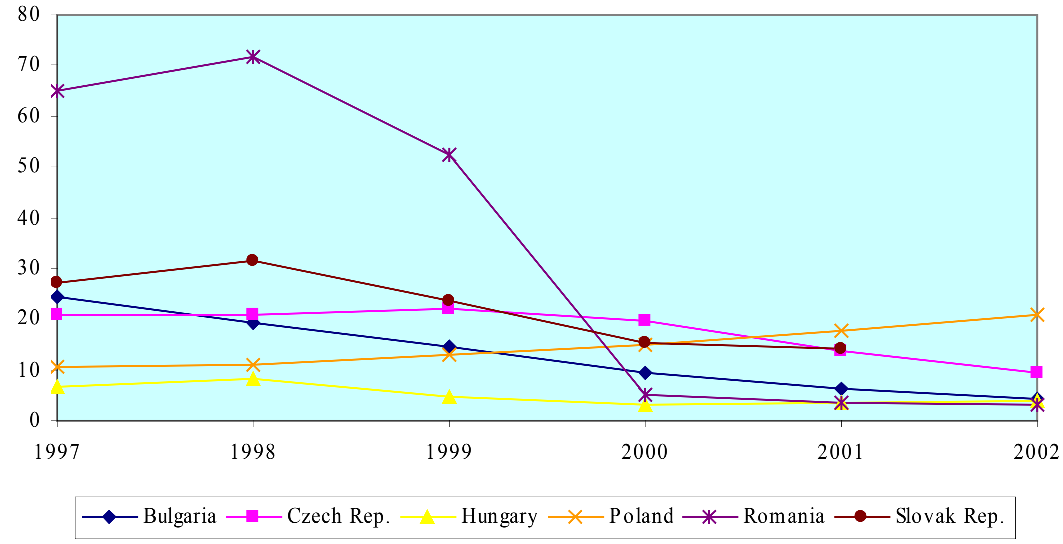


Source: International Monetary Fund – Financial Soundness Indicators

Hence, we will analyze the credit portfolio quality. As depicted in Exhibit 41, nonperforming credit portfolio remains relatively high. The average NPLs/Loans ratio of the Czech banking sector was above 20% until the end of 2000, which was higher than average of the CEE peers. As a point of reference, Eurozone average of NPLs/Loans amounted to 3.5% in 2001. Although the definition of classified loans may be broader than that of NPL, and local regulations may differ, this illustrates in relative terms the considerable burden on the balance sheets of the Czech banks at the time.[171] The fact that, even after aid measures had been implemented, the portfolio of bad loans remained substantially larger than its Eurozone peers and also higher than its CEE peers, **also does not bring evidence that aid measures have been excessive.**

[171] Please note that the increase in 1999 reflects the impact of the regulatory changes to how loans were classified and provisioned.

Exhibit 41 Nonperforming loans to total loans (in %, end of period)[172]



Source: International Monetary Fund – Financial Soundness Indicators

We will now focus on each bank individually to seek for evidence that aid granted was excessive.

1.1.1 KB

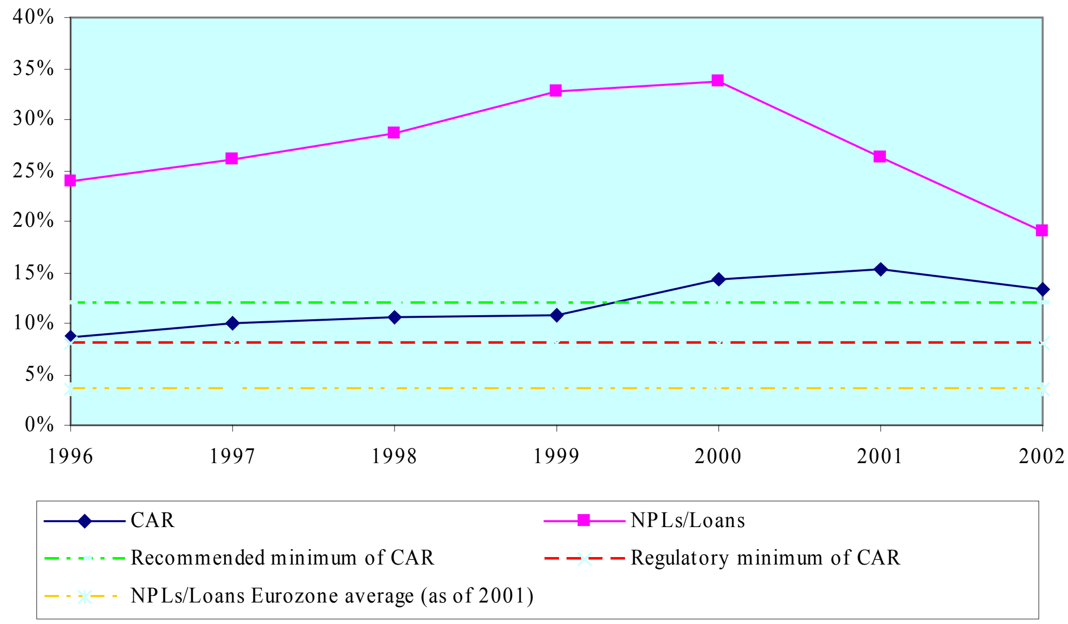
The following graph shows that KB's NPLs/Loans ratio reached its maximum (above 30 %) in 2000. Although since 2000 it steadily decreases, it is still well above its CEE peers (see Exhibit 41) as well as its Eurozone peers.

As far as prudency requirements are concerned, KB's capital adequacy ratio was slightly above the minimum capital adequacy regulatory minimum until 1999. However, it was still lower than the minimum level recommended by the Bank for International Settlements (BIS). Therefore, the 1999 bail-out was not excessive. The measures implemented in 2000 (capital increase, bail-out, tax relief) raised the capital adequacy ratio (CAR) to the level recommended by BIS, i.e. slightly above 12 %. The KB's level of CAR is fully in line with its CEE peers (see Exhibit 40).

[172] Nonperforming loans are defined as classified credits less watch credits (which, owing to their minimal degree of risk are not considered classified credits in many countries).

Thus, we cannot conclude from the above analysis that the series of measures with impact on results of KB in fiscal year 2000 were excessive. The same conclusion applies also to the state guarantee on a ring-fenced portfolio on losses realized between December 31, 2000 and December 31, 2003.

Exhibit 42 Capital adequacy ratio and evolution of NPLs – KB (end of period)



Source: Annual Reports

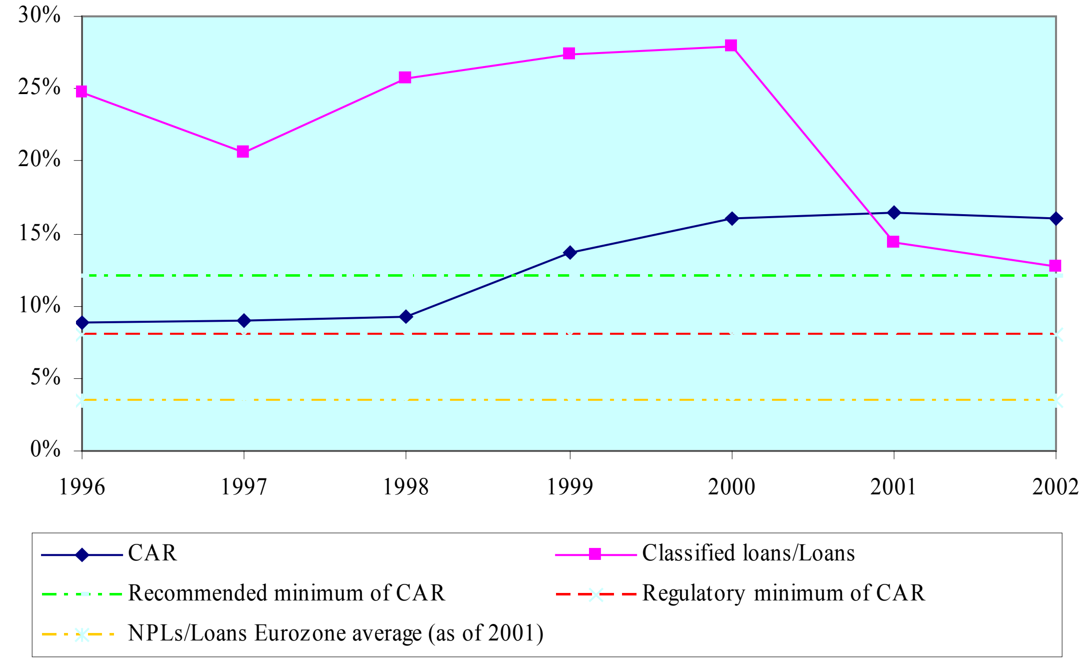
1.1.2 CS

The next graph demonstrates that even after 1998 and 1999 bail-outs, the CS's NPLs/Loans ratio reached almost 30 % in 2000. By 2002, the ratio dropped to 13 % as a result of improved prudency policy implemented by the strategic investor in CS and due to put-options realized under the ring-fencing guarantee. These levels were nevertheless well above both the CEE (see Exhibit 41) and Eurozone peers.

Regarding prudency requirements, CS's capital adequacy ratio was slightly above the capital adequacy regulatory minimum until end of 1998. Therefore, it is apparent that without the subordinated debt and 1998 bail-out, the bank would not fulfill the 8 % regulatory criterion. The 1999 capital increase and bail-out contributed to the increase in CAR to the level recommended by BIS, i.e. slightly above 12 %. Even after the ring-fencing agreement, which constitutes part of the privatization agreement, the level of bank's CAR is comparable with its CEE peers (see Exhibit 40).

As a result, we cannot conclude from the above analysis that the aid measures related to CS's restructuring and privatization were excessive.

Exhibit 43 Capital adequacy ratio and evolution of NPLs – CS (end of period)



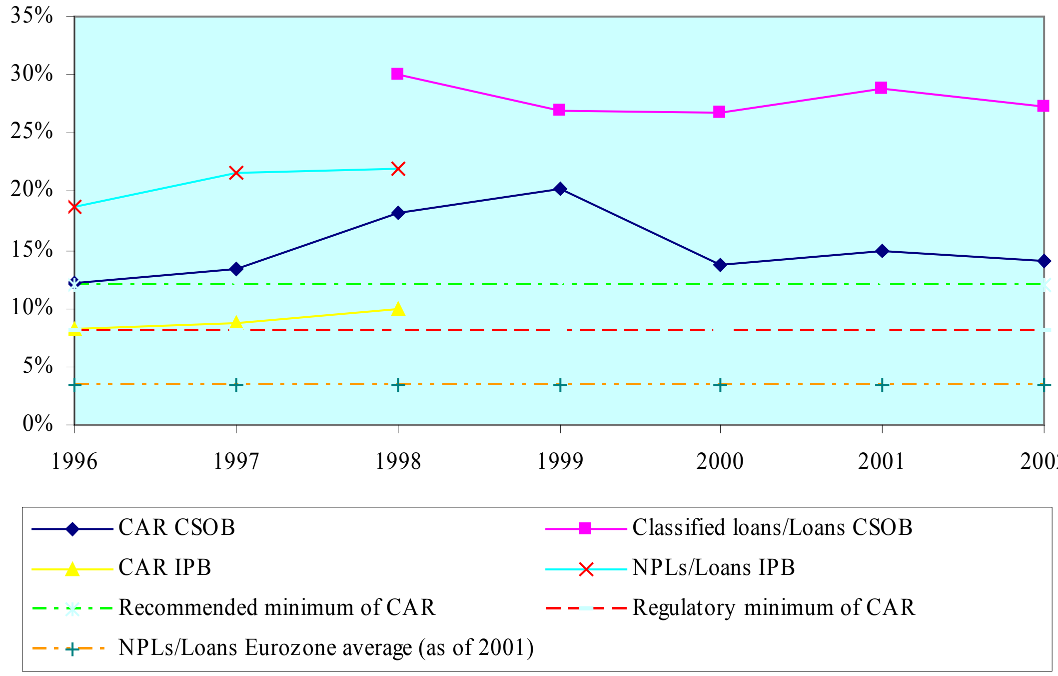
Source: Annual Reports

1.1.3 CSOB/IPB

Exhibit 44 reveals that the level of CSOB's NPLs/Loans ratio[173] remained in the same range (around 30 %), well above both the CEE (see Exhibit 41) and Eurozone peers, even after the IPB takeover. In addition, CSOB's capital adequacy ratio dropped from 20 % to level just slightly above the minimum level recommended by BIS shortly after IPB takeover. Hence, the above analysis does not provide us with arguments in favor of hypothesis that the aid measures related to IPB takeover were excessive.

[173] This ratio is based on CSOB's methodology, which is more conservative than CNB's methodology.

Exhibit 44 Capital adequacy ratio and evolution of NPLs – CSOB/IPB (end of period)[174]



Source: Annual Reports

Naturally, we cannot conclude from the above analyses that aid measures granted to CSOB, CS and KB were limited to the strict minimum necessary, as there are a number of other tests we would have to carry out in order to arrive to this conclusion (or to reject it). However, as mentioned in the beginning of this chapter, a large portion of data, necessary for these tests, contains business secrets and thus, it is classified. Therefore, we will conclude this section by stating that, based on the tests performed, we have not found clear evidence that aid measures granted to CSOB, CS and KB were not limited to the strict minimum necessary.

1.2 Foreign banks entry and competition considerations

Certainly, banks that did not benefit from any state aid measure (i.e. mainly foreign banking institutions) may argue that their position was weakened by such measures. We will focus on this issue in this chapter.

In the first section, we will analyze implications of foreign banks' presence on both competitiveness and stability of the Czech banking sector. We will begin by explaining the

[174] Creative accounting of the IPB resulted in refusal by the auditors – Ernst and Young – to complete the 1999 audit. Hence, IPB's data for 1999 are not shown in the graph.

main benefits of opening-up the financial market to foreign banking institutions. Then, we will explore factors that drive foreign banks to establish their presence in a transition economy and describe foreign banks penetration in the Czech Republic. Finally, we will discuss the nature of competition between foreign and domestic banks.

1.2.1 Benefits of Foreign Bank Entry

Benefits cited in relation to transition economies are numerous:

- As banking activity is based largely on *tacit knowledge*, liberalization efforts are driven by the need for importing and accumulation of knowledge, expertise and technology;
- It is also expected that foreign banks exert competitive pressure on domestic financial institutions[175], which are thus forced to increase their efficiency of resource allocation and raise their standards, practices and range of products;
- The increased efficiency may therefore contribute to lower costs of debt financing for domestic borrowers[176];
- "*During turbulent times, foreign banks can also provide a "safe haven" for depositors and a stable source of funds compared to domestic banks*"[177];
- Foreign banks may also encourage better regulation, supervision and accounting standards[178];
- As domestic banks desperately lacked capital at the beginning of transition, it was expected that well-capitalized foreign banks would serve as a source of finance at least for healthy domestic firms;

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[175] However, this effect may be limited to the market segment in which the foreign banks are present.

[176] Haas, R., Lelyveld, I.: *Foreign Bank Penetration and Bank Credit Stability in Central and Eastern Europe*. Research Series Supervision no. 43, Amsterdam: De Nederlandsche Bank, 2002, p. 5. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.dnb.nl/toezicht/pdf/toez_reeks43.pdf>.

[177] Mero, K., Valentinyi, M.: *The Role of Foreign Banks in Five Central and Eastern European Countries*. Budapest: National Bank of Hungary, 2003, p. 9. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.cnb.cz/pdf/foreign_bank_MK-VEM.pdf>.

[178] See e.g. Haas, R., Lelyveld, I.: *Foreign Bank Penetration and Bank Credit Stability in Central and Eastern Europe*. Research Series Supervision no. 43, Amsterdam: De Nederlandsche Bank, 2002, p. 5. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.dnb.nl/toezicht/pdf/toez_reeks43.pdf>.

- Presence of foreign banks contributes to establishing confidence of other foreign investors in the non-bank sector and also reduces their entry-costs.[179]

In sum, transition economies may potentially benefit from entry of foreign banks in terms of both the efficiency and the stability of the domestic banking system. In the next section, the author will discuss what actually drives foreign banks institutions to transition economies.

1.2.2 What Drives Foreign Banks to Transition Economies?

There are a number of reasons why foreign banks enter into transition economies. Typically:

- Foreign banks **follow their clients abroad** (either their trade or investment) as they do not want to loose them[180];
- Foreign banks feel an **urgent need for effective monitoring**. As financial markets in transition economies are less developed and mature, the only way to ensure effective monitoring is a physical[181] presence[182];
- **New business opportunities**. Deregulation in foreign banks' home countries forces banks to seek and exploit new business opportunities even abroad.[183]

[179] Wachtel, P.: Role of Foreign Banks in the Central European Economies in Transition. In: Haas, R., Lelyveld, I.: *Foreign Bank Penetration and Bank Credit Stability in Central and Eastern Europe*. Research Series Supervision no. 43, Amsterdam: De Nederlandsche Bank, 2002, p. 5. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.dnb.nl/toezicht/pdf/toez_reeks43.pdf>.

[180] See e.g. Williams, B.: *The* Defensive Expansion Approach to Multinational Banking: Evidence to Date. In: Naaborg, I. et al.: *How Important are Foreign Banks in the Financial Development of European Transition Countries?* Groningen: University of Groningen, 2002, p. 15. [On-line]. [Cit. 2004-03-02].
URL: <Http://econwpa.wustl.edu/eps/if/papers/0209/0209005.pdf>.

[181] As *tacit knowledge* is an inherent element of the banking business, delegation of monitoring is not an option.

[182] See e.g. Mero, K., Valentinyi, M.: The *Role of Foreign Banks in Five Central and Eastern European Countries*. Budapest: National Bank of Hungary, 2003, p. 8. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.cnb.cz/pdf/foreign_bank_MK-VEM.pdf>.

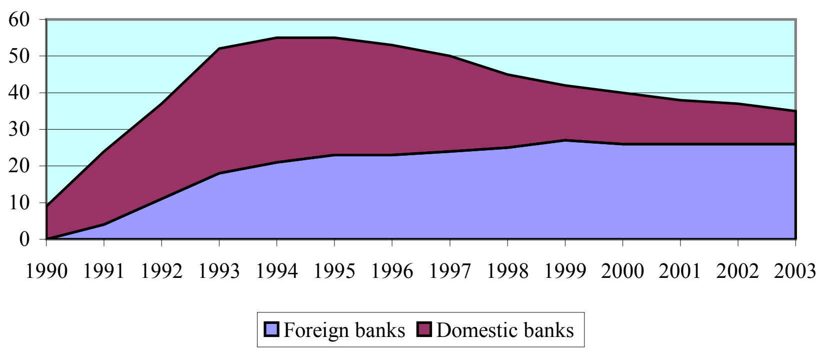
[183] See e.g. Clarke, G., Cull, R., Peria, S., Sánchez, S.: *Foreign Bank Entry: Experience, Implications for Developing Countries, and Agenda for Further Research.* Background paper for the World Development Report 2002: Institutions for Markets, Washington D.C.: World Bank, 2001, p. 8. [On-line]. [Cit. 2004-03-02].
URL: <Http://econ.worldbank.org/files/2520_wps2698.pdf>.

Having described the main reasons that drive foreign banks into transition economies, we will analyze the level of foreign bank penetration in the Czech Republic.

1.2.3 Foreign Bank Penetration and Performance in the Czech Republic

Foreign banks have been allowed to establish subsidiaries in the Czech Republic, and acquire stakes in domestic banks since 1990, whereas branches have been allowed since 1992. The graphs below show a rapid increase in all penetration measures.

Exhibit 45 Number of foreign and domestic banks[184]



Source: Czech National Bank

Specifically, Exhibit 45 illustrates that the consolidation process in the Czech domestic banking sector resulted in a declining number of domestic banks. "*This process is only partly the result of the privatization of state-owned banks to foreign strategic investors. It is also related to the economic downturn starting in 1997 and the stricter loan classification and provisioning rules the authorities introduced after the currency crisis of May 1997*." [185]

Exhibit 46 and Exhibit 47 show that during the recession years 1998 and 1999, and also during 2000 both total domestic assets and domestic private credit decreased sharply. However, this development was partially mitigated by an increase in foreign bank assets and private credit during those same years.[186]

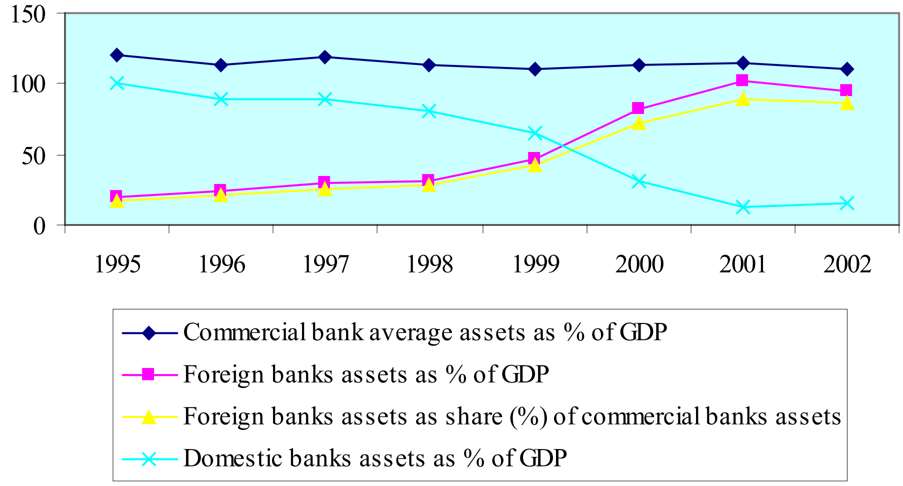
[184] For the purpose of this analysis, the author uses the following definitions: *foreign banks*: at lest 50% of the shares is foreign-owned, *domestic banks*: not foreign banks.

[185] Haas, R., Lelyveld, I.: *Foreign Bank Penetration and Bank Credit Stability in Central and Eastern Europe*. Research Series Supervision no. 43, Amsterdam: De Nederlandsche Bank, 2002, p. 22. [On-line]. [Cit. 2004-03-02].

URL: <Http://www.dnb.nl/toezicht/pdf/toez_reeks43.pdf>.

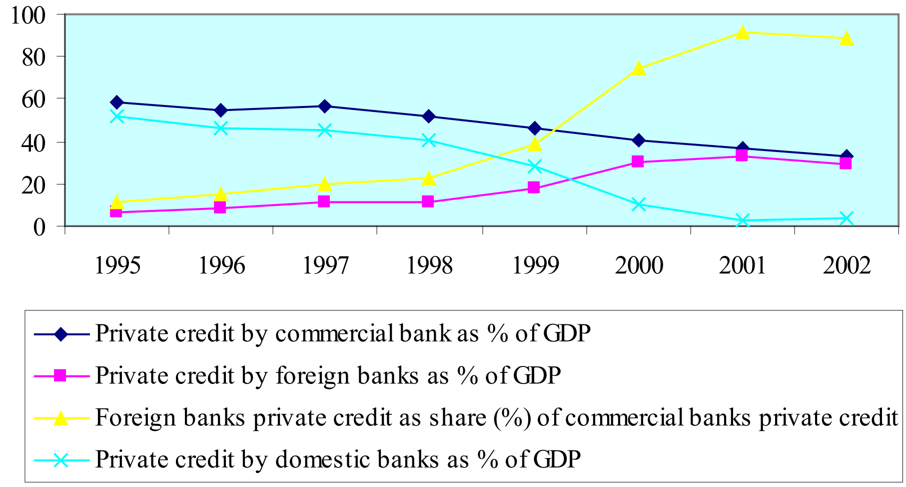
[186] Although in 1999 this increase was not enough to offset the declining amount of domestic assets fully, in 2000 it was large enough to compensate the declining trend in total banking assets.

Exhibit 46 Foreign banks' assets



Source: Czech National Bank

Exhibit 47 Foreign banks' private credit



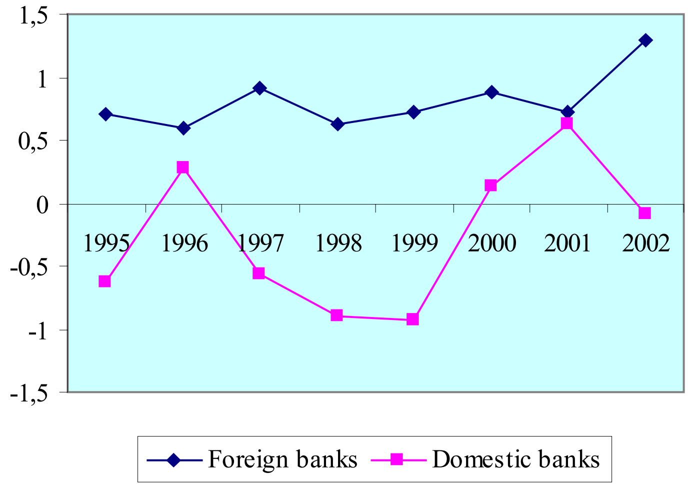
Source: Czech National Bank

"[T]he increase in foreign bank subsidiaries' credit reflects the fact that foreign banks were not scared off by problems in the host country but instead expanded their local activities."[187] In addition, such local activities proved to be relatively profitable, at least in comparison with poorly performing domestic banks (see Exhibit 48 and Exhibit 49).

[187] Haas, R., Lelyveld, I.: *Foreign Bank Penetration and Bank Credit Stability in Central and Eastern Europe.* Research Series Supervision no. 43, Amsterdam: De Nederlandsche Bank, 2002, p. 24. [On-line]. [Cit. 2004-03-02].

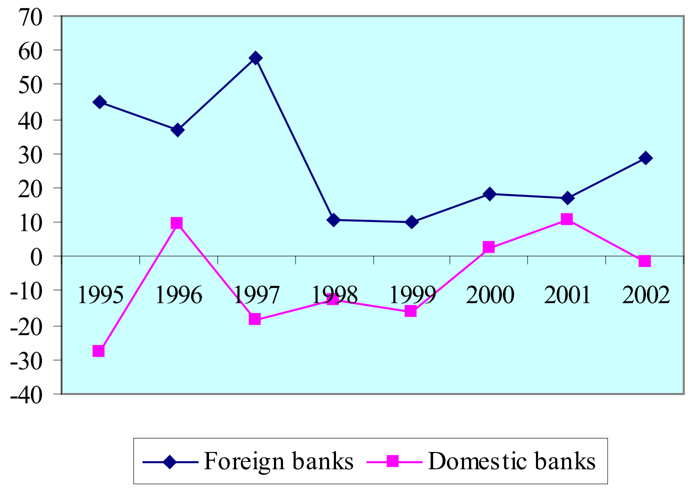
URL: <Http://www.dnb.nl/toezicht/pdf/toez_reeks43.pdf>.

Exhibit 48 Return on average assets (ROAA) of foreign and domestic banks (%)



Source: Czech National Bank

Exhibit 49 Return on average equity (ROAE) of foreign and domestic banks (%)



Source: Czech National Bank

1.2.4 Nature of Competition with Domestic Banks

In this section, we will discuss the specific nature of foreign banks' competition with domestic banks. Obviously, state injections into domestic banks did not tend to strengthen foreign banks' position in the market[188]; they rather contributed to maintain a special position

[188] However, **foreign financial institutions may have benefited from state interventions indirectly, as the state prevented contagion that would have serious devastating impact also on these foreign banks**.

of the incumbents. **However, foreign banks also enjoyed a "special position" in the market as demonstrated below.**

Despite the arguments for both opening up financial sector to foreign entities and motives driving foreign banks to transition countries (as presented in the previous sections) seemingly imply a higher level of competitiveness in the banking industry, there are also some negative aspects, which allow foreign banks to exploit a stronger competitive position in the Czech banking market than should be the case in a developed country (at least in the short term).

To begin with, **domestic banks needed time to mature** (the so-called infant industry argument). "*The essence of this argument is that even though foreign entry may lead to a more efficient domestic banking system, which may have important positive welfare implications in the long run, this may be offset by the negative effects in the short run.*" [189] **Domestic banks that are not able to cope with the increased competitive pressures due to distortion of their competitive position**[190], which is inherent to transformation from command to market economy, **may for instance fail and lead to periods of severe financial instability, resulting in further distortions of competition**. Moreover**, foreign banks tend to strengthen their position by cherry-picking**: as foreign financial institutions offer more sophisticated products and services without burden of inherited non-performing loans and other negative features typical to domestic banking sector in transition, they can easily acquire the best clients carrying the lowest risks, and thus they **make it more difficult for the domestic banking systems to gain strength and compete with them.** [191]

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[189] Haas, R., Lelyveld, I.: *Foreign Bank Penetration and Bank Credit Stability in Central and Eastern Europe.* Research Series Supervision no. 43, Amsterdam: De Nederlandsche Bank, 2002, p. 8. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.dnb.nl/toezicht/pdf/toez_reeks43.pdf>.

[190] This may especially be the case when domestic banks are still burdened by large portfolios of bad debt. See e.g. Buch, C.: Opening up for Foreign Banks — Why Central and Eastern Europe can Benefit. *Economics of Transition* 5(2), 1997, pp. 339.

[191] Mero, K., Valentinyi, M.: *The Role of Foreign Banks in Five Central and Eastern European Countries*. Budapest: Natinal Bank of Hungary, 2003, p. 16. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.cnb.cz/pdf/foreign_bank_MK-VEM.pdf>.

In addition, the transition economies offered in the early 1990s a **far more favorable regulatory and supervisory environment for foreign banks than their own home countries did**, as these countries only gradually brought their regulations and supervisory bodies into alignment with international standards.[192] "*Favourable regulation and looser supervision, coupled with more liberal licensing and a privatisation practice that was more attractive for foreigners, gave a considerable regulatory impetus to foreign banks to increase their involvement in the [Central Europe] region*."[193] [194]

In sum, **the underlying reasoning is that domestic banks, suffering from absolute distortion of competition during the command economy era,** learned to operate in a completely new environment, while bearing debts from the old era[195], whereas foreign banks present at the Czech market benefited from undeveloped regulation and supervision. **Hence a level playing field for just competition was not ensured**. Therefore, the incurrence of adequate (i.e., not excessive) aid measures to overcome these deficiencies was inevitable for the transition countries and **in principle should not be viewed as state aid distorting competition in the financial market**. On the contrary, such aid contributed to creation of a **level playing field allowing just competition between both domestic and foreign banking institutions and taking the "monobank" system as a benchmark, these measures contributed to reduce distortions of competition.** In addition, **foreign financial institutions benefited from state interventions indirectly, as the state prevented contagion that would have serious devastating impact also on these foreign banks**. As mentioned in the previous section, **the result is a sounder, competitive and more efficient banking system, ready for the competition in the international context, without a threat of destabilizing banking sector in the Common Market after EU accession.**

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[192] E.g. in terms of credit risk capital requirements, market risk capital requirements, large exposure limits or consolidated regulation.

[193] Mero, K., Valentinyi, M.: *The Role of Foreign Banks in Five Central and Eastern European Countries*. Budapest: Natinal Bank of Hungary, 2003, p. 18. [On-line]. [Cit. 2004-03-02]. URL: <Http://www.cnb.cz/pdf/foreign_bank_MK-VEM.pdf>.

[194] This is documented in section *Foreign Bank Penetration in the Czech Republic*.

[195] Please refer to section *Triggers and Causes of the Crisis* for all relevant characteristics, which discriminate domestic banks in comparison with foreign banks.

2. State Aid in Context of the EU Accession

The issue of compliance with the Community State aid rules has been one of the hardest and most controversial topics during the negotiations of the Act of Accession, specifically for the Czech banking sector. In principle, EU state aid law in connection with the Accession Treaty could have resulted in an obligation either to reimburse part of that aid, granted to the Czech banking sector and not approved by the European Commission, after accession, or to implement necessary compensatory measures. Litigation against Commission decisions would be extremely costly and long, thus bringing an unacceptable uncertainty into the banking sector.

2.1 State Aid in Context of EU Accession – the New Member State's View

Unfortunately, the language of the Accession Agreement[196], namely the part related to public aid, includes a provision that is very unfavorable for the banking sector. Under this agreement, the **European Commission had an unlimited power to review all cases of state aid in the Czech banking sector, even if they had been approved by the respective Czech state institutions,** i.e. the Office for the Protection of Competition (OPC) or the Ministry of Finance[197]. Only cases of public aid approved by the Commission are, upon accession of the Czech Republic to the EU, considered to be "*existing aid*" and the Czech Republic may continue granting such aid.[198] The "**existing aid**" is defined as follows:

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[196] The *Treaty of Accession 2003* of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/enlargement/negotiations/treaty_of_accession_2003/
table_of_content_en.htm>.

[197] Before the Czech *State Aid Act* of February 24, 2000 entered into force (May 1, 2000).

[198] However, even *existing aid* is subject to future regulation, i.e., the Commission may ask the Member State to amend the aid for the future. For example, in the German and Austrian cases concerning the so-called Anstaltslast and Gewährträgerhaftung for Landesbanken, it was ordered that existing aid in the form of a Government guarantee was incompatible with EU rules and should be phased out. For more details, see Schohaj, R.: Phase out of State guarantees in favour of the Austrian public banks. *EC Competition Policy Newsletter*, Number 2/2003, p. 84-85 and Bufton, R.: Where state guarantees supporting commercial banking activities distort competition, they must be abolished. *EC Competition Policy Newsletter*, Number 2/2003,

- **Aid measures put into effect before December 10, 1994;**
- **State aid listed in the Annex to the Accession Agreement;** measures can be put on this list and qualify as "*existing aid*" only if two conditions are met: first, the state aid monitoring authority must have communicated the measure to the Commission before autumn 2002, and second, the Commission must not have objected to the measure.
- **State aid measures which, prior to the date of accession, were assessed by the State aid monitoring authority of the new Member State** (i.e. OPC) **in so-called *interim procedure* and found to be *still applicable after accession* and to which the Commission did not raise an objection on the ground of serious doubts related to compatibility with the common market.**

If an aid measure (granted pre-accession **and still applicable after accession**) does not meet any one of the above-mentioned criteria (i.e., if it is not existing aid), it is considered to be new aid and may be therefore reviewed by the European Commission post accession and subject to the recovery procedure. "*In essence, the corollary of qualifying a state aid measure as 'existing aid' — as opposed to 'new aid' — is that the Commission can only alter it as for the future. Under the procedure applicable in such cases, the Commission may propose 'appropriate measures' (i.e. modifications to or the abolition of the aid measure) to the Member State concerned, pursuant to Article 88(1) of the EC Treaty. This implies in particular that aid amounts disbursed in the past under existing aid measures are protected from an order of recovery*."[199] **Hence, existing aid measures enjoy better legal protection.**

Since the Commission objected to list the state aid granted to the Czech banking sector in the Annex to the Accession Treaty, **the Czech authorities have decided that in order to gain legal comfort for the aid measures granted to the Czech banking sector, all public aid granted after 10 December 1994 should be subject to the above-mentioned interim procedure.**

Brussels: Directorate-General Competition of the European Commission, 2003, p. 26-28. [On-line.] [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/competition/publications/cpn/cpn2003_2.pdf>.

[199] Roebling, G.: Existing aid and Enlargement. EC Competition Policy Newsletter, No. 1/2003, Brussels: Directorate-General Competition of the European Commission, 2003, p. 33. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/competition/publications/cpn/cpn2003_1.pdf>.

In this context, we should note that this approach would evidently be set aside if the Accession Treaty contained a specific transitional arrangement. Such a transitional arrangement in the field of state aid would expressly authorize a new Member State to continue a specified aid measure for a certain period of time beyond the date of accession despite its incompatibility with the common market. However, due to political reasons (or due to failure of the government negotiators), the Czech Republic did not request such a transitional arrangement in the field of state aid into the banking sector.

2.2 State Aid in Context of EU Accession – the European Commission's View

The process of integration of the acceding countries into the European Union naturally raises concerns of the European Commission regarding the issues of appropriate treatment of state aids granted in the pre-accession period and continuing beyond accession. **The European Commission's overriding goal in this respect is to ensure that competition in the internal market is not distorted**.[200]

Whereas state aid regulation in the EU is based on the centralized monitoring of selective public support by the supranational Commission[201], the position regarding a new Member State is however different. On one hand, all candidate countries installed national state aid monitoring authorities, which by and large aligned their decisional practice with the substantive standards used by the Commission.[202] On the other hand, acceding countries with their national state aid monitoring authorities did not satisfy the second crucial characteristic of effective state aid regulation - **the supranational organization of state aid control**.[203]

[200] For more details, see *Annex II*.

[201] This should ensure that the same substantive standards are being applied with regard to all EU Member States.

[202] This resulted from the requirement that all candidate countries start introducing an effective state aid policy as part of their preparations for accession to the EU, included in the respective Europe Agreements. This demand was also subsequently included in the EU Common Positions on the accession negotiations in the Competition chapter.

[203] In this point, we may raise a relevant question, how the Commission dealt with state aids in context of the earlier accessions. The most recent case that provides a proper benchmark for our analysis is the accession of Austria, Finland and Sweden. However, all these countries were Member States of the European Economic Area

In addition, **in the absence of specific provisions**, the Commission would be competent to ensure that aid granted by the State complies with common market principles only after new Member State's accession. Moreover, only general provisions on existing aid of the EC Treaty would then apply. Under these rules, all aid measures that predate accession (i.e. before the EC Treaty came into force in the new Member State) and continue to be operated after accession, would **automatically** qualify as existing aid measures within the meaning of Article 88(1) of the EC Treaty.

Therefore, the Commission feared that the continuation of certain pre-accession aid measures that are incompatible with the common market principles would lead to distortions of competition. "*In view of this forthcoming 'big bang', the Commission would probably have to simultaneously propose a large number of appropriate measures after accession, in order to remedy distortions of competition resulting from the continued application of incompatible aid. Such a cumulation of procedures would not only draw heavily on the Commission's resources, but would also present a scenario which would take, realistically speaking, many years to complete. Due to these unavoidable delays, such a 'post accession' approach to pre-accession aid would thus not efficiently remedy distortions of competition. The key objective of the Commission as therefore to propose a framework that would offer an incentive to the acceding countries to align, where necessary, their aid regimes with common market principles already during the pre-accession period*."[204]

Hence, the Commission proposed a solution that would effectively add a second layer to the filtering process of pre-accession aid – **the *interim procedure***.

('EEA') and as such their state aid control was subject of review by the EFTA Surveillance Authority (ESA) before the date of accession. Given the fact that ESA implemented a state aid policy in the EEA during the pre-accession period which essentially followed the substantive standards of the Community state aid policy, the Commission decided (and such position is included in the respective Accession Agreements) that all state aid decisions taken by the ESA before the date of accession, and which would fall under Article 87 EC Treaty as a result of accession, shall remain valid.

[204] Roebling, G.: Existing aid and Enlargement. *EC Competition Policy Newsletter*, Number. 1/2003, Brussels: Directorate-General Competition of the European Commission, 2003, p. 33-34. [On-line]. [Cit. 2004-03-02]. URL: <Http://europa.eu.int/comm/competition/publications/cpn/cpn2003_1.pdf>.

2.3 Interim Procedure

Within the interim procedure, the national authority responsible for monitoring State aid (OPC) examines in the first instance, whether the measures in question are **still applicable** (i.e., whether their effect on competition still persist after the accession). The Commission considers the following measures to be applicable after accession[205]:

- Any aid schemes that came into effect before the date of accession and on the basis of which, without further implementing measures being required, individual aid may be granted to undertakings;
- Aid, which is not linked to a specific project, awarded before accession for an indefinite period of time and/or an indefinite amount;
- Individual aid measures for which the precise economic exposure of the State is not known on the date the aid is granted.

In addition, "*[o]nly such measures that can still give rise, after accession, to the grant of additional aid or to an increase in the amount of aid already granted, may qualify as existing aid by virtue of the interim mechanism*."[206]

In the second stage, the OPC investigates whether an aid measure in question is **state aid**. In order to qualify a measure as state aid, such measure must confer an *economic advantage* on the ailing firm that it would not have enjoyed under normal market conditions. So-called *market economy investor test* is used for these purposes. **An economic advantage is not granted (and the measure in question is not state aid) if a private investor in the position similar to the State acting in a market economy would have made the measure, and if it would have done so under the same conditions.** On the contrary, if the conditions offered by a private investor would have been less beneficial to the recipient, it can be concluded that an economic advantage is granted (and the measure in question is state aid).[207]

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[205] See *EC Decision on Komerční banka, a.s.*, State aid CZ 15/2003 – Czech Republic. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/secretariat_general/sgb/state_aids>.

[206] See *EC Decision on Česká spořitelna, a.s.*, State aid CZ 14/2003 – Czech Republic. [On-line]. [Cit. 2004-04-04].
URL: <Http://europa.eu.int/comm/secretariat_general/sgb/state_aids>.

[207] For more details see *Commission communication to the Member States concerning the market economy investor test*, *Official Journal, OJ C 307 of 13.11.1993.* [On-line]. [Cit. 2004-03-02].

Measures found still applicable and constituting state aid are assessed further on the basis of their compatibility with *acquis communautaire*.[208] The OPC then seeks legal certainty by notifying the measures to the EC. As the national bodies are the first instance of review, the *"[...] Commission would not need to carry out again a supplementary, fully fledged review of these measures, and the substantive test could be lighter than the one employed within the Community*." [209] If the Commission raises serious doubts regarding the compatibility of the notified measures with the acquis communautaire within three months from the date of receiving **complete information** on each measure, the new formal investigation within the meaning of the state aid procedural regulation of the measures in question will be filed after accession, based on the EC Treaty. This may theoretically lead to some adjustments (e.g. an obligation to reimburse part of that aid provided to the Czech banking sector or to implement necessary compensatory measures). In contrast, if the Commission does not raise serious doubts to notified measures within the three-month deadline, the notified measures will be regarded as existing aid from the date of accession.

Regarding measures labeled by the OPC either as not state aid or as not still applicable after accession and notified to the Commission, **the Commission is not empowered to review them on the basis of compatibility**. In case that the Commission endorses the OPC assessment, **it provides the Czech state with the legal comfort by means of a formal Commission decision, confirming that aid measure(s) in question is (are) either not state aid(s) or not applicable after accession.**

2.3.1 Legal Framework within the Interim Procedure

It is important to define the legal framework applicable to this very special situation. The Accession Treaty provides that aid measures granted prior to the date of accession were

URL: <Http://europa.eu.int/comm/competition/state_aid/legislation/30793_en.html>.

[208] For detailed analysis of acquis communautaire related to State aid control see *Annex II.*

[209] Roebling, G.: Existing aid and Enlargement. *EC Competition Policy Newsletter,* Number. 1/2003, Brussels: Directorate-General Competition of the European Commission, 2003, p. 35. [On-line]. [Cit. 2004-03-02]. URL: <Http://europa.eu.int/comm/competition/publications/cpn/cpn2003_1.pdf>.

to be assessed by the state aid monitoring authority in accordance with the relevant *acquis*[210]. The relevant *acquis* and the obligations of the Czech State at the time were set out in the Europe Agreement[211]. The Europe Agreement committed the Czech Republic to the **gradual introduction of EU law** and must be interpreted in light of its objectives set out in the recitals and Article 1.[212] Article 64 of the Europe Agreement provides that *public aid*[213] is "*incompatible with the proper functioning of the Agreement*". The Implementing Rules for these provisions[214] specify that the criteria for assessing the compatibility of aid with the Europe Agreement are those arising from the application of Article 87, including secondary legislation and the case law of the European Courts.[215]

Particularly, "*aid to make good the damage caused by **exceptional occurrences***" (inter alia) is compatible with the Common market according to the EC Treaty.[216] In addition, the following may be considered to be compatible with the common market:

- **Aid to promote the economic development of areas where the standard of living is abnormally low** or where there is serious underemployment; or
- **Aid to remedy a serious disturbance in the economy of a Member State**; or

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[210] The assessing authority must consider the acquis in force at the time the measures were granted. See *Judgment of May 16, 2002* in Case C-482/99 France v European Commission (Stardust Marine), paragraphs 71 and 81.

[211] *Europe Agreement* establishing an association between the European Communities and their Member States, of the one part, and the Czech Republic, of the other part. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/smartapi/cgi/
sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=21994A1231(34)&model=guichett>.

[212] „*… to promote the expansion of trade and the harmonious economic relations between the Parties and so to foster the dynamic economic development and prosperity in the Czech Republic…*" (Ibid).

[213] Subject to conditions similar to those in Article 87 EC.

[214] Adopted by *Decision 1/98 of the Association Council*, which entered into force on June 24, 1998. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.euroskop.cz/cze/file_list.asp?fcat=316&cat=5078&ts=4ec9>.

[215] On May 1, 2000 the Czech State Aid Act, fully in line with acquis, entered into force.

[216] It this context it should be noted that in case of East Germany "*aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division*" is compatible with the Common market according to the EC Treaty.

- **Aid to facilitate the development of certain economic activities** or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest.

In this context, **the particular difficulties of the Czech Republic are recognized and reflected in the provisions of the Europe Agreement and the Implementing Rules**.

Specifically, Article 64(4)(a) of the Europe Agreement recognizes the different level of economic development of the Czech Republic compared to the EU, and provides that the parties recognize that "*during the first five years after the entry into force of this Agreement,* ***any public aid granted by the Czech Republic shall be assessed taking into account the fact that the Czech Republic shall be regarded as an area identical to those areas of the Community described in Article*** **[87(3)(a)]** ***of the Treaty.***" [217] Such areas are granted more liberal treatment under the State aid rules of the EC Treaty. This provision was extended by five years by a Decision of the Association Council in 2001.

In addition, Article 46(2) of the Europe Agreement provides that **if measures were considered necessary by the Czech Republic in order to maintain the stability of its economic policy or the financial system as a whole, or to ensure that an enterprise met prudential requirements and to protect depositors and investors**, provided such measures did not discriminate on the grounds of nationality, **they were permissible**.

Moreover, monitoring authorities reviewing the State measures should have taken account of the **special circumstances**[218] underlying the measures taken by the Czech Republic prior to accession. Specifically, they should have taken account of the following facts:

- **The Czech Republic was in a particularly difficult situation economically, as explained in chapter *The Emerging Market Crisis*;**

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[217] *EC Decision of March 8, 2001* (2001/289/EC). [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/eur-lex/pri/en/oj/dat/2001/l_100/l_10020010411en00160016.pdf>.

[218] In Case C-355/95 P, *TWD v. Commission* the European Court of Justice said: *"When the Commission examines the compatibility of a State aid with the common market it must take all the relevant factors into account…"*

- **The Czech banking sector has been in the process of a fundamental restructuring;**
- **The Czech Republic was in the process of reforming its legal, administrative and supervisory systems to bring them into line with EU requirements,**
- **A shift from pre-accession industry policy may require the State to provide financial assistance to enable public companies to adapt to a new environment of fair competition[219, 220];**
- **The Commission has approved restructuring aid to banks on several occasions, specifically taking into account the requirements of the state to respond to systemic risk (as described in chapter *Uniqueness of the Banking Sector* and in *Annex III*);**
- **Uniqueness of the banking sector in terms of application of State aid rules.[221]**

From the above analysis, it is clear that the legal background in this case is very complex and complicated. **However, in a number of major decisions by the Commission** (as described in *Annex III*), **a highly pragmatic and flexible approach has been taken. Therefore, even greater flexibility should have been justified in assessing compatibility with *acquis* the case of the measures taken by the Czech Republic in the period prior to its accession to the EU.**

As we concluded in previous chapters, the incurrence of adequate (i.e., not excessive) aid measures to overcome the deficiencies of banking sector is inevitable for the transition

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[219] See *Commission Decision 92/317/EEC of 25 March 1992* on State aid in favour of Hilaturas y Tejidos Andaluces SA, now called Mediterraneo Tecnica Textil SA and its buyer (*Hytasa*), OJ [1992] L171/54, p. 64.

[220] In this regard it should be noted that the Czech banking sector is faced with strong and increasing competitive pressure from EC banks, many of which, despite the maturity of the EC banking sector, have received substantial aids themselves, which have been approved by the EC.

[221] "*The Commission is aware of the particular sensitivity of the banking sector, which calls for special attention on the part of the national and Community authorities to ensure that serious difficulties in a major financial institution do not disrupt financial links between institutions in the sector and create a more widespread crisis… [T]he Commission concluded … that the state aid rules could and should also apply to banks, while taking account of the specific nature of the sector, notably in the event of the failure of a major institution.*" (*XXVth Report on Competition Policy*. Brussels: European Commmission, 1995, p. 217-218. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/competition/publications/ra9501en_en.pdf>.

countries and **in principle should not be viewed as state aid distorting competition in the financial market**. On the contrary, such aid contributes to creation of a **level playing field allowing just competition between both domestic and foreign banking institutions and taking the "monobank" system as a benchmark, these measures contributed to reduce distortions of competition.**

Therefore, taking into account these specific circumstances (i.e., transition economy context, nature of the aid measures and legal framework of the interim procedure) and level of flexibility in a number of major decisions by the Commission (as described in *Annex III*), the expected outcome of the interim procedure would be that a vast majority of aid measures would either be labeled as not state aid (those fulfilling private investor principle or those causing no distortions of competition) or gain status of existing aid (i.e., the Commission would not raise serious doubts regarding their compatibility with *acquis*).

2.4 Outcome of the Interim Procedure

Having described both the effort of the European Commission to control the pre-accession state aids in order to avoid distortions of competition after enlargement and the legal framework of the adopted solution, we may now evaluate whether the original intentions of the Commission have been fulfilled.

To begin with, we will examine in detail the decisions of the Commission and other steps taken by the Commission in respect to banking cases notified by the Czech authorities. The first decision of the Commission was issued on December 16, 2003, regarding the measures taken for the benefit of Komerční banka. This decision was crucial for all other banking cases as this was the first time the Commission applied the principles discussed in chapter *Interim Procedure* and therefore set a case law for other banks. **The Commission concluded that all notified measures granted for the benefit of KB, i.e. the capital increase, two bail-outs, tax relief and ring-fencing, are not applicable after accession.**

In the second decision within the interim procedure, the Commission concluded that all notified measures granted for the benefit of CS after 1994 are not applicable after accession. Therefore, these measures do not become neither existing nor new aid

after accession.[222] Hence, given the legal framework, the Commission was not empowered to further investigate whether the aid measures were compatible with the relevant acquis. The same conclusion was reached by the Commission also for a group of 11 Czech "small banks", which have participated in Stabilization or Consolidation Programmes: all measures were found to be not applicable after accession.[223]

Let us now recall the Commission's definition of *still applicability* regarding individual aid measures:

- Individual aid measures for which the precise economic exposure of the State is not known on the date the aid is granted are still applicable after accession.
- Aid, which is not linked to a specific project, awarded before accession for an indefinite period of time and/or an indefinite amount.

In order to fully understand the definition of *still applicability*, we will deduce its meaning from its application by the Commission. The most challenging measure in KB's case - ring-fencing agreement – was (as described in section *Rescue, Restructuring and Privatization*) capped by CZK 20 billion and covered losses realized between December 31, 2000 and December 31, 2003. Hence, the specific amount of State's exposure was not known at the time when the measure was granted. However, the Commission concluded: "*although the actual payment under this guarantee may be physically effected after accession, there would be no further exposure additional to envisaged at the time of granting the guarantee. […] Thus, the guarantee at hand is not applicable after accession.*"[224]

The similar conclusion regarding guarantee for ring-fenced assets was reached by the Commission in the CS case: "*In the present case, the potential economic exposure of the Czech Republic was clearly known at the time when the guarantee was granted: in fact, the exposure cannot go beyond the guaranteed value of the "ring-fenced" assets. Although*

[222] Therefore, in contrast to existing aid measures, the Commission even cannot succeesfully propose changes or amendmends of these measures after the enlargement.

[223] Regarding the three outstanding cases – CSOB/IPB, GECB/AGB and První městská banka the EC did not issue decisions by the deadline of this thesis. The Czech Ministry of Finance expects these decisions in the course of June/July.

[224] *EC Decision on Komerční banka, a.s.*, State aid CZ 15/2003 – Czech Republic. [On-line]. [Cit. 2004-03-02]. URL: <Http://europa.eu.int/comm/secretariat_general/sgb/state_aids>.

payments under this guarantee may be physically effected after accession, there would be no further exposure additional to that envisaged at the time of granting the guarantee. Therefore, the Commission does not consider the measure to be applicable after accession."[225]

Such broad approach is naturally welcomed by the Czech authorities and banks in question, as it provides them with the highest possible level of the legal comfort. However, from the perspective of competition policy, some doubts arise.

First, broad definition of *still applicability*, developed by competition lawyers, provides the new Member States with guidance on what the Commissions considers as still applicable and thereby significantly simplifies the analysis that needs to be carried out during the interim procedure. However, such broad legalistic approach lacks economic analysis of each aid measure and its economic impact on the competition. **The Commission's approach, developed *ad absurdum*, implies that all capped aid measures[226], where the State's liability is precisely defined and related to events which accured before accession, approved by the relevant national competition authority, regardless of the country's level of state aid law harmonization, and granted from December 10, 1994 until the accession[227], regardless of the amount (!), are not still applicable after accession (i.e., their effect on competition after accession is zero)**. As such, the Commission is not empowered to investigate whether the aid measures were compatible with the relevant acquis. Hence**, the supranational principle in state aid control stipulated by the Commission in designing the parameters of the interim procedure** (see chapter *State Aid in Context of Accession – European Commission's View*) **is circumvented.**

Second, by its decisions in KB, CS and small banks cases, the Commission has locked itself into a dangerous trap. The decision provides all new Member States (including the future ones – e.g. Bulgaria and Romania[228]) by **recipe how to avoid the potential threat of**

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[225] *EC Decision on Česká spořitelna, a.s.*, State aid CZ 14/2003 – Czech Republic. [On-line]. [Cit. 2004-04-04]. URL: <Http://europa.eu.int/comm/secretariat_general/sgb/state_aids>.

[226] In terms of duration and amount.

[227] The actual transfer of resources may be carried out even after the accession.

[228] Provided that Accession Agreements of these countries will contain the same principles of pre-accession state aid control.

state aid recovery after the accession[229]. Moreover, in contrast with **existing aid measures, measures deemed not applicable cannot** be even phased-out after accession. **As a result, the interim procedure based on the current definition of still applicability provided the new Member States with a certain level of unfounded and ill-intentioned *ex ante* legal comfort regarding the planned aid measures and could potentially lead to massive state aids in these countries.** And that is, of course, in conflict with the Commissions original intentions - to avoid distortions of competition after enlargement.

Paradoxically, the current situation (interim procedure based on the broad legalistic definition of still applicability) **is potentially more harmful than a situation, where all pre-accession state aids would automatically gain status of existing aid** (as it was the case in the earlier accessions) as the Commission cannot even phase-out the aid measures. In this context, the following question arises: Why the Commission devised the broad legalistic definition of *still applicability* instead of pursuing detailed economic analysis of individual measures and their potential distortive effect on competition after accession?

2.5 Possible Explanations of Commission's Logic

There are at least two possible explanations of the Commission's logic that lies behind the Commission decisions and other steps taken within the interim procedure framework.

2.5.1 Explanation A

One possible explanation of the Commission's logic is that at the time when the Commission proposed the interim mechanism to be included in each of the Accession Treaties, it underestimated the real extent of pre-accession state aid problem in new Member States and, hence, it also underestimated the following factors:

- **Engagement of third parties in the process.** The Commission officials stated that a number of complaints have been filed against the Czech banking cases on various

[229] Please note that that interim procedure is not designed only for the banking industry but also for other sectors.

grounds, e.g. distorting effects of aid measures, biased documentation submitted by the Czech Republic to the Commission, etc.[230]

- **Amount of workload for the Commission bureaucrats.** Representatives of the Commission admitted that the Czech banking cases as a package belong to one of the biggest cases the State Aid Unit of DG Competition has ever dealt with. Moreover, besides the Czech banks, this unit at the same time assesses e.g. the Slovak and Hungarian banks, Czech steel sector, Polish enegy sector and last but not least, "regular" EU state aid cases. "*Rough estimates suggest that enlargement will increase our State aid workload by at least 40 %.*"[231]
- **Limited resources of DG Competition.** Given the increased workload, the DG Competition needed additional resources to perform its task. However, as noted by Commissioner Monti: "*although the budgetary authority will make some additional resources available, these will be nowhere near proportionate.*"[232]

At the time when the Commission realized the real extent of the problem, it was too late to change the parameters of the interim procedure established by Accession Treaties. **Therefore, the Commission needed to find on one hand both affordable and pragmatic solution, on the other hand, due to third parties complaints, such solution had to be sustainable.** In October 2002[233], the then Head of State Aid Unit of DG Competition, Philip Lowe[234] stated: "*there is scope to simplify, rationalise and modernise State aid rules and*

[230] See e.g. *EC Decision on Česká spořitelna, a.s.*, State aid CZ 14/2003 – Czech Republic. [On-line]. [Cit. 2004-04-04].
URL: <Http://europa.eu.int/comm/secretariat_general/sgb/state_aids> or Havligerová, J.: Drobní akcionáři IPB tvrdí, že stát neříká pravdu o bankách. *Hospodářské noviny,* 28.11.2003, p. 3 or Constitutional Watch: A country-by-country update on constitutional politics in Eastern Europe and the ex-USSR. *East European Constitutional Review*, Volume 10, Number 1, New York: New York University of Law, 2003. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.law.nyu.edu/eecr/vol10num1/constitutionwatch/czech.html>.

[231] Monti, M.: *New Developments in state aid policy*. Brussels: European Commission, December 1, 2003, p. 4 - 5. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/competition/speeches/text/sp2003_042_en.pdf>.

[232] Monti, M.: *New Developments in state aid policy*. Brussels: European Commission, December 1, 2003, p. 5. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/competition/speeches/text/sp2003_042_en.pdf>.

[233] At the time the process of interim mechanism actually began.

[234] Mr. Philip Lowe is now a Director-General of DG Competition.

procedures for the sake of enlargement and to concentrate our scarce resources on cases presenting the more important competition problems.“[235] Thus, in line with this statement and with the above-mentioned criteria, the Legal Services of the Commission devised the definition of *still applicability* (no specification of *still applicability* has been provided by the *acquis communautaire* before). This definition substantially reduced workload on both Commission and national State Aid Monitoring Units. In addition, it provided the Commission with sound basis to sustain its decision in potential legal disputes.

2.5.2 Explanation B

The second possible explanation of Commission’s logic is based on political economy considerations and assumes that the current features of the interim procedure are an outcome of the two opposite pressures:

- **DG Competition’s (or Commissioner Monti’s) pressure**. In order to sustain its credibility as fierce fighter against unnecessary market distortions, Monti had to demonstrate his determination to “***ensure the application of the State aid rules*** *in economies which are in some respects still different from those of the current Member States, and which have not always yet fully completed the process of transition from centrally planned to market-based economies.*“ [236]
- **Political pressures.** DG Competition faces many requests from investors, new Member States and also current Member States for additional flexibility to deal with the pre-accession state aid cases. “*[T]hese calls for more flexibility have been heightened by concerns, even among Member States which have traditionally supported a strict State aid control, that a ‘one-size fits all‘ State aid policy may no longer be feasible after enlargement.*” [237]

[235] Lowe, P.: *Future directions for EU Competition Policy*. Brussels: Conference at the Center for European Policy Studies, October 11, 2002, p. 3. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/competition/speeches/text/sp2002_041_en.pdf>.

[236] Monti, M.: *New Developments in state aid policy*. Brussels: European Commission, December 1, 2003, p. 4. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/competition/speeches/text/sp2003_042_en.pdf>.

[237] Monti, M.: *New challenges for state aid policy*. Brussels: European State Aid Law Forum, June 19, 2003, p. 5. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/competition/speeches/text/sp2003_042_en.pdf>.

These two pressures might have resulted in a compromise: on one hand, by enforcing the interim mechanism the Commission would demonstrate formally its strong commitment to strict competition policy (in comparison with situation, where all pre-accession state aids would automatically gain status of existing aid)**, while, on the other hand, by exercising the broad definition of still applicability on vast majority of measures, the Commission might claim that it is not empowered to assess compatibility of measures which do not have distorting effect on competition after accession** (i.e., are not still applicable).

No matter which of these explanations is more relevant (most probably, it is the mix of these two that may provide us with a likely logic that lies behind the Commission decisions and other steps taken), **the legalistic definition of *still applicability* does not correspond with the basic principle of the applied competition policy**: "*competition policy is based on law – law allowing us to investigate and enforce decisions according to the* ***economic principles which are reflected in that law***"[238], as it suppresses the economic analysis rather than reflecting it. The result is, as discussed above, very paradoxical *ex ante* legal comfort for new Member States, deviating from earlier accessions and from originally declared intentions of the Commission.

2.6 The Way Out of the Trap?

At this stage, when the main parameters of the interim procedure have been set in the respective Accession Treaties, and when the definition of *still applicability* has been exercised in a number of banking cases, the way out is difficult: complainants would have to challenge the Commission decisions at the European Court. However, due to discretion the Commission enjoys in the unique cases stemming from the current accession, it is highly unlikely the complainants would succeed.

Therefore, in order to avoid contradiction of theoretical and applied competition policy for the future round of accession, it is necessary to devise a completely new framework of dealing with pre-accession state aids, allowing either:

[238] Zekaria, S.: *Philip Lowe, European Commission, Director General, DG Competition: Interview*. Europolitics, September 25, 2003. [On-line]. [Cit. 2004-03-02]. [Emphasis added].
URL: <Http://www.eupolitix.com/EN/Interviews/200309/26545d22-8f11-46b2-abb2-cfd2029e0f4b.htm>.

- Comprehensive economic analysis of individual aid measures within the interim procedure to determine whether their effect on competition will still persist after accession (for measures adopted e.g. after the country's Europe Agreement came into force); or
- To grant all aid measures status of existing aid at the date of accession, perform a detailed economic analysis of each measure and subsequently phase-out those with negative effect on competition and incompatible with *acquis*; or (preferably)
- Combination of the above: **measures granted before certain date (set between accession and e.g. effectuation of Europe Agreement) would automatically gain the status of existing aid, the rest would be assessed before accession** (as described in the first bullet).

Naturally, even the last approach assumes unprecedented workload for both Commission and the new Member States, however, in contrast to current framework of the interim procedure, it allows them to spread the workload and its funding also to the post-accession period and provide them more time to find necessary resources. On the other hand, the shortcoming of this approach is a potential distortion of competition right after accession (before phasing-out measures with negative effect on competition and incompatible with *acquis).* However, based on Commission's experience about the nature and effect of pre-accession aid measures gained in the current round of enlargement, the Commission should be able to mitigate this shortcoming by reasonably set date until which the measures would automatically gain the status of existing aid. In sum, **all approaches introduced above are strictly preferred from competition policy view to the current approach, as they assume comprehensive analysis of each pre-accession aid measure and its effect on competition instead of current legalistic approach that provided the new Member States with a certain level of unfounded and ill-intentioned *ex ante* legal comfort regarding the planned aid measures and could potentially lead to massive state aids in these countries.**

Conclusion

The author has shown that **on the contrary to crises of banks in well-functioning market economies, where the reasons for the bank's losses are generally specific to each particular bank**[239] and related to a large extent to its aggressive commercial and credit policy, **the crisis in the Czech banking sector was caused mainly by factors not just specific to each bank, but specific also to the economy in transition.** These factors included: inherited burden of bad loans, a lack of experience doing business in the market economy, non-existent risk management and legal loopholes. Moreover, large banks were the main providers of liquidity to businesses and as such, they bore the majority of the risks and burdens of the transition by funding undercapitalized companies during their privatizations. **Naturally, these problems are an inevitable part of transition process, and thus, "*banking crises in transition countries could be more broadly viewed as a challenge of transition, or a challenge of banking sector development in the transition context.*"** [240]

Since the banking sector was unable to address this problem on its own, state financial injections became inevitable. **Although the Czech Republic has spent quite substantial fiscal costs in the process of banking sector consolidation, these costs are fully in line with its CEE peers when controlled for the size of the banking sector.** Nevertheless, aid measures were not always very efficient in the sense that by e.g. earlier direct privatizations, and faster and more complex legal reforms, the costs of banking system restructuring could have been substantially reduced. However, based on a number of tests pursued in this thesis and from the narrow competition policy view, **the author has not found any clear evidence that aid measures granted to major banks were causing unnecessary distortions of competition.**

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[239] See e.g. *Commission Decision of 29 July 1998* giving conditional approval to the aid granted by Italy to Banco di Napoli, C(1998) 2495, p.48.

[240] Zoli, E., Tang, H, Klytchnikova, I.: *Causes of Banking Crises: Banking crises in transition economies, fiscal costs and related issues*. World Bank Policy Research Working Paper 2484, Washington D.C.: World Bank, 2000, p. i. [On-line]. [Cit. 2004-15-01].
URL: <Http://econ.worldbank.org/files/1294_wps2484.pdf>.

Concerning the impact of state aids on the nature of competition between domestic subsidized banks and foreign banking institutions, the author demonstrated that **domestic banks, suffering from absolute distortion of competition during the command economy era,** learned to operate in a completely new environment, while bearing debts from the old era[241], whereas foreign banks present at the Czech market benefited from undeveloped regulation and supervision. **Hence a level playing field for just competition was not ensured**. Therefore, the incurrence of adequate (i.e., not excessive) aid measures to overcome these deficiencies was inevitable for the transition countries and **in principle should not be viewed as state aid distorting competition in the financial market**. On the contrary, such aid contributes to creation of a level playing field allowing just competition between both domestic and foreign banking institutions and taking the "monobank" system as a benchmark, **these measures contributed to reduce distortions of competition.** In addition, **foreign financial institutions benefited from state interventions indirectly, as the state prevented contagion that would have serious devastating impact also on these foreign banks**. The result is a sounder, competitive and more efficient banking system, ready for the competition in the international context, without a threat of destabilizing banking sector in the Common Market after EU accession.

Therefore, taking into account the specific circumstances (i.e., transition economy context, nature of the aid measures and purpose of the interim mechanism) and level of flexibility in a number of major decisions by the Commission, the expected outcome of the review of aid measures by the Commission within the framework of the interim procedure would have been that **a vast majority of aid measures would be after a proper economic assessment either labeled as not state aid (those fulfilling private investor principle or those causing no distortions of competition) or gain status of existing aid** (i.e., the Commission would not raise serious doubts regarding their compatibility with *acquis*).

However, broad legalistic approach adopted by the European Commission lacked economic analysis of each aid measure and its economic impact on the competition. **The Commission's approach, developed *ad absurdum*, implies that all capped aid measures approved by the relevant national competition authority, regardless of the country's**

[241] Please refer to section *Triggers and Causes of the Crisis* for all relevant characteristics, which discriminate domestic banks in comparison with foreign banks.

level of state aid law harmonization, and granted from December 10, 1994 until the accession, regardless of the amount (!), are not still applicable after accession (i.e., their effect on competition after accession is zero). As such, the Commission is not empowered to investigate whether the aid measures were compatible with the relevant acquis. Hence**,** the supranational principle in state aid control stipulated by the Commission in designing the parameters of the interim procedure is circumvented. **Paradoxically, interim procedure based on the broad legalistic definition of still applicability is potentially more harmful than a situation, where all pre-accession state aids would automatically gain status of existing aid (as it was the case in the earlier accessions) as the Commission cannot even phase-out the aid measures.**

The author presented two possible explanations of the Commission's logic that lies behind the outcome of the interim procedure. **The first one argues that at the time when the Commission proposed the interim mechanism to be included in each of the new Member States' Accession Treaties, it underestimated the real extent of pre-accession state aid problem in these countries and, hence, it also underestimated the engagement of third parties in the process, the amount of workload for the Commission bureaucrats and limited resources of DG Competition.** At the time when the Commission realized the real extent of the problem, it was too late to change the parameters of the interim procedure established by Accession Treaties. Therefore, the Commission devised the definition of *still applicability*, which substantially reduces workload on both Commission and national State Aid Monitoring Units and also provides the Commission with sound basis to sustain its decision in potential legal disputes.

The second explanation stresses political economy considerations and assumes that the current features of the interim procedure are an outcome of the two opposite pressures:

- **DG Competition's (or Commissioner Monti's) pressure** exerted in order to sustain its/his credibility as a fierce fighter against unnecessary market distortions;
- **Political pressures** exerted by investors, new Member States and also some current Member States for additional flexibility to deal with the pre-accession state aid cases. As a result of these opposite pressures, the Commission demonstrated **formally** its strong commitment to strict competition policy (in comparison with situation, where all pre-accession state aids would automatically gain status of existing aid), while, on the other hand, by exercising the broad definition of still applicability on vast majority

of measures, the Commission might claim that it is not empowered to assess compatibility of measures which do not have distorting effect on competition after accession (i.e., are not still applicable).

No matter which of these explanations is more relevant (most probably, it is the mix of these two that may provide us with a likely logic that lies behind the Commission decisions and other steps taken**), the author proposed a new framework of dealing with pre-accession state aids in order to avoid unnecessary distortions of competition after the future rounds of accession.** Within this framework, all measures granted before certain date (set between accession and e.g. effectuation of Europe Agreement) would automatically gain the status of existing aid, while the measures granted after this date would be subject of comprehensive economic analysis conducted by DG Competition within the interim procedure to determine whether their effect on competition will still persist after accession (for measures adopted e.g. after the country's Europe Agreement came into force).

Eventhough the suggested framework assumes increased workload for both the Commission and the new Member States, and (theoretically) a potential distortion of competition right after accession (before phasing-out measures with negative effect on competition and incompatible with *acquis*), **it is strictly preferred from the competition policy view to the current approach, as it assumes a comprehensive analysis of each pre-accession aid measure and its effect on competition instead of current legalistic approach that provided the new Member States with a certain level of unfounded and ill-intentioned *ex ante* legal comfort regarding the planned aid measures and could potentially lead to massive state aids in these countries.**

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Annex I: Timeline of the Czech Banking Restructuring

1990

- Two-tier banking system established.

1991

- Bankruptcy law enacted.
- Consolidation Programme I started.

1992

- Banking law enacted.
- Živnostenská banka privatization.

1993

- Bankruptcy law amended.

1994

- AGB's Consolidation Programme.

1995

- Bad loan provisioning regulation adopted.

1996

- BIS capital adequacy regulation enacted.
- Forced administration of Agrobanka, CNB guarantee for AGB's depositors, CNB credit line to AGB.
- The CNB starts a Consolidation Programme II for troubled small banks.
- Five small banks placed under forced administration; two banks have licenses revoked.
- Stabilization Programme adopted.
- Česká finanční established as a subsidiary of the CNB to take over troubled assets of small banks.

1997

- The currency crisis in South-East Asia.
- Small banks start selling assets to Česká finanční.
- State guarantee to CSOB for receivable against Slovak Republic.
- Česká finanční attempts to increase AGB's registered capital.

1997

- Sale of AGB to GE Capital Corporation with indemnification and put option. CNB increases AGB's registered capital.
- Three banks have license revoked; another goes into bankruptcy.

1998

- The Russian crisis.
- Four more banks have license revoked.
- IPB's portfolio of for co-operative housing construction transferred to KOB.
- IPB sold to Nomura.
- Banking law amended.
- Bankruptcy law amended.
- Regulations on loan classification and provisioning tightened by CNB.
- CS issues a subordinated debt of CZK 5.5 billion, underwritten by KOB.

1999

- The Government sells controlling interest in CSOB to KBC.
- KOB sets up the Revitalization Agency to resolve credits to large industrial companies.
- Government increased CS's registered capital.
- KOB acquires troubled assets from CS and KB.
- CNB revokes a banking licence of Moravia banka.

2000

- Government increased KB's registered capital.
- Bail-out and sale of CS to Erste Bank of Austria with net asset value guarantee and compensation for social loans.
- KOB sets up Konpo, Ltd to acquire assets from KB.
- CF transferred from the CNB to KOB.
- IPB undergoes a liquidity crisis, is placed into forced administration by the CNB, CNB issues an irrevocable guarantee for creditors of IPB. IPB was immediately sold to CSOB with indemnification and guarantees.
- The amended Act on Bankruptcy and Settlement and the Act on Public Auctions.
- Government granted KB state guarantee on a ring-fenced portfolio.

2001

- KOB transferred its assets to the Česká konsolidační agentura (CKA) and terminated its activities.
- Czech Tax Authority grants a tax relief in July 2001.
- Privatization of KB (business sold to Société Générale S.A.).

2002

- The amendment of the Act on Banks further strengthens CNB's ability to conduct consolidated supervision over financial sector.

2003

- The legal framework of interim procedure incorporated into the Annex IV of the Accession Agreement.
- CNB revokes a banking licence of Moravia banka.
- CNB revokes a banking licence of Union banka.
- European Commission issues its decision within the interim procedure on KB: all measures notified are not still applicable after accession.

2004

- European Commission issues its decision within the interim procedure on CS: all measures after 1994 are not still applicable after accession, 1 still applicable measure gained status of existing aid.
- European Commission issues its decision within the interim procedure on group of 11 "small banks", which have participated in Stabilization or Consolidation Programmes: all measures were found to be not applicable after accession.

Annex II: Acquis Communautaire Related to State Aid Control[242]

One of the central principles of the *acquis communautaire* related to competition policy[243] is that competition in the internal market should not be distorted (article 3(1) lit. (g) of the EC Treaty). Therefore, state aid is, in principle, incompatible with the common market and article 87(1) of the EC Treaty prohibits any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain firms or the production of certain goods. "*The aim is to ensure a level playing field within the common market for the undertakings of all member states and to prevent a 'subsidy race' between those states.*"[244]

However, articles 87(2) and (3) of EC Treaty provide for exemptions under which state aid may be justified and considered compatible with the common market. The following exemptions set out in article 87(2) are automatically justified without the Commission having a right to exercise discretion:

- Aid having a social character, granted to individual consumers; and

[242] Based on *Competition Policy in Europe and the Citizen*. Brussels: European Commission, 2000. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/competition/publications/competition_policy_and_the_citizen/en.pdf>, *EU state aid law (Czech Republic)*. Squire, Sanders, Dempsey, EU Accession Series, Issue 1, 2003. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.squiresandersdempsey.com/library/pdf/EUStateAid02.pdf> and *EU state aid law in the Slovak Republic: Impact of the Slovak Republic's accession to the EU.* Freshfields, Bruckhaus, Deringer, 2003. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.freshfields.com/practice/corporate/publications/pdfs/6669.pdf>.

[243] Acquis communautaire related to state aid control is mainly contained in articles 86, 87 and 88 of the EC Treaty, as well as in secondary legislation, guidelines, notices, frameworks and communications issued by the Commission and published on its website.

[244] *EU state aid law in the Slovak Republic: Impact of the Slovak Republic's accession to the EU*. Freshfields, Bruckhaus, Deringer, 2003, p. 2. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.freshfields.com/practice/corporate/publications/pdfs/6669.pdf>.

- Aid to make good the damage caused by natural disasters or exceptional occurrences.

By contrast, state aid falling under article 87(3) of EC Treaty can only be exempt if the Commission uses its discretionary power to assess whether the aid is compatible with the common market. This relates to aid designed to:

- Promote the economic development of underdeveloped areas (regarded as particularly backward in accordance with Community criteria);
- Promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State;
- Facilitate the development of certain activities or areas, and
- Promote culture and heritage conservation.

The Commission has adopted a number of "guidelines" or "frameworks" to clarify its State aid policy in a number of areas. The categories of aid that may be approved under article 87(3) of EC Treaty are as follows:

- Regional and structural aid as set out in the regional guidelines of 2001 and the multisectoral framework for large investment projects of 2002;
- Employment aid as set out in Regulation 2204/2002;
- Aid for environmental protection as set out in the guidelines of 2001;
- Aid for research and development as set out in the framework of 1996;
- Training aid as set out in Regulation 68/2001;
- Aid to small and medium-sized enterprises as set out in Regulation 70/2001; and
- Aid for the rescue and restructuring of firms in difficulty as set out in the guidelines of 1999.

Aid granted in conformity with all the conditions set out in these regulations is automatically considered compatible with the common market. Specifically, in case of aid for the rescue and restructuring of firms in difficulty, the following conditions must be met in order for the State aid to be cleared by the Commission:

- Full implementation of a restructuring plan;

- Provision of sufficient "*compensation measures*" to offset the distortion of competition[245];
- Proportionality of the aid to the objectives pursued and limitation of the amount of the aid to the strict minimum necessary for restructuring; and
- EU monitoring of the fulfillment of objectives in comparison to the preceding condition.

Article 88 of EC Treaty empowers the Commission to control state aid granted by member states (both individual aid awards and state aid schemes).[246] Member states must notify planned state aid to the Commission under article 88(3) of EC Treaty before granting it.[247] Once aid has been notified to the Commission, it is reviewed in one or two phases. In the first phase, the Commission has two months from receipt of the complete notification to examine the proposed aid.

[245] Quid pro quo should represent an additional effort on the part of the firm receiving aid in comparison with the restructuring operations strictly necessary for restoring its viability.

[246] *Regulation 659/99* sets out the investigation procedure in detail.

[247] The only exceptions to the general rule that all measures that meet the above criteria have to be notified in advance to the Commission are (i) if the aid measure falls under a so-called block exemption regulation (which sets out categories and conditions of aid that are automatically exempt, such as aid to small and medium-sized enterprises, training aid and employment aid), (ii) aid that is *de minimis* (i.e., under €100 000 over any period of three years), or (iii) an aid measure is granted within an aid scheme that has itself been approved by the Commission.

The first step when analyzing a case involving state aid is to examine whether state aid has been granted to an undertaking.[248] In accordance with the definition of state aid in article 87(1), four conditions have to be fulfilled for a state measure to qualify as state aid:

- The measure from which an undertaking is benefiting has to involve a transfer of *state resources*[249]*;*
- The measure has to confer an *economic advantage* on the undertaking that it would not have enjoyed under normal market conditions[250];
- The measure has to be *selective* in that it creates a distortion between undertakings benefiting from the aid and undertakings that do not benefit.
- Lastly, the aid has to affect trade between member states and **distort or threaten to distort competition**.

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[248] The Commission has issued several communications to clarify under which conditions it will consider specific measures to constitute state aid, such as the communication concerning the market economy investor test (*Commission communication to the Member States concerning the market economy investor test*, *Official Journal, OJ C 307 of 13.11.1993.* [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/competition/state_aid/legislation/30793_en.html>); notice on the application of state aid law to state guarantees (*Commission notice on the application of Articles 87 and 88 of the EC Treaty to state aid in the form of guarantees*, *Official Journal C 71 of 11.03.2000*. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/scadplus/leg/en/lvb/l26083.htm>); and the communication on services of general economic interest of 2001 (*Communication from the Commission - Services of general interest in Europe, COM/2000/0580.* [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/consumers/cons_int/serv_gen/serv_gen_int05_en.pdf>). Concerning articles 86(2) and 87(1) EC, the Commission has issued a Green Paper suggesting more specific legislation in this area (see *Green Paper on the vertical restraints in EU Competition Policy*. Brussels: European Commission, 1997. [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/en/record/green/gp9701/vrtocen.htm>).

[249] Where a public undertaking makes the transfer it also has to be shown that the measure is *imputable* to the state, i.e., the state has in fact influenced the granting.

[250] So-called "*market economy investor test*" is used for these purposes. An economic advantage is not granted if a private investor in the position similar to the State acting in a market economy would have made the measure, and if it would have done so under the same conditions. On the contrary, if the conditions offered by a private investor would have been less beneficial to the recipient, it can be concluded that an economic advantage is granted. For more details see *Commission communication to the Member States concerning the market economy investor test, Official Journal, OJ C 307 of 13.11.1993.* [On-line]. [Cit. 2004-03-02].
URL: <Http://europa.eu.int/comm/competition/state_aid/legislation/30793_en.html>.

If the Commission decides not to raise any objection, the aid measure concerned can be implemented. Where the Commission has doubts regarding whether aid measures comply with State aid rules, the second phase will be opened, in which the Commission carries out a formal investigation during which third parties and all Member States are invited to provide observations. "*If the aid has already been granted in the case of a negative decision, the Commission will require the Member State concerned to recover the aid (plus interest) from the beneficiary. The Commission will not take into account arguments that the beneficiary had legitimate expectations to the aid other than expectations that have been prompted by the Commission itself.*"[251]

Companies have the option to submit complaints to the Commission about potential illegal State aid. In this case, the Commission first checks whether such a complaint is substantiated. If so, the European Commission will investigate the complaint. If the Commission approves an aid granted to a competitor and a company can show that it is directly and individually concerned by such aid measure, it may challenge the Commission decision before the European Court of First Instance.

[251] *EU state aid law (Czech Republic).* Squire, Sanders, Dempsey, EU Accession Series, Issue 1, 2003, p. 5. [On-line]. [Cit. 2004-03-02].
URL:<Http://www.squiresandersdempsey.com/library/pdf/EUStateAid02.pdf>.

Annex III: State Aid into Banking Sector in the EU - Precedents

State aid into the financial sector is not only a phenomenon of transition countries. There are a number of precedents of banks operating in the European Union, which have benefited from state intervention. Such measures were assessed by the Commission, using the legislation and criteria specified in the *Legal Annex*.

Credit Lyonnais Case[252]

In 1993, Credit Lyonnais (CL) was a leading European banking group. Its majority shareholder was the French Government, holding 55% of the capital and 76% of the voting rights. After a period of rapid growth CL recorded very heavy losses in proportion to its own funds and solvency ratio and in 1994, it became clear that CL would have problems meeting the capital adequacy requirement unless new capital was injected.

"*The problems appear to have originated in a number of investments in speculative industrial and commercial projects, in line with Crédit Lyonnais' strategic objective to forge alliances with large industrial groups; a few speculative bankruptcies account for a large share of the losses. In addition, the large fall in property values, in particular in the Paris region, weakened the overall health of the balance sheet*."[253] In addition, CL carried out many costly acquisitions to develop its banking activities in Europe and the world.

The French Government provided aid to CL four times, in 1994, 1995, 1996, and 1997. In 1994, the main shareholder, French State, in an attempt to assist the bank carried out

[252] Based on *Commission Decision of 20 May 1998* concerning aid granted by France to the Credit Lyonnais group, C(1998), 1454, *Action brought on 11 March 1996* by Credit Lyonnais against the Commission of the European Communities, C(1996), 133 and *95/547/EC: Commission Decision of 26 July 1995* giving conditional approval to the aid granted by France to the bank Credit Lyonnais, L (1995), 307.

[253] Edey, M., Hviding, K.: *An Assessment of Financial Reform in OECD Countries*. OECD Economics Department Working Paper No. 154, Paris: Organisation for Economic Cooperation and Development, 1995, p. 56. [On-line]. [Cit. 2004-03-02].
URL: <Http://www.oecd.org/dataoecd/32/50/1863080.pdf>.

a rescue package involving mainly FRF 4.9 billion in new capital injections, setting-up of a special hive-off vehicle (EPFR) to take over FRF 43 billion of NPLs and de facto unlimited state guarantee on losses of such hive-off vehicle. However, in 1995 it became clear that the extent of the problems had been underestimated and an additional amount of FRF 150 billion was removed from the bank's balance sheet.[254] The hive-off structure was financed by CL through a loan if FRF 135 billion.[255] The annual rate of interest was set was initially fixed at 7 % in 1995 and at 85 % of the money market rate from 1996. In addition, a FRF 10 billion loan was granted by CL to EPFR to finance the interest on the FRF 135 billion loan.

In September 1996, the French authorities granted a new emergency aid to CL, in form of a capital increase, totaling FRF 4 billion.[256] In addition, the French authorities decided to compensate CL fully for the burden of the loan to the EPFR and the zero-coupon bond concept was abandoned.

In 1997, the French Government drafted a new plan to respond to the further deterioration of CL's balance sheet.[257] This plan comprised of the definitive neutralization of the costs of CL's loan to EPFR, the reimbursement of CDR's[258] operating costs, which were charged to EPFR and to the State, for FRF 7.8 billion and CDR's transformation into a public company and its reorganization. Finally, CL was sold by the French Government in 2002 to Credit Agricole for EUR 16 billion.

The Commission decision of 1995[259] reviewed the state aid granted in 1994 and 1995 and approved the 1994 measures. The Commission relied on the French authorities'

[254] The total amount of hived-off assets includes FRF 55 billion of liabilities, the net amount of the assets hived-off is FRF 135 billion.

[255] The maturity date for the loan is 31 December 2014.

[256] This aid was cleared by the Commission in 1996.

[257] This plan was cleared by the *Commission Decision of 20 May 1998* concerning aid granted by France to the Credit Lyonnais group, C(1998), 1454 and *95/547/EC: Commission Decision of 26 July 1995* giving conditional approval to the aid granted by France to the bank Credit Lyonnais, L (1995), 307.

[258] CDR is a part of the hive-off vehicle with the aim to sell all non-performing assets.

[259] *95/547/EC: Commission Decision of 26 July 1995* giving conditional approval to the aid granted by France to the bank Credit Lyonnais, L (1995), 307.

projections that the 1995 rescue plan would be self-financed by a better-fortune clause[260], the interest on zero-coupon bond subscribed by the hive-off structure and by the privatization of CL. The Commission decision of 1996[261] approved the new emergency capital increase and the neutralization measure. However, the Commission ordered CL to renounce the future tax cuts caused by its current losses and contribute 58 % of its net income to the EPFR until 2003. The Commission decision of 1998[262] approved the aid granted to CL as it was as it was the only way to restore CL's profitability. The French Government had to comply with the previous decisions and to negotiate each change directly with the Commission.

In its assessment of the aid granted by the French Government to CL the Commission considered the special nature of banks and applied the guidelines of rescue and restructuring with specific reference to the banking sector. It should be noted the Commission demonstrated in its assessment that given the circumstances and since CL's capital adequacy ratio fell below the minimum, a private investor would have not undertaken an investment in the bank, mostly because a private investor could have never mobilized such amounts as to rescue CL. Also, the Commission concluded that aid measures in question distorted competition and had effect on inter-state trade because more than half the activities of CL were taking place outside the local area of France, while the activities located in France, although spread throughout the country, were concentrated in medium-sized and large urban areas. As quid pro quo, CL sold assets worth FRF 620 billion on its balance sheet at 31 December 1994, reduced its commercial presence in the rest of the world, the CL's growth was limited by a ceiling and CL contributed to EPFR by means of a better fortunes clause.

The decision in the CL case has been followed by many subsequent cases, such as the Banco di Napoli case.

[260] The distortions of competitions were reduced by better fortunes clause, forcing CL to contribute 61 % of CL's net income to EPFR.

[261] *Action brought on 11 March 1996* by Credit Lyonnais against the Commission of the European Communities, C(1996), 133.

[262] *Commission Decision of 20 May 1998* concerning aid granted by France to the Credit Lyonnais group, C(1998), 1454.

Banco di Napoli Case[263]

At the end of 1993, Banco di Napoli (BdN) ranked seventh in Italy in terms of total balance sheet, with a capital adequacy ratio (9.3 %) above the regulatory minimum, however, with a low profitability. BdN suffered severe losses in 1994 and 1995, which had a devastating effect on bank's balance sheet and made it impossible to comply with the prudential ratios. Its majority shareholder at that time was the Italian State, holding in total 57% of the capital and 87% of the voting rights.

One of the main reasons for such extensive losses was the BdN's aggressive expansion policy. *„[T]he Bank launched a particularly active policy of expansion at the beginning of the 1990s, focusing on its network of branches and loans to the large industrial groups [...] at a time when the economy had already entered into a recession."*[264] In addition, the bank pursued unsuitable credit selection methods and inadequate risk control procedures.

The further deterioration of the bank's results led to a liquidity crisis. The crisis was temporarily resolved by a debenture loan of ITL 2 365 billion granted in January 1996 by Cassa dei Depositi e Prestiti and other public and private banks. In addition, the Italian Government approved as a matter of urgency a decree-law on the reform, restructuring and privatization of BdN.

The package of measures comprised of the following:

- Capital increase by the Treasury totaling ITL 2 000 billion;
- The possibility for the central bank to grant advances[265] to cover losses resulting from financing by the BdN to assist group companies[266] being wound up in order to facilitate the restructuring of the group;

[263] Based on *Commission Decision of 29 July 1998* giving conditional approval to the aid granted by Italy to Banco di Napoli, C(1998), 2495.

[264] *Commission Decision of 29 July 1998* giving conditional approval to the aid granted by Italy to Banco di Napoli, C(1998) 2495, p. 36.

[265] The *Treasury Decree of 27 September 1974* provides that the Banca d'Italia may grant 24-month advances at 1% on long-term Treasury bond to banks, which acting by surrogation on behalf of depositors of other banks in compulsory liquidation, are required to write-off bad debts.

- Tax concessions totaling ITL 36 billion gross;
- Setting up a hive-off structure to manage, liquidate and deconsolidate ITL 12 400 billion of bank's NPLs. The assets were transferred at net book value on June 30, 1996.

The main purpose of these operations was to clean bank's balance sheet and thus to facilitate the early privatization of the bank. The privatization process ended in January 1997, when 60 % of BdS shares were sold for ITL 61 billion to a consortium of two financial institutions.

The Commission concluded that aid to the BdN (except of advances granted by the central bank) constitutes state aid, which distorts competition to an extent likely to affect intra-Community trade.[267] However, it also stated: *„[T]he State contribution did not help to strengthen the Bank's position more than is strictly necessary and does not restrict competition from other European banks. On the contrary, the market share held by the Bank has been considerably reduced.*"[268, 269] As a result, **the aid in question was regarded as rescue and restructuring aid compatible with the common market.**

To conclude this section, we have shown that **on the contrary to crises of banks in well-functioning market economies, where the reasons for the bank's losses are generally specific to each particular bank**[270] and related to a large extent to its aggressive commercial and credit policy, **the crisis in the Czech banking sector was caused mainly by factors not just specific to each bank, but specific also to the economy in transition.**

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[266] Initially, these advances were limited to cover losses, which may have arisen in connection with winding-up of Isveimer, in which BdN had a 65% holding and which entered into voluntary liquidation. Later, the possibility of using such advances was extended to cover losses relating to assets transferred to a specific hive-off structure.

[267] The Commission declared the capital increase unlawful because it took place without a formal request to the Commission. However, the Commission considered such aid to be essential to the survival of the BdN.

[268] The total balance sheet fell from ITL 121 000 billion (end 1994) to ITL 69 000 billion (end 1997), i.e., a 43 % reduction in three years), BdN also reduced its presence abroad and sold 77 branches in Italy.

[269] *Commission Decision of 29 July 1998* giving conditional approval to the aid granted by Italy to Banco di Napoli, C(1998), 2495, p. 54.

[270] *Ibid*, p. 48.

Master's Thesis Project

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Title: State Aid to the Czech Banking Sector in the Context of EU Accession

Abstract:

The issue of state aid to the banking sector has emerged with respect to the negotiation of the Accession Agreement between the Czech Republic and the EU. After accession, EU state aid law may theoretically lead to an obligation to reimburse part of that aid provided to the Czech banking sector. Such situation would result not only into difficulties of affected banks but also to litigations of these banks against the Czech State and, most likely, to litigation against the Commission reimbursement decisions.

Under the Accession Agreement, the European Commission has unlimited power to review all cases of public aid in the Czech banking sector, even if they have been already approved by the respective Czech State institutions (e.g. the Competition Office or the Ministry of Finance). Only cases of public aid approved by the Commission will be, upon accession of the Czech Republic to the EU, considered to be "existing aid" and the Czech Republic may continue granting such aid. Therefore, all public aid granted after 10 December 1994 will be subject to the above-mentioned *interim procedure*.

It has to be stressed that the Accession Treaty deviates from the state aid rules commonly applied in the EU because the Commission will retroactively revise most cases of the state aid, including the privatizations of the major Czech banks. The respective language of the Accession Treaty (or at least the approach of the European Commission to such a revision) should more emphatically respect the past and refrain from inappropriate and unusual interference with the system of state aid provided and approved by the national authorities prior to EU accession.

Therefore, the main goal of the thesis is to depict the past, i.e. to explain the state aid to the banking sector in the context of transition. The author will show that on the contrary to crises of banks in well-functioning market economies, where the reasons for banks' losses are generally specific to each particular bank and related to a large extent to its aggressive commercial and credit policy, the crisis in the Czech banking sector was caused mainly by factors not specific to each bank, but specific to the economy in transition.

Hence, the incurrence of some fiscal costs to overcome these crises is inevitable for the transition countries and should not be principially viewed as state aid distorting competition in the financial market. Although the Czech Republic has spent quite substantial fiscal costs in the process of banking sector consolidation, the result is a sounder, competitive and more efficient banking system, ready for the competition in the international context, without a threat of destabilising banking sector in the Common Market.

Outline:

1. Introduction/Problem Statement
2. Triggers of the Banking Sector Crisis
3. Real Causes of the Crisis
4. Crisis Resolution
    - International Comparison
    - World Bank Recommendation
    - Adopted Solution
5. Costs of the Banking Sector Reform
6. Current Performance of the Banking Sector
7. Analysis of Market Distortions
8. Conclusion
9. Bibliography

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Date: 10/6/2003

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