Post-Communist Economies, Vol. 17, No. 3, September 2005

The Troubled Transition of Czech Banks to Competitive Markets

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Abstract

The Czech Republic privatised industrial enterprises rapidly but kept state control of its big banks, which were expected to finance the transition to a market economy. The outcomes were not entirely successful, certainly not for the banks themselves, which ended up technically bankrupt and were eventually sold to foreign investors. This study analyses the actions of bank managers and the policies of government to understand what went wrong, based on personal interviews with top managers and bank financial statements. It concludes that state ownership of banks was adverse to their performance, and that the implicit contract between bank managers and government ministers ('you make risky loans and we'll get growth now and bail you out later if we need to') did not work. Conflict between government's objective to finance the transition and banks' private profit objective might be resolved with clearer channels for government influence, better functioning markets and institutions, and bank managers with market economy experience. Lessons learned from the Czech experience apply not only to future cases of banks in transition economies but also to business relationships with government generally in turbulent times.

After five decades of isolation from competitive markets, Czech industry after the Velvet Revolution needed to be restructured with new technologies, modern plant and equipment, new products and new markets, and new management skills. How could the transition be financed? The Czech approach was to privatise industrial enterprises rapidly by vouchers, keep state control of the big banks, and use them to finance the transition.

The outcomes were not entirely successful. Initially good macroeconomic results gave way to currency crisis and recession. Three of the four big Czech banks were technically bankrupt by the mid-1990s, bailed out by the government, and eventually

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We are indebted to Robert Kennedy, Jana Matesová, Michal Mejstřík Lynn Sharp Paine, Ondrej Schneider, David Walker and Radoslaw Kenig for research advice and assistance, and to the Leadership Forum for financial support and conference sponsorship where previous versions of this research were discussed. Errors of fact and interpretation remain our responsibility.

ISSN 1463-1377 print/ISSN 1465-3958 online/05/030363-18

DOI: 10.1080/14631370500204396

sold to foreign buyers. The transformation of the banking sector cost the Czech economy one-third of one year's GDP or about USD 1,000 for each Czech citizen (Mejstrík, 2004).

Why did the big Czech banks perform poorly in the transition years? Were they badly managed? Could Czech bank managers have made better business decisions? The Czech Minister of Economics and Commerce during this time, Vladimír Dlouhý, said

> The problems [of the banking sector] in 1995 and 1996 were the result of poor corporate governance and poor risk management, especially inadequate provisions and reserves. The result was a large increase in non-performing loans. (*Dlouhý*, 2004)

A similar early assessment based on Czech experience from Desai (1996) was that

> ... large bank based systems should not be hastily recommended to transitional countries engaged in the privatisation of state enterprises [because they] inhibited effective corporate governance.

Were government policies mistaken? After the event there was criticism about inadequate regulation and supervision of banks, failure to develop institutions and delayed bank privatisation (*Economist*, 2002). Another insider in the Czech transition, Jiří Havel, who was head of the National Property Fund during the mid-1990s, emphasised the latter:

> The problem of Czech bank privatisation was bad timing. It was too late. It came after markets were liberalised and the interest of investors was over, and after the banking sector had lost its credibility. (*Havel*, 2004)

Václav Klaus, prime minister in 1992–97, blamed the central bank:

> There was a total misunderstanding by the central bank of the bad loans issue, of how good loans switch into bad loans. I am convinced that responsibility for the switch of good loans into bad was the super-restrictive policy of the central bank (*Lidové noviny*, 1998).

A recent analysis by Mejstřík (2004) points to both the public and private sectors:

> The Czech banks had to cope with a weak legal framework that resulted in poor corporate governance in large numbers of newly privatised industrial enterprises. They had state-appointed top managers who were less aggressive and autonomous than required by principles of prudential banking, and inexperienced staff. There was information asymmetry between borrowers and lenders. Supervision was passive and ad hoc.

Maybe the problem could not have been avoided; maybe it was caused by the dearth of valid information on which to base lending decisions, the slowness of markets to develop and transmit price and cost signals, and the lack of experience that anyone could have had to deal wisely with the unprecedented problems of financing the transition. Other countries also had problem-plagued banking sector transitions, including Poland (Bonin & Leven, 2001), Bulgaria (Erdinc, 2003) and Georgia (Amaghlobeli, Farrell, & Nielsen, 2003).

Our task is to marshal the evidence and assess the experience of the Czech banking sector. Was it possible both for banks to perform according to market standards and for government to achieve its transition goals? Could the high cost of the transition have been lower? We suggest actions that each could have taken different from those actually followed. We do not judge whether the Czech approach to making the transition—a macro-policy choice—was good or bad. Given that approach, we extract lessons from the Czech experience for both bank management and government policy implementation. The lessons learned apply not only to future cases of transition economies but also to relationships between business generally and government in turbulent times.

Starting Conditions in the Czech Banking Sector

The banking sector in Czechoslovakia in communist times consisted of a state-owned monobank with both central bank and commercial bank functions, and four specialised banks: a retail bank, Česká Spořitelna (ČS), that collected savings deposits, an investment bank, Investiční Banka, that made long-term investment loans, a foreign trade bank, Československá Obchodní Banka (ČSOB), that financed exports and imports with offices abroad, and an old small bank, Živnostenská Banka (ZB), that focused on small business customers and conducted retail foreign currency operations. In 1990 the state monobank was divided into a central bank, Česká Národní Banka, with traditional monetary and regulatory functions, and a separate commercial bank, Komerční Banka (KB). All five of the banks were licensed as universal banks on the German model, and became potential competitors, although each started with unbalanced and different types of resources and experience. Bad debts inherited from old Soviet-era loans were taken off Czech banks' balance sheets (they were CZK100 bn or USD3.5 bn) so the banks started with a clean slate (Snyder & Kormendi, 1997).

Government Transition Policy: Shock Therapy and Free Markets but Not for Banks

The government's policy implemented in January 1991 after the demise of central planning was shock therapy. State-owned industrial enterprises were privatised rapidly using vouchers (along with direct sales of a few companies to bidders, such as the sale of Škoda to Volkswagen). Vouchers were used because, government leaders reasoned, Czechs had no money with which to buy companies, and not everything should be sold to foreigners. Between 1992 and 1994 Czechs spent their vouchers on shares in state-owned enterprises being privatised, or they put their vouchers into investment funds (similar to closed-end mutual funds). Very little new cash went into the privatised enterprises.

Bank Ownership and Control: the State Remains

The banking sector was treated differently. The government's objective for banks was that they should finance the transition from a state-owned centrally planned economy to a privately owned market economy. The needs for investment by industrial companies were great, and state-owned banks could lend to meet these needs. The government could achieve faster economic growth and higher employment, at least in the short run, if banks financed the transition. Because the banking sector was critical to the transition of industry, it was kept under state control during this process. Prime Minister Klaus explained it later in an interview:

> The reason for the delay of big banks' privatisation did not consist of ideological fears. It was a purely practical consideration, that private banks will behave too prudently ... and de facto not dip into the real economy. ... It is possible to be such a parasite. ... I was always very afraid that while attempting to follow their private interests, the loan channels would be blocked. ... (*Lidové noviny*, 1998, p. 13)

Only a minority of the shares of three of the big banks—CS, IPB and KB—were put into voucher privatisation in 1992, and the government retained control as the single largest shareholder with stakes ranging from 47% to 60%. Investment funds obtained large minority ownership stakes, except in ČSOB, which was not part of voucher privatisation (Table 1). These government policies turned out to be ill-fated. Jiří Havel succinctly put it this way:

> The government did not privatise the banks, but the borrowers 'privatised the money' of the banks. (*Havel*, 2004)

It was not known then, but it is clear now, that privatised banks performed better than state-owned banks in transition countries, and foreign ownership of banks in these countries improved their performance (Bonin, Hasan, & Wachtel, 2004; Hasan & Marton, 2003; Naalborg *et al.*, 2003; Borish, Ding & Noel, 1997). We can suggest the reasons in the Czech case.

Multiple Channels of Government Influence. The government exercised its ownership officially through the National Property Fund (NPF), which held board memberships in the banks. The supervisory board of the NPF itself was nominated by the Ministry of Finance, which also placed representatives on the banks' boards. The central bank was the regulatory authority. Members of the Czech parliament, though lacking statutory control, could represent the interests of their constituents, some of which included industrial enterprises that needed financing (Figure 1). All in all, a bank's top manager faced four channels of influence from government.

Conflicting Objectives. The government's objective for the banking sector was that it should finance the transition of industry. The objective of private shareholders in a market economy is to earn a return on their investment. This objective requires efficiency-oriented bank management, which conflicted with the government's public interest objective. The task of Czech bank managers was a dual one of building banks that were profitable for their minority private shareholders while satisfying the objective of their controlling government owner. This was not the usual principal–agent problem of capitalist economies because the state was the controlling owner. Nevertheless, the problem for bank managers was how to assist the state to achieve its objective while following prudent banking practices, basing lending decisions on the credit worthiness of the borrower.

Markets: Competition is Ineffective

Banking Market Concentration. The central bank adopted an easy bank licensing policy, and by 1993 there were 52 banks, most of which were small, under-capitalised

Table 1. Czech bank ownership structure

	Česká Spořitelna			Československá Obchodní Banka			Investiční a Poštovní Banka			Komerční Banka		
	1992	**1998**	**2000**	**1992**	**1996**	**2000**	**1992**	**1997**	**2000**	**1992**	**1997**	**2001**
State	60	60	7	51	66	0	47	36	0	49	49	0
Investment Funds	26	26	0	0	0	0	45	0	0	44	27	0
Individuals incl. managers, employees	15	2	2	5	5	4	7	64	0	7	7	6
Domestic firms	0	0	11	45	3	0	0	0	0	0	5	6
Foreign firms	0	12	80	0	26	96	0	0	100	0	12	78

Source: Mejstrík, 2004.

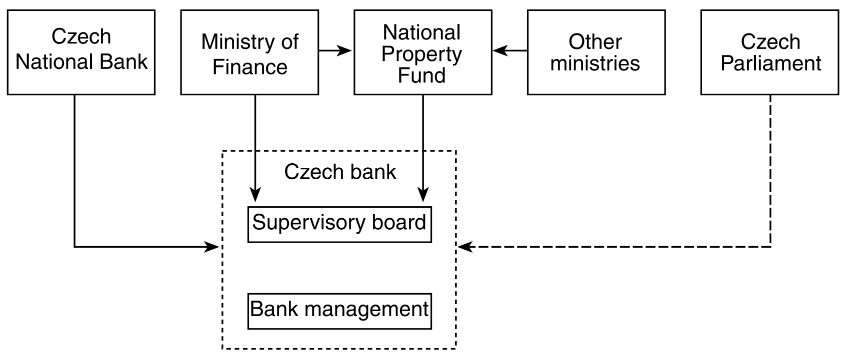

Figure 1. Government influence on main Czech banks.

and not cost-efficient (Nikiel & Opiela, 2002). New small banks typically paid the highest interest rates to attract deposits, but made the lowest quality loans because they were a last resort for borrowers. Many of the new banks failed, and the domestic bank population began decreasing in 1995.

Foreign bank branches were permitted from the start of the transition, but foreign investors could not acquire controlling stakes in major Czech banks (unlike in Poland). Foreign bank branches mainly served the needs of companies from their home countries that began operations in the Czech Republic. They made some loans to Czech companies, cherry-picking the best lending opportunities, as in Russia (Tompson, 2004), but they did not compete for the bulk of Czech banking business. The market share of foreign banks grew, but did not exceed 18% as late as 1998 (Figure 2). The four-firm concentration ratio was a high 71% as late as the eve of final privatisation in 1998 (Hanousek *et al.*, 2002; Mejstrík, 2004).

Banking Market Imperfections. The market for banking services worked poorly, which was due partly to weak institutions. Old institutions vanished when central planning ended, but new formal institutions—legal, regulatory, financial—were slow to be created by the government and did not arise spontaneously (Newman, 2000; Newman & Nollen, 1998). There was no effective bankruptcy law, weak protection of creditors' and minority shareholders' rights, little bank supervision, no regulatory agencies for financial markets or regulations about insider trading, and no standards for corporate governance in the early years of the transition (Hanousek & Roland, 2002). Even if laws and regulations were established, they were unevenly enforced.

The lack of valid, reliable information contributed to the imperfect banking market. Accounting data could not be trusted. Audits to assess financial soundness could scarcely be conducted. Bank financial statements were not suitable for reporting until 1995. Missing data, weak institutions and absent customs combined to make the transaction costs of conducting banking services high, especially via the external market. Opportunism abounded, buyers (borrowers) and sellers (banks) had unequal information, and arms-length contracts were hard to enforce. Banks as lenders and creditors were heavily disadvantaged.

Missing Capital Markets. Most transition countries depended on banks to finance their transitions, but none more than the Czech Republic. Compared with neighbouring

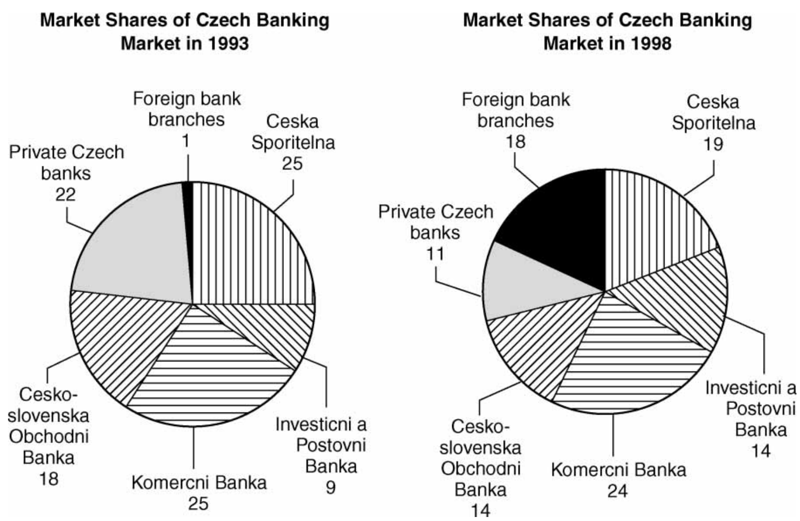

Figure 2. Shares of Czech banking market (%).

economies, the Czech Republic had the highest share of GDP in bank deposits, the highest share in corporate bonds and commercial paper, and the lowest share of GDP in stock market capitalisation. Banks owned 80% of the assets of the financial services sector and controlled 95% (Mejstrík, 2004). Trading on the Prague Stock Exchange, created soon after voucher privatisation in 1994, was light.

Because markets did not function effectively and weak institutions did not provide a supportive business environment, the task of managing banks in the transition fell wholly on their individual managers and owners. Did they have the resources and capabilities to do it?

Bank Management: Great Needs, Few Resources

Czech banks faced problems that derived from the radical differences between central planning and a market economy. Banks needed tangible resources such as financial capital and modern banking technology, intangible resources such as reputation and organisational culture, and human resources including managers with the right skills, attitudes and practices. Banks needed functional capabilities such as managerial accounting, risk management, strategic planning and consumer marketing. These functions were non-existent in central planning. What Czech banks had was an abundance of technically educated employees who were paid low wages, and they had top managers with old-regime banking values and habits but not market experience.

Bank Managers: Legacies from Central Planning

The people who secured top management positions in the big Czech banks in 1991 or 1992 came from the monobank of central planning, and they all retained their top positions into the late 1990s. Although they were experienced in the administrative tasks of banking under central planning, they did not make strategic decisions for which they were responsible. They lacked entrepreneurial vision (Dlouhý, 2004). They were new to managing risk, valuing collateral and providing for losses, and they lacked data with which to make such decisions. They had no experience with corporate governance.[1] Managers in three of the banks were described later by other Czech bankers:

> They were more or less state clerks, bureaucrats, unable to think in business terms; they didn't know much about their customers; it was an office, not a bank.
>
> They were creative, but in that unsettled environment with lack of institutions, it was disastrous.
>
> They were too politically oriented and entrenched. [The bank] should have recruited a couple of Western bankers to teach the locals.

Corporate Governance: Cross-Ownership and Conflicts of Interest

After voucher privatisation investment funds acquired sizable ownership stakes in privatised companies. Many banks created their own funds, and bank-controlled funds ended up owning the majority of industrial company shares that were held by investment funds. The funds were later criticised for their short-term interests and lack of expertise as owners (see Wright *et al.*, 1998, for a Russian perspective). Three of the four big Czech banks created investment funds (ČSOB did not). In addition, one bank's investment funds owned shares in other banks. For example, KB and IPB together owned 12.7% of ČS shares, and ČS and IPB together owned 15.7% of KB shares—each was one-third of the total ownership not retained by the government (an investment fund was limited to a 20% shareholding in any one company). The investment funds of all Czech banks together had 80% of ČS and KB shares held outside the government (Mejstřík, 2004). The result was cross-ownership of one bank by another via their investment funds. Investment fund managers were in the awkward position of representing their owners (their banks, and ultimately the government) in a competing bank.

When a bank's investment fund owned a sizable stake in an industrial company, a conflict of interest arose. The bank had two roles with the industrial company: those of lender and owner. As a lender, the bank should apply prudent lending criteria based on the creditworthiness of the borrower, including its financial soundness, business plan, quality of management and prospects in the competitive marketplace in the long run. As an owner via its investment funds, the bank might look for a short-run return, or as was often the case during the transition period, it might want to stave off losses and bankruptcy and therefore lend rather than foreclose or force default.

> Banks did not use their creditor rights to enforce restructuring of industrial enterprises because of their interdependencies with them ... Rather than close down badly managed or failing firms and reallocate capital elsewhere, the banks kept them going. Since the banks owned investment privatisation funds that in turn owned industrial firms, the banks did not want to liquidate a string of interdependent firms that were their loan customers. (McDermott, 2002)

Bank Performance

Each of the big Czech banks started in 1991 as a specialist in savings, investment, commerce or foreign trade. To compete in a market economy, banks needed to broaden their product lines and diversify into new markets, and they did so. ČS, the savings bank with ample deposits, developed a commercial lending business. IPB, the investment bank, built a retail presence via a branch bank network. KB, oriented to corporate banking, developed new products, including credit cards, and became a leader in the adoption of new banking technologies, which was a weakness for all Czech banks. ČSOB also attracted deposits with retail banking services.

Lending and Financial Performance: Poor and Getting Worse

The performance of banks can be measured in several ways. However, the data we report obscure the reality of Czech banking in the 1990s in three ways. First, some of the data were reported long after the events occurred and were not known to bank managers or regulators at the time. Second, financial accounting standards and bank regulation and supervision developed slowly; the veracity of some of the data is questionable both from the standpoint of honest errors and outright misrepresentation. Third, even if the banks' financial statements were correct, they might not show true performance because of off-balance sheet transactions. The reported performance of banks overstates their actual performance.

The performance of Czech banks up to 1996 was not good, but it deteriorated after that year. One reason was a regulatory shock from the central bank. In July 1996 the Czech National Bank introduced new rules that increased disclosure of financial results, made it more difficult to roll over old loans, and required new valuation of collateral (downward) with a consequent increase in provisions. The second shock was a downturn in the Czech economy. GDP growth became negative in 1998. The currency, which had been pegged to the German mark and US dollar, depreciated and was floated with a wide band in May 1997. These macroeconomic shocks dealt severe blows to banks. Domestic investment and saving decreased, and foreign investor interest in the Czech economy declined. Price inflation fell in 1999, which made it harder for debtors to repay what they owed because their debts did not decrease in real terms as in the days of higher price inflation.

Lending and Liquidity. The managers of the big Czech banks faced heavy political and media pressure to lend to privatised enterprises, and all of them increased their lending volume during the transition years. Total loans to all clients increased by 50% in the four years from 1994 to 1998. The banks were financing the transition. They also increased their deposits, but not by as much.[2] The banks' liquidity, measured as the ratio of loans to deposits, decreased—the banks become more loaned up. The loans/deposits ratio rose from 0.79 to 0.93 over this four-year period (Figure 3). [3]As a comparison, the ratio for small US banks in 2002 (under $100 million in assets) was 0.71 (FDIC, 2003).

Loan Quality. Non-performing loans were classified according to their likelihood of default, which depended on how far past due the payments were. 'Loss' loans counted 100% toward classified loans, 'doubtful' loans counted 50% and 'sub-standard' loans 20%. All other loans were standard (not classified).[4] The ratio of classified weighted loans to total loans, which indicates the quality of the bank's loan portfolio, was too high for the big Czech banks—19.8% in 1994—and it worsened to 23.5% by 1998 (excluding ČSOB) (Figure 4). Classified weighted loans exceeded the banks' core capital (mainly equity) in some years for some banks by 2–3 times. This meant that all of the banks' capital, and more, was at risk. The big Czech banks had double the bad loans of their Polish or Hungarian counterparts, while the classified weighted loan share for continental West European banks was only 3.4% (Nejedlý, 1999).

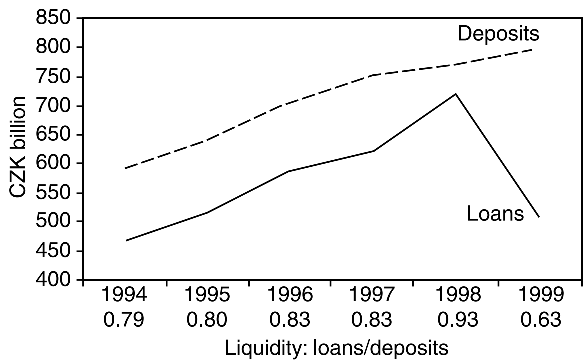

Figure 3. Deposits and loans of Czech banks (Česká Spořitelna, Investiční a Poštovní Banka, Komerční Banka).

Provisions for Losses. Banks made provisions for bad loans and established reserves to cover defaults; conservatively, a bank might hold reserves up to the amount of classified weighted loans, depending on loan collateral. The Czech banks did not achieve this standard; their reserves were far too small, and they became relatively smaller until the central bank tightened regulations. Reserves as a share of classified weighted loans were 23.1% in 1995 and fell to 11.3% in 1997 (ČSOB's provisioning was better). The big Czech banks trailed badly behind their Polish and Hungarian counterparts, whose sum of provisions and reserves as a percentage of classified weighted loans was one-third greater.

Capital Adequacy. Each of the big Czech banks achieved the internationally sanctioned capital adequacy standard of 8% by 1995 and sustained it, but just marginally so (the ratio averaged 9.1 for 1995–97 for the three banks) and by dubious means.[5] One technique was to roll over doubtful loans or grant new soft loans to prevent deterioration in the reported capital adequacy ratio. Another factor was the intervention of the government either to increase the bank's capital or to take bad loans off its balance sheet. (The exception again was ČSOB, which steadily increased its capital adequacy and did not receive any government aid after

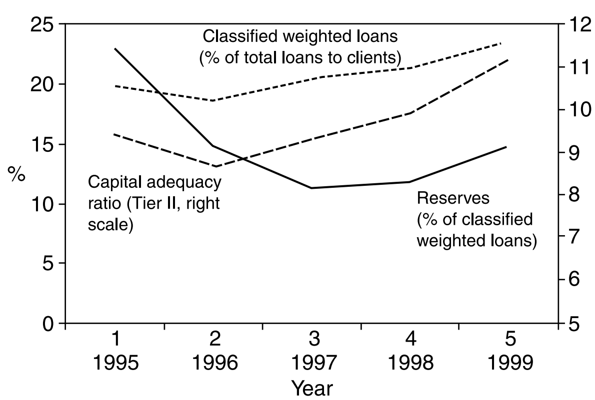

Figure 4. Financial soundness of Czech banks (Česká Spořitelna, Investiční a Poštovní Banka, Komerční Banka).

1993.) The Czech banking sector as a whole had a lower capital adequacy ratio than German or British banks ($11\frac{1}{2}$ – $12\frac{1}{2}$) or Polish banks (13.1) in 1995–97 (*Economist*, 2004b; Nejedlý, 1999). Even achieving the 8% standard was too little for Czech banks. If capital requirements had been more closely linked to actual risk, as in the proposed Basle II requirements due to take effect in late 2006, Czech banks probably would have needed more capital.[6]

Interest Rate Margin. Because they had few products at the start of the transition, the Czech banks depended on the margin between lending and borrowing rates for their net income. They had only a little income from fees for services—12 – 21% of income in 1995. The interest rate margin for the big four Czech banks was $2\frac{1}{2}$ – $3\frac{1}{2}$ percentage points in 1995 and increased somewhat after that. These margins were quite wide, which is consistent with the view that Czech banks faced risky lending conditions (Drako, 2002, 2003; Fries, Neven, & Seabright, 2002). In comparison, the interest rate margin among continental West European banks was 1.9 percentage points.

Profitability. The big Czech banks either earned very small profits or made losses. Returns on assets in 1994–96 were positive, in the 0.4 – 0.8% range. After that the big banks as a whole made losses of −0.8 to −1.4% RoA (Figure 5). Returns on equity were also small, less than 10% in the early years, with negative returns later on. In the Central and Eastern European region overall, domestic banks averaged almost 1% RoA in 1995–97 (Grigorian & Manole, 2002; Naalborg *et al.*, 2003), and continental West European banks earned 0.4% RoA and 14.6% RoE in 1995–97 (Nejedlý, 1999).

Efficiency. If financial markets are competitive, each bank faces roughly similar interest expenses, and its earnings therefore depend on its operating expenses. Input efficiency, which is the ratio of operating expenses to net interest and fees income, was satisfactory up to 1997, and similar to the continental West European average, except for IPB, whose results were worse than the others. However, the Czech banks' input efficiency worsened over time. Output efficiency, measured as the ratio of net interest income to assets (similar to a return on assets measure of profitability), was small and nearly constant over the transition period (Oster & Antioch, 2002).

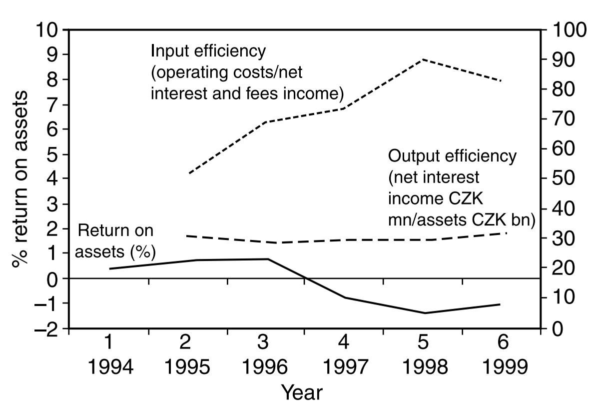

Figure 5. Profitability and efficiency of Czech banks (Česká Spořitelna, Investiční a Poštovní Banka, Komerční Banka).

Performance Summary: Bad Loans and Losses

Considering all the bank performance measures, the outcome is clear: the big Czech banks performed poorly. They loaned too much, made too many bad loans and failed to make sufficient provisions for bad loans. Their capital adequacy ratio looked satisfactory but really it was not; it misrepresented their soundness because they hid losses. Their profitability, small at first, turned into big losses. Their performance was not only worse than West European banks but also worse than domestic banks in other Central and Eastern European transition countries.[7]

Final Sale to Foreign Strategic Investors

The Czech government resolved in November 1997 to solve the banking sector's worsening problems and finally to privatise all the big banks. The government spent tens of billions of koruna to take bad loans off the banks' balance sheets, and provided guarantees to prospective investors (Table 2). The long-serving top management of ČS and KB was changed, and the government introduced incentives for the new chief executives linked to the bank's performance.

The government sold each bank to a single credible foreign strategic investor. ČSOB was in the best condition and did not require any further state bail-out; it was sold in 1999 to KBC of Belgium for a price that came close to the government's prior aid. ČS was second, purchased in 2000 by Erste Bank of Austria, but the government's cost of fixing ČS far exceeded the price it received. The sale of KB was delayed by a scandal, but in mid-2001 it fetched a price from Societe Generale of France that exceeded the government's expectations though it fell far short of the cost of the government's bail-outs. Meanwhile, IPB became insolvent, suffered a liquidity crisis, and was put under forced administration in July 2001. Three days later it was sold to ČSOB—now owned by KBC—with extensive government guarantees.

The Outcomes

At the beginning of the transition the Czech government owned four big banks that it had cleaned of bad loans from central planning days. At the end of the transition 10 years later the government had for the most part succeeded in financing the transition of the industrial economy, but it took inflows of foreign capital to do it. The four big banks were privatised to foreign owners that were mid-sized European banks. The cost of these outcomes was high. The money the government spent on financial assistance to the banks during 1994–2001 was more than three times the amount it received from their sale proceeds of CZK 102 billion.

Lessons Learned

The transformation of Czech banks and their role in financing the transition of Czech industry was a troubled case of business and government interaction. Each needed the other and each helped the other. But neither was pleased with the outcomes. The experiences, reinforced by events in other transition countries (see Megginson & Netter, 2001, and Djankov & Murrell, 2002, for reviews) lead to lessons for government officials, bank managers and business executives who deal with governments in turbulent times.

Table 2. Government financial assistance to main Czech banks and price received for final sale (CZK billion)

	Česká Spořitelna	Československá Obchodní Banka	Investiční a Poštovni Banka	Komerční Banka
Government assistance, 1994–2000				
Direct financial assistance				
Without guarantees	0	3–30	0	33–53
With further guarantees	59–67	0	99	24
Bad loan transfers	46	27	95	20
Privatisation guarantees	13	3	0	9
Equity increases	8	0	4	0
Sale to strategic investor				
Year of sale	2000	1999	1998/2000[a]	2001
Price paid to government	19	40	3	40
Stake purchased (%)	52	83	36	60
Expected net gain or loss incl. guarantees	−40 to −48	+10 to +37	− > 100	+7 to −13

Notes: Government assistance shown in this table does not include forgiveness of Soviet-era loans before 1994.
[a]See section on **Final Sale to Strategic Investors**.
Sources: Czech Ministry of Finance; Mejstřik, unpublished data.

(1) ***State ownership was adverse to firm performance***. This was demonstrated in the Czech banks' case (and shown in statistical studies of industrial firms in transition countries reviewed in the survey articles noted above). The conflict between the government's view of the public interest and the banks' need for private profit damaged bank performance, and it probably impaired achievement of the state's objective. This is not to say that state ownership of banks is necessarily a mistaken privatisation approach. Both Poland and Hungary retained state control of banks, and both countries arguably enjoyed better outcomes for the banks than the Czech Republic.
(2) ***Early privatisation was better than late privatisation***. Most industrial enterprises were privatised early, but not the big banks. The government's controlling ownership contributed to the banks' business problems.

If we accept these lessons, how do we finance the transition? 'If you stop lending, you stop the economy' (Havel, 2002). If the government's objective is worthy, and banks are essential to the solution, how can we resolve the conflict of objectives? From the Czech experience, we can point to what did not work and suggest alternatives.

(3) ***The implicit contract did not work***. To serve the government's objective, bank managers made risky loans to industrial firms that were not creditworthy, and the banks' performance suffered as a result. The government did not require much disclosure (no one would know how badly off the banks were), did not impose stringent regulations, and supervised banks only lightly. The government would bail out the banks if their bad loans were too great and their losses too large. In return, the government got economic growth and stability—and would pay for it later, if necessary. It was not written and not even verbalised, but the idea was understood: it was an implicit contract between banks and government. It was a classic case of moral hazard. 'It was banking socialism' (Dlouhý, 2002). If bank managers believed in the implicit contract, their lending decisions were more risky because the adverse consequences to them of losses from bad loans were mitigated. The implicit contract needed to be made explicit. Lending decisions must be made on prudent market-driven criteria, and lending that does not meet these criteria can be separated for government guarantees or state-assisted workouts (as in Poland; McDermott, 2002).
(4) ***Too many competing, conflicting and interdependent channels of owners' influence made managers' jobs difficult***. The government had multiple channels of influence, and they were both formal and official, and informal and political. The banks' private owners exerted additional influence—investment funds of other banks were cross-owners and had mixed motives characteristic of interlocking directorates. It is better if the government's ownership is singular and experienced, and private owners are independent.
(5) ***Government needed to take a stronger role to facilitate the creation and evolution of institutions to underpin the effective functioning of markets***, even in a conservative, free market-oriented system. The banking sector experience demonstrates that the strategy to 'depoliticise institution building and restructuring' (McDermott, 2002, p. 73) did not work. Legal and financial institutions mattered, but they did not arise spontaneously. Informal customs and practices can arise spontaneously, but slowly. Markets need more than freed-up

prices to function effectively. They need regulation to guide corporate governance and banking standards, with enforcement. They need valid, reliable and abundant information; otherwise transaction costs are too high. They need strong competitors, domestic or foreign.

(6) ***Banks alone could not finance industry's transition***. The financial sector needed alternative ways to mobilise domestic savings and tap resources from abroad. Foreign strategic investment was needed from the start of the transition, and capital markets needed to be developed to supplant bank dominance.

Whatever the business environment is, managers can act to improve the bank's business performance even if charged with fulfilling public interest objectives. Theorising about the skills, attitudes and practices that top managers need in transition economies does not have empirical support, and so the experiences from the Czech banking sector add a welcome illustration.

(7) ***Top managers are likely to perform better if they are free of the legacy of the central planning past, they have experience with the capabilities required by a market economy, and they face incentives linked to performance and prudent criteria***. To meet these qualifications often meant that successful top managers were new to the enterprise, they were young, they had foreign experience (because that was where those capabilities were found), or it meant that some of the managers themselves needed to be foreign managers.

(8) ***Decision making for credit allocation and ownership interest needed to be separated to avoid conflicts of interest***. It was not possible for banks to make sound lending decisions relating to industrial borrowers, which often meant short-term losses and political heat, and fulfil their ownership interests (via their bank's investment funds) in the same industrial companies. Chinese walls between credit and equity portfolios needed to be introduced and enforced from the time of voucher privatisation.

Notes

1. The exception was at ČSOB, which performed better than the other banks, as we shall see below.
2. All bank lending and financial performance data used in this article come from published and unpublished documents from the Czech National Bank and bank annual reports as assembled by Michal Mejstřik and the authors, some of which were reported in *Rise and Fall of IPB*, 2002.
3. The data apply to ČS, IPB and KB; we take ČSOB out of the data because of its different ownership and management characteristics (its reported liquidity was even worse but only because ČSOB made full disclosures of bad loans).
4. 'Watch' loans have to be provisioned by 10% of their face value even though they are not considered non-performing.
5. Capital adequacy measures the bank's capital compared with its assets, which are weighted according to their risk. Assets held in cash and US government bonds are riskless, whereas a risk weighting applies to much of the rest of the bank's portfolio. Tier I capital is common stock and retained earnings, and Tier II capital is long-term bonds and loan loss reserves. International standards call for banks to have Tier I capital $> 4\%$ of risk-weighted assets and Tier I $+$ Tier II capital $> 8\%$ of risk-weighted assets. Tier I and Tier II capital each

include some preferred stock, but there was no such stock in Czech banks. These definitions refer to the 1988 Basle Accord.

6. Basle II attempts to align banks' capital more closely to actual risk. It introduces operational risk that reflects the risk of mistakes and wrongdoing, it requires more capital against riskier borrowers, and it requires more openness about risk to the bank's capital position and profitability (*Economist*, 2004a).
7. Only ČSOB among the big Czech banks could claim some good performance results. ČSOB made more provisions for bad loans (it appeared to have more bad loans because it disclosed them to their full extent), its capital adequacy was better and it was profitable. ČSOB was different from the other three big state-owned banks. Its investment funds did not buy bank shares and did not face a creditor-owner conflict of interest (Ballou & Knechel, 2002; Stein, 2002); following the separation of Czechoslovakia, it was partially owned by the Slovak National Bank, which shielded it from pressure from Czech officials to make risky loans that might have precipitated an international dispute; its top manager had market economy banking experience in London, took a six-month management education programme in the US in 1993 and sought inflows of Western banking skills.

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