DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

SM/98/30
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

April 1, 1998

To: Members of the Executive Board

From: The Secretary

Subject: **Czech Republic—Selected Issues**

The following corrections have been made in SM/98/30 (1/30/98):

Page 91, bottom of page, new bullet point: added

Page 92, new fourth bullet point: added

Page 93, penultimate bullet point: revised

Corrected pages are attached.

Att: (3)

Other Distribution:
Department Heads

- The prohibition of banks from acquiring direct or indirect majority control (at least 50 percent of shares) over nonfinancial institutions and limitations on qualified participation (10 percent or more) in these to 15 percent of capital in a single institution and 60 percent in total;

- The prohibition of members of a bank's board and bank employees from participating in the statutory body or inspection board of another legal entity;

- The stipulation of requirements for professional care in trading securities in order to prevent the withdrawal of liquidity and asset stripping (also known as "tunneling"); and the separation within each bank of commercial banking from investment activities to prevent insider trading;

- Authorization for the central bank to decrease the value of a bank's stock, even during a period of forced administration;

- In addition, provisions were included to increase the deposit insurance limit from CZK 100,000 to CZK 300,000 per depositor and to oblige the CNB to compensate clients in Ceska Bank (which was closed in December 1995 and is now in the process of liquidation) in an amount up to CZK 4 million, corresponding to the coverage extended to banks under the subsequent consolidation program.

Banks have been granted six months to comply with the new rules on composition of and participation in statutory boards and professional care in securities trading, while the new rules regarding ownership participation are to be phased in over three years.

117. In the second stage, a more fundamental revision of the Banking Act aimed at restoring general confidence in the banking system was approved by the Cabinet in November 1997 and is currently under consideration in Parliament (large amendment). This revision is inspired by failures and irregularities among smaller banks and investment funds which the authorities have linked to agents acting against the interests of the banking and financial system and the absence of effective controls. The amendment would enhance transparency and also legal safeguards in banking, while harmonizing Czech legislation more closely with EU legislation. More specifically, the proposed amendment includes:

- A strengthening of the central bank's control over shareholders of a bank through the requirements that voting stock be issued only in registered form; that acquisitions of voting rights exceeding 5 percent be approved first by the CNB; that new shareholders satisfy the same "fit and proper" criterion as the founders of the bank; and by making it possible for stockholders to be stripped of their voting rights if they undermine the proper and prudential operation of the bank;

- Abolition of the economic need criterion as a condition for licencing banks;

- Improved accountability of a bank's management and board by requiring that a bank's board of directors be composed of the top management of the bank; that the board of trustees be chosen by a general meeting rather than by the employees of the bank; and that directors share responsibility for claims against themselves or the bank;

- Expanded notification and disclosure requirements through mandatory prior notification to the CNB of, inter alia, amendments to statutes or personnel changes in statutory bodies or bank director positions; and quarterly rather than annual as well more comprehensive reports;

- Enhanced flexibility of the central bank in dealing with problem banks through authorization for an administrator to liquidate a bank; provision for mandatory removal of a banks' license if capital falls below one-third of the required rate; and requirement that courts decide on liquidation of a bank and appointment of receiver within 24 hours from the submission from the CNB;

- An extension of deposit insurance to legal persons, and exclusion from insurance coverage of natural persons related to the bank (management, board members, etc.) and persons convicted for money laundering.

These amendments are proposed to take effect from April 1, 1998. Following the introduction of a money laundering act in July 1996, an amendment to the Criminal Law is also currently being prepared in collaboration with the banking supervision authorities.

Prudential Regulation

118. As described in detail in the 1996 Recent Economic Developments, prudential regulation of banks in the Czech Republic is modeled on international standards as incorporated in EU directives or recommended by the Basle Committee on Banking Supervision. These include rules on minimum capital, capital adequacy, large exposures, liquidity, foreign exchange exposure, investment requirements, required reserves, limits on bank lending and equity participation, and classification and provisioning of credits. These regulations are continuously being amended to harmonize them more closely with international and EU standards, while addressing issues specific to the Czech Republic. However, changes to regulations were relatively minor during 1996–97 and focused on improving the accounting for securities operations and valuation of securities holdings. Specifically, the changes to regulations provided for:

- Further specifications and more detailed accounting procedures with respect to off-balance-sheet items and securities operations to reflect the rapid changes in these areas;

- Stipulation of principles for creating securities portfolios and ownership interests (including separation of investment and trading portfolios), and requirement that provisions be made for individual securities and ownership interests corresponding to any shortfalls of the market price compared with the purchase price (marking to market);

- Revisions to risk weights for the calculation of the capital adequacy ratio (assignment of 50 percent and 100 percent risk weights to claims on banks under conservatorship and liquidation, respectively, compared with 20 percent for standard banks) and to specification and conversion factors for off-balance-sheet items;

- A broadening of the definition of credit exposure to single customers;

- Better monitoring of liquidity through focus on the structure and risk concentration of liabilities, notably deposits;

- Classification of foreign exchange loans which are not fully hedged against exchange rate risk as watch loans (requiring 5 percent provisioning) with effect from January 1998, with a view to encouraging enterprises to hedge their exchange rate exposure.

- Classification of foreign exchange loans as substandard (requiring 5 percent provisioning) with effect from January 1998, with a view to discouraging foreign exchange lending;

- Periodic (quarterly) reassessment of loan portfolio and other assets.

Banks were given a six-month period to create sufficient provisions for marking to market.

119. As discussed in Section A, banks are somewhat exposed to liquidity and interest rate risk, owing to the reliance of several banks on the very short-term interbank market, while their exposure to market and foreign exchange risk is limited due to a relatively small share of marketable securities in the banks' portfolios and prudential limits on open foreign exchange positions. This may be the reason why the development of regulations to control market risk (including that related to off-balance-sheet items such as derivatives) is still in its infancy, but it will reportedly be given increased attention. Likewise, the capital adequacy ratio continues to focus on credit risk with no adjustments for market risk.[75] Further, certain banking practices and tax regulations restrict banks' ability to strengthen their capital position. This includes notably the requirement that interest be accrued on classified and even lost loans for income tax purposes, while there is a limit on tax-deductible provisioning of 3 percent of average credits outstanding during the taxation period. There are also

---

[75]In January 1996 the Basle Committee issued guidelines regarding capital adequacy for market risks.

restrictions on bank's ability to write off loss loans from provisions.[76] Improved conditions for foreclosure and for writing off loss loans, as well as a more generous tax treatment of provisioning, is required to help banks strengthen their balance sheets.

Supervision

120. With the banking system under increased pressure and ongoing efforts to rehabilitate problem banks, the Czech National Bank continued to take measures to strengthen its supervisory functions in 1996–97, including an increase in the quantity and quality of staff.[77] With the scarcity of resources, the central bank's supervision has been forced to rely excessively on auditors' reports. While auditors have generally been internationally acknowledged firms, experience from the Czech Republic as well as many other countries has demonstrated that in many instances, these firms have been led or pressured to underestimate the size of bad assets or risks. The CNB has been able to conduct only one on-site inspection in each of the four large, state-controlled banks during the last four years. The improved resources should allow for a much-needed intensification of the inspection process, including greater scrutiny of off-site inspection reports and more frequent on-site inspections.

121. Moreover, the supervision of banks in the Czech Republic is currently not done on a consolidated basis.[78] This is a source of concern, given the universal nature of Czech banks and their close involvement and crossholdings with other financial institutions and the enterprise sector. However, individual banks are not owned by holding companies and generally do not own companies themselves, thus reducing the risk of contagion from related companies or forced manipulation of credit.

Capital market

122. A number of measures were taken in 1997 to restore investors' confidence and increase the attractiveness of Czech capital market:

---

[76]These include notably the requirement that court proceedings be initiated against the debtor.

[77]As an indication of the improved quality of supervision, the central bank in its capacity as chairman of the Eastern European Group of Bank Inspectors was invited to participate in the Basle Committee on Banking Supervision's preparation of "Core Principles for Effective Banking Supervision". These were issued in September 1997.

[78]The 1992 EU Directive on Consolidated Supervision requires holding companies of banks or other companies within a banking group to provide information to the supervisory authorities.