Kreditni banka crisis prompts a hard look at Czech banking
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By Alex Friedrich

When Kreditni banka crashed this summer, its 12 billion Kc ($444 million) thud was a wake-up call for bankers and politicians alike.

The sheer magnitude of the bank's losses as well as Kreditni's ties to Ceska pojistovna and government institutions set it apart from the 10 other small or medium-size banks recently liquidated or put under the forced administration by the central bank.

Banking observers say the government has finally realized it can no longer muddle along in its cleanup of the banking sector, all the while allowing fraud and inept investing to go unpenalized in the name of banking stability. The measures it is now taking are long overdue, analysts say.

Though it's unclear whether the Kreditni investigation will strengthen the central bank's regulatory authority, it could support proposed improvements to banking legislation. In any case, Czech National Bank (CNB) spokesman Martin Svehla said, "It could be an extremely important signal ... and play an important role in limiting [future] criminal activities" in the banking sector.

Despite the 50 billion Kc to 70 billion Kc lost through bank collapses, analysts say the purge isn't over yet. Kamil Janacek, chief economist of Komercni banka, said the process is only half finished, while others say another handful of banks in the 5 billion Kc range may fail by the middle of next year.

Still, banking observers stress that the problem is small considering the size of the sector. Just 8 percent of all banks have been liquidated, and those account for just 3 percent to 4 percent of all banking assets.

Banking "is not in a crisis, but it's in trouble," said Miroslav Singer of CERGE, the graduate research arm of Charles University.

To Singer, the political debate over whether the Cabinet or Parliament should be the body to investigate the matter is absurd.

"In other countries there are multiple investigations of such things. The more people investigating, the better," said Michal Tomasek, Komercni banka's advisor to the European Union, echoing the opposition Czech Social Democratic Party's views on the matter.

Those looking for the root of the problem might find it in bank licensing. Back in the early 1990s, the central bank generously granted universal banking licenses to help fuel a loan-starved fledgling business sector. Fraud was rampant. Some owners used their banks as personal money machines and never paid back their "loans," while others "borrowed" money from banks just to buy shares in them.

Bank owners had little if any banking experience and started their banks with dangerously low share capital, frittering away resources on bad loans and foolish trades on the capital markets.

Those banks couldn't collect because both laws and judges favored the debtors, and loopholes in the criminal code allowed the crooked to go free. Just this summer, police concluded that Jiri Cadek, former vice president of the bankrupt Banka Bohemia, did not act illegally when he and two other officials secretly sold an estimated $1.2 billion worth of unauthorized bank guarantees, thereby driving the bank to ruin.

"The whole case demonstrates a failure of the country's security mechanisms," said former Banka Bohemia director Arnost Klesla.

After watching five banks go under in three years, the central bank in January found a guinea pig - Ekoagrobanka - for its new program to clean up the banking sector. Its aim was to purge the sector of insolvent banks and, if possible, to prevent crashes. Shareholders of insolvent banks would take the hit. The central bank would slash the stock's value, force them to raise more share capital, and then bring in foreign investors or larger banks if they didn't.

Svehla said the plan was successful in eliminating insolvent banks or forcing them to merge with others. On the basis of audits for 1995, all existing banks have enough reserves to cover losses.

But Ivan Angelis, secretary-general of the Association of Banks, said, "The weakness of the plan was that it was not coherent or consistent enough to definitely heal the banking sector. It selected weak banks and let them fall by the side ... but the aspect of therapy was too weak."

Meanwhile, the central bank's goal of making shareholders pay was "nonsense from the beginning," said Singer. "The gaps in funding in problem banks were much larger than the share capital."

Though share-capital increases have covered some of the losses, Angelis said, the size of most losses means "it's legally and practically impossible" to force shareholders to cover them.

"That's the price of reform," Svehla said.

The central bank further squeezed small banks this summer when it raised the minimum reserves they must keep from 8.5 percent to 11.5 percent of principal deposits, causing a trickle-down effect of increasing interest rates. Less than two months earlier, the discount, Lombard and repo rates, which are charged on various interbank transactions, had risen as well. Those increases have put a choke hold on many small banks, analysts say.

But the size of the Kreditni explosion caught most observers off-guard. Though banking experts saw its collapse coming, original estimates were only a third of the true cost, and as later estimates ballooned, politicians woke up. "I believe they didn't know that the end would be as disastrous as it was," Angelis said.

Not even Ceskoslovenska obchodni banka knew the true extent of the problem this summer when it negotiated with banking officials to take over Kreditni and then balked when it saw the bill.

Soon the Czech press reported that the government itself had lost up to 2 billion Kc in the collapse. Customs officials kept funds in Kreditni even when the Finance Ministry knew the bank was having problems. "Its experience with other banks, such as Banka Bohemia, was that the bank would have survived if large clients had not withdrawn their money," Angelis said. So officials may have wanted to avoid ruining the bank by seizing government funds.

The chain of collapses has not gone unnoticed abroad. "I've experienced a few investors concerned about [the banking sector]," said Wood & Co. banking analyst Martin Nejedly. He added that he has managed to assuage their fears. Foreign investors are mainly interested in the major banks, which remain mostly unaffected.

One exception may be Ceska sporitelna, which lost money on the Czech interbank-loan market when the small-bank borrowers welched. "Ceska sporitelna began provisioning heavily, and we could see that profits were really low, especially in 1995," Nejedly said.

The collapse may also mean the further privatization of Kreditni's majority shareholder, Ceska pojistovna, analysts say. Kreditni's collapse has hurt the insurer's share price so much that Investicni a postovni banka is trying to sell its stake in Ceska pojistovna to investment company PPF, which would then have 36 percent (see accompanying report).

The government's decision to set up an investigative body, however, has improved the credibility of the banking sector, said CS First Boston's vice president for equity research, Sandy Chen. "I think it sends a very good signal to the capital markets. Finally Parliament is getting stricter."

One European Union representative agrees. "It's a good sign that the system is cleaning itself," said Giorgio Ficarelli, head of the Phare section. "We're quite satisfied with the steps taken by the Czech National Bank."

Svehla said that in this year's draft amendment to the Act on Banks, the central bank is proposing to strengthen the powers of the banking supervisory board. Among other things, the board would have the power to take action against irresponsible shareholders "and not just against the bank itself, as is now the case."

-- Ladka Bauerova contributed to this report