SCIENTIFIC INFORMATION

Development analysis of minor and medium size banks in the first half of the 90ies in the CR

Analýza vývoje malých a středních bank v první polovině devadesátých let v ČR

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INTRODUCTION

Every fast economic change and what more given the revolutionary convulsions of 1989, lead to the economic changes. In the case of the Czech Republic the change from centrally planned to market economy after 1989 has taken its toll. As a law of nature mistakes are natural. However, it depends on how serious these problems are. The aim of this article is to point out the main reasons which led to economic collapses and financial losses in small and medium size banks in the Czech Republic, with a resulting negative impact on the government budget. In this unstable world of ours, there still exist many totalitarian regimes and also some states with more or less directive economies managed by governmental or religious institutions. These are mainly less developed countries, where sooner or later some significant changes towards market economies can be expected. These countries cannot survive without the help of the developed countries. Experience and know-how from the analyses of financial institutions, political, social, personal transformations, etc. can lead to decreased risks for the aid recipient countries as well as for donor nations.

SUPPOSITIONS

The inception of small and medium size banks on the Czech financial market after 1989 was preceded by a short period little known to the public. This stage, however, had had both positive and negative effects on the future of Czech banking system. It speeded up the origin of small and medium size banks and thus supported the minor privatisation, but on the other hand, it indirectly, and unknowingly unfavourably influenced many strategic decision of the would be future top-management in these financial institutions.

This happened in the second half of 1988 and 1989. At that time, the larger and economically stronger agricultural enterprises were intensively looking for ways on how to manage their own banking and financial services and to limit the monopoly of the individual of foreign trade enterprises. Simply said, an informal initiative "from bellow" originated, with the aim of establishing their own "agricultural bank" and an enterprise for foreign trade. I believe that the objective of this analysis is not to determine whether the described goals were attained or not; or whether the set economic objectives were realistic given the limitations imposed by state monopoly in those days. The most important factor for the following development, was the reality that it gave birth to a numerous and very enthusiastic group of workers who were hungry for success. A significant informal sector originated. It was powerful in its range and functional structure. These were mostly agricultural personnel in regions of the then Czechoslovakia Ministry of Agriculture and Nutrition and the already stated pressure group of agricultural enterprises.

1ST STAGE

Immediately after the revolutionary change in 1989, as soon as the situation enabled private activities in banking and finance, six independent subjects -agro banks - were established, five of them under another name (and of course some other small banks from other fields of business were also established). The agro bank group mostly exploited the technical, financial and personnel foundations of agricultural regions. In those days a sum of 50 million CZK was enough to establish a bank. This was not a problem for agricultural cooperatives and some relatively rich, state enterprises of the then existing agrocomplex.

Once again, in a short history of small and medium banking, personal contacts and friendship among former agrarians who were now in banking profession proved vital. This was the development stage when the banks had to increase their total assets from 50 million to 500 million CZK (as a minimum). The reasons were simple. The most creditworthiness cover with fewer risks was provided by other banks. For example, in the index determined by the Czech National Bank "credit engagement", the weight of these deposits was set at 20% or 20% of the nominal value of the security for the credit, which was equivalent to the same value as 100% of the nominal value of the granted loan.

In reality, there existed situations (beyond clients knowledge) for creating the assets; say when Bank "A", granted a credit for the purchase of "securities" covered by the stock of Bank "B", the client did not only buy "securities" i.e. the shares of Bank "C" stock, but also the stock necessary for the guarantee of the Bank "B". For the minimum security, as it has been explained above, only 20% of the nominal value of Bank "B" stock was enough. The rest could be used for the security of a further credit, perhaps in a major bank. The liability for paying the share of a stock company was an advance payment of only 30% of the purchase price and the rest to be paid within one year. Clients could use substantial financial sources, temporarily unblocked, for the privatisation of large industrial enterprises (to use the financial resources a security for some further credits), speculation trade, setting up of investment funds and other funds etc. The presumption for the success of this model from the clients' point of view was partly the documentary form of the stock and partly the necessity to realise the whole transaction within a day for fear of breaking the internal regulations of individual banks. It was therefore possible to legally build and manage a large financial empire without investing a Crown, which were amateurishly managed under the control of dilettantes that was clearly undesirable for the society.

Some small banks were established at the time of the revolutionary euphoria at the end of 1990 and the beginning of 1991. In banking and finance, the de-scribed period was characterised by the absence of functional bank law and of other regulative rules. Another external negative factor was the reality that some key supporters of economic changes accused bank representatives of not being ready to undertake risks and not comprehending the needs of emerging entrepreneurial group.

Enthusiasm for all the innovation existed among the citizens, too. Often it happened that whenever a small bank opened its new branch, there used to be many new clients standing in queues, asking for the transfer of their accounts from the big banks to the new small bank. The growth of deposits in small banks was moreover supported by big banks through mid-term and short time bank loans. The growth of deposits was caused by some inconsiderate suggestions from boards of directors and top managements of these institutions. For example, in one of the new banks the branches obtained a premium rating for the newly acquired assets to the old ones as a percentage. And the most successful staff and groups received high bonuses.

The results of this action, was a minimum caution in transactions and trading activities and very rapid non-cash payments. This signalled a further substantial factor for a situation which could be described as catastrophic. Non-cash bank issues in commercial banks, is a phenomenon, which, if not regulated (by a system of bank reserves creation, directory of capital adequacy, credit engagement and other limits), is very dangerous. This creates a situation where say, when the deposits of one subject are granted by a bank, for example in form of a credit to the second subject, who realises his economic objectives and pays off the third subject who deposits the money in the same bank. The bank has a double sum of non-cash money in its obligators, but only half of it is in form of assets in non-interest-bearing treasury and the second half in the form of credit (at that time with a liquidity problem and more- over with an enhanced risk).

In the case of continuing return of financial resources to the banks and their return into the economy in form of loans, according to the above-described model, it leads to unambiguously uncontrolled, wild issue of money (non-cash issue of money) and thus endangers bank liquidity, and that is precisely what happened.

The false achievement in these and their insufficient prudence, general enthusiasm, pressure from the political and state economic management, indiscipline activities, inexperienced entrepreneurs and the often negative influence on the decision processes in regions, the partial absence and failures to react quickly to negative trends in the banking sector by responsible state organisations o predefined the development that followed. If you will, I would place the described stage to the period from 1991 till the first half of 1993, at maximum till the end of 1993.

2ND STAGE

The second stage, the second part of the development of small and medium size banks, presented an intensive break from an ostensible prosperity into deep, differentiated problems concerning economic results and liquidity. What actually happened at that time? Firstly, the wrong strategic decisions making continued at board level and some members of top management had vested interests and this also affected the performance of lower management.

Up to that time, the existing surplus of free financial resources in those banks was transferred unprofessionally to mainly unsuitable areas of investment trading in securities and capital market. Instead of marketing the valuable, highly liquid securities with state guaranty, these institutions often made mandatory deals with private brokers of private speculative firms, which were often indirectly personally connected to bank owners. As a result, there was the further liquidity distress and the origin of unstable environment as far as the creation of acceptable economic results was concerned.

Towards the end of 1993 and during 1994, it was evident, that the bank control was difficult and the problems in banking sector were acute, deep rooted and that threatened the economic stability in the country. The existing bank law, valid from 1st February 1992, was insufficient for managing the banking sector, bank supervision and clients' protection. This reality saw a quick adoption of law on Czech National Bank and the Bank Act amendment in 1994.

Profound supervisions and inspections of small banks proved the necessity of radical solutions in the whole system. Banks classify their credit portfolio, according to the determined methods, into groups according to their risks (presumable losses) and to creating corresponding reserves. These measures led to the cleaning up distorting influence of clients outstanding in banking. This has brought about effective results in the whole business.

The unpaid off credits which, positively influenced bank yields, were by then in the range of the corresponding relevance of the real portfolio state. They were eliminated by the duty to create a reserve. With respect to the low-quality insurance of the bank assets, their unsuitable structure and mostly less valuable clientele, the liquidity of the affected banks was not disturbed. The ratio between the high and low quality, mainly loss-making, credits grew worse even by the fact that the worthwhile, valuable ones were gradually paid and were not compensated.

The affected banks were on one hand at the limit of their possibilities in providing new assets depending on the regulative function of the indication called "capital adequacy", and on the other hand, due to the lack of accessible financial sources. The outflow of clients and the non-payment of loans caused a reflective effect of the non-cash issues. A certain influence came from the change in attitude of major banks, which formally provided medium term deposits to small banks and did not restore them. The ratio of short-term deposits to the medium term ones changed very fast and reversed the credit portfolio.

Short-term credits were mostly paid or were transformed into unprofitable assets. The banks were not able to meet their requirements on the level of compulsory minimum reserves for ensuring the classified unprofitable credits.

3RD STAGE

The third stage passed over very fast. After the deep thorough checks carried out by the Czech National Bank, specific conditions were given to minor banks for their further activities, which were aimed at curtailing their risky ventures and by so doing moderate unpleasant impacts of the previous activities. Banks, on the bases of their own data and analyses, made by the Bank supervisory board, worked out their own consolidation programmes. Their realisation was very problematic. In all it could be underlined that due to the weight and complexity of shortcomings in the management of these financial subjects, self-restoration was quite impossible.

The banks mostly underestimated the situation and tried (besides the standard methods) to select ways leading to an optical improvement of their portfolio, which made the situation still worse. It was the matter of over-crediting, which often improved the bank position to its clients, but it had no influence on the volume total loses nor even the contemporary improvement of liquidity. Some assets were transferred by mandatory agreements (to solve the problems) to different private financial and other institutions engaged in forfeiting, factoring, claiming their debts back. Though not always the case, but in most cases the losses grew deeper. The main reasons were again unprofessional or disproportionate enforcement of their own interest on the expense of the banks hardships; and probably also the close informal links between the owners of cooperating institutions and the leading bank shareholders, who mostly took decision in those matters. At the same time the influence of major production enterprises on bank decision-making started to manifest itself. This was caused by two main factors. The banks top management, after the experiences with the amateurism and lack of discipline of the most small and medium entrepreneurs, begun to trust the large and well- known enterprises. At the same time, the main shareholders in small banks linked up with the owners of these enterprises. An informal personal and probably even hidden formal communication became popular. It gave raise to further ill-judged credit provision activities.

SOLUTION

The gradual imposition of compulsory forced administrations in most small or and medium banks opened the door the solution to the situation. Firstly, the exploitation of all the available means in order to at least offset some losses reduced their basic assets dramatically. Due to this operation, the unsuitable group of shareholders was forced out and this was followed by the replacement of share issues with state organisations. Some of the banks went into liquidation, bankruptcies, others were cleared of risky assets and after that, new owners were found or they were divided up, so that the viable part was identified and sold to strategic prospective buyers-investors. The remainder mostly underwent gradual liquidation with the help of state institutions with minimum risks. This period, except for some special cases, come about in 1994–1996.

CONCLUSION

The above-presented informative-analytical contribution is not supported by the published information, but by the author's own experience and practical knowledge.

Because of the bank secrets, it was not possible to give concrete numbers from the banking sector financial data, examples of some active credit trade etc. Given the reality that some active financial resources are "the blood" of economics and the banking sector its "heart"; it is quite obvious that this area has to live up the expectation of society. Individual economic relations and conflicts come to grip, including different intents of criminal groups. This contribution does not consider the negative influence of these groups in the characteristics of the development of small and medium banks, because it is a very professional matter and different in the view. But it can be stated, that the success of these activities certainly corresponds to the legislative level and understanding of the bank ethics.

To substantiate the assertions made in this article and as a substitute for the commonly defined sources used in similar contributions, this one deals with the brief history of one of the banks, which for our purpose shall call Bank "X". The bank balance was in the range of 16–18 billion CZK during the last months before being put under forced administration.

Compulsory forced administration – due to months of breaks in activities with classified portfolio and valuable information from the centre to the branches- a further decrease by minimum 5% appeared. On the bases of several of audits, the classification was legally corrected, i.e. got worse by 30%. The internal correction at the end of the compulsory forced administration adjusted the portfolio by further 10% (wider influences – the influences of the solution of some other banks, the level of re-financing credit and some other financing arrangements before buying the healthy part of the bank by a strategic investor).

DEVELOPMENT CHARACTERISTICS

1st Stage period – massive support of minor privatisation in the absence of legislative rules, lack of professionalism or a concept (ca 10% from the total loss during the bank existence).

2nd Stage period – capital business (ca 35% losses).

3rd Stage period (10% total losses in Bank "X").

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