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BANKING REFORMS IN THE CZECH REPUBLIC, POLAND AND RUSSIA

I INTRODUCTION

The Czech Republic, Poland and Russia are countries that are reforming their economies at different speeds. Each of them represents a separate grouping within the Center and Eastern European Countries (CEEC) (2) with different characteristics and at different stages of transition. In less than six years dramatic progress has been made in reforming their banking industry: the ownership structure is being changed through privatization; a new institutional framework for financial intermediation has been implemented; money and capital market instruments have been introduced; financial services modernized; and payment systems improved.

Under communism, the banks' economic role was limited and passive. Their main functions were to channel funds allocated by the central plan into stateowned industries and to monitor enterprises' compliance with the plan.

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(2) Until recently centrally planned countries (central European, Balkan, ex-Soviet and ex-Yugoslav) were called either communist or Eastern European Countries. The Bank for International Settlements in its Annual reports and some other sources (e.g. Business Eastern Europe), have made a new classification based on macroeconomic indicators, business climate, and government enthusiasm for reform. The first grouping consists of countries that stand out in their stability, prosperity, and attractiveness, such as the Czech Republic, Estonia and Slovenia. The countries of the second category have strong private sectors, and a well-educated population, but indecisive governments. Within the second „division", Poland, Hungary and Slovakia are leading, while Croatia, Latvia and Lithuania are following behind. The next grouping consists of four sub-groups. The first sub-group comprises small, poor countries with reformist governments, such as Albania, Moldova, the former Yugoslav Republic, Macedonia and Kyrgyzstan, all with limited business prospects. Representative of the second sub-group, Russia is powerful enough to undertake half-hearted reform. Western interest in its economy continues to grow despite its instable political situation. Characteristics of the third sub-division are stumbling reforms and limited foreign interests in Romania, Bulgaria and Serbia-Montenegro in the Balkans and Belarus, Ukraine and Kazakhstan in the former Soviet Union. The last fourth sub-group consists of war-ruined republics, such as Georgia, Armenia, Azerbaijan, Bosnia-Herzegovina and Tajikistan, *See*, Edward Lucas, *Divide and Prosper*, BUSINESS EASTERN EUROPE, January 2, 1995, at 1.

Thus, in each country the first step in the transition to a market economy was to create a viable banking system. The old monobank system, in which the national bank served as both a central bank and a monopolistic commercial bank, has been abandoned. A two-tier banking system has been created in which the national bank functions as a traditional central bank, and the newly-created commercial banks have begun functioning on a profit basis. (3)

These positive changes have not been sufficient, nor have they kept pace with other macroeconomic developments. The state-owned commercial banks have not yet met the challenge of economic transformation to efficiently finance growth and modernization of the economies. It is evident that each country faces similar problems, but the severity of these problems differs significantly from country to country. The policy makers' approaches to solving these problems also vary.

This paper will analyze the similarities and differences between the Czech, Polish and Russian banking systems. In addition to comparative analysis, it will also examine legal, political, and psychological obstacles that must be overcome. It opens with an examination of the macroeconomic setting for banking reforms, and discusses the processes of transition to a market economy, focusing on the influence of economic conditions on different approaches and reform strategies. The next section will describe common problems inherited from the centrally planned economy, and will provide examples of different solutions for solving non-performing loan problems. The third part will describe the banking structure and regulation for each country, while the fourth part will concentrate on the role of the central bank, its independence from the government, and the system of bank supervision, regulation and oversight for both sound lending and the safety of deposits. The paper will conclude with a discussion of some of the difficulties that the banking industry will face in the future, together with proposed solutions to the problems these difficulties pose.

II MACROECONOMIC SETTING

The *Czech Republic* is one of the most prosperous and stable countries within the CEEC with a pro-business and pro-Western government, a stable political system, a strong currency and substantial domestic purchasing power. (4) After the collapse of the Soviet bloc, Czechoslovakia moved

(3) *See,* D.M. Kemme and R. Masunga, *Introduction: An Overview of Monetary and Banking Reform,* in MONETARY AND BANKING REFORM IN POSTCOMMUNIST ECONOMIES, (D.M. Kemme and A. Rudka ed., 1992) at 2.

(4) The relative level of economic development is difficult to determine, but according to some sources, the Czech Republic is second only to Slovenia among CEEC and at approximately the same level as the poorest countries belonging to the EU (between Ireland and Portugal). *See,* OECD Economic Review, The Czech and Slovak Republics, 1994 at 65.

westward both politically and economically. (5) The 1993 disintegration of the Czechoslovak Federation created problems in administrative adjustment and slowed the pace of transition for a short period of time. But, economically, the dissolution had more positive than negative effects. (6) For example, while separation led to a 5.3 percent short-term fall in industrial output, the recession ended in mid-1993, and in 1994, the economy showed the first signs of overall growth since 1990. GDP was up by 5 percent in the last quarter of 1995 compared with the same period in 1994, and inflation was kept under control, so that average rate was 9.5 percent in 1995. (7)

A stable exchange rate is one of the economic developments that distinguished the Czech Republic from the other transforming economies. A new foreign exchange act on October 1995 makes the koruna (8) fully convertible for current-account transactions and introduces further liberalization on the capital account. Another is the unemployment rate which declined from 5 percent in 1992 to 2.9 percent in 1995 due to the on-going process of privatization and rapidly growing services sector. The capital account has been helped by direct foreign investment, portfolio investment, and credits to Czech firms from abroad. In 1995 the weakness of the economy has been the foreign trade deficit leading to a substantial current-account deficit of $1.9 billion in 1995. It is not yet a serious threat to economic stability since deficit will be financed by a surplus on the capital account. (9) Czechoslovakia's hard-currency foreign-debt of $9.5 billion at the end of 1992 was divided between the two successor states. The Czech Republic inherited 73 percent of the total, or $6.9 billion. New borrowing has led to a rise inconvertible currency gross debt to $10.3 billion at the end of 1994 against total foreign currency reserves of $8.9 bilion. (10)

Poland is representative of a second group within the CEES with a booming private sector, a fast rate of growth, a well-educated population, but an indecisive government. Poland was the first country to undertake economic transformation (the „Balcerowicz Plan" was adopted at the end of 1989) and the first country to pull out of the deep post-communist recession which hit the entire CEEC. After two years of recession, the

(5) An Association Agreement with the European Community, participation in NATO's Coordinating Council, membership on the Council of Europe, and an active role in the Conference on Security and Cooperation in Europe are among the most important political developments. It is expercted that the Czech Republic will become a full European Union member by the year 2000. *See,* EIU Country Profile Czech Republic 1994–95 at 10.

(6) For example, the budget has benefited from the cessation of transfers to the Slovak Republic. *See, supra* note 3, at 64.

(7) *See,* EIU Country Report Czech Republic, 4th Quarter 1995, at 5.

(8) The koruna (or crown) is the Czech currency.

(9) *See, supra* note 6, at 7 *and* EIU Country Report Czech Republic, 2nd Quarter 1996, at 1.

(10) *See,* EIU Country Profile Czech Republic 1995–96 at 33.

economy started to recover when GDP increased by 2.6 percent in 1992 and accelerated to 5 percent in 1994. (11) The yearon-year inflation rate declined substantially from 250 percent in 1990 to 44 percent in 1992 and to 27 percent in 1995. The decline in inflation points to the broad success of monetary policy and the policy of using the exchange rate as a nominal anchor. (12) On the other hand, unemployment rose from 6.3 percent in 1990 to 16.6 percent in 1994 due to continuing macroeconomic adjustment. (13) Moreover, the slow speed at which unemployment was absorbed into the economy raises the issue of whether the labor market adjustment is complete.

Poland's external position also worsened with resumed growth. Reflecting the sharp deterioration in the trade balance, the current-account deficit increased from —0.3 percent of GDP in 1992 to about —2.7 percent of GDP in 1993. The collapse of the Council of Mutual Economic Assistance (CMEA), the conversion to market prices, and the settlement in hard currencies contributed to trade deficits. In 1995 foreign trade supported Polish GDP growth, but signs are emerging that exports are slowing and imports increasing. (14) The capital account was in deficit during 1991–92 due to a limited inflow of foreign investment and registered only a small surplus in 1993. One reason for the limited inflow is the prior level of debt and de facto default in the early 1980s. The major sources of capital flows to Poland have been international financial institutions, especially the World Bank. (15) At the end of 1994, Poland's external debt was estimated at $45.3 billion. Poland has agreements with the Paris Club (from 1991) and with the London Club (from 1994) to repay reduced debt (in each case around half of debt is written off) to the first one by 2014 and to the second one by 2024. (16)

Macroeconomic developments in *Russia* are far behind the Czech Republic and Poland because of its late start on economic reforms under more difficult initial conditions. Political and economic disintegration of the USSR contributed to collapsing output and soaring inflation. Between 1989 and 1992, aggregate output fell by about one-third, capital investment by more than one-half, industrial output by one-fourth, and agricultural production by 15 percent. (17) GDP declined by 4 percent in real terms for the corresponding period in 1995, with industrial output falling by 3 percent. In 1992 a unified exchange system replaced the system of multiple exchange rates and the chaotic Russian economic situation began to stabilize. Various

(11) EIU Country Profile Poland, 1995–96 at 18.

(12) Ajai Chopra, *Monetary Policy and Financial Sector in* REFORM IN POLAND: THE PATH TO A MARKET ECONOMY (IMF, Occasional Paper 113, 1994), at 24.

(13) *See, supra* note 10, at 20.

(14) *See*, EIU Country Report Poland 4th quarter 1995, at 21.

(15) Paul Mylonas, *Integration into the World Economy*, in REFORM IN POLAND: THE PATH TO A MARKET ECONOMY. *supra* note 11, at 68.

(16) *See, supra* note 10 at 40.

(17) RUSSIAN FEDERATION, (IMF Economic Reviews, no. 8, 1993), at 3.

data indicate that the worst may be over. In the first half of 1995, the total balance of payments showed a current-account surplus of $10.6 bilion. (18) The current account was strengthened by a foreign trade surplus that grow in 1995 to reach 19.9 billion. Other successes in 1995 have included the relatively encouraging progress in reducing inflation from 17.8 percent per month in January to 4.5 percent in September, and an increase in foreign direct investment. However, the capital account deficit rose in 1992 to —$9.9 billion due to domestic capital outflows. The total debt is currently estimated at $103.5 billion. In October 1995 Russia reached the agreement with the London Club on the rescheduling of the commercial debt of $32.5 billion over 25 years with sevenyear grace period. Similar deal is reached with the Paris Club on the rescheduling $45 billion debt in May 1996. (19)

a) The Transition to A Market Economy

The transformation of centrally planned economies into market economies required two fundamental developments: 1) the creation of markets for goods and services, financial assets and labor; and 2) the development of new instruments for macroeconomic management. The main elements of the reforms have been: price liberalization, the implementation of restrictive monetary and fiscal policy, privatization, the liberalization of foreign trade and the promotion of foreign investment, and the modernization of economic institutions through a new legal system.

As discussed, all three countries faced macroeconomic difficulties at the beginning of their economic transformation. The first concern was the inflation caused by the reduction or elimination of subsidies and decontrolled prices. Budget deficit, growing unemployment and declining industrial output also characterized the CEEC economies. Due to different economic and political conditions, two approaches toward macroeconomic stabilization were taken: „shock therapy" and a gradualist approach. „Shock therapy" was applied in Czechoslovakia and Poland (especially in the first phase of its transition), while Russia opted for a gradualist strategy.

The *Czech Republic* and *Poland* have moved a long way towards establishing — or more accurately, re-establishing — market economy, through budget deficit cuts, the liberalization of domestic prices and import restrictions, exchange rate devaluations and interest rate increases. Both have enacted the basic legal and institutional frameworks for a market economy. Both have liberalized foreign trade, achieved current account convertibility of their national currencies, given high priority to attracting foreign investment and made commitments under the European Agreement to align their commercial and financial laws with the European Union. (20) They have

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(18) EIU Country Profile Russia 1995–96, at 39–40.

(19) *id.*

(20) *See*, Colin Jones, *The Genie is Out*, THE BANKER, April, 1994 at 15.

made substantial progress in reinstating or compensating former owners for expropriated property. In the Czech Republic a second wave of voucher privatization ended in 1995. During the first phase of privatization, completed in December 1992, 1,491 formerly state-owned enterprises were privatized. In the second phase, 846 companies had been offered to the public in exchange for voucher points. New proposals for further privatization no longer considered vouchers as an option. The assumption is that share flotation will be used and the aim is to have only four enterprises under partial state control in five years. (21) Although privatization of Polish state-owned assets had been slowed, the development of the private sector has been extraordinarily rapid, and by 1993 it accounted for 59 percent of all employment. (22) Mass privatization, after many delays, finally started in November 1995, when 15 investment funds were chosen and given allocation from a first trench of 415 state firms. (23)

In *Russia* the real beginning of the transition to a market economy was delayed. Several years of debate and hesitant half-measures impeded the replacement of old economic structures with new institutions. The first moves toward the privatization of Russian industry mainly took the form of creating new cooperatives. One reason for its gradualist approach is that Russia never had a significant capitalist tradition. In addition, there was strong political and intellectual opposition to market-oriented reforms and a powerful industrial and agricultural bureaucracy. (24) In 1993 the government of young reformers introduced radical changes through the privatization of many state enterprises, the liberalization of prices, tight fiscal and monetary policy. The initial idea of privatization was to revitalize the economy and improve the efficiency of enterprises. But ideological and political considerations were mixed with pure economic objectives. By 1994, 70 percent of all enterprises had been privatized (25) through voucher privatization and the promotion of employee buy-outs, but fundamental restructuring within the enterprise is still needed. (26)

b) Problems Inherited from Centrally Planned Economies

In addition to privatization, the transition to a market-oriented financial sector has been among the most important developments in the respective countries. Enterprise privatization without banking reform could not ensure successful credit allocation. Similarly, banking reform without enterprise

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(21) *See*, EIU Country Report Czech Republic, *supra* note 6, at 15–16.

(22) *See*, EIU Country Profile Poland, *supra* note 10 at 6.

(23) *See*, EIU Country Profile Poland, *supra* note 10, at 14.

(24) Marek Dabrowski, *The First Half-Year of Russian Transformation in* CHANGING THE ECONOMIC SYSTEM IN RUSSIA, (A. Aslund and R. Layard, eds., 1993), at 5.

(25) EIU Country Profile Russia, 1995–96, at 16.

(26) L.D. Nelson and I.Y. Kuzes, Evaluating the Russian Voucher Privatization Program, 36 COMPARATIVE ECONOMIC STUDIES, no. 1 (1994), at 63.

privatization could not result in productive allocation of credit. (27) Because of the radical changes in economic structure introduced by privatization, new institutions were necessary to mobilize savings, facilitate efficient payment systems, and improve investment and resource allocations by making credit available on the basis of expected profitability and ability to repay.

The Czech Republic, Poland and Russia started banking reforms with similar problems, inherited from their former centrally planned economies when the financial sector was passive. (28) The most serious problem was the stock of unprofitable enterprise loans held by the commercial banks. Even after the banking reforms started, and despite poor quality loan portfolios, the banks continued to lend to enterprises because there was no basis for judging which companies might survive market competition. The additional reason was that poor reporting and accounting systems made it difficult to evaluate the financial position of the companies. Efficient management and experience in processing and appraising loan applications have been generally lacking in all countries. Another inherited problem is the high segmentation of the banking system and low degree of risk diversification. Most loans by the private banks are highly concentrated by region or sector. Additional problems were inadequate clearing and settlement systems, weak competation between undercapitalized banks and lack of skilled personnel.

But some of these problems were solved differently. For example, *Poland* adopted a decentralized approach in handling nonperforming loans while the Czech Republic and Russia adopted a centralized approach. Under the decentralized approach, banks have to restructure their bad loans by out-of-court settlement processes known as „conciliation proceedings", and to work with the management of delinquent debtors directly. Conciliation agreements could include a rescheduling of claims, a partial write-off, or conversion of debt into equity. In the case of the *Czech Republic*, some nonperforming loans have been transferred to government sponsored agencies created specifically for this purpose. (29) In March 1991 the Consolidation Bank was established to take over non-performing loans, totaling 110 billion korunas ($3.6 billion) from various commercial banks. (30) After three years,

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(27) John P. Bonin, *On the Way to Privatizing Commercial banks: Poland and Hungary Take Different Roads*, 35 COMP. EC. STUDIES, no. 4, (1993), at 104.

(28) Problems inherited from centrally-planned period relevant to financial sector are generally found in *Excerpt from 60th Annual Report*, Bank for International Settlements, June 1991, at 62–64. *See also, supra* note 2, at 156–157.

(29) Some of the bad loans were exchanged for the National Property Fund bonds, while others were transferred to the Consolidation Bank. *See*, H.J. Blommestein and J.R. Lange, *Balance Sheet Restructuring and Privatisation of the Banks*, in TRANSFORMATION OF THE BANKING SYSTEM (OECD, 1993), at 32.

(30) For a comparative analysis dealing with bad loans in the four Visegrad countries — Poland, Hungary, the Czech Republic and Slovakia — *See*, Karoly Okolicsanyi, *Visegrad Banking Systems Stunt Economic Growth*, RFE/RL Reserach report, October, 1993 at 35. The free-trade agreement was signed by the four countries in Visegrad (Hungary), as one of many intra-regional initiatives for the smooth transition to a market economy. *See also, Private Pay Plan*, THE BANKER, September 1994, at 44.

the large commercial banks managed to write off or sell to the Consolidation Bank a large part of their bad loans and limit the increase of new ones. In *Russia*, the large number of written-off debts was responsible for the enormous budget deficit problems. (31)

III BANKING STRUCTURE AND REGULATION

The success of the transformation programs in all three countries depends on the development of efficient financial intermediaries and credit and capital markets. Banking system reforms in the respective countries began in late 1989 and the early 1990 s. After enactment of new banking laws, financial restructuring began with the development of the central bank, followed by the creation of commercial banks, and continued with the establishment of capital and securities markets.

In the beginning od 1990, the *Czech* monobank was transformed into a twotier system: the central bank and a system of commercial banks. (32) The State Bank of Czechoslovakia (SBC) became a central bank responsible for the stability of the Czechoslovak currency and the development of sound monetary policy, while two newly established banks and the ongoing Investicni Bank performed commercial lending activities. The 1991 Banking Act permitted the establishment of new private banks and encouraged the activities of foreign financial institutions. Organized as universal banks with the German banking structure as a model, they were transformed into modern financial intermediaries, providing a wide range of commercial and investment activities and services to clients. The central bank issues banking licenses and regulates and supervises commercial banks. At present there are more than fifty domestic banks, ten branches and fifty representative offices or subsidiaries of foreign banks. (33) In 1992, five state-owned banks were privatized during the first voucher privatization but the government retained a 37 to 53 percent stake in four of the privatized banks. Komercni Bank is one of the „Big Four" banks that had an almost 30 percent share of the domestic market at the end of 1993, with total assets of 287 billion korunas

(31) David Youtz, *Report on the Conference on „Money, Banking and Credit in Eastern Europe and the Soviet Union,", Appendix A in MONETARY AND BANKING REFORM IN POSTCOMMUNIST ECONOMIES supra* note 2, at 160.

(32) Until 1990 only three banks besides the central bank functioned in the financial sector: one specialized bank for trade, and two savings banks. *See*, Petr Vojtisek, *Restructuring of the Banks in the Former Czech and Slovak Republic* in TRANSFORMATION OF THE BANKING SYSTEM (OECD 1993), at 69.

(33) *See*, Richard Salzmann, *The Engine of Change*, THE BANKER, April, 1994, at 16. *See also*, Julian Duplain, *Banking Law to Get „Small Amendment"*, BUSINESS EASTERN EUROPE, June 6, at 6. Foreign banks operating in the Czech Republic are subject to the same banking legislation as domestic banks, including the initial capital requirement. In spite of the relatively large number of foreign representative offices and subsidiaries, total lending by foreign banks accounts for only about 1 percent of total bank credit.

($9.6 billion). (34) Proposals from the Czech National Bank are expected for the reduction of the National Property fund share in Komercni Bank from 48 percent to 34 percent. (35)

In *Poland* four different groups of banks currently operate: state-owned commercial banks, specialized banks, private banks and cooperative banks. The National Bank of Poland (NBP) and nine state-owned commercial banks took over the commercial activities of the monobank. The NBP was transformed into a central bank while its regional divisions became separate state-owned banks. (36) The current and former state-owned *commercial* banks, together with the four specialized banks, continue to dominate the financial system, accounting for over three-quarters of total banking sector assets. An essential objective of banking reform has been to prepare state-owned commercial banks for privatization by recapitalizing them. (37) So far, three state banks have been successfully privatized, two in 1993 and another one in 1994. The entire privatization program is expected to be completed by the end of 1996.

Each of the four large state-owned *specialized* banks in *Poland* deals with one of the following banking activities: foreign trade, consumer currency deposits and transactions, agro-industry lending, and housing construction loans. A 1994 law provides for recapitalization and fundamental changes in the structure of both the Bank for Food Economy (BFE) and rural cooperative banks. The law created a three-tier system: primary cooperative banks at the local level, regional banks as umbrella organizations for all primary banks in a specified geographical area, and a national bank of which regional banks would be mombers. (38) Recent government proposals for bank consolidation suggest the creation of two major banking groups, one based on the foreign trade bank, and the other specialized in household hard-currency deposits. The idea of consolidating banks prior to sale may succeed in some rationalization, which may facilitate later privatization. (39)

The *cooperative banks* service the agricultural sector and account for only 6 percent of total banking sector assets. Despite their huge number (over 1600), they represent a small part of the Polish banking system. Deposits

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(34) *id.*

(35) *See, supra* note 6, at 16.

(36) In November 1991 these nine state-owned banks were transformed into corporate entities wholly-owned by the Polish State Treasury. *See*, P. Wyczanski and J Zebrowski, *The Restructuring of the Banking System in Poland in* TRANSFORMATION OF THE BANKING SYSTEM, *supra* note 28, at 77.

(37) EIU Country Profile Poland 4th quarter 1995, at 13–15.

(38) At the top of this structure, the Bank for Food Economy will become its national bank, after being transformed into a joint-stock company (with a 56 percent share held by the state Treasury). The restructuring plan for the BFE has yet to be determined. With such a structure, future bad loans to the state farms and agricultural processing and distribution sector will be avoided.

(39) *See, supra* note 13, at 14.

are fully guaranteed by the Treasury which might cause budgetary problems with significant consequences. Because of the likelihood of such problems, they were supervised by the NBP until a new law was passed in 1994, which provided the three-tier structure mentioned above. (40)

The *private banks* are regulated by the 1989 Banking Law which laid out a liberal policy for the entry of new private banks. The reason for the liberal approach and limited barriers to entry was the desire to demonopolize the banking sector before privatization of the large state banks. As a result, a large number of new banks were opened, so that by 1993 about 85 private banks were in operation. Despite the growth in the number of private banks, they remain very small compared with their state-owned counterparts, holding only 10 percent of banking sector assets. Only seven Western banks currently have licenses to operate in the Polish financial market, while six have been waiting for approval from the NBP. (41)

The *Russian* banking sector consists of over 2000 commercial banks with more than 43,000 branches and offices. It is regulated and supervised by the Central Bank of Russia and based on the Law on Banks and Banking Activities of 1990. One-third of these banks have been transformed from the former stateowned specialized banks while the rest are newly-chartered. A bank cannot operate without a licence issued by the Central Bank. (42) Initially, all the largest banks were directly or indirectly owned by the state and, in tandem with the privatization of enterprises, the banking sector is gradually being privatized. (43) The banking system is highly concentrated,

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(40) *See*, A. Chopra, *supra* note at 11. This structure is similar to those of Japanese financial institutions for agriculture, forestry, and fisheries, organized into a hierarchy at local, prefectural, and national levels, with the Norinchukin Bank at the top. *See, e. g.,* THE BANKING SYSTEM IN JAPAN, Federation of bankers Associations of Japan (Zenginkyo), 1994, at 24–26.

(41) The NBP has not issued a licence to a foreign bank for more than two years, an indication that the licensing policy is strict and restrictive. While the Western bankers waiting for licenses complain that the NBP is pursuing a protectionist policy, the central bank explains that since 1992 only one Polish bank has received a licence. *See*, C. Wellisz, *NBP Bank Licensing Policy Remains Tight*, BUSINESS EASTERN EUROPE, August 22, 1994, at 4. But under the terms of association Agreements with the European Union, the Polish financial market will be open to Western competition in 1997. *See*, EIU Country Report 4th quarter 1995, at 14.

(42) Until recently the Central Bank issued three types of licenses. More than 2000 banks have only domestic (Ruble) licenses, while only 209 banks have currency licenses. *See, Russia's „Hard Currency" Banks*, THE BANKER, May, 1993 at 21. Previously banks had to operate for one year to receive a domestic hard currency license, allowing them to work with Russian hard currency holders. Banks could subsequently receive an extended hard currency license, giving them the right to work with some non-residents. Finally, banks could be licensed for general hard currency activities to work with all non-residents, open branches abroad and buy foreign securities. As of May 1996, the Central Bank increased capital requirements for new banks but will grant hard currency licenses to new banks at once, replacing the prior phase system. *See*, Julie Tolkacheva, *Russia Central Bank Changes Licensing Requirement*, Reuter, April 23, 1996 (internet)

(43) *See*, RUSSIA: The Banking System During Transition, (World Bank Country Study, 1993) at 13.

so that the five largest banks hold one-third of total loans with a similar proportion of total assets. The second largest, Sberbank (Saving Bank), clearly leads in accepting household sector deposits (holding 90 percent of all deposits) and operates through about 40,000 branches. (44) Russian banks, organized as universal banks, are not banned from owning subsidiaries engaged in any type of financial business. (45)

The banking sector, one of the most advanced sectors of the Russian economy, is characterized by relatively easy entrance into the business. Several reasons are responsible for such a development. One of them is a strong need for financing consumer goods imports and the raw materials exports which are a main source of the Russian trade surplus. Legal restrictions on the activities of other financial market institutions, both domestic and foreign, are responsible for the unique position of banks. (46)

a) Capital Requirements

The problem for all three countries is that minimal capital requirements are set low and are quickly eroded by inflation. (47) In *Poland*, for example, the minimum capital required to start a new private bank was Zl 4 billion ($0.4 million) in 1989, an amount that was quickly eroded by hyperinflation. It was subsequently raised to Zl 10 billion and, in 1993, to Zl 70 billion. (48) Since 1989, the Polish licensing policy for new banks has become more restrictive concerning the qualifications of the bank's management, the scope of operations, and the provisions of the bank's articles of association. The Polish Banking Act of 1992 adopted Weistern-style prudential rules requiring the accumulation of loan-loss reserves against the qualified portion of the portfolio, and the achievement of minimum risk-adjusted capital adequacy ratios according to Basle Accord standards. Loans are classified into four categories: pass, substandard, doubtful, and loss. Required reserves are 20 percent for substandard loans, 50 percent for doubtful and 100 percent for loss. (49) Nevertheless, private banks experience problems with bad loans, inadequate capital, and insolvency. The NBP has directly supported a restructuring of some private banks by direct capital injections, purchase of long-term obligations issued by these banks, and rediscount credit. However, such interventions increased base money and added to inflation.

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(44) *id*, at 9.

(45) *id*, at 17.

(46) The bank equity instruments are the oldest and the most liquid instruments in the Russian security market. *See*, OVERVIEW OF THE RUSSIAN SECURITY MARKET report by Rinaco Plus & Ares Associates, October, 1994 (internet).

(47) A bank's capital is the excess of its assets over its laibilities. As a cushion against a bank's insolvency, capital protects depositors. Capital adequacy regulation requires that banks maintain sufficient levels of capital against their assets. *See*, J.R. Macey and G.F. Miller, BANKING LAW AND REGULATION 1992, at 284.

(48) *See also*, Ajai Chopra, *supra* note 11, at 36.

(49) *See*, Pawel Wyczanski and Janusz Zebrowski, *supra* note 35, at 85.

After the collapse of three *Czech* banks in the first five months of 1994, new banking licenses were temporary frozen until new banking amendments were issued. (50) In addition, stricter rules for establishing a bank have been introduced. They include a higher minimum capital of 500 million korunas (%17.6 million) instead of 300 million korunas. (51) The new Czech central bank's regulation requires banks to allocate their assets into four categories: standard, non-standard, suspicious, and non-performing. Required reserves are 5 percent for the first category, 20 percent for the non-standard category, 50 percent for the suspicious category, and 100 percent for the non-performing category. (52) Capital adequacy requirements based on the Basle standards were increased from 5 percent in 1992 to 6.6 percent in 1993. (53)

The *Russian* Central Bank has been trying to strengthen the banking sector, where many banks are weak and under-capitalized. In January 1995, following the October 1994 ruble crash, the Central Bank raised the capital requirement to R2 billion ($1 million) and to the ruble equivalent of ECU 5 million ($4 million) starting from 1999. (54) The Central Bank increased charter capital requirements for new banks to R12 billion ($2.43 million) from R6 as of May 8 1996. Capital may include intangibles such as the management's banking expertise. (55) In Russia, risk coefficients used to evaluate assets are generally less stringent than those specified in the Basle Accord. Under Central Bank regulations, loans to enterprises have a coefficient of between 20 to 50 percent; investments in real estate or joint stock companies carry a coefficient of 25 to 80 percent, compared to 100 percent under the Basle Accord. Moreover, while the Basle Accord focuses on the ratio of capital to risk-weighted assets, the Russian regulations focus on the ratio of capital to deposits. (56)

b) Deposit Insurance

A 1994 amendment to the *Czech* Law of Banking provides statutory protection for small depositors, with a guarantee of a 90 percent refund of deposits up to 100,000 korunas ($3,450) in the case of bank failure. Banking institutions and the state are required to contribute to a newly-established

(50) *See*, BUSINESS EASTERN EUROPE, June 6, 1994 at 6, *See also, infra* note 62.

(51) *Juggling with success*, THE BANKER, September, 1994, at 44.

(52) *See* Petr Vojtisek, *supra* note 31, at 75.

(53) *See, supra* note 32, at 16.

(54) *See, The Road to Damascus*, THE BANKER, September, 1994. The R5 million capital requirement established in 1991 is raised to R 100 in 1992 and to R2 billion in 1995. *See also*, Julie Tolkacheva, *supra* note at 41. The Central bank withdrew 28 licenses between January and March 1996, and granted only six licenses in the same period.

(55) Melanie L. Fein, *The Emerging Russian Banking System: An Overview*, October 26, 1993, at 10.

(56) *See*, RUSSIA, *supra* note 42, at 39.

deposit insurance fund. (57) Until the amendment was enacted, none of the fifty small private banks in the Czech Republic had deposit insurance. The Czech National Bank only guaranteed deposits in the big four banks.

Although formal deposit insurance does not exist for private banks, the *Polish* National Bank informally guarantees household deposits with 100 percent coverage for the first ECU 1,000 and 90 percent coverage for the next ECU 2,000. The fear of a bank panic that might undermine or damage confidence in the banking system motivated the NBP to compensate depositors after some private banks were closed in 1991. Although NBP bailouts serve to stabilize the situation in the short run, they also signal that it is willing to back the entire banking system, leading to a serious moral hazard problem.

The *Russian* Banking Law states that banks are required to insure individuals' deposits in accordance with procedures and terms prescribed by the Central Bank. So far the Central Bank has not prescribed any deposit requirement. (58) The state-controlled Sberbank (Saving Bank) is the only bank which provides 100 percent insurance coverage and effectively guarantees the repayment of deposits on demand. (59) Without some form of deposit insurance, the Russian commercial banks cannot compete with Sberbank for deposit-taking activity.

IV THE CENTRAL BANK

The central bank in all three countries conducts the following functions:

- issuing money and organizing its circulation
- acting as a lender of last resort
- organizing interbank payments
- conducting open market operations
- buying and selling foreign exchange on the free market
- issuing licenses to commercial banks for conducting banking operations, and
- supervising the activities of commercial banks

All three central banks' activities are aimed at maitaining the stability of the currency; conducting national credit, monetary and foreign exchange policies; protecting the interests of creditors and depositors of the banks; and

(57) J. Dee Hill, *Banking Act to Restrict Western Branches*, EIU BUSINESS EASTERN EUROPE, September 12, 1994, at 8.

(58) Melanie L. Fein, *supra* note 54.

(59) The Sberbank is the only bank that has an explicit government guarantee on deposits. *See*, RUSSIA, *supra* note 42, at 17.

assisting in economic development directed toward integrating their countries into the world market. Regarding monetary instruments and the ability of the central banks to conduct monetary policy, the traditional instruments utilized in a market economy are being developed. Reserve requirements, open market operations, and discounts or refinancing of enterprise loans made by commercial banks are the principal mechanisms for influencing liquidity. The interbank money markets and markets for treasury securities are still evolving.

In addition to the conduct of monetary policy, the central banks' main functions in all three countries are overseeing financial markets and banks, and supervising the payments system. To operate successfully, a central bank needs complete autonomy, so that its decision-making can be free from political pressure. A central bank can never be absolutely independent from other government institutions, since it has to take into account their goals and actions, but it must have financial and legal autonomy. (60)

The *Czech* Central Bank is largely autonomous and organized on principles similar to those of the German Bundesbank. (61) Although independent from the government, the Central bank supports the government's general economic policies, unless they conflict with the objectives of monetary policy. (62) An essential condition for successful implementation of its monetary policy was the introduction of an efficient payment system. The former unreliable and obsolete clearing and settlement system was replaced with a computerized clearing network in early 1992. (63) In addition, the Central Bank functions as the lender of last resort to the banks, suprevises them, issues and revokes licenses of banks and lays down prudential rules. After the collapse of some private banks, the new 1994 amendment to the Banking Act increased the supervisory and regulatory powers of the Central Bank, so that it could intervene earlier on the grounds of a private bank's financial instability. Previously, the Central Bank could close or take over a bank only in the case of reasonable suspicion of illegal activity. (64)

The *Polish* General Inspectorate of Bank Supervision of the NBP conducts both off-site analysis and on-site inspections, and a detailed training program (including an inspection manual) to further strengthen these capa-

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(60) CENTRAL BANKING TECHNICAL ASSISTANCE TO COUNTRIES IN TRANSITION (IMF1994), at 109–113.

(61) The German Bundesbank served as a model for the statute governing the State bank of Czechoslovakia, because of the high degree of autonomy that the Bundesbank enoys and its outstanding record in safeguarding the stability of the German currency. *See*, Vladimir Jindra, *Problems in Czechoslovak Banking System* in MONETARY AND BANKING REFORM IN POSTCOMMUNIST ECONOMIES, *supra* note 2, at 52.

(62) *id.*

(63) D. Folkerts-Landau, et all, *Reforming Payment Flows in Formerly Centrally-Planned Economies in* TRANSFORMATION OF THE BANKING SYSTEM, *supra* note 28, at 204.

(64) *See*, Julian Dublain, *Czech Republic: Banking Law to get „Small Amendment"*, EIU BUSINESS EASTERN EUROPE, June 6, 1994, at 6. The Banka Bohemia collapsed in April, 1994 as a result of selling prime rate guarantees, while the Mlada Boleslav — AB Bank was closed in May 1994 due to problems with lending to its own shareholders.

bilities is being developed. In addition to introducing several regulatory changes in August 1991, the NBP has consolidated a multitude of clearing accounts into a single centralized account for each bank. Furthermore, the National Clearing House, which was created in 1991 as a private company with ownership by 17 major commercial banks and the NBP, implemented a new system of overnight clearing and settlement of paper documents in April 1991. An electronic payments system is also being developed to complement and eventually replace the paper transaction system. The revision of the Polish accounting plan for banks (prepared with IMF technical assistance) has been completed, and it is expected that by 1995 all banks will report under the new system.

In 1993 the Banking Supervision Department, created within the *Russian* Central Bank, took responsibility for off-site regulatory activities such as bank licensing, auditing, and supervision and regulation. A banking inspectorate has also been created within the Central Bank to conduct regular audits of the bank's operations. A state program concerning conversion of the accounting and statistics systems to international standards and practice was approved by the government in 1994. (65) The two pressing issues remaining are training personnel to supervise the operations of commercial banks and reforming the payment system. The present payments system is still based on the needs of the centrally planned economy. The Central Bank has played a major role in the reform of the payments system by replacing old payment demand orders with new checks. Intra-city clearing and setlments have been improved, particularly in Moscow, while inter-city improvements are delayed. Currently a team of experts from the IMF and other multinational agencies is helping the Russian Central Bank to coordinate and guide the reform of the domestic payments system. (66)

V CONCLUSIONS

Judgments about the success of banking reform in the three countries discussed above cannot yet be made because reform does not end with the establishment of independent commercial banks. In addition, data on many basic variables are issued by multiple and inconsistent sources. They are incomplatible with other data, and are not relible. (67)

The success of the banking system is measured by its ability to allocate financial resources efficiently and competitively, while maintaining price

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(65) *See*, Olga Prokofyeva and Nadejda Ivanova, *Statement on Banking Supervision* in CENTRAL BANKING TECHNICAL ASSISTANCE TO COUNTRIES IN TRANSITION , *supra* note 59, at 33–35.

(66) *See*, RUSSIA, *supra* note 42, at 43.

(67) Because of the unreliable data some of the most respected institutions in the forecasting business, such as the Vienna Institute, the IMF, and the OECD, have uderestimated or overestimated the economic revival in much of the CEEC. *See*, E. Lucas, *Painting by Numbers*, EIU BUSINESS EASTERN EUROPE, October 31, 1994 at 1.

stability and promoting growth. To establish and secure the credibility of the banking industry, it is essential to attain the following three elements: price stability, a safe and efficient payments system, and sound financial intermediation. Achieving price stability is the very foundation of financial system credibility. The Czech Republic, for example, achieved price stability through a well-designed macroeconomic policy. Tight fiscal and wage policies, stringent measures limiting credit expansion, and a decrease in the real money supply were all responsible for curbing the rise in prices in the Czech Republic. The second element, the safety and efficiency of the payments system, underlies both depositors' and borrowers' confidence in the financial system, while the third factor, the soundness and stability of the overall financial system, depends on banks' self-discipline in decision-making as well as on supervision by the monetary authorities. As discussed earlier, the banking reforms in all three countries have had significant positive results, butt much remains to be done.

To a certain degree, all three countries still exhibit the following characteristics and problems:

- the most powerful commercial banks are still state-owned
- new private banks are small and at a competative disadvantage with powerful state banks
- new banks are underctaffed, undercapitalized, and have narrow regional or sectional specialization
- varying degrees of government interference still influence bank operations
- deposit insurance is inadequate but required to improve confidence in the banks
- bank services and management remain far below world standards in many areas
- regulations concerning bank establishment, deposit insurance, bank audits and capital adequacy also do not meet international standards.

All three countries have been making efforts to build a banking structure compatible with that of the European Union, and to create an attractive financial environment for foreign investments. But foreign participation in banking operations has been negligible in all three countries, reflecting the still restrictive bank licensing policy.

Besides these common problems, each country faces its own specific ones. For example, the *Polish* banking reforms focused primarily on state-owned commercial banks, but more measures are needed to complete their privatization. (68) The problems of the private and cooperative banks have

(68) *See*, S. Sikora and M. Miszcrak, *The Privatization of the Banks in Poland* in TRANSFORMATION OF THE BANKING SYSTEM, *supra* note 28, at 129–134.

to be addressed in order to minimize moral hazard. In spite of the large number of banks, competition within the system is limited because banks are reluctant to encroach on other banks' territory, and because of the competitive disadvantages private banks face.

The success of the *Czech* banking system is due to a long tradition of prudent monetary and fiscal policy, and reliable and solid principles of banking conduct. (69) Firmly established macroeconomic and political stability, with a healthy budget position, low internal and external debt, and moderate inflation, are additional factors contributing to the achievements in the banking industry. The problems the Czech banks will face will de characteristic of banks in any market economy, and less related to transformation problems. (70) Although independent, the commercial banks in the Czech Republic still operate deeper within the shadow of the central bank than do their counterparts in Poland.

Banking reforms depend on the progress of economic reforms. Poland and the Czech Republic started their transition to a market economy earlier than Russia did, by developing a market-oriented financial infrastructure and, thereby, better preparing their societies for the new transformations. *Russia* has shown little interest in the experience of the other two countries of the CEEC. One explanation for such an attitude is that Russia's unique character renders the experience of the others inapplicable. (71) More likely it is hard for Russia to follow the example of the countries it used to lead. However, Russia has expressed interest in learning from Western bankers and financial experts based on their national experience, even, though their systems and experiences are even more different from Russia's than those of the other CEEC. For example, the International Steering Committee for Payment System Reform in Russia is made up of representatives of the western central banks (the U.S. Federal Reserve, the Deutsche Bundesbank, and the Bank of France), and representatives of multinational organizations such as the European Bank for Reconstruction and Development, the European Commission, the World Bank, the Organization for Economic Cooperation and Development, and the International Monetary Fund. (72)

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(69) Czechoslovakia was the first country to establish a national system of credit and deposit insurance in 1924. *See,* P.F. Bartholomew and V.A. Vanderhoff, *Foreign Deposit Insurance Systems: A Comparison,* in the course material for International Banking Structure and Regulation I.

(70) *See,* Richard Salzmann, *supra* note 32, at 16.

(71) According to some authors, the economic situation in Russia is different from that of other CEEC, and its whole political and socio-economic history as well as experience is unique. *See,* Anders Aslund, *The Gradual Nature of Economic Change in Russia* in HANGING THE ECONOMIC SYSTEM IN RUSSIA(A. Aslund and R. Laylard, ed., 1993), at 19–38.

(72) The Committee is chaired by the Central Bank of the Russian Federation and provides general direction and coordination for payment projects and promotes a consensus on payment policies and strategies. *See,* CENTRAL BANKING TECHNICAL ASSISTANCE TO COUNTRIES IN TRANSITION, *supra* note 59, at 5.

Under the auspices of multinational organizations, technical assistance and training programs have been provided to the CEEC from the initial stages of designing structural reforms to concrete implementation of specific projects. Such assistance and coordination was necessary, since personnel and technical, supervisory and even cultural elements of the modern financial system were lacking. But the implementation of structures and project based on the experiences of different countries might not be applicable to the financial needs of a particular country in transition. Some of the banking systems are becoming hybrids by adopting central bank operations similar to those of Germany's Bundesbank, a supervisory system like that of Belgium, commercial banking activities modeled on those of France, and financial advising practices similar to those used in the United States. (73) But the U.S. and West European banking systems have developed in response to their specific historic and economic circumstances, and none of them is completely applicable to the needs of the countries in transition. At this point, any change might seem positive, but over time, conflicting and contradictory reforms may not fit together and may be responsible for a loss of public confidence in the reform process.

The transition to a market economy is a complex and difficult process. The confidence of the people is the most important element in a successful transition. High expectations for a quick economic recovery and gains from reform among the population put great pressure on government authorities, which might hamper the conduct of economic policy and implementation of structural reform. After several years of decline, people must see real improvements in their living situation, if support for reform is to continue. But not all processes can develop quickly. Speed is very often less important than careful sequencing of reform steps and building confidence in well organized, multi-year reform programs.

The banking reforms in the Czech Republic, Poland and Russia have shown impressive progress in transforming their banks into modern, competitive, and efficient financial institutions. However, a multitude of problems, both financial and institutional, still undermine the banks' ability to fully support the economic transition. Strong commitment to achieve set goals, further assistance from western and international financial institutions, and the confidence of their populations in reforms are the basis for completion of the banking reforms and integration into the international financial industry.

(73) *See*, David Youtz, *supra* note 30, at 160.