Annex 5 –
Challenges to Banking Sector Stability in selected Acceding Countries

I Background and Purpose

Following their accession to the European Union in May 2004, the eight Central and East European countries of the first wave, having been judged to have converged sufficiently with the 15 existing members of the Union in regard to the political and economic criteria established in Copenhagen, will continue to undergo structural and institutional change. Moreover, they will be committed to entering a process leading up to the adoption of the common currency. The EU has set a target date of 2007 for the accession of two additional countries in the region, Bulgaria and Romania, which are in the process of negotiating the final chapters of the *acquis communautaire* that will define the path by which they too will harmonize their institutions. All of these countries have already made dramatic strides in improving the stability and efficiency of their banking sectors as well as in eliminating restrictions on capital flows. However, these processes are not complete and further progress along these lines, including such phenomena as increased competition in the banking sector and more substantial flows of short-term capital, in and of itself has the potential to increase the risks of instability in the banking sectors of the individual Acceding Countries. Moreover, there may well be developments in macroeconomic trends, exchange rates and direction and composition of financial flows due to accession to the EU and preparation for eventual accession to the Euro Area that could exacerbate these risks.

In this paper, we attempt to examine the characteristics of the banking systems of selected Central and East European countries to determine their relative ability to cope with these pressures and derive a set of priorities for further strengthening of the banking sectors in light of the upcoming challenges they will be facing in this critical period. We have chosen to focus on the banking sectors of Poland, the Czech Republic and Romania. These three countries have followed rather different paths in the transition of their banking sectors from collections of state undertakings that largely served to intermediate between the government budget and budget-financed enterprises and institutions and collect household savings to groups of predominantly privately held banks functioning in competitive markets for financial services. In each of the cases, extensive restructuring of the banks was required due to the substantial burden of non-performing loans that threatened their viability as financially independent institutions. The paths chosen in restructuring by these three countries have had considerable impact on the roles currently being played by the banking sectors in financial intermediation in the respective economies and provide us with a spectrum of experience to consider in assessing their ability to withstand the strains that might develop in the course of their accession to the European Union and preparation to join the Economic and Monetary Union thereafter.

II Progress to Date in Restructuring of the Banking Sectors

At the outset of their transition from centrally planned to predominantly market-oriented economies, the Acceding Countries countries of Central and Eastern Europe shared the common problem that their banking sectors were characterized by a relatively small number of large, state-owned institutions that, due to political pressures and inappropriate incentives to management, had become burdened by large volumes of non-performing loans. These banks were therefore financially unviable as independent institutions

without significant restructuring of their balance sheets. These banking institutions lacked not only the financial capital, but also the human and physical capital that would be necessary to compete in a liberalized market for financial services. In some of the countries, political leaders were unwilling, at least at the outset, to accept a transformed banking sector that would likely be dominated by foreign banks. On the other hand, experience in other emerging markets strongly suggested that banking sector reform was only likely to achieve significant results with the entry of foreign banks and strategic foreign investors in domestic institutions, bringing the need to compete in offering financial services, as well as serving to transfer management expertise and technical know-how.

The Czech and Polish banking sectors, and to a somewhat lesser degree the Romanian banking sector, are now overwhelmingly in private hands. As of mid-2003, 83% of the authorized capital of the Polish banking sector was privately held, up from 51.1% at the end of 1995. Of total bank capital at mid 2003, 61.2% was held by foreign investors. While banks with majority private capital accounted for only 13.0% of total assets held by Poland's commercial banks in 1993, by mid-2003 this share had reached 66.9%.

In the Czech Republic, the state held a mere 4.1% of equity capital in the banking sector at the end of 2002, down from 31.0% as late as the end of 1996. An initial privatization effort in 1991-1993 as part of the mass voucher privatization program was subsequently followed in 2001-2002 by the privatization of state-owned stakes in the largest banks with the participation of foreign strategic investors. As of end-2002, 81.9% of the equity in Czech banks was held by foreign entities. Among the four largest banks, the foreign equity share is a startling 95.5%, but even among the remaining banks (excluding 9 foreign branch banks), foreign control exceeds 50%. In terms of bank assets, the share held by majority private-owned banks in the Czech Republic had risen to 95.4% at the end of 2002, up from 79.4% at the end of 1993.

Of Romania's 31 banks (excluding branches of foreign banks), only 3 remained controlled by the state in 2002. Romania's state savings bank remains fully in state hands, while the state retains majority stakes in the Eximbank and the largest commercial bank, Banca Commerciala Romana. Romania is currently in the process of selling 12.5% stakes in the latter to the EBRD and the International Finance Corporation of the World Bank Group, while the former is to be converted into a state export credit agency. The majority privately-owned banks in the country held 59.6% of Romania's total banking assets at the end of 2002, including 7.4% held by branches of foreign banks. As of end-1994, Romania's majority privately-owned banks had held a mere 19.6% of bank assets.

The privatization of the banking systems in the transition economies of Central and Eastern Europe was aimed not only at attracting capital injections and increasing efficiency in the financial services sectors, but also at eliminating the inappropriate incentives to bank management that contributed to the burden of non-performing loans inherited from the socialist era. As we point out below, privatization was a necessary, but not a sufficient condition for accomplishing these goals. State-owned commercial banks were under substantial pressure to extend further credits to financially troubled state-owned enterprises. In turn, state-owned banks were fairly confident of repeated government bailouts if needed. As a result, commercial banks slated for privatization

were badly under-capitalized and a program of restructuring was required prior to and in conjunction with the privatization process. The Polish strategy, characteristic of much of Poland's policy in regard to economic transition, was aimed at privatizing the bank sector as quickly as practicable in an effort to minimize the fiscal cost of bank restructuring. In contrast, the Czech Republic and Romania stretched out the process by nearly a decade due to unrealistic expectations in regard to the potential selling prices of the assets as well as to the domestic political opposition to potential foreign domination of the bank sector.

By the end of 2000, the share of total Czech bank assets held by majority state-owned banks at 28.2% was actually higher than the 20.6% at the end of 1993. In Romania at the end of 2000, the share of total bank assets held by state-owned banks still remained at 50.0%, down from 75.3% at the end of 1998. As a result of the delays, inappropriate incentives to bank managers remained in place at key institutions and soft lending practices persisted, eventually boosting the fiscal cost of restructuring and impeding the efficiency of the domestic banking industry. In contrast, in Poland the share of majority state-owned banks declined steadily to the neighborhood of 24-26% in 1998-2002 from 86.2% in 1993.

In the Czech case, the partial privatization of three large commercial banks that were hived off from the once monolithic Czech National Bank began early in the decade through the voucher privatization program. However, in this process the large investment funds that ended up with the stakes in the banks were, in turn, managed by the banks. Thus, the banks essentially controlled their own shares and gained stakes in many of their most important debtor enterprises as well. Because of lax regulation of the financial sector, the result of the voucher privatization process was detrimental to corporate governance in the banking sector. Moreover, as the state retained controlling stakes in a majority of banks, soft lending and inefficient bank operations were preserved. The state created the Konsolidacny banka, a so-called hospital bank, in 1991, and subsequently two other specialized asset management agencies, to take the non-performing loans off the balance sheets of the commercial banks, restructure them and attempt to recover the assets. However, the mandate for debt recovery frequently seemed weaker than an implied imperative to prolong the existence of important debtor enterprises and Konsolidacny banka itself was at times used for directed lending.

Even the sale of a fourth Czech bank, IPB Bank, to a foreign investor in 1998, which did not involve the removal of non-performing loans from the balance sheet or any state debt guarantees, did not produce the desired result in terms of the bank's operations. The bank's condition deteriorated further. The foreign investor chose not to undertake extensive debt restructuring, selling off the choicest assets and engaging in creative accounting. Inattentive auditing and delayed reaction by the Czech bank supervisory authority allowed a crisis to develop. In 2000, after panicked depositors staged a run on the bank, the Czech National Bank was forced to take over its administration. It was thereafter sold to a strategic foreign investor, this time with assumption by the state of bad debts and the extension of state guarantees. Konsolidacny Banka ceased its other activities at that time, was transformed into the Konsolidacny Agentura, and concentrated on asset recovery. The Czech Republic thereafter rapidly completed the privatization of the remaining state-owned commercial banks the following year with sales to foreign strategic investors.

The Polish experience was vastly different. The Polish approach to re-capitalization and restructuring of the banking sector was decentralized in character and, as a result, asset recovery was enhanced and the fiscal cost of the restructuring process was minimized. However, due to a strong political imperative to protect domestic banks from foreign competitors and maintain restrictions on foreign participation in the Polish bank sector, the privatization of the bank sector proceeded at a modest pace until 1999, as can be seen from Table 1 on the structure of the banking system. State-controlled banks still controlled 48.0% of bank assets in 1998. Nevertheless, the re-capitalized commercial banks early on found it necessary to improve their investment strategy as it was made explicit that no further rounds of re-capitalization would be forthcoming from the state. The largest commercial banks participated in the Enterprise and Bank Restructuring Program in the period 1993-1996. Rather than transferring non-performing loans from their balance sheets to a state asset management agency, the state presented the banks with treasury bonds in return for which they were to actively pursue the work-out of non-performing loans with debtor enterprises, typically resulting in debt-equity swaps or bad debt write-offs. Smaller banks were restructured and sold or merged into stronger banks under the auspices of the National Bank of Poland. In addition, foreign banks applying for licenses to operate in Poland were obliged to provide affordable credits to or acquire troubled banks in return.

While the operational characteristics of the Polish domestic banking system improved due to these initiatives, the continued strong role of the state meant that soft loans to state enterprises were still made and, for the most part, banks were content to concentrate their efforts on investing in treasury securities and engage in only limited lending to the non-financial private sector in view of inadequate capabilities for assessing credit risk. With the lifting of restrictions on foreign participation in the Polish banking sector in 1998, foreign ownership increased dramatically. At the end of 1998, out of 83 total commercial banks, 31 banks with majority foreign ownership, including 3 foreign branch banks, accounted for 43.7% of bank equity and only around 17% of total net assets. By the end of 1999, 39 foreign-controlled banks out of a total of 77 commercial banks accounted for 50.2% of bank equity and a surprising 47.2% of total assets. The National Bank of Poland pointed out that in view of the diffuse shareholding structure of a number of additional banks, they were de facto controlled by foreign capital, bringing the market share of foreign-owned banks up to 70%. The official share of foreign-owned banks reached 76.3% of bank equity and 66.9% of assets by mid-2003. Sales of two additional major state-owned banks had originally been planned for 2003 together with an offering of a minority stake in one of these on the domestic stock market, but the transactions have been significantly delayed.

Romania delayed the privatization of its major state-owned commercial banks because their poor financial condition and the stop-and-go nature of the domestic economic recovery impinged on their likely market value. Instead, Romania engaged in repeated rounds of bank re-capitalization at substantial fiscal cost and with only temporary impact on the balance sheets of the state-owned commercial banks. These re-capitalization efforts were defeated due to a number of factors, including a lack of co-ordination with enterprise restructuring, faulty internal controls and auditing practices, lax legal and regulatory regimes, and little attention to improving the management teams in the state-owned banking sector. Finally, in 1999, a re-capitalization program was

initiated that involved the transfer of assets to a state management company at the recommendation of the World Bank. By the end of 1999, the AVAB, the Romanian state asset management company, was managing a portfolio of $2.3 billion in non-performing loans. It was estimated that this round of bank clean-up was accomplished at a cost of 4% of GDP. As indicated above, Romania is currently in the process of privatizing the last of the majority state-owned banks. As of the end of 2002, the private banking sector in Romania was almost entirely controlled by foreign entities. Of the 59.6% of bank assets controlled by majority privately owned banks, 56.4% were controlled by banks with a majority of foreign capital, including branches of foreign banks.

To gauge the scope of the bad loan problem in terms of its burden on the banking sectors and the improvements made to date, we turn to data on the quality of bank assets reported by the bank supervisory agencies. Looking at the share of non-performing loans as a share of total loans in each of the countries as of the end of 2002, keeping in mind that the asset recovery rate has been the lowest of the three and the estimated fiscal cost of restructuring has been the highest as a share of GDP, Romania's reported figure for non-performing loans as a share of the total is the lowest of the three bank sectors we are examining at only 2.3%. However, due to a change in Romanian banking regulations effective at the outset of 2003, financial performance of the debtor enterprise became a criterion in assessing the quality of bank assets and the share of non-performing loans was expected to end the year at close to 5% of total loans. This was nevertheless down from a high of 71.7% at the end of 1998, just prior to the transfer of assets to the state asset management agency. Note that these figures are for the economy as a whole and include loans both on the balance sheets of banks and those transferred to the agency. In the Czech Republic, the share of non-performing loans has also declined substantially in recent years, from 21.51% of the total at the end of 1999 to 8.1% at the end of 2002. In the first half of 2003, the Czech share fell further to 6.3% despite the fact that non-performing assets could no longer be transferred to the *Konsolidacny Agentura*. While the Polish share of non-performing loans at its low point at the end of 1997 was 10.7% of the total, it increased substantially in 2001-2002 due to the difficult macroeconomic situation and reached 21.9% at the end of 2002. In this period, the increased proportion of non-performing loans in Polish banks' portfolios reflected in particular bad loans to small- and medium-sized enterprises and sole proprietorships. In addition, a higher share of loans to construction enterprises fell into that category as the construction sector struggled with declining demand for its services over a two-year period. In comparison, the Tables 9-10 provide data on non-performing loans in Hungary and Slovakia for the purposes of comparison. The European Central Bank reports on average across EU banking sectors non-performing and doubtful assets amounted to 2.90% of total assets in 2001 and 3.06% in 2002, adding that even within the European Union, due to differences in national definitions of non-performing and doubtful loans, these ratios are not completely comparable across countries.[1]

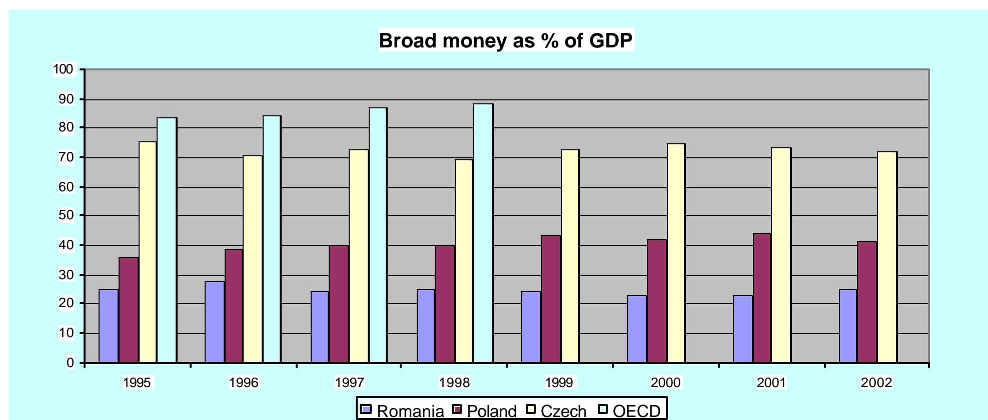
In addition to the processes of restructuring and privatization that were launched by the economic transition of the 1990s, the impact of increased competition in the financial services sectors has generally been to trim the number of banks after initial periods of expansion, through mergers or withdrawal of banking licenses. Smaller domestic banks

[1] EU Banking Sector Stability, European Central Bank, November 2003, p. 19.

were particularly vulnerable in the highly risky lending environment, lacking experience in risk assessment. This process has tended to preserve a rather highly concentrated character in the banking sectors of the region. In the Czech Republic, there were 37 banks operating at the end of 2002, down from a peak of 55 in 1995-1996. In Poland, the number of banks peaked in 1997-1998 at 83 but fell to 59 by the end of 2002. In Romania, the number of banks grew through 1998, reaching 36, but was trimmed to 31 by the end of 2002. The market shares of the 5 largest banks in each of the countries in recent years testify to the high degree of concentration that has resulted. (See Tables 2-4.) In Poland, the five largest banks accounted for 53.6% of total assets, 60.2% of total deposits and 48.6% of outstanding loans at the end of 2002. In the Czech Republic, the respective shares reached 65.8%, 77.3% and 65.5%, while in Romania they came to 66.6%, 68.5% and 58.0% for the five largest banks. For the ten largest banks in each market, the shares in each of the countries fall in the range of 75-85%. In all three of the countries, the consolidation of the financial sector has resulted in a large proportion of financial assets being held by foreign investors. In light of approaching EU accession, this process will continue and will help to strengthen capital positions, bring about improved governance and introduce a wider range of financial services. In comparison, the degree of concentration differs widely among the individual bank sectors of the EU countries. The share of the five largest banks in total assets in 2002 ranged from 20% in Germany and 30-31% for the United Kingdom, Luxembourg, and Italy to 79% in Finland and 82-83% for Belgium and the Netherlands.[2]

III Current Indicators of Operational Efficiency and Financial Stability

In this section, we undertake an examination of the relevant indicators to determine the evolution of the role of banks in financial intermediation in these economies, the impact of the macroeconomic environment and growing competition in the financial services sector on the efficiency and profitability of banks, and their likely ability to withstand shocks, both direct and indirect, due to adverse developments in the economic environment.



[2] Structural Analysis of the EU Banking Sector Year 2002, European Central Bank, November 2003, p.24.

The role of commercial banks in financial intermediation in Poland and Romania is much weaker than is typical for developed countries, largely thanks to the relatively short period that has intervened since the restructuring of the bank sectors. While the typical ratio of broad money (M2) to GDP in more developed countries is in the neighborhood of 70-80%, for Romania, this ratio remained in the range of 23-25% throughout the period 1997-2002, having peaked at 27.9% in 1996. In Poland, this ratio peaked at 43.8% in 2001, up from only 36.1% in 1995, and slipped modestly to 41.6% in 2002. It is only in the Czech Republic that this indicator falls in a range typical among developed economies, remaining at 70-75% in 1995 through 2002. Iakova and Wagner, however, suggest that rather than reflecting a stronger role due to a healthier banking system, this indicator for the Czech Republic reflects the much lower and more predictable rates of inflation there in the past decade than in many other transition economies.[3] Figures on domestic credit to the private sector as a share of GDP would seem to offer a more telling comparison. Again, the Czech Republic stands out, but far more modestly. While the international financial institutions have suggested that the volume of credit to the private sector as a share of GDP in economies at this stage of development should exceed 30%, in Romania in 2002 this ratio stood at only 8.4%.[4] For Poland, the ratio remained in the neighborhood of 18% through 2001 before falling slightly to 15.2% in 2002, reflecting the impact of tight monetary policy. While the ratio of domestic credit to the private sector to GDP in the Czech republic peaked at 54.3% in 1997, due partly to the recession that was setting in and an extended period required to clean up the troubled portfolios of the banking sector, it slid to only 24.3% by 2001 and further to 20.0% the following year. In sharp contrast, the comparable indicator for the aggregate of the 12 banking sectors of the EMU members rose from 103% in 1997 to 116% of aggregate GDP in 2002.[5]

In difficult economic times or when concerned with meeting tighter prudential standards of bank supervisory authorities, banks in the region, which have lacked extensive experience in credit risk assessment and which might also have had reason to question the transparency of enterprise financial records, were willing to finance only the most solvent of enterprises and shifted the composition of their assets instead in favor of government securities. Lack of technical skills in assessing credit risks in a relatively unstable economic period helped to make banks reluctant to extend credit to smaller companies at such times. A 2003 IMF working paper by Cottarelli et al. on the growth of bank credit to the private sector in Central and Eastern Europe concurs that "…data suggest that--in the context of increased overall financial deepening--privatization, public sector retrenchment, and, possibly, the overall progress towards market institutions and the quality of legislation to protect creditors' rights have been key factors behind rising BCPS [bank credit to the private sector] ratios."[6] This study also found that growth of

---

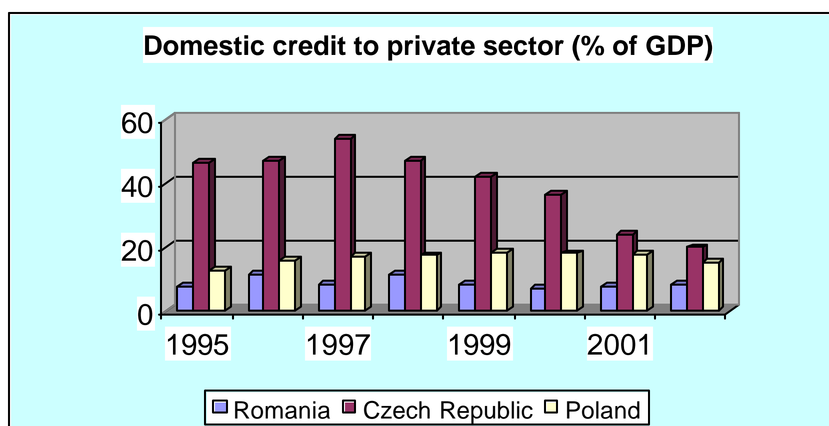
[3] Dora Iakova and Nancy Wagner, "Financial Sector Evolution: Challenges in Supporting Macroeconomic Stability and Sustainable Growth," in Into the EU: Policy Frameworks in Central Europe, Robert A. Feldman et al., International Monetary Fund, (Washington, DC, 2002), p. 40.

[4] Daniel Daianu and Octavian Ionici, "Achievements and Challenges for Banking Sector Development in EU Acceding Countries: Southeast Europe and Baltic Countries," presented at the OECD Forum on Trade in Services in South Eastern Europe, (Bucharest, June 2003), p. 13.

[5] European Central Bank, Structural Analysis of the EU Banking Sector, p.25.

[6] Carlo Cottarelli, Giovanni Dell'Ariccia, and Ivanna Vladkova-Hollar, "Early Birds, late Risers, and Sleeping Beauties: Bank Credit Growth to the Private Sector in Central and Eastern Europe and the Balkans," IMF Working Paper WP/03/213, November 2003, p. 23.

bank credit to the private sector in most of the countries in the region did not generally correlate with increases in net foreign liabilities of their bank sectors, although it notes that bank credit to the private sectors in Estonia, Latvia, Poland, and Slovenia was supported by increased net foreign borrowing.[7]



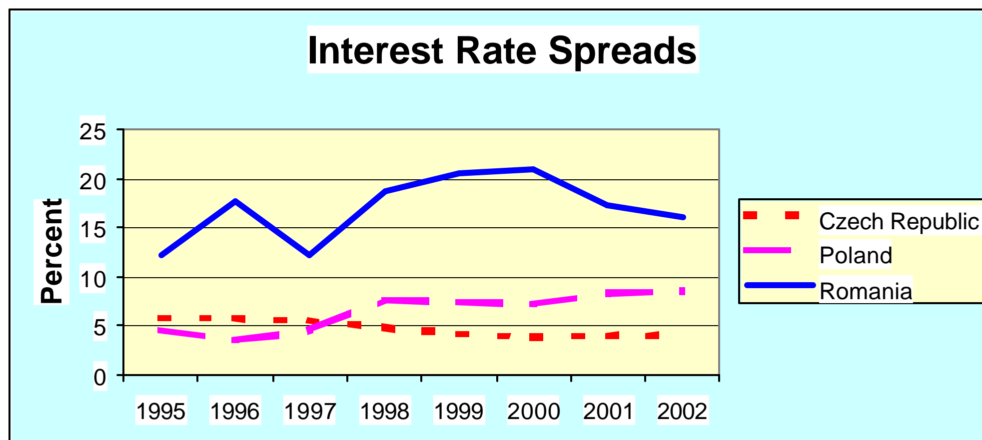
While the growth of domestic credit has increased substantially in the past several years in most of the region as banks became more confident in assessing credit risks, particularly after the entry of foreign strategic investors into bank sectors bringing both capital and expertise, domestic credit growth has also reflected monetary policy swings and developments in the real economy that in some cases temporarily reversed credit growth. With improvement in both macroeconomic conditions and the health of the banking sector, credit growth vis-à-vis non-financial enterprises began to accelerate in Poland in 2003, offsetting a continued slowdown in lending to households and maintaining year-on-year growth in total lending at around 5%. In the Czech Republic, in contrast, retail lending, up 30% year-on-year at mid 2003, was responsible for a surge in the volume of domestic credit in 2003, with acceleration in both consumer and mortgage lending. Retail lending is attractive to Czech banks in view of the relatively low current level of indebtedness of domestic households, while corporate lending has continued to contract as banks have sought to further shore up the quality of their portfolios. The share of retail loans in total loans by Czech banks rose to 21.5% by mid-year from 19.0% at end-2002. Starting from a much lower base, domestic credit to the private sector continued to grow apace in Romania, accelerating from a year-on-year rate of 30% at end-2002. Retail lending, mortgage lending in particular, has been growing at rates several times growth of corporate lending, but from a much smaller base. Retail loans represented 19.7% of total loans outstanding from Romanian banks in 2002.

Developments in interest rates reflect the trends in the efficiency of the bank sectors in financial intermediation. We would expect that privatization and increased competition in the bank sector, particularly from branches of foreign banks and banks with foreign strategic investors, as well as inflows of direct foreign investment into the

---

[7] Ibid., p. 7.

corporate sector and increased availability of credit from abroad, have compelled the banks in the Acceding Countries to narrow the spread between their lending and deposit rates. This was hopefully made financially feasible by the increased efficiency of their operations, which we will examine in turn. Interest rate spreads have narrowed modestly in the Czech Republic, from 5.8% on average in 1995 to 3.8% in 2000 but rising slightly to 4.0% in 2001-2002, before resuming a narrowing trend in the course of 2003, as competition for the retail lending market heated up. Interest rate spreads have narrowed in Romania as well as bank restructuring got under way in earnest. The average interest spread declined to 16.1% in 2002 from 20.8% in 2000. In Poland, the average spread rose abruptly in 1998 to 7.6% from only 4.5% in 1997 as a result of the take-off of consumer lending for which much higher spreads are typical in view of greater risk perceived. Spreads exhibited declines in 1999-2000, but widening of the average spread in 2001-2002 coincided with the difficult macroeconomic situation and rising shares of



non-performing loans. The average spread between deposit and lending rates rose to 8.5% by 2002 from 7.2% in 2000. More recently, as Polish headline policy interest rates have come down in an effort to jump-start an economic growth rebound, lending rates have followed suit, although Polish banks have found it necessary to keep deposit rates from falling as quickly in order to attract household savings. As a result, the average interest spread on local currency loans and deposits dropped by 30 basis points in the first half of 2003. In contrast, overall for the banking sectors of the European Union members, the overall interest rate spread was 3.8% at the end of 2002, but declined to 3.5% at mid-2003.[8]

Despite declining interest rate spreads, higher net interest margins than typical in developed market economies suggest that competitive pressures and efficiency in the Acceding Countries' banking sectors still compare unfavorably. Figures on net interest margins are available for Poland and the Czech Republic through 2001. The average net interest margin declined substantially in Poland in the period 1996-2001, from 5.98% to 3.38%, testifying to increasing competition in the market over that time. In the Czech Republic over this period, net interest margins remained in the range of 1.9-2.1%, with the exception of 1998-1999, which was characterized by high headline policy interest rates and heightened concern over the quality of loan portfolios, when the figure pushed

[8] European Central Bank, EU Banking Sector Stability, p. 20.

up to the 2.5-3.0% range. This can be compared with an average for the EU bank sectors of 1.52% in 1998.[9] In addition to the influence on interest rates of increased competition in the bank sector, they will also continue to be affected by a continued reduction in rates of inflation down toward Euro Area levels and continued restructuring of the real sector which should lead to an improvement in the banks' perception of lending risks. It should be noted, however, that in most of these economies a great deal of this convergence has already taken place and between lending rates in those countries and in the EU there is already less of an interest rate differential than existed in the late 1990s between the newer EU member-states and their predecessors in the union.

Turning to the issue of profitability of banking activity in these economies, we have comparable data on return on assets and return on equity for the Czech Republic and Poland through 2001. For Romania, on the other hand, data are available only for 1998-2002. The data on the Czech Republic are presented in Table 11 for the period 1996-2001. Losses or very low rates of return in the Czech banking sector through 1999 largely reflect the results at large state-owned banks that were being restructured prior to their privatization. In 2000-2001, return on average assets for Czech banks was positive, but fell from 0.69% to 0.45%. Return on average core equity fell from 14.99% to 9.99% in 2001. Polish banks were profitable throughout the 1996-2001 period, but rates of return, presented in Table 12, declined monotonically thanks to increased competition in the market. The reported 3.77% return on average assets in 1996 slipped to 1.75% by 1998 and modestly further to 1.36% in 2001.

Prior to restructuring, the Romanian bank sector enjoyed rates of return above average for the region thanks to the unstable macroeconomic situation in the country that afforded the opportunity for substantial gains from foreign currency speculation and investment in government debt securities. But as in the case of the Czech Republic, once restructuring got under way, the data also reflect losses at state owned banks undergoing restructuring, so that rates of return were very low in 1998 and negative in 1999. Rates of return improved thereafter through 2001 following the restructuring and increased participation of foreign capital in the sector, but declined modestly in 2002 thanks to increased competition in the market. Return on average assets reached 3.1% in 2001 and slipped to 2.6% in 2002 while return on average equity hit 21.8% in 2001 but declined to 18.3% in 2002. Return on average equity declined from 100.1% in 1996 to 28.4% in 1998 and then to 18.5% in 2001. Thus in 2001, the last year in which we have data comparable across the three banking sectors, Romania actually reported the highest average rates of return. For comparative purposes, Tables 13-14 provide these data for two other Central European countries, Hungary and Slovakia. It should be noted that on average in the EU in 1998, return on average assets ran 0.56% and return on average equity was 11.31%.[10] The European Central Bank noted that return on average equity (in the case of the EU, after taxes and extraordinary items, unlike the Central and East European data that is presented before taxes) declined to 8.6% in 2002 from 10.1% in 2001 and further that these indicators varied widely among the bank sectors of the individual countries, ranging from 2% to 15%.[11] The European Central Bank also

---

[9] Iakova and Wagner, op. cit., p. 45.
[10] Ibid.
[11] European Central Bank, EU Banking Sector Stability, p.15.

calculated return on equity and return on assets for an aggregation of the 50 largest banks in the EU. Return on assets for this group declined from 0.76% in 2000 to 0.39% in 2002 while return on equity fell from 14.6% in 2000 to 8.5% in 2002. Data for mid-2003 showed improvement in both these indicators for the 50 largest banks with return on assets rising to 0.43 and return on equity to 11.4%.[12]

It is interesting to note that in the data available for Poland on operating costs as a share of total assets over this period, no significant decline was evident despite the apparent impact of competitive pressures on net interest margins. The ratio of operating costs to average assets improved modestly over this period in the Czech Republic, from 2.24% in 1997-1998 to 2.13% in 2001, and not at all in Poland. This would suggest that banks in the region have so far sought to rely on improved asset management in responding to downward pressures on profitability, either neglecting or having little success in improving efficiency through lower operating costs. And further, that lowering operating costs in the future, such as through the introduction of more modern banking information technology, might be a prime source for maintaining competitiveness in the enlarged European market post-accession. In comparison, the ratio of operating costs to assets EU banks on average fell to 1.68% in 2002 from 1.74% a year earlier. It should be noted that in the case of Poland, income from other activities was rising over the period as a share of total assets, which nearly compensated for the decline in net interest margin. The ratio of combined income to total assets remained in the range of 6.4-7.0% throughout 1998-2001. In the Czech case, there was no offsetting impact from sources of income other than interest and the combined income ratio declined from 4.5% in 1997 to 3.5% in 2001. On average in the EU, the ratio of net interest income to total assets rose to 1.57% in 2002 from 1.51% a year earlier while the ratio of total income to assets fell to 2.55% in 2002 from 2.62% in 2001.

Turning to the issue of financial stability of these bank sectors, having noted the decline in non-performing loans as a share of assets following restructuring in Section II above, we now look at the issue of capital adequacy. All three of the bank sectors have consistently exceeded the minimum international standard of 8% capital adequacy in 1996-2002. However, it must be noted that the national methodologies used in calculating risk weighted capital-asset ratios make the figures somewhat incomparable among the bank sectors in the region and with banking sectors in developed market economies. Due to lack of the necessary data, none of these three countries takes market risk into account in classifying assets nor do they represent consolidated capital adequacy statistics. At least in the cases of Romania and Poland, we know in addition that through 2002, no capital charges against the assets of subsidiaries or any explicit charges for foreign currency, interest rate or equity positions were considered in the calculations. These represent substantial risks for the region's banks. Furthermore, due to the relatively high rates of inflation in Romania in the post-transition period, fixed capital has been included in the calculations at inflated prices, overstating the capitalization of the banking sector. Romania's loan classification scheme was revised in 2000 to incorporate stricter standards. Nevertheless, it is illustrative to examine the published capital adequacy figures, presented in Tables 15-17. In the Czech Republic, the ratio of core capital to risk-weighted assets increased from 9.3% in 1996 to 15.5% in 2001 before

[12] These and following profitability indicators for EU banks appear in Ibid., p. 14

dipping to 14.2% in 2002. In Poland, this ratio rose modestly from 12.3% in 1996 to the neighborhood of 13% in 1999-2000 and then improved markedly to 15.0-15.5% in 2001-2002 although the data in the later years do not adequately reflect risk associated with the growing volume of consumer credit in that period. The European Central Bank reports that the average capital adequacy ratio (Tier 1 capital to total assets) across the EU in 2002 was 8.3%, unchanged from a year earlier and varied only slightly among the bank sectors of the individual countries[13].

IV Bank Regulation and Supervision

Improved bank regulation and supervision have been primary factors in shoring up the stability of the financial sectors of the economies in transition to date. Because of surviving substantial state-owned stakes in major commercial banks and politically-sensitive state-owned enterprises through much of the period in a number of countries, the situation in their banking sectors was fraught with moral hazard. Poor corporate governance and expectations of repeated government bailouts did not provide bank managements with appropriate incentives. In many cases, government officials used bureaucratic power to direct lending with soft repayment terms to financially troubled state enterprises. Bankers found it necessary to rely on implicit government guarantees on credits as bankruptcy procedures seldom provided resort to collateral if necessary to recover assets. Auditing practices initially fell far short of international standards. Inadequate scrutiny in licensing new banks with insufficient capital to operate in an environment of lax supervision resulted in a rash of bank failures in some of the economies in the early post-transition. Bank supervisory efforts suffered from lack of independence, resources and expertise. The result was the heavy burden on the bank sectors of significant shares of non-performing loans that we have described above and that served as a brake on economic recovery and growth due to inadequate financial intermediation.

In the post-transition period, the Acceding Countries benefited from the advice of the international financial institutions in regard to improving the stability of their financial sectors. Joint working groups of the IMF and World Bank, under the Financial Stability Assessment Program, have conducted reviews of bank supervision in individual countries, measuring conformance with the 25 Basel Core Principles for Effective Bank Supervision established under the auspices of the Bank for International Settlements and have made recommendations where such conformance was incomplete. The working groups also conducted simulated stress tests for the individual bank sectors to determine if they would remain stable after suffering particular shocks. The Financial Stability Assessment Programs for Poland, the Czech Republic and Romania were completed in February 2001, June 2001, and September 2003, respectively. In each case, the working group determined that the bank regulation and supervision functions being carried out were generally compliant with the Basel Core Principles. However, specific further steps were recommended.

---

[13] European Central Bank, EU Banking Sector Stability, p. 22

In the case of Poland, the assessment of bank supervision resulted in recommendations that more autonomy be granted supervisory agencies with legal protection for supervisors, information exchange be improved among the agencies supervising the bank and non-bank financial sectors, frequent, consolidated reporting be required, corporate governance principles be instilled and enforced, and stronger powers to intervene and enforce regulations in banking institutions be granted.[14] The assessment noted that these judgments were based on legislation and regulations rather than actual practice and that, in fact, regulators had made considerable efforts to compensate for these shortcomings. In the case of the Czech Republic, the working group recommended that supervisors make additional progress in adopting a risk-based approach, including risks other than just credit risk, apply capital charges for risk on a consolidated basis, require approval of explicit loan and investment and risk management policies at banks, strengthen regulations with respect to anti-money laundering measures, and add human capital and technical resources to the supervisory effort for the assessment of market risk and risk management systems.[15] In the case of Romania, the working group also cited the need for greater legal protection of supervisors, to expand supervisory efforts to credit unions, to require consultation with home country supervisors before authorizing foreign participation in the Romanian bank sector, and to require banks to hold capital against market risk. The working group noted that most of the issues would be addressed in upcoming amendments to the country's Bank Act and through harmonization with EU regulations scheduled for 2004.[16]

Improvement in bank supervision legislation and practice has been achieved in the process of harmonizing domestic legislation with the *acquis communautaire,* as the Acceding Countries have moved toward meeting the requirements of the eight directives that govern the financial sectors of member states. A number of the provisions relate directly to bank regulation and supervision. The first and second directives set the rules for licensing new banks, including minimum capital requirements, and provide for cooperation between national bank supervisory authorities while retaining home country responsibility for the single license required to operate anywhere within the EU. The Bank Account directive establishes a common form of annual account for financial institutions and the Consolidation Supervision directive requires that supervision of banks be conducted via prudential measures compiled on a consolidated basis for all of the institutions' activities. The Own Funds directive establishes the criteria for calculating this concept for use in prudential considerations while the Solvency Ratio directive sets a minimum for the risk-adjusted capital asset ratio at 8%, the international standard. In addition, a Large Exposure directive restricts a bank's exposure to a single client to no more than 25% of its own funds and the total of all loans amounting to 10% or more of the bank's own funds to be less than eight times the bank's own capital.

Progress in these countries on meeting these directives has been reported by the European Commission in its annual country reports on the state of preparedness for

---

[14] International Monetary Fund, "Republic of Poland: Financial System Stability Assessment," Country Report 01/67, (Washington, DC, June 2001), pp. 44-45.
[15] International Monetary Fund, "Czech Republic: Financial System Stability Assessment," Country Report 01/113, (Washington, DC, July 2001), p33.
[16] International Monetary Fund, "Romania: Financial System Stability Assessment," Country Report 03/389, (Washington, DC, December 2003), pp. 25-26.

accession. It should be noted that negotiations on Chapter 3 of the *acquis* on the free provision of services, which addresses the financial services sector, were closed provisionally for Poland in November 2000 and for the Czech Republic in March 2001 and closed in December 2002 along with all negotiations on accession for the 10 countries that will join the EU on May 1, 2004. The 2003 progress report from the European Commission on preparedness of the Czech Republic notes that Czech banking sector legislation is mostly in line with the *acquis* and bank supervision is satisfactory, but that capital adequacy rules have not been implemented completely. The report notes the February 2003 agreement that is to bring about greater cooperation between the bank and financial market supervisory agencies, deemed of particular importance because of the nature of Czech banks that operate as broad-ranging financial conglomerates. In the case of Poland, the commission noted a number of the same shortcomings cited in the 2001 IMF-World Bank assessment, including inadequate legal protection of supervisors and incomplete calculation of capital adequacy but noted progress in conducting consolidated supervision of financial services. Romania's negotiations on Chapter 3 were opened only in December 2002 and remain open. While the 2003 progress report notes that banking sector supervision is much closer to meeting EU standards than supervision of other segments of the financial services sector in Romania, recent progress has been slow and limited to implementing legislation. The report identifies remaining shortcomings in the areas of capital adequacy regulation, supervision of financial conglomerates and liquidation of credit institutions.

In conclusion, these detailed assessments of the banking regulation and supervision efforts in the Acceding Countries have generally testified to significant progress made in recent years and have indicated that for the most part these activities live up to accepted international standards. The remaining shortcomings relate primarily to limited consideration of categories of risk in connection with determining capital adequacy, linked to insufficient skills and information available for the task, failure to make explicit in legislation expectations for corporate governance and investment and risk management policies of banking institutions, inadequate coordination of information and supervision across the various segments of the financial services market to assess capital adequacy on a consolidated basis, and a need to improve the independence of and legal protection for supervisors.

V Challenges to the Banking Sectors in the Run-Up to Accession and the Euro and Policy Implications

Accession to the European Union is likely to present the banking systems of Central and Eastern Europe with the potential need to cope with a new set of stresses. The banking systems will face growing capital inflows together with possible change in exchange rate regimes as well as downward adjustment of interest rates in the convergence toward Euro Area rates. By the time of accession, all constraints on capital account flows (with the potential exception of temporary restrictions permitted in extraordinary situations) and barriers to foreign competition in the financial sector will have been lifted.

Substantial capital inflows, initially largely in the form of direct investment, will fuel growth in domestic investment and consumption, in turn widening current account

deficits. To the extent that current account deficits would come to be financed to a significant extent with short-term debt, the potential for sudden, sharp reverse flow of capital is created if foreign investors come to change their sentiment about the country. Brouwer et al. note that to some extent the vulnerability of local banks to such a sudden withdrawal of short-term foreign capital is being diminished by the increasing role of foreign branch banks and subsidiaries in intermediating foreign capital inflows to the non-financial private sector.[17] Nevertheless, to maintain stability in the financial sector it will behoove national policymakers to carefully manage domestic demand, first of all through cautious fiscal and monetary policies, to avoid accelerated widening of payments imbalances, particularly if there is a growing tendency to finance them with debt of short maturity.

While deposits in foreign currency declined as a share of total deposits as confidence in a fairly stable exchange rate increased, in the run-up to EMU accession, Euro deposits may become increasingly popular. Sensitivity to interest rate differentials among local currency and Euro deposits in domestic banks and between Euro deposits at home and those held abroad could generate destabilizing capital flows. To the extent that banks' balance sheets are asymmetric in terms of their assets and liabilities denominated in foreign currencies, sharp movements in exchange rates can have a substantial impact on their financial situation. Additionally, sharp exchange rate movements may also have serious consequences for the financial conditions of the banks' major customers, their ability to repay loans denominated in foreign currency, and hence for the quality of the banks' assets. Tables 18-20 present the trends in the share of foreign currency denominated credits to and deposits received from the non-financial private sectors by commercial banks in each of the three countries. Note that the share of foreign currency is lower the greater the degree of macroeconomic and exchange rate stability, although it is not possible to draw a robust conclusion on the basis of such a limited sample.

Entering into the ERMII mechanism, a requirement for the two-year period preceding the scheduled accession of the country to the Economic and Monetary Union, is likely to make only rather modest exchange rate flexibility practicable, but the exchange rate will technically be permitted to fluctuate within 15% bands around the central rate. It will continue to be necessary for bank supervisors to monitor banks' open foreign currency positions and limit them if they threaten to create serious exchange rate risk to the balance sheets. It will also be necessary to monitor vulnerability to asset quality in the form of foreign currency lending to customers who might be unable to repay in case of unfavorable movements of the exchange rate.

Acceding to the EU means opening the banking and financial services market wide to foreign competitors. Local banks will see net interest margins narrow and will seek to achieve greater efficiency by reducing the ratio of operating costs to assets, perhaps by growing assets rapidly through risky lending behavior. Under this scenario, domestic banks may more rapidly approach a threatening proportion of troubled loans in their portfolios to the extent they have engaged in insider lending or implicit government-directed lending, although as state-owned stakes in banks in the region have dwindled

[17] Henrik Brouwer, Ralph de Haas and Bas Kiviet, "Banking Sector Development and Financial Stability in the Run-Up to EU Accession, (Bank of the Netherlands, 3-4 June 2002), p. 7.

this is less likely to be a problem in the extension of new credits but relates more to possible inherited burdens of troubled loans. Thus, it will be crucial to strengthen independence of supervisory agencies, enforce avoidance of conflict of interest and impose exposure limits, encourage the principles of good corporate governance, and improve standards for auditing. It should be noted that a greater preponderance of foreign banks operating in the region widens the possibility for cross-country contagion of instability in the banking sector as the foreign banks tend to have operations in several of the countries of the region. If significant outflows of capital are generated by losses of confidence in one or more of the bank sectors, the impact on exchange rates could well impact the timing of Euro adoption.

In acceding to the EU, these countries will be instituting a more substantial financial safety net. In harmonizing legislation with the EU norms, the Acceding Countries will have instituted deposit insurance equal to the EU minimum of 20,000 Euro. This level is quite high relative to the levels of average income and average size of individual deposits. Providing insurance at this level has the potential to provide mixed incentives to bank management to act responsibly if their depositors are not expected to pay the price for risky behavior. The other component of the safety net is the lender of last resort. This will remain strictly a central bank function. The fact that banking sectors in these countries are for the most part highly concentrated increases the likelihood that financing would be provided to a domestic bank in serious difficulty as it would represent a serious systemic threat. On the other hand, after accession, supervision of EU-based foreign branch banks and foreign strategic bank investors is the purview of their home country. Thus, cooperation and harmonization of incentives across national boundaries for bank supervisory agencies will be increasingly important.

We have seen that capital adequacy as measured by national supervisory agencies is currently well above the 8% standard in the Acceding Countries. On the other hand, we have also catalogued remaining insufficiencies in auditing standards, in the assessment of a broad category of risks for the purpose of capital charges, a dearth of information-sharing on credit risk among credit institutions, less than adequate corporate governance to discourage insider lending, and problems in the judicial system that undermine the protection of creditors' rights and resort to collateral (including real estate) in an effort to recover assets. Moreover, as noted above, the banking sectors are for the most part highly concentrated, which increases the likelihood that the national safety net (the lender of last resort) would kick in and thus represents greater moral hazard. One suggested approach to buffering against these uncertainties in assessing the condition of banks is to increase the statutory minimum capital adequacy ratio.

More limited resources and skills are likely to characterize bank supervisory agencies in the Acceding Countries for some time to come. This will become even a more critical limitation as the regulatory standards are harmonized with the provisions of the Basel II capital adequacy regulations that will become compulsory in 2007. The new regulatory scheme is designed to address a wider spectrum of risk assessment in weighting assets and enforcing increased transparency to bring to bear the discipline of markets to contain risk-seeking by banks. These new standards will require even more sophistication in banks' asset and risk management strategies and in information technologies that will have to be matched in the supervisory agencies as well. Within

these agencies, it will be necessary to shift scarce resources to review higher risk activities and banks' policies for controlling their risk exposure. It has been suggested that in light of this necessity, banks in relatively poor financial shape should be required to pay higher premiums for deposit insurance because of their risk-seeking behavior. Banks should also be required to provide more information about their risk-taking for the public record so that limited supervisory resources can be supplemented by scrutiny on the part of depositors concerned for the safety of their funds. Higher levels of concern by depositors would raise the cost of financing for banks. To the extent that levels of deposit insurance are high relative to the size of average individual deposits, however, the incentives for this type of scrutiny are reduced.

VI Conclusions

In examining the recent developments in the banking sectors of three selected Central and East European countries scheduled to accede to the European Union, we have noted significant achievements in improving the efficiency and scope of their roles in financial intermediation through restructuring and privatization, the opening of the banking markets to foreign participation and the enhancement of bank regulation and supervision, both in principle and in practice. In these efforts, the Acceding Countries have been aided by technical advice and resources from the international financial institutions and the European Union. Most usefully, the process of harmonizing the national legislation and practice with the EU's own banking directives has provided a critical road map for domestic policymakers and legislators in preparing the bank sectors to cope with the stresses and opportunities of the post-transition and post-accession economic and financial environment. We have also noted areas where additional progress is required if there is to be substantial certainty that these bank sectors will continue to promote financial stability, provide an improved financial intermediation function and help to drive robust economic growth. Improved corporate governance and auditing standards will be critical not only in the banking sector but across the economy. Should banks find it preferable to boost lending to households rather than to a corporate sector that may be masking the actual risks involved, a costly misallocation of capital on a large scale could result in these economies.

Whatever the sources of potential instability in the banking sector considered here, it remains that the most critical element to insure that the probability of instability is minimized as these countries accede to the EU is bank regulation and supervision. A regular process of stability analysis and stress testing on bank-sector data should be maintained. The supervisory agencies can be instrumental in directing banks to increase provisioning against risks, and to gain greater skill in assessing and managing credit risks and managing their assets to insure necessary liquidity. Legislation and regulations having been strengthened, but resources, including both professional skills and technology, and time are necessary in the case of both the supervisory agencies and the judicial systems to get up to speed in implementing them. It should clearly be a high priority for the European Union to insure that resources, both technical and in the form of human capital, available to the supervisory agencies are supplemented.

List of Tables

		Page
Table 1	Structure of Banking Systems	17
Table 2	Concentration Indicators (2000-2002) -Czech Republic	18
Table 3	Concentration Indicators (2000-2002) - Poland	18
Table 4	Concentration Indicators (1998-2001) - Romania	19
Table 5	Market share of banks and foreign bank branches	19
Table 6	Czech Republic -Evolution of non-performing loans	20
Table 7	Poland-Evolution of non-performing loans	20
Table 8	Romania-Evolution of non-performing loans	20
Table 9	Hungary-Evolution of non-performing loans	21
Table 10	Slovakia-Evolution of non-performing loans	21
Table 11	Czech Republic - Financial stability indicators	21
Table 12	Poland - Financial stability indicators	22
Table 13	Hungary - Financial stability indicators	22
Table 14	Slovakia - Financial stability indicators	22
Table 15	Capital adequacy (1996 - 2002) – Czech Republic	23
Table16	Capital adequacy (1996 - 2002) – Poland	23
Table 17	Capital adequacy (1995 - 2002) – Czech Republic	23
Table 18	Czech Republic: Currency Composition of Credits to and Deposits from the Non-financial Private Sector	24
Table 19	Poland: Currency Composition of Credits to and Deposits from the Non-financial Private Sector	24
Table 20	Romania: Currency Composition of Credits to and Deposits from the Non-financial Private Sector	25

Data Appendix

Table 1

Structure of banking systems	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Czech Republic										
No. of banks	45	55	55	53	50	45	42	40	38	37
-domestic	33	43	32	32	26	20	15	14	12	11
-foreign	12	12	23	23	24	25	27	26	26	26
% state-owned bank assets	20.6	20.1	17.6	16.6	17.5	18.6	23.1	28.2	3.8	4.6
Banks per mil population	4.4	5.3	5.3	5.1	4.9	4.4	4.1	3.9	3.7	3.6
Romania										
No. of banks	14	20	24	31	33	36	34	33	33	31
-domestic	13	17	16	21	20	20	15	12	9	7
-foreign	1	3	8	10	13	16	19	21	24	24
% state-owned bank assets		80.4	84.3	80.9	80.0	75.3	50.3	50.0	45.4	41.2
Banks per mil population	0.6	0.9	1.1	1.4	1.5	1.6	1.5	1.5	1.5	1.4
Poland										
No. of banks	87	82	81	81	83	83	77	74	64	59
-domestic	77	71	63	56	54	52	38	27	18	14
-foreign	10	11	18	25	29	31	39	47	46	45
% state-owned bank assets	86.2	80.4	71.1	69.8	51.6	48.0	24.9	23.9	24.4	26.6
Banks per mil population	2.3	2.1	2.1	2.1	2.1	2.1	2.0	1.9	1.7	1.5

Sources: *EBRD Transition Reports (1999, 2000, 2001,2002,2003); Central Banks Bulletins*

Table 2

Concentration Indicators (2000-2002) -Czech Republic				
				- % of total values -
Year	**Banking groups**	**Assets**	**Deposits**	**Loans**
Dec 2000	C3	53.0	70.97	52.12
	C5	66.09	77.06	68.46
	C10	78.54	87.40	82.67
Dec 2001	C3	58.7	69.14	59.27
	C5	68.38	76.86	70.66
	C10	80.60	87.96	82.99
Dec 2002	C3	57.18	64.24	53.51
	C5	65.75	77.29	65.48
	C10	79.78	85.41	79.96
* C5 – market share of first 5 banks according to the size;loans made to clients(net); deposits received from clients				
Source: CNB				

Table 3

Concentration Indicators (2000-2002) - Poland				
				- % of total values -
Year	**Banking groups**	**Assets**	**Deposits**	**Loans**
Dec 2000	C5	46.5	54.7	46.1
	C10	66.7	70.3	66.7
	C15	78.8	82.6	76.8
Dec 2001	C5	54.7	59.8	52.1
	C10	77.6	82.1	75.7
	C15	82.4	85.4	81.3
Dec 2002	C5	53.6	60.2	48.6
	C10	76.8	82.2	74.0
	C15	82.7	85.6	79.9
* C5 – market share of first 5 banks according to the size;				
Source: PCB				

Table 4

Concentration Indicators (1998-2001) -Romania				
				- % of total values -
Year	**Banking groups**	**Assets**	**Deposits**	**Loans**
Dec 1999	C5	61.44	61.25	57.60
	C10	77.20	77.27	78.32
	C15	83.69	82.69	85.16
Dec 2000	C5	65.46	67.50	59.11
	C10	82.25	84.13	78.05
	C15	89.59	90.63	87.54
Dec 2001	C5	66.63	68.51	58.04
	C10	83.01	85.31	78.56
	C15	90.47	91.86	88.08
* C5 – market share of first 5 banks according to the size				
Source: NBR				

Table 5

Market share of banks and foreign bank branches						
						-end of period
	Net assets					
Romania	2000		2001		2002	
	ROL billion	%	ROL billion	%	ROL billion	%
Banks with majority domestic capital, of which	**114,563.9**	**49.1**	**154,469.2**	**44.8**	**204,833.9**	**43.6**
w majority state-owned capital	107,536.4	46.1	144,342.3	41.8	189,806.2	40.4
w majority private capital	7,027.5	3	10,126.9	3	189,806.2	3.2
Banks with majority foreign capital	**100,565.9**	**43.1**	**163,413.9**	**47.3**	**230,207.0**	**49**
I. Total commercial banks	**215,129.8**	**92.2**	**317,883.1**	**92.1**	**435,040.9**	**92.6**
II. Foreign bank branches	**18,124.3**	**7.8**	**27,337.6**	**7.9**	**34,671.3**	**7.4**
Banks with majority **private capital** including foreign bank branches	125,717.7	53.9	200,878.4	58.2	279,906.0	59.6
Banks with majority **foreign capital** including foreign bank branches	118,690.2	50.9	190,751.5	55.2	264,878.3	56.4
Total (I+II)	**233,254.1**	**100.0**	**345,220.7**	**100.0**	**469,712.2**	**100.0**

Table 6

Czech Republic-Evolution of non-performing loans						
	1996	**1997**	**1998**	**1999**	**2000**	**2001**
Non-performing loan/total loans(%), of which	23.09	20.8	20.31	21.51	19.42	13.76
Substandard	3.19	2.74	3.36	4.26	6.2	3.34
Doubtful	3.25	3.03	3.65	4.16	3.08	3.05
Loss	16.64	15.03	13.3	13.1	10.14	7.37
Non-performing loans/GDP (%)	13.39	12.58	11.09	10.54	8.77	6.25
Source: CCB						

Table 7

Poland-Evolution of non-performing loans						
	1996	**1997**	**1998**	**1999**	**2000**	**2001**
Non-performing loan/total loans(%), of which	13.4	10.7	10.9	13.2	14.9	17.8
Substandard	3.9	3.8	3.9	5	4.2	4.7
Doubtful	1.6	1.2	1.9	3.3	5	4.7
Loss	7.9	5.8	5.1	4.9	5.6	8.3
Non-performing loans/GDP (%)	2.6	2.3	2.6	3.5	4.2	5
Source: PCB						

Table 8

Romania-Evolution of non-performing loans						
	1996	**1997**	**1998**	**1999**	**2000**	**2001**
Non-performing loan/total loans(%), of which	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Substandard	18.2	12.5	13.2	17.3	1.73	0.61
Doubtful	10.1	9.9	7.7	6.7	0.74	0.93
Loss	32.9	42.6	50.8	28.7	3.92	4.27
Total	**61.2**	**65**	**71.7**	**52.7**	**6.39**	**3.4**
Source: NBR						

Table 9

Hungary-Evolution of non-performing loans*						
	1996	**1997**	**1998**	**1999**	**2000**	**2001**
Non-performing loan/total loans(%), of which						
Substandard	1.8	11.8	2.3	1.3	0.9	1.4
Doubtful	2.0	2.3	3.7	1.6	1.1	0.7
Loss	5.2	2.7	2.3	1.8	1.3	1.3
Total	**9.0**	**6.8**	**8.2**	**4.6**	**3.3**	**3.4**
Source: National Bank of Hungary						

* Sum of loans assigned Substandard, Doubtful, and Loss classifications.

Table 10

Slovakia-Evolution of non-performing loans						
	1996	**1997**	**1998**	**1999**	**2000**	**2001**
Non-performing loan/total loans(%), of which						
Substandard	1.48	2.07	3.51	3.15	1.71	1.71
Doubtful	1.83	2.56	2.65	3.29	2.24	1.26
Loss	16.45	26.56	29.52	23.02	17.98	18.89
Total	**19.76**	**31.19**	**35.69**	**29.46**	**21.93**	**21.86**
Source: National Bank of Slovakia						

Table 11

Czech Republic - Financial stability indicators						
	1996	**1997**	**1998**	**1999**	**2000**	**2001**
Net interest margin (%)	1.88	1.97	3.04	2.48	2.09	2.04
Non-interest income/average assets (%)	2.12	2.56	1.39	1.48	1.06	1.47
Operating costs/average assets (%)	2.21	2.24	2.24	2.24	2.07	2.13
Profit before tax/average assets (ROAA)(%)	0.3	-0.27	-0.54	-0.29	0.69	0.45
Profit before tax/Tier 1 equity (ROE)(%)	4.88	-4.26	-8.12	-5.12	14.99	9.99
Source: CNB						

Table 12

Poland - Financial stability indicators						
	1996	**1997**	**1998**	**1999**	**2000**	**2001**
Net interest margin (%)	5.98	5.23	4.58	4.01	4.26	3.38
Non-interest income/average assets (%)	1.81	2.04	2.01	2.48	2.73	3.05
Operating costs/average assets (%)	3.94	3.99	4.1	4.1	4.36	3.94
Profit before tax over average assets (ROA)(%)	3.77	3	1.75	1.6	1.51	1.36
Profit before tax/Tier 1 equity (ROE)(%)	100.1	67.5	28.4	23.1	21.7	18.5
Source: PNB						

Table 13

Hungary - Financial stability indicators						
	1996	**1997**	**1998**	**1999**	**2000**	**2001**
Net interest margin (%)	4.9	4.5	4.5	4.1	3.9	4.1
Non-interest income/average assets (%)	0.1	0.7	-1.0	0.5	1.0	1.7
Operating cos ts/average assets (%)	3.7	4.0	4.0	4.0	3.7	3.7
Profit before tax/average assets (ROAA)(%)	2.0	1.0	-2.2	0.5	1.2	1.7
Profit before tax/Tier 1 equity (ROE)(%)	24.7	11.0	-24.7	6.3	14.4	18.3
Source : National Bank of Hungary						

Table 14

Slovakia - Financial stability indicators						
	1996	**1997**	**1998**	**1999**	**2000**	**2001**
Net interest margin (%)	0.13	1.80	1.20	0.45	1.85	2.30
Non-interest income/average assets (%)	2.26	1.33	1.70	1.75	1.14	1.06
Operating costs/average assets (%)	2.35	2.35	2.40	2.69	2.55	2.45
Profit before tax over average assets (ROA)(%)	-0.43	-0.18	0.04	-3.99	0.54	1.15
Profit before tax/Tier 1 equity (ROE)(%)	-11.92	-4.97	-0.08	-61.20	8.90	19.29
Source : National Bank of Slovakia						

Table 15

Capital adequacy (1996 - 2002) – Czech Republic								
								- %, end of period -
	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Solvability rate		9.28	9.65	12.02	13.64	14.9	15.5	14.2
Source: CCB								

Table 16

Capital adequacy (1996 - 2002) - Poland								
								- %, end of period -
	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Solvability rate		12.3	12.5	11.7	13.2	12.9	15.0	15.5
Source: PCB								

Table 17

Capital adequacy (1995 - 2002) - Romania								
								- %, end of period -
	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Solvability rate	13.8	13.3	13.6	10.3	17.9	23.8	28.8	24.8
Source: NBR								

Table 18 -- Czech Republic: Currency Composition of Credits to and Deposits from the Non-financial Private Sector

Czech Republic		1997	1998	1999	2000	2001	2002	2003
CZK Credits	Bil CZK	912.6	860.0	838.5	838.3	627.2	813.8	750.6
For. Curr. Credits	Bil CZK	200.3	213.8	193.9	160.5	155.6	133.1	124.1
of which, in Euro	Bil CZK						88.6	89.8
Total		1112.9	1073.8	1032.4	998.8	782.8	946.9	874.7
CZK Credits	% share	82.0	80.1	81.2	83.9	80.1	85.9	85.8
For. Curr. Credits	% share	18.0	19.9	18.8	16.1	19.9	14.1	14.2
of which, in Euro	% share						9.4	10.3
CZK Deposits	Bil CZK	962.0	985.3	983.3	1027.2	1169.3	1310.2	1415.6
For. Curr. Deposits	Bil CZK	138.5	142.5	147.9	157.5	176.0	166.7	166.2
of which, in Euro	Bil CZK						98.0	100.8
Total		1100.5	1127.8	1131.2	1184.7	1345.3	1476.9	1581.8
CZK Deposits	% share	87.4	87.4	86.9	86.7	86.9	88.7	89.5
For. Curr. Deposits	% share	12.6	12.6	13.1	13.3	13.1	11.3	10.5
of which, in Euro	% share						6.6	6.4

Source: Czech National Bank

Table 19 -- Poland: Currency Composition of Credits to and Deposits from the Non-financial Private Sector

Poland		1997	1998	1999	2000	2001	2002
PLN Credits	Bil. PLN	80.1	94.8	122.2	139.0	142.0	137.5
For. Curr. Credits	Bil. PLN	16.4	28.3	33.0	41.2	50.1	55.6
Total		96.4	123.1	155.2	180.2	192.1	193.1
PLN Credits	% share	83.0	77.0	78.7	77.1	73.9	71.2
For. Curr. Credits	% share	17.0	23.0	21.3	22.9	26.1	28.8
PLN Deposits	Bil. PLN	104.4	143.6	168.6	197.0	218.2	212.2
For. Curr. Deposits	Bil. PLN	32.4	34.2	41.3	43.9	52.8	48.9
Total		136.8	177.7	209.9	241.0	271.0	261.2
PLN Deposits	% share	76.3	80.8	80.3	81.8	80.5	81.3
For. Curr. Deposits	% share	23.7	19.2	19.7	18.2	19.5	18.7

Source: National Bank of Poland

Table 20 -- Romania: Currency Composition of Credits to and Deposits from the Non-Financial Private Sector

Romania		1997	1998	1999	2000	2001	2002	2003
ROL Credits	Bil. ROL	16232.4	24272.6	24444.9	30410.8	47533.3	66728.8	135292.5
For. Curr. Credits	Bil. ROL	19668.3	34813.9	33274.5	44596.3	70721.1	112897.6	170189.1
Total		35900.7	59086.5	57719.5	75007.1	118254.5	179626.4	305481.6
ROL Credits	% share	45.2	41.1	42.4	40.5	40.2	37.1	44.3
For. Curr. Credits	% share	54.8	58.9	57.6	59.5	59.8	62.9	55.7
ROL Deposits	Bil. ROL	5567.5	9252.0	14773.9	19323.9	26712.6	49701.9	76738.0
For. Curr. Deposits	Bil. ROL	17686.3	30201.5	50481.5	74856.3	115784.1	146811.7	171168.7
Total		23253.8	39453.5	65255.5	94180.2	142496.8	196513.6	247906.7
ROL Deposits	% share	23.9	23.5	22.6	20.5	18.7	25.3	31.0
For. Curr. Deposits	% share	76.1	76.5	77.4	79.5	81.3	74.7	69.0

Source: National Bank of Romania