LOAN PROVISION IN THE CONTEXT OF THE GROWING AMBITIONS OF BANK INSTITUTIONS AND THE REAL ECONOMIC ENVIRONMENT

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Abstract: *The topic of this contribution is the potential risky aspects of the growth strategies of banks when providing loans in the real economic environment in the Czech Republic. The primary starting point of this article is a basic analysis of evolutions in the bank sector in the Czech Republic over the past 10 years relating to the development and structures of loan portfolios, and the capital adequacy of banks, in the context of the overall macro-economic developments – e.g. GDP, average wages, etc.*

Key Words: *bank, loans, capital adequacy, indebtedness*

JEL Classification: *G21, O16*

1. STRATEGIES OF BANKS OPERATING IN THE CZECH REPUBLIC WHEN PROVIDING LOANS – AN INTRODUCTION

The strategies of banks operating on the Czech market are primarily influenced by their enduring advantageous capital situation – with surpluses of deposits over loans. This, at first glance, positive reality is exploited by the "maternal" foreign banks while establishing ambitious growth strategies for their "daughter" (subsidiary) companies operating in the Czech Republic. Their aims are equally also indirectly supported by the problem-free developments in the Czech banking sector during the course of the first waves of recession between 2008-2010 and the outcomes of "load-bearing" tests conducted by the Czech National Bank, which regularly confirmed that Czech banks should be able to withstand even relatively unfavourable economic development scenarios without encountering greater problems. Is then, the projection of increasing the volume of loans provided - whether to company or to domestic clients, on the assumption of upholding the rules for managing loan risks, truly so problem-free?

1.1 The Capital Funding of Banks

Since 2007, the so-called BASEL II concept of the capital adequacy of banking sectors has been implemented in the Czech Republic. This has to do with the Directive of the European Parliament and Advisories 2006/48/ES and 2006/49/ES, which – inter alia, summarise the procedures for establishing capital requirements for financial institutions.

The overall ratio of loans to deposits, in the Czech banking sector, fluctuates around the 80% mark, which is one of the lowest values in the whole European Union. Czech banks are, in the main, clear creditors of European banking groups – which are the owners of the majority of Czech banks. In comparison with the international situation, the Czech banking system is well capitalised. For the key indices for capital adequacy[1], the Czech banking sector markedly exceeds the 9 % border, which European banks must fulfil by the end of June, 2012. According to topical data, the capital adequacy of the Czech banking sector amounted to 15.3% at the end of 2011. [2]

Table 1. Capital Adequacy

	2008	2009	2011	2011
Czech Bank Sector	**12.3**	**14.1**	**15.5**	**15.3**
ČS a.s.	10.3	12.3	13.9	13.1
ČSOB a.s.	10.3	15.0	18.0	15.6
KB a.s.	12.1	14.1	15.3	14.6

Source: ČNB; Annual Reports: ČS a.s, ČSOB a.s., and KB a.s.

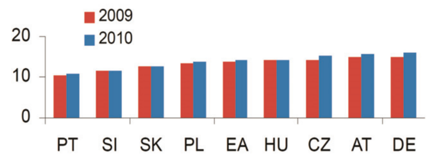

Figure 1 Capital Adequacy in %, from 2009 to 2010 – International Comparison
Source: [8] ROZUMEK, D., ***Aktuální situace českého bankovního sektoru. (Actual situation (of) Czech Banking Sector)***, p. 16

[1] Definition of "Capital Adequacy": Capital Adequacy represents the minimal level of capital, which a bank must maintain with a view to the volume and riskiness of its transactions, and which graphically illustrates just what proportion of the capital was invested into the bank by its owners in order to be financially strong, reputable and stable. The higher the capital adequacy the bank, the better financial stability the bank will have and this increases the probability that the bank will be able to meet its obligations. The value of the capital adequacy should not dip below 8%. [2] Basel II sets the concept for the calculation of the requisite capital as follows:

$$\frac{RC}{RWA + 12.5 * (B + C)} \geq 0.08$$

Where: RC = Regulated Capital made up of entries from Tier 1, Tier 2, Tier $3_{využitý}$, reduced by the write-down/off entries; RWA = Risk Weighted Assets; B = Capital requirements to meet market risks, and C = Capital requirements to cover operational risks [6]

Another capital aspect, tracked by the Czech National Bank, is the cash-flow of Czech subsidiaries to their foreign "maternal" banks. The average engagement of Czech banks with regard to their maternal bank groups has, long-term, fluctuated far below the set 25% limit. [2]

From the capital resources point-of-view, the Czech bank sector can thus be considered as stable, profitable and indubitably therefore no risk of the need for state intervention threatens; as we have been witnesses to in a number of European states recently.

1.2 Development of the Volume of Loans Provided

The volume of loans provided in the Czech Republic over the last decades has, without question, shown a growth trend, with marked dynamics, and higher than in other Eurozone countries. Were we to compare the overall growth level of loans provided in the course of 2002 and 2011, we would discover that their volume during this period has grown by cca. 2.6 times.

The most significant growth is visible for loans provided to the Czech domestic household sector, where a more than six-fold rise over the past decades has been registered. This growth trend was maintained even in the period of recession around 2009, where a slow-down in the growth dynamics took place. Despite the continued growth of loan-indebtedness of Czech households, in comparison to those of other Eurozone countries, they are still roughly only half as much. For objective evaluation however, it is necessary to take into account the fact that households in the ČR are, in comparison to Eurozone countries, substantially poorer. The average indebtedness of households as a ratio of Gross Domestic Product within the whole of the EU is not quite 55%, while the financial assets of households in EU countries exceeds 200% GDP; while in the ČR, this share is cca. 80%. The indebtedness of households in the ČR is thus, with regard to the asset-base, higher than in other Eurozone countries, which increases the risk of a debt trap. However, while the development of domestic loans does not threaten the financial stability of banks for the time being, social problems do threaten. [4] From a risk perspective, for Czech banks a favourable reality exists, whereby especially mortgage loan volumes continue to grow – i.e. insured by the certainty of reclamation of the property against which the mortgage is issued. Of course, a risk factor for banks does lie in the possibility of a radical slump in property prices on the real estate markets, as a consequence of recession. Market prices of real estate have indeed sagged slightly over the past few years, but the slump was not substantial since it was only of the order of single percentile figures. In view of the lower degree of indebtedness of Czech households and the relatively stable real estate market to-date, the domestic household sector is perceived by banks operating in the ČR as being highly perspective for further dynamic growth.

Developments in the field of loan provision to the entrepreneurial sector were, in comparison with domestic households, significantly laggardly. In the recession period, banks exerted significant pressure on the revision of loan limits provided as well as on their reduction. Despite the ensuing growth of loan volumes, recorded in 2011, one has still to attain the levels registered in 2008.

In spite of the fact that in the last recession period, lasting from 2009 to 2010, a worsening of the economic situation did take place for the majority of entrepreneurial subjects, this fact did not- taken together with the pressure to reduce loan limits, have a significant influence upon worsening the quality of bank´s loan portfolios. The main reason clearly being the fact that the majority were covered in full, or at least in part by property or other assets – and to a great extent as well, equally covered by personal guarantees (e.g. Notarised Bills of Exchange, Guarantor Proclamations, etc.).

The low level of losses incurred from the provision of loans during the economic crisis period has had an indisputable impact on banking strategies.

2. LOAN PROVISION DEVELOPMENT IN THE CONTEXT OF OVERALL MACRO-ECONOMIC DEVELOPMENT

Although the overall volume of loans provided in the Czech Republic had a steady growth trend, this was not completely in harmony with the overall macro-economic environment, and especially with the creation of the Gross Domestic Product, industrial production and average wages, which it outreached to a significant extent. Similar trends can also be seen in other Eurozone countries, nevertheless, the difference isn´t so significant. Equally, it is also necessary to take into consideration the capital situation of firms, domestic household property and assets, and their level of indebtedness.

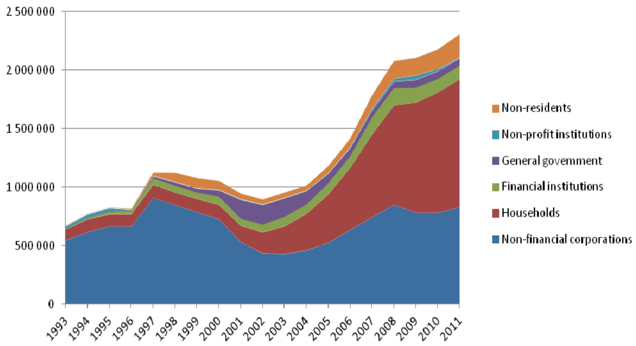

Figure 2 Client Loans in the ČR, by Sector, in millions of CZK
Source: [1] ČNB, Own work

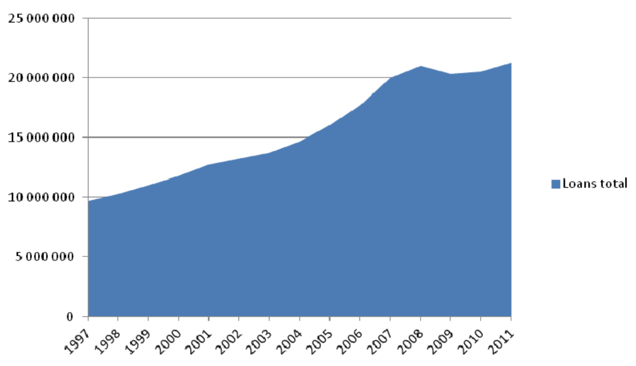

Figure 3 Client Loans – Total in the Euro Area, in millions of Euro
Source: [5] European Central Bank, Own work

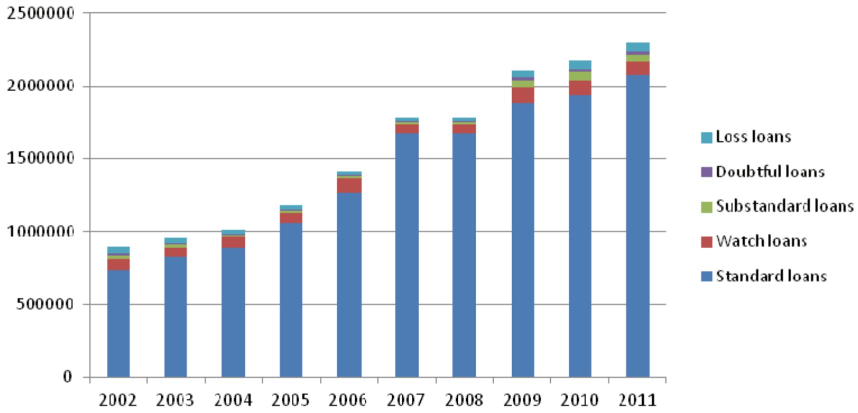

Figure 4. Client Loans by Category, in millions of CZK
Source: [1] ČNB, Own work

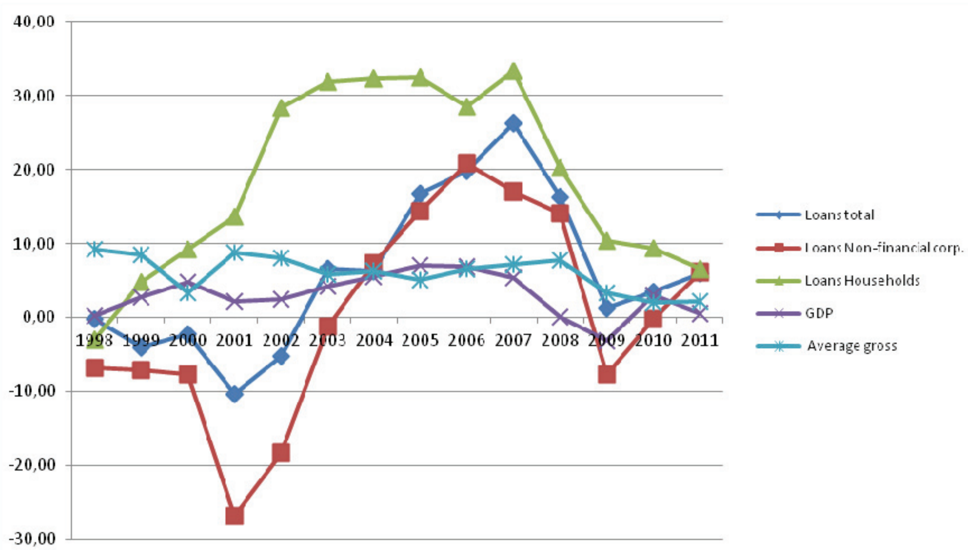

Figure 5. Loan Growth Trends, GDP and Average Wages in the ČR
Source: [1] ČNB, [3] ČSÚ, Own work

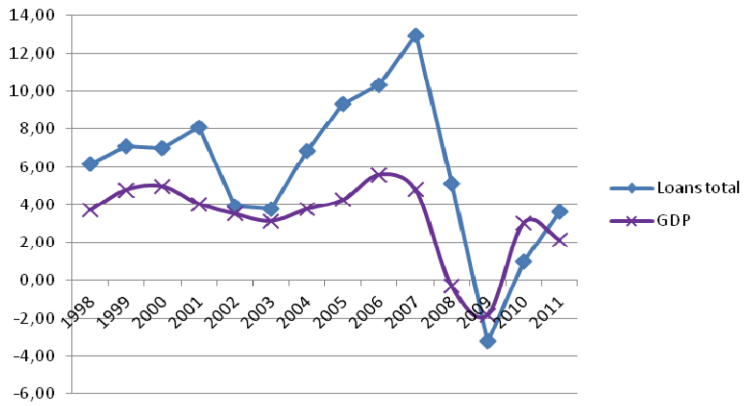

Figure 6. Loan Growth Trends, Eurozone GDP
Source: [5] ECB, Own work

3. CONCLUSION

The actual situation of the Czech banking industry does not demonstrate, according to the basic parameters tracked by the ČNB and ECB, negative or (high)risk aspects:

- Banks have sufficiently high capital volumes at their disposal; they are constantly profitable, their capital adequacy - fluctuating around 15%, significantly exceeds the legislatively set minimum limit of 8% (Basel II).
- The qualitative structure of the loan portfolios of Czech banks has been stable long-term, with a low share of untrustworthy or loss-inducing loans (in 2011, 90% of all loans were classified as standard, while the share of untrustworthy or loss-making loans only amounted to 4%).
- From the ČNB side, no over-the-limit capital drains from banks operating in the Czech territorial markets towards their maternal banks were identified.
- During the recent first wave of recession, no significant worsening of the capital situation occurred, nor did the quality of loan portfolios suffer.

Based on these attributes, the growth strategies of banks operating on the Czech banking markets for the near-term future are driven, without regard to the macro-economic prognosis for the development of the Czech and European economies. Market potential is seen especially in the domestic household segment, including self-employed private persons working on Sole Trader´s Licences, where the level of indebtedness is – for the time being; significantly lower than it is in more developed Eurozone economies.

The question remains, to what extent is this trend on the long-term horizon without risk and still prospective? Potential risks can be perceived and identified predominantly in the following aspects:

- Greater dynamic growth in volumes of loans provided to entrepreneurial and domestic household clients, as well as the municipalities and local administrations than is the realistic macro-economic growth.
- Growing indebtedness of firms which does not correspond to equal growth in their economic performance and liquidity.
- The growing degree of indebtedness of domestic households in ratio to their ownership of property and other assets + the high repayment burden in relation to incomes – which, in addition, are growing markedly slower than the loan/debt burden of the households + instability as a consequence of the cyclical development of economies (e.g. growing unemployment).
- The risk of losses in values of properties and assets set against loan provisions and guarantees – slumps on the real estate markets as a consequence of recession + the worsening property/asset ratio of individuals who have provided personal guarantees => a lower degree of insurance/assurance of loan guarantee throughout the course of its provision than it was initially at the time of its provision => possible increases in numbers of untrustworthy and loss-inducing loans.
- The growing degree of indebtedness of municipalities and local governments in the context of reductions in the income-base of local authorities + the low level of loan guarantees provided by such municipalities/local authorities.

The risk of siphoning-off capital by maternal banks outside the standard payment of share of the profit, for instance, in the form of over-invoicing for services provided, etc.

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