

**LEGAL, INSTITUTIONAL AND REGULATORY  
FRAMEWORK TO DEAL WITH BANKING  
RESOLUTION AND INSOLVENCY**

**A REVIEW OF THE CZECH CASE**

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**List of abbreviations**

AB	Act No. 21/192 Coll., on Banks, as amended
ABC	Act No. 328/1991 Coll., on Bankruptcy and Composition, as amended
CNB	Czech National Bank
GBII	Global Bank Insolvency Initiative (Report)
MoF	Ministry of Finance

## **INTRODUCTION**

This report describes and comments the main elements of the legal and institutional framework that the Czech Republic has in place in order to deal with seriously distressed/insolvent banks.

In particular, the report covers the following areas:

- A general overview of the Czech bank insolvency law (section I);
- The institutional arrangements necessary for dealing with bank insolvency (section II);
- General legal issues arising in bank insolvency proceedings (section III);
- The legal framework empowering the banking authorities to assume control of a distressed bank either in the context of official administration or under any other arrangements which allow regulators to conduct the restructuring of an insolvent bank (section IV);
- The specific techniques to restructure insolvent banks (section V);
- The legal underpinnings and modalities of bank liquidation proceedings (section VI), and
- Key features of the legal framework in the context of systemic banking crises (section VII).

At the end of each one of the above sections, in those areas where the evaluation found weaknesses or there is scope to improve the current situation, the paper makes general or specific recommendations. In all cases we avoid making suggestions that could distort the global coherence of the existing Czech approach.

The report focuses on resolution of the situation when all private sector solutions have been exacerbated.

### **I. OVERVIEW OF THE BANKING SECTOR LEGISLATION**

The Czech Republic's current bank insolvency regime is a key component of its general framework of banking regulation. For a proper understanding of such insolvency regime, it is necessary to briefly discuss the basic foundations of the general banking legislation and the general experience during the transition process.

After turbulent 1990s, the Czech banking system has evolved to a much better standard in terms of supervision and regulation as well as performance. The Czech banking system, part of the emerging EU financial market, is basically controlled by foreign banking groups, and seems to be financially well stabilized at the moment. However, the hard won stability and the reliance on foreign capital presents new challenges. The Czech National Bank became a host-

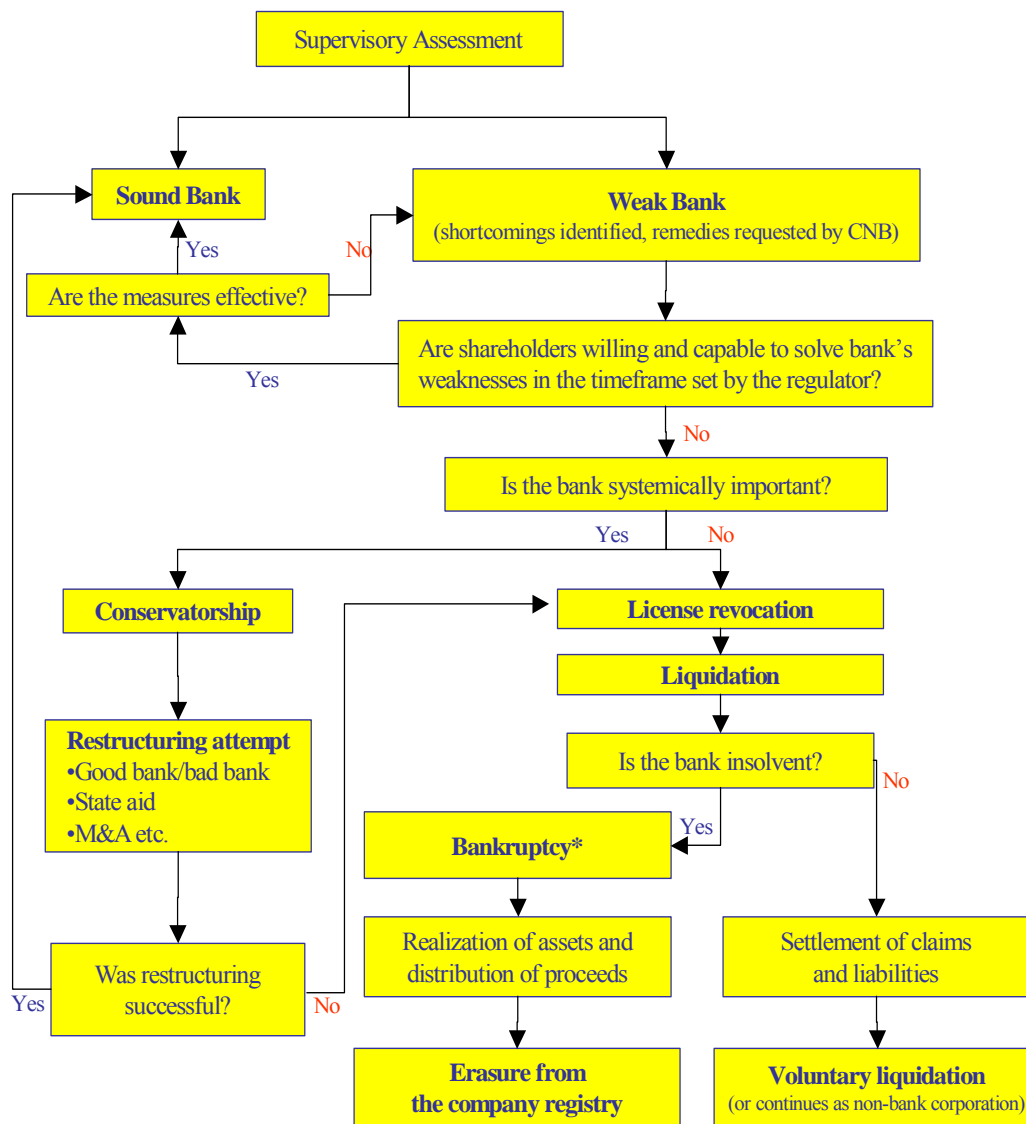
country regulator, which needs to deal with large foreign financial groups and cooperate with their home-country regulators.

Specifically, in terms of the insolvency framework, it evolved through difficult times in the past decade, dealing with bank insolvencies which endangered the whole system in the context of a weak institutional environment. The main objective of the regulatory actions was to retain trust and stability, whereas the future cases of banks in difficulties are likely to be less systemically important and such that the coordination among foreign and domestic supervisors is to be of the essence.<sup>1</sup>

A pictorial overview of the different steps for dealing with insolvent banks is provided in Box 1, which is based on the diagram on the topic reflected in the GBII Report:

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<sup>1</sup> The terms more frequently used in this report, including insolvency, bankruptcy, liquidation, and conservatorship, are generally used in the sense described in Appendix 1 which follows the Main Report under the Global Bank Insolvency Initiative (GBII), nevertheless, in parts of this document on which they are used specifically in reference to the Czech legal texts they shall be understood in accordance with the corresponding Czech Laws, i.e. the Act on Bankruptcy and Composition (for the 2 first terms), the Commercial Code in relation to liquidation (“Likvidace”), and the Act on Banks for the case of conservatorship.



\* Composition is a legal alternative hardly ever plausible in case of banks.

## II. KEY INSTITUTIONAL ASPECTS OF THE BANK INSOLVENCY REGIME

### A. Description of current situation

#### 1. Corporate insolvency law versus special bank insolvency regime

*In designing a response to the problems of bank insolvency, a country must first consider which type of legal proceedings is most conducive to attaining key policy objectives. A choice has to be made between a system based on the type of proceedings generally applicable to insolvent corporations, and a special regime exclusively for banks.*

The current system of the bank insolvency relies almost fully on the proceedings generally applicable to insolvent corporations, unless the Czech National Bank considers the bank in

question to be systematically important. In such case the CNB may introduce the conservatorship, which is not an option available to all non-banks.<sup>2</sup>

In terms of options to “resolve” a bank in trouble, the current legislation includes only limited modifications to the general insolvency framework, which strengthen the position and role of the banking sector regulator. However, the new Act on Bankruptcy and Composition, currently in preparation, is likely to strengthen CNB’s role. Nowadays, the exceptions to the general framework are limited to:

- An option to impose conservatorship<sup>3</sup> on systemically important banks (including the right to appoint a conservator). In this context only the conservator has the right to file a bankruptcy proposal during conservatorship (Article 12a Section 3 of the Act on Bankruptcy and Composition);
- The right to withdraw the banking license and thus trigger the liquidation proceedings (including the exclusive right of CNB to nominate the court-appointed liquidator of a bank).

Except for the conservatorship-related modification mentioned above, these modifications of the general bankruptcy framework do not constrain the right to petition the bankruptcy to the courts, without the consent of the CNB. Any unsatisfied creditor of a bank may file a bankruptcy proposal and so can the bank as a debtor<sup>4</sup>.

## **2. Basic institutional arrangements and autonomy**

*To perform their insolvency-related functions successfully, banking authorities will need to act without interference in their day-to-day operations and decision-making and must be insulated from pressure by market participants.*

The Banking Regulation and Supervision Department (BRSD) is a part of the hierarchy of the Czech National Bank. One of the seven members of the Bank Board of the CNB is assigned a direct responsibility for operations of the department. The Governors are appointed by the President of the Czech Republic for a term of six years and the independence of the central bank is embedded in the Constitution. The independent standing of the CNB is generally recognized. The relationship of the specific banking regulators with the government is made through the CNB.

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<sup>2</sup> Conservatorship may be used in some cases involving non-bank financial entities. Those cases include insurance companies, on which the conservatorship can be introduced by the MoF, and investment firms on which the Czech Securities Commission can also use the conservatorship.

<sup>3</sup> In strict sense it should be understood that conservatorship’s nature under the existing Czech legislation is more that of a regulatory measure aimed at dealing with prudential shortcomings than a proper insolvency-related measure.

<sup>4</sup> Under the law is a debtor who can submit a bankruptcy request; therefore whenever a bank presents a request is the entity as a debtor the one that is acting and not the bank’s management as part of an act of administration.

The personnel of the BRSD is hired according to the rules of the CNB and must comply with the CNB's rules of conduct to avoid conflicts of interests with the regulated banks. The funding for the department comes through the budget of the CNB, which is fully in competence of the Bank Board.

The CNB has a reporting duty to present its Annual Report, including the budget, to the Czech Parliament within three months of the end of the calendar year. The report shall include information on the salaries of the members of the Bank Board of the Czech National Bank.

Nevertheless, while the general autonomy of the CNB is well established, specifically, in terms of actions related to banks in distress, there is a need to seek the opinion of the Ministry of Finance before some of the key regulatory actions (conservatorship, license revocation) can be undertaken.

While recognizing that the involvement of the Ministry of Finance is required when there is a need to deal with cases of systemic implication, there is room to consider strengthening the autonomy of the banking authorities to deal with cases on which the stability of the whole system is not involved. Coordination both, with the Ministry of Finance and with regulators of other segments of the financial sector shall always be of paramount importance.

### **3. Legal protection of banking authorities and their staff**

*The authorities dealing with bank insolvency must take difficult decisions on a wide variety of issues. To be able to ignore pressures from interested parties and act more swiftly and effectively, they need adequate legal protection. Of particular importance is personal protection from civil and criminal liability of senior staff and other officers or agents of the banking authorities who are involved in the declaration of a bank's insolvency and the administration of its restructuring and/or liquidation (including individuals who are appointed as official administrators or liquidators), other than for intentional wrongdoing (e.g., abuse of power, theft, conversion of assets, conspiracy, etc.).*

The banking law does not include any explicit provision for the protection of CNB's officials. The staff of the Banking Regulation and Supervision Department is protected by the provisions of the Act No. 65/1965 Coll., Labor Code. These provisions are fully applicable for the officials' actions during the standard supervision procedures and limit civil liability of any official to maximum of the 4.5 multiple of his monthly wage.<sup>5</sup> Bank conservators are appointed from among the CNB employees and CNB generally provides further support to guarantee that the conservator can hire lawyers to defend himself. The bankruptcy trustees

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<sup>5</sup> According to Article 179 Section 2 of the Labor Code, the amount of compensation for damages to be paid by an individual employee as a result of his/her negligence can not exceed an amount equal to four and a half times his/her average monthly earnings.

have to arrange adequate insurance to be eligible for their jobs and their protection thus depends on the extent of the insurance coverage. Overall, the conservator is generally better protected than liquidators and trustees.

Considering the difficult nature of their duties, consideration should be given to provide conservators, liquidators and trustees with a more structured system of legal protection directly reflected in the law.

#### **4. Transparency**

*The legal framework should require agencies dealing with insolvent banks to operate with the maximum degree of transparency compatible with the need to preserve confidentiality.*

The Department of the Banking supervision publishes an Annual Report on its activities, including general information on legislative and economic developments relevant to the banking supervision<sup>6</sup>. It also keeps up-to-date list of the licensed banks and banks in insolvency proceedings available on-line. Moreover, in case that some bank enters into insolvency proceedings the CNB immediately informs the public on the developments through the website and public announcements.

Regarding the license revocation and consequent start of liquidation, the courts must report their decision and the bank needs to add “in liquidation” to its business name registered in the company registry kept by the regional courts. Similarly, the acceptance of the bankruptcy petition by a court is reported by the court on its official bulletin board. Unfortunately, there is no central bulletin board or registry which would record and publish impositions of bankruptcy and/or liquidation in real time. In theory a regional court may approve the bankruptcy petition filed by creditors, without CNB noticing in advance. This is still the case, despite changes introduced in 2003, which oblige the court to deliver the decree of bankruptcy adjudication to the Czech National Bank without undue delay (ABC, Article 13 (8)).

Liquidators as well as trustees are obliged to report to the shareholders at least once a year at the general meeting and have to present the annual and final accounts. Moreover the trustee is obliged to report to the creditors’ committee. These obligations arise from general provisions in the Commercial Code and the ABC.

#### **5. The right to appeal**

*In an administrative system, where the initiation of insolvency proceedings takes the form of a decision of the supervisory authority, the law should grant the bank’s owners an opportunity to appeal against the decision to a special court or seek judicial review in the general*

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<sup>6</sup> See the IMF Country Report No. 1/113 for assessment of the Transparency of Banking Supervision (pp. 48–51).

*administrative courts. In all cases, the available remedy should be specified in the legislation and the procedure should be expeditious. It is, however, of singular importance that the exercise of any rights of appeal or review do not automatically lead to an interim restoration of the old owners and directors in the bank's management. It is also important that the system for the exercise of any right of appeal or judicial review includes safeguards for the avoidance of abuse by interested parties and should not result in the provision of interim relief by way of staying of the administrative proceedings.*

Regarding the imposition of conservatorship, the decision, including the right to appeal, is governed by the Act No. 71/1967 Coll., on Administrative Proceedings. The Act on Banks grants to the bank's Board of Directors an opportunity to appeal against the imposition of conservatorship to the Board of the CNB. The Board of the CNB has to seek the opinion of the Minister of Finance. The appeal has no suspensory effect (AB, Article 26 (8) and Article 41). The decision on the appeal has to be taken within 30-60 days (general terms given by the Act on Administrative Proceedings).

Similar procedural rules apply to license revocation, but in the later case, opposite to the situation in the case of conservatorship, the decision to revoke the license is not legally binding until the appeal is resolved. The appeal procedure to which CNB must respond gives those in control of troubled bank extra time, which could be misused. On the other hand, if the CNB considers shortcomings "serious" then it can use the wide discretion provided by the Act on Banks and impose sanction with immediate effect (Article 26). Moreover, extra time introduces some flexibility into the process. CNB can, for example, launch the proceeding as a credible threat of license revocation and force the bank to take remedial measures, without actually revoking the license.

## **6. Judicial review**

*To guarantee the legality of official actions and protection of the legitimate interests of private parties, affected parties should be able to challenge the decisions made by banking authorities in administrative law by filing judicial review proceedings before the administrative courts or by appealing to a special tribunal.*

The affected parties have unconstrained right to appeal to the courts of the Czech Republic. The courts may review whether the CNB acted in accordance with the applicable laws.. The parties based in the EU may appeal to the European Commission, in certain matters such as State Aid issued in favor of their competitors. The decisions of the Czech authorities affecting the common market can also be challenged at the European Court of Justice. In matters affecting human rights, such as access to fair and timely legal proceedings, the challenge can be brought to the European Courts for Human Rights. Moreover, foreign shareholders may require monetary compensation based on bilateral investment protection treaties (provided

that such treaties cover given case) and initiate arbitration proceedings against the Czech Republic.

## **B. Weaknesses and potential improvements**

The Czech Republic relies on the corporate bankruptcy framework with several modifications. In general, there is no need to introduce separate legislation for the bank insolvencies. The recommendations contained in this report seem to be more relevant for the new Act on Banks, which CNB plans to submit in the medium term. This however assumes, that the new Bankruptcy Act, which includes the clause that a bank with a valid license can not enter insolvency proceedings, provides sufficient treatment for the bank insolvencies during the interim period until new Act on Banks is approved.

An important aspect of the bank insolvency regime is the functional independence of the regulator. In the current system salient decisions are taken by the Banking Board of the CNB, which possesses sufficiently independent standing. Should the banking supervision be carved out of the CNB the new regulatory body should be given independence comparable to the CNB. Also consideration should be given to increase the independence of the CNB on decision to deal with distressed banks in cases without systemic effects, as commented below in subsection II. A. 2.

In order to prevent unexpected surprises, the courts should report to CNB that a petition for a bankruptcy has been filed. This would give CNB a chance to plan for the even of imposition of bankruptcy, which is not possible under the current system, when courts are obliged to report on their final decisions. Should the clause forbidding imposition of bankruptcy on banks with valid license be introduced soon, this recommendation would not be necessary.

The bank insolvency framework would benefit from the improvements of the general insolvency framework, including:

- increased demands for the qualification and capacity of bank trustees;
- improved transparency by introduction of the central registry of the adjudicated bankruptcies;
- streamlining of the formal bankruptcy procedures to limit the scope for misuse of various checks and balances in order to artificially prolong bankruptcy proceedings.

### III. GENERAL LEGAL ISSUES IN BANK INSOLVENCY PROCEEDINGS

#### A. Description of current situation

##### 1. Czech legal framework for bank insolvency

In the Czech Republic, there are two main types of insolvency proceedings relevant to banks:

1. bankruptcy – governed by the generally applicable insolvency law (Bankruptcy and Composition Act), which does not contain any special provisions for bank insolvencies; and
2. conservatorship – governed by the Act on Banks<sup>7</sup> and applicable only to licensed banks, which are systemically important.

The bankruptcy proceeding is run by a court-appointed trustee and conservatorship by a CNB-appointed conservator. The Czech legislation concerning bank insolvency thus represents a mix of court-based and regulatory-based system. Its key features are summarized in Table 1.

**Table 1. Comparative review of Bankruptcy and Conservatorship**

	Bankruptcy	Conservatorship
Who can propose it?	At least two unsatisfied creditors Bank management Liquidator Conservator (with CNB’s consent)	Bank Regulation and Supervision Department of CNB
Who declares it?	Bankruptcy court	The Czech National Bank (with previous opinion of Ministry of Finance)
Who administers it?	Trustee, who is appointed by the court from the general list of trustees.	Conservator, who is appointed by the Banking Board of CNB from among its employees.
Applicability	All companies	Banks of systemic importance (excluding foreign bank branches).
Triggers	Balance-sheet insolvency (“overindebted” bank) Liquidity insolvency (not able to satisfy mature obligations for a period of time)	Shortcoming in bank’s actions endangering the stability of the banking system
Objective	Maximize the asset value and satisfy claims according to priorities	Maintain/restore the stability of the banking sector (implicit goal)
Includes restructuring?	Only through composition (which is very rarely feasible)	Yes, in theory at least (no successful case to date <sup>8</sup> )
Leads to	Law allows for preservation of	In most cases

<sup>7</sup> The Act on Banks regulates banks’ (i) conservatorship (Part Nine: Conservatorship, Articles 27-33) as well as (ii) revocation of their licenses (Part Ten: Revocation of the License, Articles 34-35), and (iii) liquidation (Part Eleven: Bank Liquidation, Article 36).

<sup>8</sup> Two larger banks – IPB and Agrobanka – were restructured during the conservatorship relying on a good bank/bad bank concept. Both cases involved substantial amount of the state aid.

liquidation?	business activities (sale of business) but it happens rarely in practice; legal entity ceases to exist	(at least of the "residual bank"), although it is not explicitly stated in the law.
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Bankruptcy proceedings are applicable to all companies, including banks and non-financial companies, in the situation of balance-sheet insolvency. The balance-sheet insolvency condition states that “[T]he debtor has gone bankrupt if it has more creditors and has not been able to satisfy its mature obligations for a longer period of time. Should the debtor have ceased the payments, it is understood not to have been able to satisfy its mature obligations for a longer period of time” (ABC, Article 1, Section 2). Bankruptcy proceedings are applicable also when the company is overextended, i.e. when the company has more creditors and its due obligations involves all its assets (including expected future income) ABC, Article 1, Section 3.

Bankruptcy is declared by an insolvency court (upon a petition of any two parties possessing mature unpaid claim, the bank management or the liquidator) and administered by a trustee appointed by the court. An alternative to bankruptcy procedure for an insolvent company is composition, in which the debtor makes an agreement with all creditors on the distribution of the remaining assets. However, composition in the case of banks with a plenty of dispersed creditors/depositors is rarely feasible.

The conservatorship is applicable only to banks with valid Czech banking license (excluding branches of foreign banks), if the shortcomings in their activities endanger the stability of the banking system. Before imposing conservatorship the CNB is obliged to seek the opinion of the Ministry of Finance. The main task of the conservator is to maintain or restore the stability of the banking sector, i.e. to minimize the adverse effects of the insolvent bank on the sector. To this goal the conservator may (i) either restructure the bank, so that after the termination of conservatorship the bank continues normal operations, or (ii) if the above is not possible, the license is finally withdrawn and the bank goes into liquidation, or the bank enters bankruptcy proceeding and its activity is terminated.

As the main goal of conservatorship is not explicitly stated by the AB, the conservator is subject to the standard provisions of the Commercial Code and needs to take care of shareholders’ interests, which can conflict with public interest on stabilization of banking sector.

All conservatorships in the Czech Republic since 1990 (with only one exception) led to liquidation of, at least, the residual bank. Thus conservators’ task was reduced to the transfer of valuable assets to other, credible financial institutions and liquidating non-viable part of failed bank. The liquidations (as well as bankruptcies) to take several years due to lengthy judicial proceedings and plentiful litigations initiated in most instances by bank’s original

shareholders. Thus, the legal consequence of conservatorship was license revocation<sup>9</sup> and a complete liquidation of the bank as legal entity.

The CNB may impose conservatorship even if the bank is not balance-sheet insolvent, providing that it can justify that there is a danger of systemic implications.

## **2. Authority to initiate proceedings**

*It is generally accepted that the supervisory authority must have the power to initiate insolvency proceedings against a bank.*

The Czech National Bank has the power to initiate insolvency proceedings<sup>10</sup>. The imposition of conservatorship takes the form of a decision of the CNB. The CNB can not file a petition on bankruptcy to a bankruptcy court directly from the position of the regulator. However, it can effectively file a bankruptcy through indirect means:

- It can revoke the license and nominate the liquidator. The liquidator appointed by the court has to assess the solvency of the bank and if he finds it insolvent he is obliged to file a petition on bankruptcy. Similarly, the conservator is obliged to file a petition on bankruptcy if the bank is insolvent, but must seek prior consent of the CNB.
- If CNB is one of the creditors with unsatisfied mature claims it needs to find one more such a creditor and together they can file bankruptcy.

A bank, as a debtor, and creditors are also entitled to file a petition on bankruptcy. In these cases the law does not require prior consultation with the CNB. The way of involvement of the CNB in the bankruptcy proceeding is just the common regulatory power as long as the bank has its license. The CNB's powers towards a trustee in bankruptcy are analogous to those towards a bank's management prior to bankruptcy. The CNB is not explicitly entitled by the law to be heard prior to the original decision on the declaration of bankruptcy and the courts do not have explicit obligation to inform CNB that they had accepted bankruptcy petition for consideration.

## **3. Licensing implications of bank insolvency**

*The law should clearly specify the relationship between the declaration of a bank's insolvency and its status as a licensed institution. However, the automatic withdrawal of authorization is not advisable unless the bank has already been placed in liquidation.*

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<sup>9</sup> What remained from the bank would be in legal terms a standard joint-stock company.

<sup>10</sup> It must be taken into account that, as has been described above, the power of the CNB to initiate insolvency proceedings is not exclusive since two or more creditors can also petition the Courts to initiate a bank's bankruptcy.

In the Czech legal system, the revocation of license and the commencement of insolvency proceedings are independent processes. The license can be revoked by the Czech National Bank, after seeking the opinion of the Ministry of Finance, if “serious shortcomings persist in the activities of a bank” (AB, Article 34(1)). The license may also be revoked if the bank does not start its activities within twelve months of being granted its license, if it has ceased to accept deposits from (or provide credits to) the public for six months or more or if the license was obtained through false information stated in the application. Furthermore, the Czech National Bank has to revoke the license if it becomes aware that the bank’s capital adequacy on a solo basis is lower than one-third of the capital adequacy ratio laid down by the Czech National Bank.

While the automatic threshold for the revocation of the license is one-third of the required capital adequacy ratio, the condition for the commencement of bankruptcy proceeding is the bank’s “inability to satisfy its mature obligations for a longer period of time”. In addition, licensing is in the power of the Czech National Bank, while bankruptcy proceeding is commenced by a court upon the proposal of the bank, as a debtor, creditors, liquidator or conservator (with the consent of the CNB). Thus the decisions concerning licensing are dissociated from the bankruptcy process. License may be revoked without the bank entering bankruptcy and bankruptcy may be declared without the bank losing its license.

The revocation of license is also independent from the commencement of conservatorship. Conservatorship may be imposed only on a bank with valid license but, as is explicitly stated in the Article 34, Section 1 of the Act on Banks, the revocation of license “need not be preceded by the imposition of conservatorship”.

In our opinion, a good part of the problems that the above disconnect produces can be remedied through the provision (which, as we understand, would be included in the upcoming project of reform of the general bankruptcy legislation) stating that in order to initiate any kind of bankruptcy proceedings against a bank, it has to be delicensed previously by the CNB, in the absence of the delicensing decision by the CNB no bankruptcy action can proceed. Additionally, we propose that the power of the CNB to revoke the license of a distressed bank, should not be as rigid as it currently is under the legislation in force. If an appropriate “prompt corrective action” regime (which we will discuss below in this document) would be introduced into the banking law, the CNB’s power to revoke any bank’s license would be more directly related to the non compliance with the previously imposed recovery program, and, in any case, it would be somehow more flexible than the current situation under which, given the loss of 2/3 of the required regulatory capital, the bank’s license has to be compulsorily revoked.

#### **4. Availability and operation of the moratorium**

*In official administration, the moratorium at most will provide a very narrow window for the exploration of restructuring possibilities. Beyond that point, it will merely constitute a step towards a bank's liquidation.*

According to the Section 29(3) of the Act on Banks if the bank's situation so requires, the conservator may, with the prior consent of the Czech National Bank, which shall seek the opinion of the Ministry of Finance, suspend partially or fully the depositors' right of disposal of their deposits in the bank. This provision effectively enables CNB to impose a moratorium, even though the moratorium is not explicitly embedded in the law. However, all the reservations listed in the GBII report (pp. 25 and 26) apply thus a moratorium on credits and deposits could serve only as an intermediary step to get some more time for a real solution, but if the appropriate restructuring operation (e.g. a quick transfer of all deposits and equivalent good assets of the distressed bank to a sound financial institution) is not executed in a very short period of time, then the moratorium would merely constitute a step towards a bank's bankruptcy/liquidation.

#### **5. Shareholders' rights**

*The property-rights-based rationale for the continuing participation of shareholders in the governance of an insolvent bank is stronger in cases where the bank still has a positive net worth. In any event, the recognition of any shareholders' rights in the context of official administration (including their pre-emptive rights of participation in the bank's recapitalization) should not affect the powers of the banking supervisory authority to take swift action as needed, including the power to decide on the fitness of large shareholders of banking institutions.*

The bank shareholders retain their voice only if a solvent bank enters a liquidation proceeding (voluntary liquidation) or if all shareholders and creditors can agree on the composition. Both procedures are applicable only in highly specific cases when a cooperative solution is easy to achieve and when a swift action of a Supervisory Department is not needed. In any case, the banking regulators should perform the difficult task of avoiding interference of shareholders in the performance of the required efficient restructuring operation while, at the same time, respecting their ownership rights.

A system under which appropriate consideration can be given by the courts to legal actions from the shareholders seeking appropriate compensation, but without interfering the effectiveness of the regulatory actions needed, may help to solve the above difficult dilemma.

#### **B. Weaknesses and potential improvements**

The legal framework for banking resolution and insolvency could be strengthened by the introduction of a prompt corrective action regime, facilitating relationship between regulators and statutory bodies of banks in difficulties. Apart from existing instruments discussed

elsewhere in the report, the regime could rely on a more formal recovery program, including permanent supervision, as described below:

***-Prompt correction regime***

In order to ensure smooth functioning of the corrective action regime the hierarchy of triggers should be stipulated in the law. This would impose credible deadlines on all stakeholders involved in the problem resolution, while ensuring necessary flexibility for the most efficient mode of resolution. The proceedings could be strengthened by the introduction of several thresholds, passing of which would trigger certain actions and gave CNB the right to impose stringent measures. The triggers would provide better balance between the current ample discretion of CNB to introduce number of intermediary measures when it identifies “shortcomings in the activities<sup>11</sup>” or when the capital adequacy falls below two thirds of the required level (see page 25 for details) and the rigidity of the obligation to revoke the license when CAR falls below one third of the required level.

**Table 2 Possible hierarchy of triggers in the prompt corrective action regime**

Trigger	Compulsory action	Optional action
<b>CAR falls below regulatory threshold</b>	Recovery program	Conservatorship
<b>CAR falls below 2/3 of regulatory threshold</b>		Conservatorship License revocation
<b>CAR falls below 1/3 of regulatory threshold</b>	License revocation	Bankruptcy initiated

While legislation should require the authorities to observe the principles set out above, the law should also provide flexibility to the banking authorities to handle exceptional cases, such as

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<sup>11</sup> Currently, the CNB may propose the following remedial measures (AB, Article 26 (1)):

- a) demand that the relevant bank or foreign bank branch remedy the situation within a specified period, and in particular that it restrict some of its permitted activities or cease non-permitted activities, replace persons in the management of the bank or foreign bank branch, or create an adequate amount of provisions and reserves, or that the bank reduce its capital to a specified extent, replace members of the supervisory board or use its profit after tax preferentially to supplement its reserve funds or to increase its capital,
- b) change the license by excluding or restricting some of the activities listed therein,
- c) order an extraordinary audit at the expense of the bank or foreign bank branch concerned.
- d) impose conservatorship,
- e) impose a fine of up to CZK 50,000,000,
- f) reduce the capital of the bank by an amount corresponding to the loss after clearance thereof with reserve funds and other funds, provided that the loss exceeds 20% of the bank’s equity,
- g) prohibit or restrict the execution of transactions with legal entities which have close links with the bank or which belong to the same consolidated group as the bank or which have a special relation to the bank (Article 19).

bank failures with systemic implications that may cause disruptions or even the collapse of the payment and settlement systems, trigger bank runs or cause other serious disruptions in the financial system. If the authorities deem that the failure of a bank has serious systemic implications, they will need to employ a restructuring technique that minimizes any systemic risks, even if some of the above principles cannot be fully observed. However, to limit these exceptions exclusively for the most serious cases a joint declaration of the Board of the Czech National bank and the Ministry of Finance should be a precondition for the use of the exceptional measures.

The general guide for the regulatory actions should be the perceived viability of the bank. Revocation of license is a solution for cases when CNB is convinced that the bank is not viable and that the recovery program and/or conservatorship are unlikely to be successful. Thus the license revocation should become the prerequisite for the bankruptcy proceeding.

The prompt corrective action regime critically depends on the high efficiency of the banking supervision, which is capable to identify early a breach of the thresholds, and on the high quality of accounting standards, which prevent affected banks to “cook the books” to avoid regulatory action.

#### ***-Recovery program***

Recovery program is a set of remedies proposed by the bank management and approved by the supervisor, which addresses the list of shortcomings previously identified by the supervisor. It is aimed to provide cooperative bank owners and managers with reasonable time frame to stabilize the bank. Although the current legislation already grants the banking regulator legal power to impose most of the required measures, the idea of the program is to formalize in a more structure manner the agreement between the distressed bank and the bank regulator, to provide the opportunity for the regulator to exercise permanent supervision on the distressed bank, and to provide a more objective criteria to trigger, in case of non-compliance, more severe measures such as conservatorship, license revocation, etc.<sup>12</sup>

The permanent supervision aims at providing the supervisor with an enhanced access to information and decision-making in real time so that he/she can devise alternative scenarios to be implemented if the recovery program fails.

Thus, as explained above, the processes between detection of shortcomings and revocation of the license would be more predictable and structured through the formally approved recovery program, which would provide: (i) sufficient flexibility for cooperative approach to remedy

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<sup>12</sup> Considering that the existing legislation provides the CNB with most or perhaps all of the regulatory powers required to implement a recovery program it may be possible to introduce the suggested scheme just by a regulation from the CNB instead of needing a law.

and (ii) credible deadlines and constraints. The formal recovery program would help to avoid undue delays, extensive regulatory forbearance and limit external interference.

Consideration should also be given to introduce, by law, the possibility that the banking authorities could grant some limited flexibility to the distressed bank for compliance with some regulatory requirements, as long as it occurs in the context of the recovery program.

#### ***-Permanent supervision***

Regime of permanent supervision should be introduced during the period of preparation and implementation of the recovery plan. The regime should consist of: (i) regular presence of the supervisor in the key decision making processes in the troubled bank, and (ii) reporting duty of the bank towards the permanent supervisor, who would have to acknowledge all substantial decisions.

The permanent supervisor should only acknowledge reported proposals; he or she should not be equipped with administrative powers in order to avoid the transfer of responsibility for specific decisions from troubled bank management to the supervisor. The permanent supervisor should hold the management accountable on the basis of objectives specified in the agreed recovery plan. Should the management take actions inconsistent with the recovery program, the CNB would be entitled to impose conservatorship or other stringent measures.

## **IV. OFFICIAL ADMINISTRATION OF BANKS**

### **A. Description of current situation**

#### **1. Overview**

*In many countries a form of insolvency proceedings is recognized, under which a bank is placed under “official administration”. Under official administration, the relevant authority will decide on the extent to which the bank can be restructured or needs to be liquidated. Official administration provides the relevant authority with the opportunity to assess the bank’s condition, as soon as possible, and to take actions to protect the bank’s assets.*

Under the current Czech laws the main type of official administration than can be imposed is the CNB’s supervised conservatorship which can be imposed on distressed banks of systemic importance. Conservatorship is regulated by the Articles 27 through 33 of the Act on Banks (henceforth AB).

#### **2. Triggers for official administration**

*One of the basic choices to be made is between a mandatory and a discretionary system: in deciding to impose official administration, should the law allow the supervisory authority to*

*exercise “discretion”, or should the decision be automatically triggered by criteria embedded in law?*

The Czech National Bank may impose conservatorship in the situation where shortcomings in a bank’s activities endanger the stability of the banking system and the shareholders have not taken the necessary steps to eliminate those shortcomings (AB, Article 30). The CNB needs to seek an opinion of the Ministry of Finance on the imposition of conservatorship. The conservator is appointed by the Banking Board of the CNB<sup>13</sup> from among its employees (AB, Article 28, Section 1).

Imposing conservatorship is one of seven remedial measures and sanctions<sup>14</sup> that the Czech National Bank is entitled to choose if it detects “any shortcomings in the activities of a bank or a foreign bank branch”. Moreover, the choice of the CNB is constrained by an obligation to select measures and sanctions “according to the nature of the shortcoming<sup>15</sup>”.

Further, the CNB is entitled to impose conservatorship, if the bank’s capital adequacy on a solo basis is lower than two thirds of the required capital adequacy ratio. It is a duty of statutory bodies of a bank to notify the CNB at the earliest opportunity when it “becomes aware that the bank is, or will become, insolvent or that the bank has incurred, or will probably incur, losses which have caused, or may cause, the bank’s capital adequacy on a solo basis to fall below two thirds of the ratio laid down by the Czech National Bank.”

If a bank is in conservatorship, the only party that may file a bankruptcy petition is a conservator, with the prior consent of the Czech National Bank, if he becomes aware that the bank is insolvent (Article 29, Section 4 of the AB and Article 12a, Section 3(b) of the ABC).

## **2. Assumption of control by the insolvency officials**

*It is essential that automatic and full control of the bank be transferred immediately to the official administrator or liquidator. The law must be absolutely clear on the moment and scope of the transfer of control from owners and directors to the official administrator.*

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<sup>13</sup> The CNB will also determine the remuneration for executing the conservatorship.

<sup>14</sup> See footnote 11.

<sup>15</sup> Shortcomings in the activities are defined as (AB, Article 26 (3)):

- a) a failure to comply with the conditions stipulated in the license or to fulfill the conditions under which the license was granted;
- b) failure to comply with, or circumvention of, the Act on Banks, special legislative acts, legal rules and the provisions issued by the Czech National Bank;
- c) execution of transactions by the bank in a manner which is detrimental to the interests of its depositors or which endangers the safety and soundness of the bank;
- d) management of the bank by persons who are not sufficiently competent or who are not trustworthy;
- e) a situation where the total volume of reserves and provisions set aside by the bank is not sufficient to cover the risks arising from the volume of classified assets recorded by the bank;
- f) contravention of a legal rule of the state within the territory of which the bank has a branch when carrying business activities within the territory of that state;
- g) a fall in capital below the minimum level (CZK 500 million).

### ***-Assumption of control by the conservator***

The duties of all bodies of the bank are suspended at the moment the written decision to impose conservatorship is served (AB, Article 29, Section 1). Subsequently, the conservator convenes and attends a General Meeting and acts in the capacity of the statutory body.

The conservator has the capacity to decide on matters falling within the powers of the General Meeting, with a prior consent of the CNB. Moreover, if the bank's situation so requires, the conservator may, with the prior consent of the Czech National Bank, which shall seek the opinion of the Ministry of Finance, suspend partially or fully the depositors' right of disposal of their deposits in the bank. If the conservator becomes aware that the bank is insolvent, he shall file a petition for composition or bankruptcy, with prior consent of the CNB.

The name of the conservator is a necessary part of the CNB's decision to impose conservatorship. The conservator is appointed and dismissed by the Bank Board of the CNB. The conservator is entitled to take on additional persons to execute the conservatorship, except for persons having a special relation to the bank

### **3. Elements of official administration**

- *The law needs to specify clearly who shall have the authority to appoint, replace and discharge the official administrator.*
- *The legal framework could provide for the temporary protection against creditors' rights.*
- *The official administrator would need full powers to manage the loan portfolio, including taking action to collect non-performing loans.*
- *The official administrator needs to decide the extent to which the bank is to be restructured or liquidated.*
- *The legal framework needs to set a specific timeframe for the performance of the critical elements of official administration, allowing at most for a limited number of extensions.*
- *The official administrator should be authorized to continue the bank's operations, to the minimum extent necessary to maintain the residual value of the bank.*
- *The law needs to strike a balance between the need for confidentiality and transparency in the conduct of the official administration.*
- *The legal framework should provide clear rules on who carries the expenses of the official administration, at minimum providing that the estate of the bank should bear all relevant expenses.*

- *Provisions need to be made for an orderly transfer of power and information from the official administrator to the liquidator. The official administrator can be asked to prepare a final report on the conduct of the official administration.*

### ***-Elements of Conservatorship***

- *Appointment, replacement and discharge of the conservator.* The conservator is appointed and dismissed by the Bank Board of the CNB. The names of the conservator and deputy conservator are necessary parts of the CNB's decision to impose conservatorship. The court plays only a formal role of recording in the Companies Register the imposition of conservatorship, the termination of conservatorship, the dismissal of a conservator and the appointment of a new conservator. The Czech law does not impose requirements on the conservator's qualification, nor does it specify grounds for replacement or dismissal of the conservator. The responsibility for appointing, replacing, and dismissing the conservator is fully born by the CNB.
- *Temporary protection against creditors' rights.* Protection against depositor's rights is regulated in the Article 29, Section 3: "If the bank's situation so requires, the conservator may, with the prior consent of the Czech National Bank, which shall seek the opinion of the Ministry of Finance, suspend partially or fully the depositors' right of disposal of their deposits in the bank.
- *Protection of assets, containment of liabilities and pursuit of claims.* The conservator acts in the capacity of the statutory body and with the consent of CNB decides on matters falling within the powers of the General Meeting. The conservator is authorized to pursue the bank's claims, take necessary steps to protect the bank's assets, and defend the bank in a court of law against claims made upon the institution. This also gives the conservator powers to manage the loan portfolio, including taking action to collect non-performing loans (with prior consent of the CNB). Further, the conservator has an authority to negotiate financial liquidity support from the state authorities<sup>16</sup>.
- *Preparing an inventory of assets and liabilities and timetable.* The law does not specify a time frame in which the conservator should take stock of the bank's assets and liabilities ("due diligence"). The conservator has the authority to obtain any and all information relevant to the financial condition of the bank, on a "solo" as well as a consolidated basis. The only time limit concerning the actions taken within conservatorship is the maximum duration of 24 months. This time is fixed and can not be extended. No time limits are set for specific actions within conservatorship.

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<sup>16</sup> It is explicitly provided by the law that "[during conservatorship, the CNB may render financial assistance to the bank in question to overcome any temporary shortage of liquidity" (AB, Article 32(1)).

- *Decision on restructuring or liquidation.* A conservator decides the extent to which the bank is to be restructured or liquidated in order to minimize adverse effects of the bank's conservatorship on the banking sector. Conservator may also decide whether to file a petition for composition or bankruptcy. For decisions concerning restructuring, the conservator needs prior consent of the CNB to the extent to which these decisions are on matters falling within the powers of the General Meeting. If the conservator becomes aware that the bank is insolvent, he is entitled, with the prior consent of the CNB, to file a petition for composition or bankruptcy.
- *Temporarily operating the bank's business.* The conservator is authorized to continue the bank's operations, to the minimum extent necessary to maintain the residual value of the bank. This authority stems from the fact that the conservator is entitled to act in the capacity of the statutory body and decide, with CNB's prior consent, on matters falling within the powers of the General Meeting .
- *Confidentiality.* All persons exercising conservatorship "shall maintain confidentiality regarding all information acquired in the context of the performance of their occupation, employment or duties. They may divulge to third parties information in aggregate form only such that the specific bank or person in question cannot be identified. The obligation of confidentiality shall persist even after their occupation, employment or duties have ceased. ... [They] may use information acquired when performing their duties solely for executing the tasks of ... conservatorship or in court proceedings concerning actions against decisions made in the context of exercising banking supervision or in like proceedings before an international authority" (AB, Article 25a (1-2)).
- *Cost of conservatorship.* The law explicitly states that "the costs associated with conservatorship shall be covered from the bank's assets and shall constitute an expense of the bank for achieving, maintaining and securing income for the purposes of legal entity income tax" (AB, Article 27 (2)).
- *Termination of conservatorship.* There are three possible ways of terminating conservatorship (i) the CNB terminates conservatorship by its decision or (ii) conservatorship is automatically terminated by declaration of bankruptcy or (iii) upon the lapse of 24 months from the imposition of conservatorship. The termination of conservatorship must be recorded in the Companies Register upon the Czech National Bank's proposal.

## **B. Weaknesses and potential improvements**

### ***-Conservatorship***

The conservatorship should serve as a short term measure (up to one or, maximum, just a few weeks) providing supervisor with time and legal power to restructure and preserve banking business<sup>17</sup>. In the current system the conservatorship can be introduced only if the stability of the banking sector is endangered. This excludes its use in the case of small (or even most medium size) banks, where a well design conservatorship coupled with the use of appropriate restructuring tools, as explained below, could save a reasonably healthy amount of banking businesses.

In most cases on which conservatorship is allow by law to be used as a long term strategy, it would end up in a bail-out of the bank, which would be impossible to justify outside of the context of a systemic crisis. If conservatorship (as we would advise) is understood as a short term measure, aimed at providing the regulatory authorities with the necessary time to perform the appropriate resolution operations and with the appropriate legal powers to deal with fraudulent, non-cooperative, or incompetent management and/or shareholders, who are not willing or able to implement the recovery program, then the requirement of systemic implications should be dropped<sup>18</sup>.

### ***-Multilateral framework***

A multilateral framework for the resolution of difficulties with foreign bank branches should be developed. Currently there are Memorandums of understanding between CNB and home country regulators of the most important foreign banks present in the Czech banking market. However, a multilateral framework could be a much more efficient tool for the resolution of an emergency situation. The framework could be developed within the context of the EU and ECB initiatives, in which CNB already participates.

The framework regarding the cross-border bank insolvencies is largely absent. There is almost no experience in recovering banking assets abroad, and there are not explicit and precise procedures for dealing with foreign branches and subsidiaries of bankrupt banks. The CNB should participate in efforts to develop the standards for the role of the host country supervisor in multinational bank insolvencies. Until these standards are developed or a

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<sup>17</sup> The supervisor's actions should be aimed at preserving the maximum amount possible of banking business (asset value) but, of course, not the bank itself.

<sup>18</sup> It must be stressed that we only recommend the possibility of widening the use of conservatorship to the case of banks with non systemic implications ONLY after conservatorship had been restricted by law to be a measured with strict time limitation (of only a few days) thus not understood as a way of delaying/avoiding the final resolution of non systemic banks in a more definitive way.

suitable multilateral framework is in place there is no substitute to reliance on bilateral memorandums of understanding.

## **V. BANK RESTRUCTURING**

### **A. Description of current situation**

#### **1. Overview**

*The purpose of bank restructuring is to secure the continuation, on a financially sound basis, of the bank's business, or part thereof, as a going concern.<sup>19</sup> Various methods can be used for the purpose of restructuring a bank in the context of insolvency proceedings. The most common techniques employed are: mergers or acquisitions; purchase-and-assumption transactions; operations involving the creation of bridge banks or a good-bank/bad-bank separation; and, in the event of large bank failure with major systemic implications, temporary nationalization of the insolvent bank as a last resort.*

The Czech legal framework does not explicitly specify any particular technique for bank restructuring and gives CNB and the bank shareholders wide discretion to agree on whatever they consider to be the most appropriate method. In case that a cooperative agreement can not be reached, due to unwillingness or incapability of shareholders, then statutory body and/or shareholders of insolvent banks have no other option<sup>20</sup> then file for bankruptcy. Alternatively, they can wait until the CAR of their bank falls under one third of the regulatory limit, in which case the CNB will have to withdraw the license and nominate liquidator. Court appointed liquidator would then find out that the bank is insolvent and file for bankruptcy<sup>21</sup>.

#### **2. Main restructuring techniques**

*Principles for bank restructuring:*

- *Limit moral hazard: In a sound and efficient financial system, only well administered institutions should remain in business. It is not the role of authorities to prevent bank failure, but rather to facilitate the rapid exit of insolvent institutions from the financial system. Exceptions to this principle should only be allowed based on justifiable considerations directly related to the stability of the financial system.*

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<sup>19</sup> Restructuring may result in either the survival of the bank as a legal entity or the dissolution of its legal personality even if part of its economic operations will continue.

<sup>20</sup> Assuming that the bank in question would not endanger the stability of a banking sector. If it would imposition of conservatorship would also be an alternative.

<sup>21</sup> In theory a bank with a CAR below 1/3 of the threshold may be marginally solvent, however, license withdrawal inevitably causes fall in the value of the bank's assets coupled with a deposit withdrawal en masse, thus a bankruptcy is practically inevitable consequence of the license withdrawal.

- *Least-cost solution: In choosing between alternative schemes, the authorities should engage in restructuring operations that minimize restructuring costs.*
- *Preference for private-sector solutions: The legal framework should encourage reliance on private-sector solutions, whenever this is feasible. A private-sector solution is one in which a bank's existing ownership is augmented or replaced, as a result of the restructuring, by new private investors (including another private bank).*
- *Where a third party – and especially another healthy financial institution – is capable and willing to assume the responsibility for recapitalization and future management, an insolvent bank can be restructured on an open-bank basis by means of a transfer of its legal ownership from the existing shareholders to that third party.*

#### ***-Bank Restructuring prior to Official Administration***

If the CNB detects any shortcomings in the activities of a bank it is entitled to adopt remedial measures and penalties according to Article 26 of the Act on Banks. Moreover, if CNB becomes aware that bank's capital adequacy on a solo basis is lower than two thirds of the required ratio<sup>22</sup>, it shall open administrative proceedings and impose one or more of the following remedial measures on the bank (AB, Article 26 (1)):

- a) to increase its capital so as to attain the prescribed capital adequacy thereof on a solo basis,
- b) to acquire assets with a risk weighting of less than 100% only,
- c) not to acquire any share of the capital and voting rights of any legal entity, except for agreements concluded before the imposition of this measure, and not to establish or acquire any other legal entity or organizational unit thereof,
- d) not to provide any credit to a person having a special relation to the bank,
- e) not to offer interest rates on deposits exceeding the usual current interest rates on deposits of like amounts and with like maturity as ascertained by the CNB.

Articles 26 and 26a of the Act on Banks provide tools for the CNB to induce restructuring without imposing any form of the official administration. During the 1990s these tools were complemented by a number of ad hoc programs for small private banks (Consolidation Program II and Stabilization Program) and forced mergers with other small banks, which seemed to have better financial standing (see Appendix for more details). The difficulties of the large state-owned banks were also addressed by ad hoc measures coupled with bail-outs and ring-fencing guarantees prior to their privatization to the foreign strategic investors.

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<sup>22</sup> The statutory body or supervisory board is obliged to notify CNB at the earliest opportunity if it becomes aware that the bank is, or will become, insolvent or that the bank has incurred, or will probably incur, losses which have caused, or may cause, the bank's capital adequacy on a solo basis to fall below two thirds of the required ratio.

### ***-Bank Restructuring during Bankruptcy Proceeding***

A bank may enter bankruptcy proceeding whenever it has not been able to satisfy its mature obligations. If the bank's problems endanger the stability of the banking sector, CNB's action (in the form of conservatorship) may precede that of the bankruptcy court. The Act on Bankruptcy and Composition does not provide space for reorganization in the sense of the US Chapter 11. Once a bankruptcy court accepts a petition on bankruptcy, finds the bank being balance-sheet insolvent, adjudicates bankruptcy proceeding and appoints a trustee, the trustee's task is to achieve a proportional satisfaction of the creditors from the property belonging to the bankruptcy estate" (ABC, Article 2, Section 3). The process of bankruptcy usually consists of selling separate assets of the bank with the aim to liquidate the bank as a legal entity and achieve proportional satisfaction of all creditors/depositors. Restructuring hardly ever takes place, especially due to the lengthiness of bankruptcy proceedings which strongly pushes the financial situation of the debtor to even worse position.

### ***-Bank Restructuring during Conservatorship***

Restructuring is not legally defined as a phase of conservatorship. Rather, it is upon the discretionary power of the conservator who is accountable to the Czech National Bank. In the moment of introducing conservatorship and appointing the conservator, the management powers are transferred to the conservator.

The main task of the conservator is to minimize the adverse effects of the insolvent bank on the sector. In order to fulfill this objective, the conservator may either restructure or liquidate the bank. However, in the 1990s conservatorships typically led to liquidation. The reason is that the owners of insolvent banks, who bore at least part of responsibility for the banks' problems, did not have capacities and willingness to participate in restructuring. The Composition (see below) proved useful only in one case. In all other cases conservators' task became to transfer a part assets to other, credible financial institution, with the consequent revocation of banking license and liquidation of the bank as legal entity. The largest bank failure was addressed by the sale of whole enterprise coupled with government guarantees, which was legally and operationally the most feasible strategy.

### ***-Deposit Insurance Fund and its role in restructuring***

There is a formal deposit insurance scheme within which deposits in both local and foreign currencies are guaranteed up to 90% per person (legal or physical) per bank. The maximum amount paid out to the depositor is limited to the equivalent of EUR 25,000.

All banks and subsidiaries of foreign banks are required to participate in the deposit insurance scheme, i.e. to contribute to the Deposit Insurance Fund (DIF). The foreign bank branches are required to offer the same level of protection as that offered by the DIF. The branches of foreign banks (outside of EU) can be exempted from the scheme if they are able to

demonstrate to the CNB that they participate in a deposit insurance scheme providing at least such a protection as the one provided according to the European Community law (Article 411, AB).

The Fund is managed by a Board, consisting of 5 members appointed by the Ministry of Finance. At least one member has to be an employee of CNB proposed by CNB and two members have to be members of the Boards of Directors of licensed commercial banks.

The Deposit Insurance Fund (DIF) is financed through contributions from banks' yields on investments of funds and borrowings. The annual contribution of a bank to the Fund amounts to 0,1% of the average value of insured deposits for the previous year. In case of a construction savings bank, the contribution amounts to 0,05% of the value of insured deposits for the previous year. The deposit insurance premiums are not risk-related, though the lower rates paid by the construction savings banks are justified by their lower risk profile.

The Act does not state explicitly that the claims against the Fund are guaranteed by the state. In case the DIF is not able to meet its obligations from its own resources, it shall secure the necessary financing on the market, in which case the contributions of the obliged entities are raised to a double of the base rate.

The statutes of the DIF do not allow it any for of active participation in the bank restructuring, even though it could legibly reduce the cost of the insolvency. The DIF's role is limited to collecting information about all insured depositors and organizing the distribution of payments. Proceeds from the closed liquidation and bankruptcy proceedings are sources of income for DIF. The DIF takes over the claims of all insured depositors and tries to maximize its income from these proceedings.

## **B. Weaknesses and potential improvements**

Strengthening of the prompt corrective action regime, recommended above, should improve chances of successful restructuring prior to any form of official administration. Similarly, partial transfers would provide effective restructuring tool during the conservatorship.

### ***-Partial transfers***

Partial transfer of deposits and good assets for adequate price could be a tool of choice. Partial transfer is less costly, preserves more of a banking business and protects the faith to the banking sector. However, efficient supervision is a key prerequisite for partial transfers. The supervisor must be able to (i) detect problems before the gap between assets and liabilities widens and (ii) act promptly to avoid undue delay. The strengthened prompt action regime and the recovery program prior to imposition of conservatorship, described above, would be instrumental to achieve such efficiency.

Partial transfer of assets and liabilities to sound financial institution should be embedded in the legal framework. It seems that the current legal framework does not allow for partial transfers with the speed it requires to be efficiently applicable to banks in distress; only sale of the whole business is legally and operationally plausible. Transfer of deposits entails preference of depositors over other classes of creditors, thus must be defined by law to be legally feasible.

Additional funding needs to be provided to make partial transfer possible. In emergency situations it could be obtained either as a state aid or from the Deposit Insurance Fund. In both cases the least cost principle would be the key criteria. The state aid is forbidden by the EU competition rules and it is unlikely that the needed exception could be obtained from the DG Competition in a timeframe typically available for recovery operation. The DIF contribution could be the most efficient alternative in cases when: (i) the contribution would be less than the amount payable for the insured deposits and (ii) deposits and assets would be transferred to a sound financial entity<sup>2324</sup>.

#### ***-Deposit Insurance***

If, as suggested above, quick transfer of deposits and equivalent good assets to a sound financial entity is to be used as a tool of choice to deal with small and middle size banks<sup>25</sup> on the verge of insolvency, in most cases some additional funding needs to be provided to make the operation possible. In emergency situations, and assuming that state aid is not to be used, the needed funding could come from the Deposit Insurance Fund. The DIF's contribution could be the most efficient alternative in cases when: (i) the contribution would be less than the amount that would need to be paid to cover insured deposits in case of bank's liquidation, and (ii) deposits and assets would be transferred to a sound reputable bank<sup>26</sup>. It would satisfy the least cost criteria and possibly also the "private investor test," which is used by the DG Competition to accept DIF's involvement as compatible with the ban on state aid (few more changes to the DIF statute would be needed to achieve full compatibility with EU rules).

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<sup>23</sup> Unless the DIF and CNB, which ought to approve such transaction, misjudged the buyer, the risk that the DIF would have to pay again would be very low as the failure of the institution chosen in the receiving end would be highly unlikely.

<sup>24</sup> In any case it must be taken into account that any use of public funds, or compensation to depositors beyond the specific limits established in the context of the deposit insurance scheme can only be justified in cases of systemic implications, and that their use in situations of clear absence of systemic implications is a suboptimal scheme

<sup>25</sup> We need to be aware that in cases of very big banks it may be difficult to find a suitable acquirer in the short time framework available which makes this tool normally less usable in those cases.

<sup>26</sup> Unless the DIF and CNB, which ought to approve such transaction, severely misjudge the buyer, the risk that the DIF would have to pay again would be very low as the failure of the chosen financial entity on the receiving end would be highly unlikely.

### *-Unsuccessful restructuring*

The CNB should have a right to submit petition for bankruptcy directly. The need to initiate the liquidation or be one of the creditors unduly complicates the initiation of bankruptcy in situations when all other possible solutions have been unsuccessfully tried (see next Chapter VI).

## **VI. BANK LIQUIDATION AND BANKRUPTCY**

### **A. Description of current situation**

Under the current legislation of the Czech Republic, the two legal proceedings that could be embedded within the concepts that the GBII Report includes as predominantly dealing with unviable banks would be bank liquidation and bankruptcy. In this document we will discuss them separately, first the banking liquidation and then the bankruptcy proceedings as applicable to banks.

#### **1. Bank Liquidation**

*In liquidation, an insolvent bank is dissolved after a liquidator assumes legal control of its estate, collects together and realizes its assets, and distributes the proceeds to creditors, in full or partial satisfaction of their claims, in accordance with the principle of equal (pari passu) treatment of similarly situated creditors and the applicable rules on priority. The voluntary liquidation of solvent banks is not discussed in this chapter.*

In the Czech Republic, there is no special legal framework for bank liquidation. The process of bank liquidation is regulated by the general legal framework for liquidation as stipulated in the Commercial Code. The formal process of involuntary bank liquidation (“likvidace” in the Czech legal terminology<sup>27</sup>) is rather complex from the procedural point of view as it includes the following steps:

1. the CNB revokes the banking license and
2. nominated the liquidator, which needs to be formally appointed by the court;
3. if liquidator finds the bank insolvent, he is obliged to file the petition for bankruptcy to the court;
4. if the court adjudicates the bankruptcy, then the court also appoints the bankruptcy trustee, who takes over the powers of the statutory bodies from the liquidator;

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<sup>27</sup> The “likvidace” is general legal process defined by the Commercial Code for voluntary winding up of commercial companies. Banks may enter the process involuntary following the license revocation. “Likvidace” is used for solvent entities only, whose claims and liabilities can be settled in full. “Likvidace” should not be confused with liquidation of insolvent entities (realization of assets and distribution of proceeds in full or partial fashion), which under the Czech legal system takes place within the bankruptcy proceedings (“konkurz”) or composition (“vyrovnani”).

5. the trustee realizes bank's assets and distributes the proceeds to creditors;
6. once the claims are satisfied, in full or partial fashion, the trustee submits the final report, the bankruptcy is concluded and trustee hands over the control back to the liquidator<sup>28</sup>;
7. the liquidator formally winds up the residual legal entity and erases it from the company registry. The erasure formally concludes the bank liquidations.

In theory, the above procedure allows for number of variations, which are, however, practically very unlikely. For example, liquidator may not find the bank insolvent or the residual legal entity may not be wind up but can continue to operate as a standard joint stock company<sup>29</sup>. These variations allow some flexibility for special cases; however, CNB usually has alternative tools to achieve same ends.

#### ***-Legal framework: commencement, role of liquidator, accountability***

*The law will have to determine who is allowed to initiate liquidation proceedings against a bank and on what grounds.*

The involuntary liquidation can be initiated only by the CNB, following the revocation of the banking license. The CNB has the exclusive authority to submit a proposal for the nomination of the liquidator, for the dismissal of the liquidator and for the nomination of a new liquidator or a proposal for the winding up of the joint-stock company if the bank's license has been revoked (AB, Article 36). The court has to rule on the proposal within 24 hours after its submission.

The trigger for ignition of liquidation is the revocation of license. The license can be revoked on the grounds of shortcomings in actions described in Article 26 (1) of AB or must be revoked if the capital adequacy falls below one third of the required level.

The liquidator may be a natural person or a legal entity, who has not, or has not had, a special relation to the bank, who is, or has been in the last five years, the bank's auditor, or who has contributed to the bank's audit in any way.

#### ***-Establishing condition and protection of assets***

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<sup>28</sup> This part of the procedure is virtually untested as no bank emerged from the standard bankruptcy procedure yet. Moreover, if a trustee finds that the property is insufficient to cover the costs of bankruptcy proceeding then he can directly propose the formal liquidation and erasure from the registry.

<sup>29</sup> Banks can take no other legal form than joint stock company (akciová společnost, a.s.) and only when they become licensed they enter the special legal regime for banks. However, when their license is revoked they remain subject to the Act on Banks and other relevant legislation until they settle their claims and liabilities (AB, Article 35(2)).

*The liquidator should be able to assume control of the bank without delay. The legislation must ensure that the liquidation process will not be derailed by the liquidator's legal or practical incapacity to make immediate payments against its various costs.*

The bank enters the liquidation within 24 hours following the CNB's nomination of the liquidator acceptable to the court. The approved liquidator assumes control immediately when the Court decision comes into force and he takes over all powers of the statutory body.

Liquidator's capacities are judged by the CNB prior to his nomination to ensure that chances of successful liquidation are maximized. The liquidator can be a physical as well as legal entity. As opposed to the conservatorship, the CNB is not entitled to provide an emergency credit line to the bank in liquidation. This is consistent with the role of liquidation within the Czech legal framework, where the liquidation, as understood by the GBII, would be performed within the bankruptcy proceedings (see Chapter IV and Appendix on definitions of key terms).

#### ***-Realization of assets***

*An effective liquidation system will give the liquidator comprehensive powers to realize the assets of the estate in the manner that appears to be most advantageous in light of the specific circumstances.*

The liquidator decides on all matters falling within the powers of the statutory body and thus has sufficient powers to perform his duties. However, he is unlikely to exercise them as, for the reasons mentioned above, the realization of assets would be done by a bankruptcy trustee. The liquidator would take over only at the very end after all assets were realized and wind up the remaining empty shell legally.

#### ***-Distribution to creditors, depositor pay-off and termination of the liquidation***

*Soon after the commencement of liquidation, the liquidator should invite creditors to file their claims against the bank. The liquidator will have to check both the amount and the validity of each claim. The priority of different classes of claimants should be set out in the law.*

The liquidator is obliged to announce the commencement of liquidation to all known creditors. Without undue delay he should publish at least twice, at least two weeks apart, a call for all creditors to register their claims. The registration period shall not be shorter than three months (Article 73 of the Commercial Code).

In the case of the bankruptcy proceeding it is a part of the adjudication of bankruptcy that all creditors should register their claims within the period not shorter than thirty days and not longer than three months. The ABC also specifies that during the bankruptcy procedure, secured creditors are entitled to receive 70% of the proceeds from the sale of the pledged assets immediately after the assets' sale. At the end of the bankruptcy procedure the proceeds are distributed as follows:

1. cash expenses and remuneration of the trustee;
2. the costs connected with maintenance and administration of the estate;
3. the judicial fee for bankruptcy;
4. the claims to maintenance following from law;
5. claims against the estate that have not yet been satisfied and work claims – specified claims of employees;
6. the claims of the owners of mortgage bonds (if the bankrupt is a bank);
7. A 30% part of the remaining proceeds from realization of the estate is distributed among the first class creditors (these include other than above-specified claims of employees, certain payments to supplementary pension schemes, and claims to maintenance following from law). If some claims of the first class remain unsatisfied they enter the second class;
8. A 70% part of the remaining proceeds is distributed to the second class creditors (these include other than above-specified claims, unsatisfied parts of claims of secured creditors and unsatisfied parts of claims of first class creditors).

If the bank was placed into conservatorship and the CNB extended emergency liquidity, then CNB's claim is put on the top of the priority list.

## **2. Bankruptcy (as applicable to banks)**

### ***-Triggers of Bankruptcy***

The bankruptcy is triggered by a petition filed to a bankruptcy court when a bank is bankrupt. A bank is obliged to file a petition, if it finds itself bankrupt. This obligation applies to the statutory bodies of the bank and to the liquidator. "Should these persons not fulfill this obligation, they are liable to the creditors for damages arisen to them there through unless they prove that the damages were caused neither by their intention nor by their negligence; if more persons are concerned, they are liable for the damages jointly and severally" (ABC, Article 3, Section 2)<sup>30</sup>.

Moreover, any two creditors are entitled to file a bankruptcy petition (ABC, Article 4, Section 1). The CNB is not entitled to file a bankruptcy petition from the position of the banking sector regulator but it may file a petition if it is one of the two creditors with unsatisfied claims on the bank in question.

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<sup>30</sup> If the petition was rejected by the court, the obligation is understood not to be fulfilled and the statutory body or liquidator may file an application for composition; "however, if the composition was not approved of or confirmed, they shall file the application for adjudication of bankruptcy within 15 days" (ABC, Article 3, Section 4).

In the case of debtor's petition the court declares bankruptcy within 10 working days from the day of delivery of a complete bankruptcy petition, if the petition testifies that the debtor has gone bankrupt. No appeal is admissible against the court's decree on adjudication of bankruptcy (ABC, Article 12a, Section 1).

In the case of creditor's petition the court declares bankruptcy without undue delay if the bankruptcy petition testifies that the debtor has gone bankrupt. Only the debtor may appeal against the decree on adjudication of bankruptcy unless the debtor acceded himself to the proceedings.

***-Assumption of control by a bankruptcy trustee***

The effects of the court's adjudication of bankruptcy arise upon publication of the decree on the official bulletin board of the court; the debtor becomes a bankrupt with the following immediate effects (ABC, Article 14, Section 1):

1. the entitlement to dispose of the property belonging to the estate is passed to the trustee. The bankrupt's legal acts concerning this property are ineffective vis-à-vis the bankruptcy creditors. The person who concluded an agreement with the bankrupt may withdraw there from unless they knew of adjudication of bankruptcy at the moment of conclusion of the agreement;
2. the bankrupt may reject the receipt of a donation or inheritance only upon a consent of the trustee;
3. proceedings on claims that concern property belonging to the estate or that are supposed to be satisfied from this property whose participant the is bankrupt are interrupted except for criminal proceedings (in which, however, compensation of damages must not be decided upon); except for proceedings regarding the claims that must be filed in bankruptcy, the proceedings may be continued upon application of the trustee or other participants of the proceedings and the trustee shall become participant of these proceedings instead of the bankrupt;
4. proceedings on claims that regard property belonging to the estate or that are supposed to be satisfied from this property may be commenced only upon application of the trustee or against him;
5. enforcement of a decision affecting the property belonging to the estate shall not be admissible to realize and no right to a separate satisfaction shall be possible to acquire regarding this property;
6. it comes to extinction of rights to a separate satisfaction regarding the property belonging to the estate and acquired by the creditors within the last two months before the application to adjudicate bankruptcy was filed or after it was filed; however, if

things, rights or claims were also sold within this period, the acquired proceeds shall fall into the estate;

7. immature claims of the bankrupt and his obligations that are supposed to be satisfied from the estate are considered mature in the bankruptcy proceedings;
8. it comes to extinction of the bankrupt's mandates, powers of attorney including "procurations" and so far not accepted offers to conclude an agreement if they concern the property belonging to the estate; however, powers of attorney granted by the creditor for the purpose of bankruptcy proceedings shall extinct on the day when the adjudication of bankruptcy becomes final and conclusive;
9. compensation against property belonging to the estate is not admissible;
10. it comes to extinction of encumbrances over property belonging to the estate that arose upon strikingly disadvantageous conditions during the last two months before the application to adjudicate bankruptcy was filed or after it was filed;
11. effect of a merger agreement or a transfer of assets to the bankrupt's associate that did not become effective before adjudication of bankruptcy requires an approval of the bankruptcy creditors.

The name of the trustee is a necessary part of the court's decree of bankruptcy adjudication. The trustee has to be chosen from a list of trustees maintained by the court. The list of trustees may include only (i) a flawless person fully capable of legal acts, having appropriate professional skills (skills are not specified) and agreeing to the registration., or (ii) a general commercial partnership that execute the activity of trustee through its associates with regard to whom it proves to comply with conditions of registration with the list<sup>31</sup>. Only a person impartial in the case may be appointed as trustee by the court. A person registered with the list may refuse its appointment as trustee only for important reasons. The court may exceptionally appoint as the trustee also a person not registered with the list if it complies with the conditions for registration with the list and agrees to the appointment.

Article 2, Section 3 requires the trustee to pursue the goal of achieving a proportional satisfaction of the creditors from the property belonging to the bankruptcy estate upon conditions stipulated by the Act on Bankruptcy and Composition<sup>32</sup>.

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<sup>31</sup> The general commercial partnership appointed as the trustee must inform the court without undue delay about who of its associates will execute the position of trustee on its behalf.

<sup>32</sup> The terms of reference to the trustee are provided in Article 8, Sections 2-8:

1. The trustee has to proceed with a professional care.
2. The trustee is liable for damages arisen from a violation of the obligations imposed upon him by the court or stipulated by law.
3. If a general commercial partnership has been appointed as trustee, its associates are liable for damages caused in connection with execution of the position of trustee jointly and severally.
4. The trustee must conclude an agreement on insurance of its liability for damages that could arise in connection with execution of the position of trustee.

### *-Elements of bankruptcy*

- *Appointment, replacement and discharge of the trustee* is fully in the hands of the bankruptcy judge, who may or often may not consider proposals submitted by creditors of the bankrupt bank. The CNB has no role in appointment, replacement and discharge of the trustee. As opposed to liquidators, the CNB has no right to nominate a candidate and thus has no tool to ensure adequate skills and capacity of the trustee.
- *Protection of assets, containment of liabilities and pursuit of claims.* When the bankruptcy is declared, only the trustee may dispose with bank assets and liabilities. The trustee has full powers of the statutory body, which he can employ to maximize to value of the estate. For some actions the trustee needs approval of the court and/or the body representing creditors (see Article 14 of the ABC noted above).
- There is little discretion of a trustee regarding the *extent to which the bank is to be restructured or liquidated.* The Czech bankruptcy framework does not contain specific provisions for restructuring, thus bankruptcy is tantamount to a liquidation of assets. Partial exceptions are possible if trustee reaches some agreement with creditors. In any case it is highly unlikely that trustee would succeed where bankers failed themselves.
- *Preparing an inventory of assets and liabilities and the timeframe.* The law specifies a timeframe neither for the “due diligence” nor for any other major element of bankruptcy. There are no time limits imposed on the decision-making of the bankruptcy court and the trustee during the proceeding. According to a World Bank<sup>33</sup> study the duration of Czech bankruptcy proceeding – if all possible delays that might take place during the proceeding are accounted for – is longer than 9 years, which makes Czech bankruptcies lengthiest and least efficient in Europe.

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5. The trustee is entitled to a remuneration and coverage of cash expenses. The trustee’s claims are satisfied from the estate, and, if thus not fully satisfied, from the deposit for costs of bankruptcy paid by the applicant.
  6. Should the trustee not fulfill his obligations properly, the court may impose on him a disciplinary fine of up to 100 000 Czech crowns.
  7. The creditors may adopt a proposal that the court deprive the trustee of his position and appoint a new one. The court may reject such proposal only if it has essential doubts regarding the change in the person of trustee.
  8. For important reasons, the court may deprive the trustee of his position upon request of any of the participants or of the trustee or even without any request. Should the court deprive the trustee of his position, it must appoint a new one. The deprivation of the position of trustee shall not result in extinction of the trustee’s liability described above.
  9. Even after the end of execution of his position, the trustee must keep confidentiality on facts identified by special provisions to be secret that he had learnt in the course of execution of his position; he may be deprived of this confidentiality by the person in whose interest he has to keep it or by the court.

<sup>33</sup> World Bank (2003). *Closing a Business*. [www.worldbank.org](http://www.worldbank.org)

- *Temporarily operating the bank's business.* The trustee is authorized to continue the company's operations, to the minimum extent necessary to maintain the residual value of the company<sup>34</sup>.
- *Confidentiality.* The trustee must keep confidentiality on facts identified by special provisions to be secret that he had learnt in the course of execution of his position; he may be deprived of this confidentiality by the person in whose interest he has to keep it or by the court. This applies even after the end of execution of his position.
- *Cost of bankruptcy.* The trustee shall be entitled to a remuneration and coverage of cash expenses. The trustee's claims shall be satisfied from the estate, and, if thus not fully satisfied, from the deposit for costs of bankruptcy paid by the applicant. Agreements concluded with the participants of proceedings on other remuneration or coverage are null and void. Accounting of remuneration and coverage of expenses shall be made by the trustee in the final report, and, if no such report is made, upon cancellation of bankruptcy; before this moment, the court may approve advance payments. According to circumstances of the case, the court may adequately increase or reduce the remuneration calculated according to a particular regulation. Upon consent of the court and based on a decision of the creditors' committee, the creditors may (even repeatedly) provide the trustee with an advance payment to cover his expenses; in granting the advance payment, the creditors may specify the purpose for that the advance payment is supposed to be spent and the terms of accounting. Activities that the trustee is obliged to do may be entrusted by the trustee to third persons on credit of the estate only upon consent of the creditors' committee.
- *Termination of bankruptcy.* The court cancels bankruptcy proceeding by a decree (a) if it finds out that the prerequisites of bankruptcy are not given, (b) after satisfaction of the distribution schedule, (c) upon request of the bankrupt if all bankruptcy creditors expressed their consent on a document with officially verified signatures and upon a consent of the trustee, (d) if it finds out that the estate's property does not suffice to cover the costs of bankruptcy (things, rights, claims and other property values excluded from the estate shall not be taken into consideration), (f) if it came to a merger of the bankrupt or to transfer of the bankrupt's assets to its associate. If the reason for the termination of bankruptcy is either "b" (satisfaction of the distribution schedule) or "d" (insufficient property to cover the bankruptcy costs), then the termination of bankruptcy implies the dissolution of the company as a legal entity – according to Article 68, Section 3f, of the Commercial Code.

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<sup>34</sup> Nevertheless, due to the nature of the banking business, it is practically impossible to continue providing banking services (normally banking license is revoked, deposits are frozen, lack of resources for lending, etc.

### *Composition*

The Czech insolvency legislation does not include a reorganization chapter. Instead, it defines composition proceeding as an alternative to bankruptcy proceeding. Composition, being in general more flexible and more debtor-friendly than bankruptcy, represents a faster and less costly solution to the situation of insolvency. However, it is much less frequent, as it requires an agreement on the redesign of property rights over the debtor's assets to be reached between the debtor and the creditors.

Only the debtor can file for composition and he can do so only before the court has already adjudicated a bankruptcy proceeding. A composition can consist of issuance of new shares or other securities issued by the debtor or even in kind, e.g., in surrendering of a part of values not immediately connected with the debtor's entrepreneurial activity. Within the composition application, creditors who have no priority must be offered payment of at least 30% of their claims within two years from submission of the application (Article 50 (1d), ABC). Necessary conditions for the court to confirm the composition include that priority claims have been paid or their payment has been assured and that creditors of other claims have been satisfied to the same extent unless they agreed to a more advantageous satisfaction of certain creditor (Article 60 (1), ABC).

Insolvent debtors in the Czech Republic opt for composition very rarely. This is true for corporations in general as well as for banks. The reason for virtually no use of composition is the fact that only a few debtors are able to fulfil strict legal requirements while proposing a solution acceptable for creditors. This did not change even after the amendment to the Act made in May 2000 which reduced the minimum that has to be offered to creditors without priority from 45% to 30%. Worth to add, the returns from bankruptcy proceedings are often very low, much below 30%, which negatively affects the debtors' tendency to opt for composition.

The bankruptcy proceedings have been used as an almost exclusive solution to insolvency situations in the Czech economy. For example, according to the Ministry of Justice figures less than 0.5 % of corporate insolvencies were resolved by composition (20 out of 4087 cases). Only one case of bank insolvency was resolved by the composition, under highly specific conditions. In 1996 Podnikatelska banka became overindebted and was placed under conservatorship<sup>35</sup>. New investor increased the bank's capital and achieved composition agreement.

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<sup>35</sup> Podnikatelska banka had miniscule market share, but could be placed under conservatorship only because the Act on Banks applicable in 1996 did not require systemic importance as a precondition for conservatorship.

## **B. Weaknesses and potential improvements**

### ***-Liquidation***

It is questionable whether the process of bank “likvidace” needs to be so complex. The CNB, as a bank regulator and supervisor, is generally in a better position to judge whether the bank is insolvent than a liquidator. Moreover, the license revocation is most likely to trigger bank run, which in turn results, given the typical maturity structure of bank’s assets and liabilities, in either illiquidity or insolvency or both. The whole procedure could be simplified by giving CNB the right to file the petition for bankruptcy from the position of the regulator and to nominate the trustee to ensure his capacity and competence. The trustee would then take care of the whole process of liquidation, from the beginning until the erasure of the bank from the Commercial Registry.

### ***-Bankruptcy***

There is general problem with the low participation of the CNB in the bankruptcy proceeding. The CNB should have the right of nomination or of consent to the bank bankruptcy trustee appointed by the court, in order to ensure sufficient capacity and expertise of the trustee.

The draft of the new bankruptcy law stipulates that the banks with valid license may not enter the bankruptcy proceedings. This should provide sufficient protection until other recommendations on bank insolvencies, including more structured triggers, are considered and embedded in future banking laws.

## **VII. SYSTEMIC BANKING CRISES**

### **A. Description of current situation**

#### **1. Introductory note**

*A systemic banking crisis is typically characterized by some or all of the following features, in a combination that is serious enough to have an adverse effect on the real economy: (a) a large part of the banking system faces financial problems; (b) there is a system-wide drop in bank asset quality; (c) there is a likelihood of widespread loss of credit discipline; and (d) the operation of the payment system is in danger.*

Especially features (a), (b), and (c) constituted persistent problems of the Czech banking sector during the 1990s. Specific cases and financial institutions concerned are summarized in Appendix II.

#### **2. Institutional arrangements for systemic crisis management**

The institutional framework for the resolution of a systemic banking crisis in the Czech Republic comprises of the following state bodies:

- the Government (to make key political decisions);
- the Ministry of Finance (MoF);
- the Czech National Bank (CNB); and,
- temporarily, the Czech Consolidation Agency (Česká konsolidační agentura – CKA).

The Czech legislation does not envisage the establishment of special institutions or committees for the case of a systemic financial crisis. Therefore, there would either have to be emergency legislation or the crisis would have to be dealt with under the existing legislation. The authorities and responsibilities of the individual institutions are specified in their respective laws.

### **3. Key elements of the Institutional/legal framework for dealing with a systemic banking crisis**

*In general terms, the institutional framework for dealing with a systemic banking crisis may require the following three layers, reflecting three types of functions required in these circumstances.*

1. The Government and the Ministry of Finance (in some aspects also the Czech National Bank) have the legal authority to take key policy and budgetary decisions in relation to the containment of the crisis.
2. The *agency responsible for the implementation of the restructuring strategy*, once the situation has been stabilized, is the Czech National Bank within its regulatory/supervisory role. The monitoring of restructuring takes the form of either supervising the managers of the banks in fulfilling their restructuring pledges or supervising the conservator's restructuring effort when the bank is in conservatorship.
3. The third layer consists of *other institutions that may be needed to assist in the collection of problem loans* and the cleaning of the banking system from non-performing assets. This role has been played by the Consolidation Agency. This agency was established in early 1990s as the Consolidation Bank (Konsolidacni banka - KoB). In 2001, it was transformed to a non-bank institution (Ceska Konsolidacni Agentura - CKA). Act No. 239/2001 Coll. on Ceska konsolidacni agentura

While the Czech National Bank is generally assessed as a transparent institution, the Consolidation Agency is often perceived as having a somehow deficient regime in terms of corporate governance. On the one hand, the Agency is subordinated to the Ministry of Finance, which is responsible for the Agency's actions. On the other hand, many important decisions of the Agency are made by its supervisory board whose members are appointed by the Chamber of Deputies of Parliament of the Czech Republic. Thus there seems to be a mismatch between powers, responsibilities, and accountabilities of the Agency.

### ***-Crisis containment - the Government and the Ministry of Finance***

*At the outset of a systemic banking crisis, the government needs to step in, to contain the crisis, restore confidence, and develop a comprehensive restructuring strategy. Two key principles at this stage of government involvement are (a) the need for coordination and exchange of information among all government agencies (government, banking authorities); and (b) clear legal authority to take the measures that may be required.*

According to the Budgeting Rules valid until 2001, the Ministry of Finance had the authority to issue state guarantees for credits (Article 36 of the Act No. 576/1990 Coll. on Budgeting Rules). The currently valid Budgeting Rules (Act No. 218/2000 Coll.) require that the issue of such guarantees is assumed in a special law (Article 73). Therefore, in case of a banking crisis it would be necessary that the Parliament enact a special law in case special rules for the use of public funds are needed.

The current Budgeting Rules provide the government with some limited flexibility that could be used in case fiscal funds need to be used in the event of a systemic crisis. Considering the relative size of the public funds that historically have been needed to deal with this type of events both in the CR as well as in many other countries, it would be most unlikely that the existing limited flexibility would be sufficient to confront a systemic crisis.

It follows from the above characterization that most likely neither the Ministry of Finance nor the government can, by their decision, dispose of sufficient resources in order to tame a systemic crisis. In effect, rules of fiscal discipline mean that the measures containing the crisis would have to be taken in the Parliament. As is most usual in most countries in cases of banking crisis, there would have to be a political consensus that the government intervention is desirable and the Parliament would have to adopt an emergency legislation clearly defining the legislative authority to implement the necessary measures.

### ***-Crisis containment – the role of CNB***

*During the early stages of a systemic banking crisis, the central bank may be called upon to provide emergency liquidity support to troubled banks.*

The primary objective of the CNB shall be to maintain price stability. However, in accordance with its primary objective it is also responsible for administering payments and clearing between banks and contributing to the safety, soundness and efficiency of payment systems. Moreover, the CNB supervises the activities of banks, foreign bank branches and any consolidated groups and has a power issue binding legal provisions. Further, the CNB has to take a position on any proposals presented to the Government that concern the fields of its competence and act as an advisory capacity in matters of banking. Finally, the CNB may exceptionally provide short-term credit for a period of up to three months. When providing

such credit, the Czech National Bank shall require adequate collateral (Act on CNB, Article 29).

All the above duties and competencies make CNB a key party in dealing with a systemic banking crisis. CNB should be the first state body to notice the threat of the banking crisis because it has the best information about the banking sector and promptly apply its instruments to prevent the spread of the problems. The CNB is also in the best position to inform and coordinate information exchange with the other state bodies, especially the MoF and the Securities Commission, while dealing with the crisis.

#### ***-Asset management – the role of the Ceska Konsolidacni Agentura***

*An important and complex area of systemic bank restructuring relates to the way the authorities deal with impaired (bad or doubtful) assets of the banking system. In a systemic crisis, bank administrators and/or liquidators are often overwhelmed by the volume of impaired assets that must be realized.*

The traditional solution of the 1990s was to transfer the overwhelming volume of impaired assets to the CKA for gradual sale and workout, thus separating the bad asset workout from the banking sector privatization and restructuring. The CKA arose in 2001 from the Consolidation Bank (Konsolidační banka) which was the entity dealing with banks' bad loans from the early 1990s. The CKA is intended to be a temporary workout vehicle and should be closed down in the near future (the Act on CKA presumes cessation by the end of the 2011 at the latest).

In any case, under the existing legal framework, the activities of the CKA, or any future equivalent, must not be in violation of the rules governing public assistance, especially with the Act No. 215/2004 Coll. on State Aid and Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty. The EU law, in principle, prohibits any provision of public support, which distorts or might distort competition to the extent that might impede the free trade between EU member states. The European Commission may allow an exception from this prohibition.

## APPENDICES

### I. Definitions of key terms

Terminology of this Report is based on the terminology of the GBII Report.

**Insolvency proceedings:** all types of official action involving the removal of management and/or imposition of limits on, or suspension of, the rights of shareholders and the assumption of direct control by a banking authority or other officially-appointed person over a bank that has crossed one of the thresholds (illiquidity threshold, balance-sheet threshold, regulatory threshold) for the commencement of insolvency proceedings. The optimal means of dealing with an insolvent bank's problems may entail the preservation of the viable parts of its business through their transfer to other banks and the liquidation of the residual entity.

**Official administration:** those forms of insolvency proceedings, in which an official authority (either a court-appointed administrator, a banking authority or an administrator appointed by a banking authority) assumes direct managerial control of an insolvent bank, with a view to protecting its assets, assessing its true financial condition, and then either conducting all the necessary restructuring operations, or placing the bank in liquidation.

**Bank restructuring:** a set of actions designed to substantially modify the operations and financial structure of a banking institution. The purpose of restructuring is to ensure the continuation of the bank's business, in whole or in part, as an economic unit ("going concern") on a financially sound basis. Restructuring should be contrasted with an outright revocation of a bank's license, as well as the liquidation of an insolvent bank following the cessation of its economic activities.

**Liquidation:** a form of insolvency proceedings leading to the legal dissolution of an insolvent bank. The objective is to ensure an optimal (i.e., value maximizing) realization of assets and the orderly distribution of proceeds to creditors, in accordance with the applicable legal rules. Although bundles of assets may be sold as part of a business, with a view to maximizing their total economic value, liquidation results in the disappearance of the bank as a separate legal entity.

Note: legal term of liquidation in the Czech framework does not relate to insolvent companies but to companies in general (usually upon the owners' decision to close the business), i.e. legally it includes both forced and voluntary liquidations.

**Conservatorship:** (conservator led, CNB supervised) a type of official administration (official administrator). Can be also viewed as a mean of bank restructuring. For a closer definition see Chapter III.

**Systemic banking crisis:** a crisis typically characterized by some or all of the following features, in a combination that is serious enough to have an adverse effect on the real

economy: (a) a large part of the banking system faces severe financial problems; (b) there is a system-wide drop in bank asset quality; (c) there is a likelihood of widespread loss of credit discipline; and (d) the operation of the payment system is in danger.

## II. Resolution of bank insolvencies during the 1990s

Bank	Date of resolution*	Specific** causes	Type of resolution/measures
<b>Kreditni a prumyslova banka</b>	Sep 1993 Aug 1995	Connected party lending	Conservatorship, bankruptcy (Oct 1995)
<b>Banka Bohemia</b>	Mar 1994 Jul 1994	Unauthorized and illegal issuance of so called "Prime Bank Guaranties"	Conservatorship, liquidation; depositors were fully compensated by MoF and CNB
<b>AB Banka</b>	Dec 1995	Connected party and other fraudulent lending	Liquidation), bankruptcy (Mar 1999); depositors were fully compensated by MoF and CNB
<b>Ceska Banka</b>	Dec 1995	Connected party lending	Liquidation, bankruptcy (Jun 1996); DIF paid regular and additional compensation according to the law
<b>Ekoagrobanka</b>	Jan 1996 May 1997	Poor credit risk management, losses on securities	Conservatorship (with liquidity support from public funds), liquidation of the remaining legal entity
<b>Prvni slezka banka</b>	May 1996	Poor credit risk management	Liquidation, bankruptcy (Nov 1997); DIF and additional compensation of depositors by CNB
<b>COOP</b>	Apr 1996 May 1998	Poor credit risk management	Conservatorship (liquidity support, all depositors were allowed to withdraw their deposits), liquidation
<b>Podnikatelska banka (now J&amp;T banka)</b>	Jun 1996	Poor credit risk management	Conservatorship (DIF and additional compensation of depositors by CNB), composition
<b>Kreditni Banka Plzen</b>	Aug 1996	Connected party lending	Liquidation, bankruptcy (Dec 1998); DIF and additional compensation of depositors by main shareholder Ceska pojistovna (state controlled insurance company)
<b>Agrobanka</b>	Sept 1996 Sep 1998	Connected party operations	Conservatorship (liquidity support and public funds' support for sale of core business), liquidation of the remaining legal entity
<b>Velkomoravska banka</b>	Jul 1996 Jul 1998	Poor credit risk management	Conservatorship, bankruptcy (Jul 1998); DIF and additional

<b>Realitbanka</b>	Jul 1996 Apr 1997	Connected party lending	compensation of depositors by CNB Conservatorship, bankruptcy (Mar 1997); DIF and additional compensation of depositors by CNB
<b>Moravia banka</b>	Nov 1999	Connected party lending	Stabilisation Programme; bankruptcy (Dec 1999), liquidation; DIF paid regular and additional compensation according to the law
<b>Bankovni dum Skala</b>	Mar 1997	Poor credit risk management	Liquidity support and support with public funds for sale of core business, the remaining legal entity was liquidated
<b>Evrobanka</b>	Jun 1997	Poor credit risk management	Liquidity support and public funds supported sale of core business, the remaining legal entity was liquidated
<b>Foresbank</b>	Mar 1999	Poor credit risk management	Stabilisation Programme; public funds' supported sale of core business; the remaining legal entity continues as a non-bank company
<b>Pragobanka</b>	Oct 1998	Poor credit risk management	Stabilisation Programme; bankruptcy (Nov 1998); DIF paid regular and additional compensation according to the law
<b>Universal banka</b>	Feb 1999	Connected party lending	Stabilisation Programme; bankruptcy (Feb 1999); DIF paid regular and additional compensation according to the law
<b>Banka Hana</b>	Dec. 2000	Poor credit risk management	Stabilisation Programme; business purchased by another bank, the remaining legal entity continues as a non-bank company
<b>Plzenska Banka</b>	Jul 2003	Fail in fulfilment of its duties as depository bank for investment company and following litigation	Bankruptcy (Apr 2003), liquidation
<b>Union Banka</b>	May 2003	Connected party lending	Liquidation, bankruptcy (May 2003)

\*) Introduction of conservatorship (where relevant), date of revocation of banking license

\*\*) Poor loan quality can be considered as a general problem in practically all cases. It was essentially reflected in poor credit management processes (lack of experience, inadequate responses to transformation of economy from planned to market driven, weaknesses in legal and judicial framework limiting creditors' rights, etc.) and (often) misuse of banks' funding for improper financing of shareholders' activities.