Standard Summary Project Fiche

1. Basic Information
1.1. Désirée Number

CZ00-03-01

1.2. Title

Strengthening Credit Risk Management Methodology and Application in the Banking Sector

1.3. Sector

Economic Criteria

1.4. Location

Czech National Bank

2. Objectives

2.1. Wider Objective

- Existence of a functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the Union

2.2. Immediate Objectives

The Immediate Objective of this Project is to:

- Reduce the proportion of loans made by banks in the Czech Republic which are not repaid in full by the borrower.

2.3. Accession Partnership / NPAA Priority

The Accession Partnership (December 1999) highlights the following priorities:

- **Short-term**: complete the restructuring of the banking sector (the privatisation of the two remaining major banks; resolve bad loan problem).

The National Programme (May 1999) highlights the following priorities in the field of financial services/banking:

- **Short-term**: finalization of the process of privatization of the last big commercial bank (Komercní banka); improvement of credit risk management in the banking sector by the implementation of the CNB provision on Capital Adequacy of Banks taking into account a market risk;

- **Medium-term**: continuation of process of stabilization of the Czech banking sector; preparation for integration of the Czech Banking sector into the internal market.

3. Description

3.1. Background / Justification

Since 1989, the banking sector structure has undergone very dynamic development. A large number of the newly established banks were unable to cope with the strong competition and risky conditions associated with the economic transformation and were forced to terminate their operations. The tightening of the conditions for setting up new banks has restricted the entry of new entities into the sector, particularly since 1996. Recently, the structure of the banking sector has been affected by mergers of individual banks, leading to a concentration of the sector. Between 1989 and the end of 1998, a total of 63 banking licences were granted and 18 revoked. Of these, 14 were revoked because of the relevant bank’s poor financial situation and failure to meet the prudential rules, 3 as a result of mergers, and 1 because the bank failed to start its operations within the allotted legal period.
As of 31 December 1998, there were 45 banks and foreign bank branches operating in the banking sector, a fall of five from the same time a year earlier.

A total of 52,760 people were working in the banking sector as of 31 December 1998, i.e. 7.6% less than a year earlier. The number of banking units dropped by 10% during 1998 to 2,220. The cuts in workforce and banking units were generated primarily by an effort to rationalise operations and increase efficiency.

The decline in the number of banks and the ever-increasing level of total managed assets has brought about an increase in the average bank size. As of 31 December 1994, the average bank was managing total assets of CZK 27.7 billion, whereas by the end of 1998 the figure had almost doubled to CZK 55.5 billion.

Large banks still have the dominant share in all the main products. However, the high pace of growth in foreign banks and foreign bank branches seen since about 1995 has led to a constant decline in this ratio. At the end of 1998, the share of the large banks in total credits granted was down by 3.2 points against a year earlier, while that of foreign banks and foreign bank branches was up by 2.2 points. The deposit structure saw a similar trend, with the large banks’ share falling by 4 points and that of foreign banks and foreign bank branches increasing by 3 points. The expansion in building savings also resulted in a strengthening of the share of specialised banks, which rose by 1.4 points for total deposits to 7.1% and by 1.3 points for total credits to 2.9%. The group of small banks currently has the lowest shares for all monitored products.

Credit portfolio quality remains one of the main problems of the Czech banking sector. The large proportion of classified loans in bank portfolios has its origin largely in the period of transformation and privatization of the economy, but the current recession has also begun to make its mark. The curtailment of lending activities is a logical consequence of tighter internal credit-granting procedures. The overall volume of classified loans as of 31 December 1998 was CZK 270 billion or 0.7% more than a year earlier.

The share of classified credits in overall credits granted rose by 0.2 points during 1998 to 27.1%. This large volume of classified credits ensues primarily from banks’ inability to recover their claims by seizing collateral, particularly in the case of real estate.

This extremely high proportion of bad loans leads to financial difficulties in the banks, reduces their ability and willingness to lend, particularly to SMEs, leading to a chronic shortage of investment capital for businesses and a negative impact on economic development. The problem of bad loans and their negative impact on Czech banking sector and economy was emphasized by the European Commission in the latest Regular Report on Czech Republic.

3.2. Linked Activities

A training programme for Czech banks has been financed from the 1997 budget focussing mainly on the obligations arising from the acquis and the issues raised by the launch of the Euro. One small component on credit risk methodology proved extremely popular, leading to the idea that the time might be ripe for a larger-scale project focussing on this key issue.

Under Phare 1998 – Institutional Building Program has been implemented Twinning Project in the field of banking supervision in the co-operation of Federal Ministry of Finance of Germany, Bank of Greece and the Czech National Bank since November 1999.

The Project pursues three objectives:

- Contribute to the adaptation of the Czech banking supervision to the legal standards of the European Union as well as internationally accepted good practices and standards;
• Support the further development of an advanced and effective banking supervision in the Czech Republic and implementation of good practices and standards;
• Support the involvement of the supervisory authority into international co-operation.

In the scope of the second objective, among others, the advanced Methodology for assessment of Risk management in banks to be applied by the Banking Supervision of the Czech National Bank will be developed.

3.3. Results / Outputs

• Identification of gaps in the credit risk management methodology applied by the individual Czech commercial banks, their removal by defining of an appropriate credit risk management methodologies for the banks and their implementation in the banks incl. training of responsible staff.
• Training materials elaborated relating to: Credit Sanctioning or Approval; Credit Administration, Measurement, Monitoring; Control over Credit Risk; Supervision of Credit Risk; Credit Risk Policy – Accurate Pricing, Superior Asset Selection, Portfolio Liquidity, Portfolio Diversification; Expert Systems – Client Rating or Grading, Financial Analysis Systems, Credit Scoring;
• Approximately 3,500 credit risk officers trained in new methodology;
• Approximately 90 credit risk methodology specialists trained in new methodology, including via fellowships/study visits to EU Member States;
• Approximately 50 top bank managers trained in new credit risk management methodology and systems, via workshop seminars;
• Approximately 50 Czech trainers trained, under the selection of the Banking Association, including via fellowships/study visits to EU Member States;
• Increased skills level within the commercial banking sector, in order better to assess and manage credit risk, thereby contributing to the reduction in the numbers of bad loans;

3.4. Activities / Inputs

Services will be provided via a single Technical Assistance/Training contract, providing for:
• Analysis of the credit risk management methodology applied by the individual Czech commercial banks, focusing on identification of possible gaps/short-comings (approximately 30% of Project time);
• Proposals and recommendations concerning the most appropriate credit risk management methodology for individual banks to close identified gaps/short-comings (approximately 30% of Project time);
• Development and delivery of training programmes/consultative services, including the training-of-trainers (approximately 40% of Project time).

The T.A. experts will work in close co-operation with the Czech National Bank and the Association of Banks, although sizeable training needs analysis, delivery and expert consultations will actually be carried-out on-site in support of the commercial banking sector (in particular Credit Risk Management and In-house Training Departments).

Data protection and confidentiality rules shall be fully respected during the implementation of the Project.
Only commercial banks which are members of the Association of Banks, may benefit in the Project. The only prerequisite for a bank to become a member of the Association of Banks is to be licensed as a banking business under the Act on Banks.

In view of commercial role of the main project beneficiaries, co-financing will be provided to support the Project’s goals, primarily provided from the commercial banks themselves (this will represent a ‘head fee’ per trainee and will be used to cover:

- Costs associated with logistic expenses (estimated at approx. 0.6 MEUR, covering simultaneous interpretation, translation of training documents, room-hire etc.), plus
- Costs associated with study visits to selected commercial banks in the EU (estimated at approx. 0.1 MEUR, covering travel and subsistence etc.).

In analysing credit risk management methodology, the T.A. experts should pay particular attention to the basic distinction between two types of credit risk management methodology:

- Credit risk management methodology used for retail banking;
- Credit risk management methodology used for wholesale banking.

As regards the type/process of risk management, three key areas are distinguished for demarcation and the further development of methods, systems and training materials:

- Process of assessing credit risk,
- Process of monitoring credit risk and
- Process of controlling credit risk.

Key modules for training will minimally cover the following fields:

- Credit Sanctioning or Approval; Credit Administration, Measurement, Monitoring; Control over Credit Risk; Supervision of Credit Risk; Credit Risk Policy – Accurate Pricing, Superior Asset Selection, Portfolio Liquidity, Portfolio Diversification; Expert Systems – Client Rating or Grading, Financial Analysis Systems, Credit Scoring.

Training will be provided at three levels of specialists in banks involved in applying new methodology (including data protection rules):

- Top Management (approximately 50 people): training will primarily be delivered in the form of workshops, aimed at introducing key techniques and principles, with the aim to ensure support of the management to utilisation of revised methodology;

- Credit Risk Methodology Specialists from Credit Risk Management Departments (approximately 90 people, including the Czech National Bank): training will primarily take the form of practical seminars, including microeconomics, qualitative and quantitative methods, wide use of case-work and the practical application of the revised methods to relevant cases. Training will also take the form of study visits/consultations in the EU-Member States with commercial banks applying similar methodology.

- Credit Officers (approximately 3,500 people): training will primarily take the form of practical, local seminars, with the extensive use of case-work and the application of the revised methods to practical cases, with the aim to ensure day-to-day application of the revised methodology.

In addition, in order to ensure the continuation of systematic training in this field, trainers will be selected (with a view to ensuring a regional coverage) by the Association of Banks for further training-of-trainers, allowing such trainers to continue the project’s roll-out. It is assumed that approximately 50 trainers will be selected for additional training (these will be selected from the Credit Risk Methodology Specialists).
4. Institutional Framework

The Project shall be implemented under the authority of the Association of Banks and its Committee for Joint-Projects and will be managed by the Steering Committee consisting of members the Committee for Joint-Projects, representatives of European Commission, Czech National Bank (CNB) Phare Unit and the Banking Institute.

The Programme Officer at the CNB shall be responsible for the preparation, technical control and implementation of the project.

Each beneficiary commercial bank shall nominate a team of experts headed by the Director of Credit Risk Management Department to cooperate with the experts of the contractor.

5. Detailed Budget (in MEUR)

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<th>Project Components</th>
<th>Investment Support</th>
<th>Institution Building</th>
<th>Total Phare (I + IB)</th>
<th>National Co-financing</th>
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6. Implementation Arrangements

6.1. Implementing Agency

Responsibility for the administration related to the procedural aspects of procurement, contracting and accountancy will rest upon the CFCU. Responsibility for the administration related to the preparation, technical control and implementation will rest with the Czech National Bank. The Contact Person is Mr. Jan Málek, Phare Senior Programme Officer, Czech National Bank, Na Prikope 28, 115 03 Prague 1.

6.2. Non-standard Aspects

DIS Manual procedures will be followed.

6.3. Contracts

One contract for T.A. services to a value of 2 MEUR is expected to be concluded.

7. Implementation Schedule

Start of Tendering       3Q/00
Start of Project Activity 1Q/01
Project Completion      2Q/02

8. Equal Opportunity

Equal opportunity principles and practices in ensuring equitable gender participation in the Project will be guaranteed.

9. Conditionality and sequencing

Any bank which is member of the Banking Association may nominate top management and credit risk methodology specialists to participate in the training, subject only to co-financing. However, banks which wish to benefit from the training for credit officers must nominate at least one person to participate in the training of trainers course for every 100 credit officers who are trained (eg 10 credit officers trained, at least one trainer trained; 110 credit officers, at least two trainers). The participating bank must also undertake to ensure that trainers will
provide refresher courses & training for new staff at least once per year for five years after the initial training.

Co-financing will be provided (from the commercial banks and the State) for:

- Costs associated with logistic expenses (estimated at approx. 0.6 MEUR, covering simultaneous interpretation, translation of training documents, room-hire etc.), plus
- Costs associated with study visits to selected commercial banks in the EU (estimated at approx. 0.1 MEUR, covering travel and subsistence etc.).

Annexes to Project Fiche

1. Logical Framework Matrix
2. Detailed Implementation Chart
3. Cumulative Contracting and Disbursement Schedule for the Project (in MEUR)
## Strengthening Credit Risk Management Methodology and Application in the Banking Sector

**Project Number:** CZ 00-03-01  
**Date of Drafting:** 04/2000  
**Contracting Period Expires:** 31/10/2002  
**Disbursement Period Expires:** 31/10/2003  
**Total Budget:** 2.7 MEUR  
**Phare Contribution:** 2.0 MEUR

### Wider Objective

**Existence of a functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the Union**

- Acknowledgement by the European Commission
- EC Regular Report
- National & CNB statistics
- International reports/publications
- Reports from commercial banks
- Other Copenhagen criteria fulfilled

### Immediate Objectives

**Reduce the proportion of loans made by banks in the Czech Republic which are not repaid in full by the borrower.**

- Proportion of classified loans among those made by banks established in the Czech Republic in the five years following the completion of the project does not exceed 15% of total lending in those years (by value).
- Overall proportion of classified loans held by banks established in the Czech Republic does not exceed 24% within five years of project completion.
- Volume of lending by banks established in the Czech Republic is greater in real terms in each of the five years following the completion of the project than in 2000

#### Indicators of Achievement

- Trainees trained (as indicated)
- Trainers trained and Association of Banks develops systems to reutilise
- Acceptance of the proposals and recommendations and their implementation, analytic and comparative studies, trained personnel
- Monthly progress reports from the Czech National Bank Senior Programme Officer;
- Reports from consultants;
- Reports issued by

#### Sources of Information

- CNB statistics
- Analytic and comparative studies
- Reports from participating banks
- Annual Reports of participating banks
- A&E reports from implementing units
- Recommendations implemented by top management bodies of the individual banks;
- World economic growth remains positive for each of the five years following the completion of the project

### Outputs

- Identification of gaps in the credit risk management methodology applied by the individual Czech commercial banks, their removal by defining of an appropriate credit risk management methodologies for the banks and their implementation in the banks incl. training of responsible staff.

#### Indicators of Achievement

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#### Sources of Information

- Monthly progress reports from the Czech National Bank Senior Programme Officer;
- Reports from consultants;
- Reports issued by

#### Assumptions and Risks

- Other key measures to strengthen the economy are also implemented
- World economic growth remains positive for each of the five years following the completion of the project
- Training materials elaborated relating to: Credit Sanctioning or Approval; Credit Administration, Measurement, Monitoring; Control over Credit Risk; Supervision of Credit Risk; Credit Risk Policy – Accurate Pricing, Superior Asset Selection, Portfolio Liquidity, Portfolio Diversification; Expert Systems – Client Rating or Grading, Financial Analysis Systems, Credit Scoring;
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- Increased skills level within the commercial banking sector, in order better to assess and manage credit risk, thereby contributing to the reduction in the numbers of bad loans;

<table>
<thead>
<tr>
<th>Inputs</th>
<th>commercial banks</th>
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| T.A. services provided by specialist firm(s) in the field of credit risk management, with services provided via training seminars, consultations, study visits/consultations with commercial banks from EU Member States applying similar methodology | - All major banks agree to participate, provide necessary cofinancing & nominate trainers to be trained
- Lessons learned from training programme for Czech banks financed from the 1997 Phare budget
- Phare 1998 banking supervision Twinning Project support the further development of an advanced and effective banking supervision in the Czech Republic and implementation of good practices and standards, including advanced Methodology for assessment of Risk management in banks to be applied by the Banking Supervision of the Czech National Bank |
## Detailed Implementation Chart for the Project

### Annex 2

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**Credit Risk Management Methodology, Training**

- **Tender Launch (September 2000)**
  - X

- **Contract Signature**
  - X

- **Project activities commence**
  - X

**Analysis of the credit risk management methodology**

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- Proposals/recommendations concerning revised methods, systems
  - X X

- **Development of training programmes**
  - X X X X

- **Delivery of training**
  - X X X X X X X X

- **Consultative, on-the-job training/systems development/management**
  - X X X X X X X X

- **Staff training/fellowships**
  - X X X X X X
Cumulative Contracting and Disbursement Schedule for the Project (in M€)  

Annex 3

Cumulative Quarterly Contracting Schedule (M €)

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Cumulative Quarterly Disbursement Schedule (M€)

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