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Czech Capital Markets and Pension Funds

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1. Rebirth of Czech Capital Markets

Development of Czech capital markets in transition period is a very impressive story full of expectations and full of bitterness. The greater expectations were in the beginning of a reform process the deeper disillusion followed later. Just in the beginning we can say that initial expectations connected with the capital markets were maybe too high, much higher than the reality could ever fill. Let us start this chapter with a description of initial conditions for the Czech capital markets.

Primarily there was never any deeper tradition of stronger role of capital markets in the former Czech Republic.¹ We must say that Czech markets cannot be evaluated through the prism of US capital markets where the role of them is extreme. Czech tradition was much closer to the German model of financial markets, the model in which not capital markets but banks really do play a crucial role in the economy.² There is no country on European continent (only Britain is maybe some exception but *sensu stricto* it is not on the continent) comparable with USA.

Where these ideas of strong capital markets role came from? Many of Czech reform ideas (including some reform mistakes) in this field were caused by the charming influence of American capital markets (and by American economic textbooks). It does not mean that the American economic model is wrong, of course, only its adequacy for reforms in central Europe is our Hamlet's question.

Just in the beginning of a reform process it was generally accepted that it is necessary to rebuild all standard market institutions. (See Scenario of Economic Reform accepted in 1990.) No doubts that among these institutions were seen from the very beginning also financial institutions like commercial banks, stock market or mutual funds. But designers of Czech economic reform were solving one more important question: How to build capitalism

¹ From the formal point of view Czech stock market is very old. It started under the Austrian monarchy, than it was active in the period of the first republic (Czechoslovakia 1918 - 1938). But it was all of its history on the second level of importance while banks occupied first level. After the world war II due to the influence of huge nationalization and the ideas of planned economy Czech stock market disappeared totally. The rebirth of Czech capital market started after 50 years in early 90s.

² The same was in Austrian tradition.

(standard market economy) without adequate capital sources? Then the idea of voucher privatisation came, distribution of national property on the basis of vouchers.³ This non-standard method of privatisation⁴ distributed shares of the companies by a special technical scheme to the citizens older than 18 years who made a registration for it. If there were distributed these shares in voucher scheme in the first step than it was a natural question, where will be these shares traded after voucher privatisation. It had a natural answer: In the stock market of course. We can conclude, that a concrete idea of crucial capital markets role was an integral part of voucher privatisation.

We have to pinpoint that this idea was also in accordance with liberal visions of after-reform Czech future. Czech reformers (Klaus, Ježek, Dlouhý, Tříška and Dyba) were economists from academia. They were heavy influenced by liberal economic ideas mainly by F. A. von Hayek and Chicago school. Due to the development of economic theory in 80s in which liberal theoreticians re-conquered a new reputation and were awarded by many Nobel-prizes, Czech economists were convinced, that there are the proper ideological examples to be followed. In discussions Western Europe with its high social standards was seen as something like “half-socialism,” in comparison to the USA and other liberal ideals. This difference between Europe and USA was seen mainly in the role of the state and in the role of capital markets, in the question of economic freedom and the effectiveness of allocation of sources.

Another question is, if Czech companies were really adequate to be traded just in the stock market. What are the standard requirements for the firm to enter the stock market? It must be big enough measured or by nominal value of the issue of shares or by expected market capitalisation. It must have some positive history and some explicit vision of potential growth (production, market share) or profit making (distribution of profit, dividend policy). The majority owners of the firm have to be quite transparent or better say crystal clear. If firm enters a stock market it must have also some positive expectation of future demand for its shares. And last but not the least: there must be also some financial sources in the economy or outside, which could such demand create.

Only a minimal number of Czech firms in 1992 really met these requirements: Maybe one or two dozens of Czech firms were at least big enough to be traded on the stock market, but hundreds of others were not. Only few firms had some positive history and relatively positive forecast of their future position based on the famous product (like Pilsner breweries) or natural monopoly position (like power plants, energy distribution or telecommunications). The majority of firms were in quite doubtful position. They lost Eastern European markets (many times with worthless receivables in their balance sheets) and they could not compete with western firms. They needed a deep restructuring and a huge investment into new technologies. They were in a very complicated situation before privatisation; an uncertainty of the behaviour of new owners reduced dramatically an interest of potential partners for co-operation.

The effect of voucher privatisation was following. Voucher scheme created administratively Czech stock market.⁵ Voucher shares created a huge equity market in the Czech Republic. In 1994 (after second and final wave of voucher privatisation) about 1760 items (incl. several dozens of bond issues) were traded on the Prague Stock Exchange. This number was

³ The concrete shape of Czech voucher privatization was elaborated by Tomáš Ježek and Dušan Tříška but it was accepted as a part of reform program because of political and professional authority which had in this time Václav Klaus.

⁴ Voucher privatization was several times repeated in transition countries from that time. It is a question if now can be voucher privatization labeled as a non-standard method. On the other hand for the Czech reform terminology „non standard method“ is a real synonym of voucher method.

⁵ Polish and Hungarian capital markets were not created administratively. Their fate was quite different.

comparable with London, where a bit more than 2200 items were traded in that time. But by this number all of similarities of these two markets finished. Prague Stock Exchange had a minimal liquidity and the prices there were not representing any real value of the firms (value derived from fundamental analysis). Many of the shares were traded quite exceptionally; price of many others could not be explained by any economic factors.

The reason why Prague stock market failed in aspiration to fill an allocation function is very simple. Czech firms were too small to be traded on public markets.⁶ A decision to enter public markets was not the decision of firms themselves, but it was a decision of the state authority. That was why firms were not anyhow interested in being there. Firms had not any real benefit from this situation. From the firm point of view their presence on the public markets was connected only with additional costs and other problems. Listing of a company must have some economic reason but these reasons absented in the Czech Republic totally. Firms come to the stock market to receive additional financial sources or for the firm itself or for its shareholders. Nothing like that in Czechia ever happened. From the beginning of the new history of Czech financial markets no initial public offering (IPO) was done.⁷

Czech firms for following ten years had bitter proofs that their presence on the stock market is only a traditional example of the suppressive power of the state: Somebody politically decided that they will be traded there. They had not any advantage from it, but they had many obligations e. g. to report periodically their results, to organise general meetings and behave in accordance with many other complicated formal rules and they were penalised for mistakes in these activities. No surprise that many firms really wanted to exit the market: to be delisted.

If Czech equity market is often heavy criticised that it does not function well, we must not overlook that in the same time spontaneously started other important segment of Czech capital market – the bond market. The bond market had the same or similar formal rules as the share market had and the same or similar market channels to trade bonds. On the other hand Czech bond market had not any exceptional problems for the whole period from 1991 till now. Bonds were seen as a serious alternative to credits.⁸ All issuers of bonds voluntarily behave in a strong accordance not only with the market rules but also with the conditions of issue. The reason why is quite simple – firms have a significant benefit from issuing of bonds and a significant penalty for breaking the rules. That was why bonds finally pushed out the shares from the market, at the end of the century represented about 80 % of transactions on the Prague Stock Exchange (see table 1).

Many discussions were focused to analyse why Czech financial markets failed. After the initial happiness based on fact that the markets started to work first disappointments were formulated. Politicians labelled them as baby decease quite adequate for such period of transformation. From 1995 critiques rose dramatically.⁹ The core of the problem was seen in an insufficient protection of minority shareholders. The problem was trivial: On the stock market are traded mainly the shares of smaller shareholders (individual and institutional), while for majority stakes of firms other selling procedures are used. If smaller shareholders

⁶ Some of „traded“ issues of shares were only about 1 million USD, about 800 less than 3 million USD (100 million CZK), 1200 less than 6 million USD (200 million CZK). Source: Commercial Register

⁷ The only exception was IPO of software firm T 602.

⁸ The only problem of bond market was in a strong competition with credits. Banks offered to many potential issuers such credit conditions, that bonds could not compete with credits, because issuing expenditures were in case of bonds more expensive than credits. Banks did not like to share their best clients (potential issuers of bonds) with other investors.

⁹ Also foreigners who lost some money on the Czech market started with massive negative advertisement. They wanted to show that they did not lose their money (or money of their clients) because of their naiveté but because some objective reasons.

are not protected, they lose interest to be active on the market. The better protection will be the more shares will be traded and people finally will accept investment to stock as a real alternative to their bank deposits.

I do not apologise in any respect the disorder of the Czech commercial law. It is true that Czech rules of the game were inadequate, unclear and the legal enforcement of investor's rights was minimal. But it is only one side of the reform coin. On the reverse side of it we can dispute not only the quality of the rules of the game but also the qualities of the players. Voucher privatisation created 6,2 million shareholders in the Czech republic. It means that about 60 % of all Czechs (and 80 % of adult population) started with some individual portfolio. Such number is enormous, in 1992 this percentage in Great Britain was about 11 %.¹⁰ All these voucher shareholders had not any experience with an investment on capital markets. That was why about two thirds of voucher investors invested through investment privatisation funds (IPF). Inexperienced voucher shareholders created other problem: How to introduce standard market with a non-standard behaviour of players? Czech voucher shareholders did not feel that voucher investment is about their money, they understood voucher scheme as some kind of lottery games. Of course, sum of potential individual revenues from voucher scheme was not extremely high, in average about two or three monthly salaries.¹¹ That was why the prevailing majority of Czech voucher shareholders was very passive and wanted sooner or later to sell their shares to obtain some cash.

What was the situation in privatised companies? No doubts that the target of privatisation is to create a concrete owner, owner whose target is to maximise company's performance. But the specific situation of Czech enterprises was different. If standard motivation of management or owner is similar (to maximise benefit from entrepreneurial activities); Czech managers and majority owners were in another circumstances. There was not possible to reach positive economic results in a short run. It was not possible to create profit but it was possible to create some interesting cash flow. Many of them did not follow a positive strategy for the privatised enterprise but a positive strategy for their individual account. That was why many enterprises did not create real profits but they transferred financial sources to the accounts of key owners or managers. Enterprises were tunnelled because it was the best way how to maximise effect.¹² We can conclude more generally that privatisation created conditions in which the redistribution of wealth was much more profitable than to add some new value.

We have to realise that total absence of any control and absence of standard market institutions enabled the tunnelling of enterprises. Czech state resigned for any deeper control of its enterprises in 1990. From this time the property rights of the state were executed only formally without any positively formulated policy. Joint-stock companies designed for voucher privatisation were transferred from so called founding ministries to the National Property Fund (NPF). Neither special institutions nor qualified staff for this purpose was created in NPF. The respective department of NPF was in 1993 responsible for more than 1500 companies. This department consisted from 15 officers only, so one officer was in average responsible for 100 companies! This was an effect of idea of quick privatisation. No

¹⁰ British individual holdings of shares were the biggest in Europe in that time. It was a result of relatively successful privatization.

¹¹ Some of shareholders reached a really nice revenue from vouchers, records were in hundreds thousands crowns (more than three thousand dollars) but it was only an exception. Majority of voucher shareholders obtained about twenty or thirty thousand CZK, many of them lost everything. Because the people did not invest from their personal pursue (they paid only registration fee about 30 USD), they did not feel it as a real damage.

¹² The expressive word tunnelling has origin in Czechia.

special institution for the real control of enterprises was formed, because this problem had to be solved by the rapid privatisation.

Compared to other privatisation programs Czech privatisation was really extremely quick but not so quick to solve the problem of the execution of property rights. Enterprises were in an “ownership vacuum” for a long time for the enterprises from the first wave of voucher privatisation it meant that it was from 1991 to 1993. For the enterprises from second wave was this period for one year longer. Also just after voucher privatisation majority shareholders were not created. The ownership was dissociated into several groups and many individual holders. Effective coalitions of owners were formed for about two years. We can conclude that Czech enterprises were out of the effective control by owner for about four years and some of them even much longer. This situation led to the hostile behaviour of company management to their enterprises; the volume of it depended only on their moral qualities. And we can continue: Hostile majority owners who continued in this direction replaced many of managers after privatisation.

Later on Dušan Tříška and Robert Holman¹³ in some discussion in Czech Economic Society mentioned (1997), that nobody could seriously propose such a rich capital market for Czechoslovakia, capital market with a stock exchange and a second organiser of market RMS, capital market with hundreds of stocks. They argued, that these institutions of so called Czech “capital market” were planned by reformers mainly as a simple technical redistribution mechanism for the time just after the voucher privatisation.¹⁴ Sounds nice but I am not convinced that such idea of temporal capital market was really intention of reform designers. I believe that this argument was used in defence against frequent critiques of the poor Czech capital market order. I believe that in early stadium of reform when voucher scheme was prepared, Klaus, Tříška, Ježek, Rudlovčák, Dlouhý etc. were really convinced that vouchers would be followed by standard capital market.

Also Václav Klaus wrote in a newspaper article in spring 1992 (April 21) that the role of minority shareholders is very important, but nobody expects, that minority shareholders could replace the management. He expected that small shareholders will be the holders of important stakes of the issues and it will depend on them if companies could find any additional financial sources at the stock market. It witnesses about his conviction of the role of the stock market in the after-reform period. It is interesting that in the same article is Klaus against the stricter protection of smaller shareholders. He argues that many formal rules in that area follow a good idea but he was very sceptic if these rules (state intervention) could be successful. The only role of the state Klaus saw in regulation of information duties of enterprises. (Klaus 1993, p. 30)

Critiques of capital market regulation reached their first peak in the half of 90s. The only one from reform prophets changed his evaluations – Tomáš Ježek.¹⁵ From his new post of the

¹³ Dušan Tříška, former deputy minister of finance and for a long time the close academic collaborator of Václav Klaus, was one of the key authors of voucher scheme. Robert Holman became the advisor of Václav Klaus in early 90s.

¹⁴ This argument was several times used also by Vladimír Rudlovčák also long time close collaborator of Václav Klaus and deputy minister of finance responsible for regulation of capital market. His statement led finally to his replacement on the post of deputy minister.

¹⁵ Ježek was a colleague and personal friend of Václav Klaus from academia. He was heavily influenced by liberalism of F. A. von Hayek and quite openly propagated it in 80s. After velvet revolution he became an adviser of Václav Klaus and after election in 1990 minister of Czech government responsible for administration of national property and its privatization. He did not follow Klaus to his political party ODS and he was a founding member of ODA, smaller liberal party. He finished to be minister in 1992,

chairman of the Stock Exchange Chamber he argued that reform is not completed because of a lack of regulation on the capital market. Penitent Ježek initiated amendments of commercial code and many other acts to strengthen rules and regulation. These amendments were after emotive discussions accepted in 1996 just before elections.¹⁶ The amendment was prepared out of legislative organs of the government it was a legislative initiative of a group of members of parliament.¹⁷ This showed once more an important thing: the government of V. Klaus was not convinced enough that such change is necessary.

Nevertheless these changes in law were generally oriented in the right direction, typically Czech problem was in the quality of them and in their minimal accordance with functioning of other institutions. Ježek solved the problem like the popular Czech hero Brave soldier Švejk (from the book of J. Hašek) who in the old Austrian army loyally served to his old emperor but the result of such activity was quite different. Ježek implemented many new legal institutions to improve Czech capital markets but he many times practically reached an opposite effect.

First problem was an effect of stricter regulation under conditions of an insufficient enforcement of law. Stricter rules function properly in conditions of perfect enforcement of law or in the conditions in which such rules have a high natural authority. In Czech conditions subjects could be divided into two groups. In one group are subjects, which always behave in accordance with the norms in the second group are subjects, which did not. Why some subjects do it and the other did not? In the first group are firms, which are motivated to be in accordance with law because of their market reputation or their other obligations (some foreign firms, state holdings, financial institutions, entrepreneurs with moral barriers or strategy etc.). Stricter rules in such conditions relatively worsened situation of “good” group and helps to the “bad” group. (If somebody makes additional hurdles for my competitor I am relatively better off.) If amendments from 1996 were not followed by the changes in enforcement of law, they had many times such paradoxical effect.

What was inside these amendments? The most important were mandatory offers to minority shareholders in case of the take-over of the company. When some shareholder or group of them (through concerted conduct) reached more than 50% (66,6 % and 75 %) of the shares they were obliged to make a public offer of a contract for the purchase of this company's other publicly tradable shares.¹⁸ The price of the shares was derived from public markets prices (weighted average from the last six-month period). This rule is a standard on many markets but in the Czech Republic it opened a space for many non-ethical behaviours. Many of the majority shareholders stopped their purchase of the shares just on the barrier of 49,9 % of the company because they did not want to cover any costs of mandatory offer.¹⁹ They many times argued that they had to invest into the company, not into its shareholders which bought their shares for the price many times lower than now. Other shareholders made hidden concerted conduct: they really controlled more than 50 % of the company but they did not

but till 1994 he was a chairmen of the executive committee of NPF. After his replacement in NPF he was heard more and more critically against the insufficient capital market regulation.

¹⁶ Act No. 142/1996 Coll. For more detail evaluation see Havel (1996). Complete text of the commercial code after this amendment in English was issued by Trade links (1997).

¹⁷ Author of the core of the amendment was professor Dědič from Prague School of Economics. Because of the proposal was not discussed enough and many other changes were included, Dědič sometimes bitterly joked that everybody who walked around his proposal something amended without any deeper discussion.

¹⁸ Commercial code, section 183b

¹⁹ Less than 49,99 shares are necessary for an effective control of the company when part of the shares is dissociated among small shareholders.

report it and for minority shareholders it was very complicated or ever impossible to find some proofs for the court decision.

Second type of mandatory offer was very similar in case of de-listing of a company from public markets. Shareholders, who made a decision on the general meeting of shareholders about de-listing, were obliged to make a public offer of a contract to buy company's other publicly tradable shares from shareholders, who were against the decision or absented or in this voting or on the general meeting of shareholders.²⁰ This created a second problem. It was generally accepted that on Czech public markets are too many companies, many of them had to be de-listed. But this institute of mandatory offer conserved the previous situation. After an exit from public markets was connected with some other additional costs, majority of firms prolonged their being there.

The changes (1996) of the law were huge; it is not possible to describe all of them. More interesting is that a majority of Czech lawyers criticised amendments. Firstly they criticised many concrete mistakes.²¹ Secondly they argued more generally, such a change erased many of the institutes which maybe were not optimal but after five years of functioning there were some experiences with them. New institutes, which replaced them, were once more on the beginning. The entrepreneur could not be sure what real intent of the law is, he had to wait years for new court decisions, which explain real meaning of many articles. This legal uncertainty really damaged the entrepreneurial activities.

The real development of trading on public markets was following. Just after voucher privatisation trading with shares started. Because of low volume of the market and many extremely small issues of shares, prices on these markets corresponded minimally with real performance of the firms (issuers). Due to the "pocket volume" of the Czech market prices could be easily manipulated. The reason why prices really were manipulated was trivial: The biggest shareholders in this time were among the privatisation investment funds, the higher was the evaluation of their assets the higher were their fees.²² There were other reasons for manipulation with the prices like evaluation of pledges for banks and other financial institutions or evaluation of nonmonetary contributions to the registered capital of firms. Extreme volatility and levels of prices came in the time when the majority group of owners was formed in competition. But after a majority shareholder reached the target (intended percentage of shares) prices lowered dramatically.²³ In the second half of nineties practically in all voucher enterprises majority owners were established, from this time disappeared any interest to trade shares of many firms. These firms were on the market (or on Prague Stock Exchange or on a second organised market – RM system) formally. It was possible to trade with them, but they were traded quite rarely. When they were not traded one can found in the column of the price the price of the last settled trade, many times several weeks or months old.

Czech blue chips like Komerční banka, ČEZ or Český Telecom (at maximum half dozen firms) were rare exceptions on the markets. They were traded frequently in higher volumes. Paradoxically among the most traded shares were companies with a dominant state share. In 2000 state firms (state was majority shareholder) Český Telecom, Komerční banka, ČEZ, České radiokomunikace, Česká spořitelna and Unipetrol represented about 95 % of the whole

²⁰ Commercial code, section 186a

²¹ Later on in 1997 was accepted a new "technical" amendment which corrected mistakes from 1996.

²² Assets of the funds are evaluated by the prices from public markets. The fee for the administration of the fund was derived from the evaluation of the assets, in case of voucher privatization it was usually the maximum of legal sum 2 % p. a. from total assets of the fund.

²³ For example the price per share of Most coal company exceeded 1000 CZK in the time, when Appian Group bought the last shares for reaching majority position (1997). Then the price fell: In 2001 made Appian public offer to remaining shareholders with the price 140 CZK per share.

trade on the share market of PSE!²⁴ It witnesses about the situation that some of the most important companies were excluded from the privatisation for a long time. The other reasons why portfolio investors were interested was in their conviction that the state has an implicit (not legal) guarantee in the companies with the significant state share and that they are too big to fail.

Just after amendments of law from 1996 improvements of the Czech capital markets were maybe very limited but not totally worthless. They did not improve the real situation too much but they signalled that after a long period of negligence the state and politicians started to change the situation. So the problem was not solved yet but it was described enough, it was a part of the government program and it was a real will to make other positive changes. Such signal was very useful for investors, because they are planning their investments in long run schemes. And changes in law have an importance not only for law itself, because law is also seen as a minimum of moral.

Real situation improved much slower through 90s because of gradual changes mainly of informal institutions. These improvements could be seen in market culture. Many unfair contracts, which were very frequent in the beginning of the market, were rarer in second half of 90s. There were more reasons why situation changed. First was in natural development of an ownership structure. There was not any new wave of voucher privatisation. The majority of dramatic take-overs were over. More and more enterprises were in the hands of final investors, investors who preferred long run effects more than effects in short run. Some foreign investors came and also Czech investors developed slowly.²⁵ So the period of spontaneous stealing was over and new values like reliability, fairness, positive history etc. were discovered as a condition of further development. Secondly there were some limited improvements in formal institutions like a court system and hostile managers and owners were much more afraid of civil and penal procedures. From 1996 also some improvements in regulation started.

Let us also remark that stealing is not a process, which could be continuously repeated. Unfair deal is mostly something like a one shot gun. People can do it only once or maybe once more, but after it their partners are educated enough, mainly when they lost a huge sum of money. But the same could be repeated in several varieties. That is why the same or similar people started in 1990/91 by founding of new banks, in 1992 privatisation investment funds and broker companies, later on health insurance companies, pension funds and they finished by founding of banking coops (kampelickas).²⁶ All these companies gave them chance to be present not only in these financial institutions but also in many firms, which were by them or directly held or connected with deep financial links. "Bad boys" from these financial institutions infected many other firms in their portfolios. On the other hand the process described above is not infinite and after several years the space has to be occupied by firms which convinced their clients that they are better, they convinced their clients by a long positive history of trade relations. New unfair dealers are not excluded totally from the market but their field is smaller and smaller.

Supervision and regulation of Czech capital market started as a very slim organ. Originally it was a department of the Ministry of Finance. In the first half of 90s activities of the ministry were oriented mainly to the license practice. Ministry controlled if all the requirements of the law to obtain the license were filled, if not they asked for additional information or they

²⁴ ČEZ, Český Telecom and Unipetrol were in state hands also in 2003.

²⁵ Privatization buccaneers changed quickly into serious salesmen.

²⁶ Now many of them are among the traders with receivables mainly of bankrupted companies. Many times they are buying the bad assets they personally created and no doubts that they know them best.

rejected the application for a license (broker, fund, issue of bonds). There were not any special activities in the financial companies. It witnesses about two facts. First was an enormous number of subjects: thousands of listed companies and hundred of funds, brokers etc. It was impossible to organise control activities in all of them.²⁷ They could not be effectively inspected. The second is the naive liberal reform idea: According to it subjects of civil law had the chance to defend their interests by proper investment decisions and legal procedures. There was no space for any suppression from the side of state. The effect of such policy was very sat, too many subjects, too many frauds, too many disappointed investors.²⁸

Regulation body on Ministry of finance started in 1990 with staff less than 10 people. In 1996 it has about 50 employees. During 1997 when the new Securities Bureau within Ministry of finance was founded the staff rose up to 80 people, what was the number by which started newly founded SEC in March 1998. In 2002 Czech SEC had slightly less than 150 employees.²⁹ Also from these numbers is quite understandable that the role of regulation rose gradually.

From 1995 rose also the discussions about the shape of regulation. Some politicians spoke about the necessity of an independent body (Ježek, Pilip). The others like Kočárník, Klaus or Rudlovčák did not feel it enough. One side stressed that the independence is the first step to the efficient regulation, the other side pinpointed that real powers of regulatory organ are more important than pure independence. They argued that Czech courts are undoubtedly independent but not efficient. Other arguments were if it is clever do divide the regulation of financial market into more organs. Finally independent SEC was founded and it has been functioning since March 1998. Also new SEC was evaluated as an important signal to solve problem from the past, it was another clear message that there are new ways for regulation with new people and new organs.

From this time regulation of Czech financial markets is provided basically by three institutions. Capital markets subjects are regulated by SEC, insurance companies and pension funds are regulated by the Ministry of Finance and banks are regulated by the Czech National Bank.³⁰ The relations between regulators are complicated. For example for regulation of pension funds is responsible MoF but for their investment into the instruments of capital market is responsible SEC. That is why some discussions are now about the consolidation of the regulation into one institution, which is the model in some European countries. It is true that in the conditions of the small state like Czech Republic it is not possible and useful to divide financial markets strictly into commercial and investment banking. It is possible to abstractly speak about the “Chinese walls” but reality is about combining of the markets. The same situation is in Germany, the most important neighbour of Czechia.

Also the level of independence of SEC is disputable. Czech SEC is independent from the law and it has a complicated system of nomination into the presidium of SEC. Members are appointed by the president on the basis of the government proposal.³¹ This complicated procedure led many times to the negative effect, when months and months the places in presidium of SEC are free. Another problem is connected with financing of SEC. Independent

²⁷ Only several dozens inspections is possible to do at the end of 90s. (Regulation analysis 2002)

²⁸ This was in a strong contradiction of the liberalism, it was a real failure. To start the game without the rules and without the enforcement of them is really nonsense.

²⁹ The numbers are not fully comparable. SEC as an independent regulator has also some technical roles, which on the MoF were filled by other services departments.

³⁰ It is not the whole system. For example small banking (co-ops - *kampeličky*) are regulated by a special bureau.

³¹ In practice it is bit more complicated, because the proposal is submitted to the government by the minister of finance. A special approval of secret services is necessary for appointment.

SEC has a budget (part of the state budget), which has to be approved by the parliament. The proposal of the budget submits the minister of finance to the government, then to the parliament, so the SEC depends somehow on the MoF, on government, on the parliament and on the parliamentary budget committee, which has a crucial influence for the final shape of the budget. On the other hand there is no chance to finance SEC completely from independent sources, from the sources paid by the persons who are trading on the markets. One can object that the model of financing of SEC is similar to the financing of the courts, but judges are independent persons. Maybe the independence is really not the crucial problem.

SEC started its activity by re-licensing of the subjects of capital markets. The idea was to clean the market from the subjects, which do not meet the requirements of the law. All the subjects had to submit a new application for a license with all necessary documents. Nevertheless re-licensing was an administrative process only; it swept the market from many suspicious or small subjects. From that time also rose quite new critiques of SEC and generally of the regulation: the market is now over-regulated, and administrative requirements are so strict that it is impossible to work. In 2002 only three subjects submitted new application for a license for brokerage, it is much less than before. On the other hand Czech market is full of subjects, investment banking is in global crisis and after joining EU it will be possible to use here license from all EU countries (and also Czech licenses will be valid in all European countries).

New deep changes in the law came in 2000. They were motivated not only by the target to improve the market situation but mainly by harmonisation with EU norms. Harmonisation is the necessary condition to join EU, because subjects with the Czech license will have the possibility to function on the whole EU market. That is why EU is afraid of poor license policy and regulation in candidate countries. Changes in 2000 practically harmonised Czech law with EU. We have to mention that many of these changes were more formal than real. The law is too complicated to be respected in all its articles. Also an enforcement of rights of shareholders is still complicated. On the other hand from the formal point of view the target was reached. All the standard institutes were formally implemented into the Czech law, now it is necessary to reformulate (re-codify) the law to be better understandable. This is the government program for next years, changes will start by a new Civil code.³²

What were the most important changes in 2000? Firstly the majority shareholding was redefined. Now only 40 % of the shares trigger a mandatory offer (if it is not known that some shareholder has more). The other important rule is the right of market organiser (PSE or RM System) to exclude some shares if the securities are not traded enough. If all organisers exclude the security it loses status of the registered (former publicly traded) security. This is not followed by the necessity of mandatory offer to the majority shareholders and it is a real instrument how to clean the market from the subjects, which do not meet the requirements to be traded on the capital market (because of low volume of trading).

What will be the future of Czech capital markets? They could be the part of global markets and they will be sooner or later interconnected with other European markets. It is not important if Prague Stock Exchange (PSE) will function as a desk of Frankfurt or London Stock exchange now. Important fact is that in the near future Prague will be important local place for Czech issuers of bonds and maybe also for several dozens of share issuers. New chances open enter of some foreign companies on the Czech stock market. In 2002 replaced on PSE the issue of Česká spořitelna shares of its majority owner Austrian Erste bank (first foreign issue on PSE). This title is traded quite successfully now better than it was expected.

³² Recodification of the Czech civil and commercial law is one of the crucial parts of the government program after elections in 2002.

By the case of Erste bank Prague market shows, that it could be possible to collect money of Czech investors by the means of the national market.

After many problems in 90s Czech capital markets reached the structure and standards which are adequate (or closer) to their role in many smaller European countries. It is not a big surprise, but it is much less than expected in the beginning of the reform: Czech Republic is not the little USA. Some limited space for future development is identified.

Table 1. Prague Stock Exchange: Trade value broken down by shares + units and bonds

	Total value	Shares + Units value (mil. CZK)	Shares + Units %	Bonds value (mil. CZK)	Bonds %
1993	9,020.1	7,129.5	79.04	1,890.5	20.96
1994	62,026.2	42,593.9	68.67	19,432.3	31.33
1995	195,406.9	125,642.8	64.30	69,764.1	35.70
1996	393,199.6	249,935.2	63.56	143,264.3	36.44
1997	679,537.5	246,301.9	36.25	433,235.6	63.75
1998	860,191.6	172,594.0	27.06	687,597.6	79.94
1999	1,187,485.7	163,456.7	13.76	1,024,029.0	86.24
2000	1,222,832.8	264,145.3	21.60	958,687.6	78.40
2001	1,987,179.0	128,754.0	6.48	1,858,380.0	93.52
2002	1,793,100.0	197,400.0	11.0	1,595,700.0	89.0

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Number of issues on PSE

	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993
Total	153	186	245	290	402	412	1750	1764	1055	982
Shares + units	79	102	151	195	304	320	1670	1716	1028	971
Bonds	74	84	94	95	98	92	80	48	27	11

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2. Czech Pension Funds

2. 1. Basic information about the Czech pension system

Czech pension system is under a deep discussion now. The basic problem of Czech pensions is in the changes of the population structure in the Czech Republic. The life expectancy is now higher than before, and it will rise in future. The Czech birth rate is one of the lowest in

Europe; Czech women in average have only 1,13 children (2002).³³ The number of inhabitants in productive period of the life decreases, while number of pensioners increases. The expected data from the trends are not optimistic. If now the country has about 2 people in active age per pensioner in 2050 only one man will work for a pensioner (development with no policy changes). This is a real danger for the type of intergenerational solidarity, which developed in 20th century in Europe. This led to the necessity of deep changes of the pension system, population growth stimulation and a new immigration policy. Politicians have quite bitter news for their population. Changes in pensions in Germany or France led to the massive protests of trade unions, and the same could be expected in the Czech republic.

Basic and the most important pillar of the Czech pensions is a type of **defined benefit pay as you go system**. A European traditional pension model was implemented in Czechia in 20th century. This system was unified under socialism and the guarantor of it is the state, which through the state budget collects pension insurance payments and from these sources pays pensions. Under socialism the pensions were not so high but the people became pensioners relatively soon, men in 60 and women in 57 (and even sooner if they had children).³⁴ In 90s the system was slightly modified, the main change is that men are now retired in 62 and women in 61 (and sooner if they had children). The last amendment of the pension act was approved by the parliament in 2004. According to it, the pension age will be one year longer than before. The change of the pension age is implemented gradually and it will be finished after 2010. But nobody believes that this could be the final shape of the pension system. DB PAYG could survive for several years only, and that is why now the change of DB PAYG into the notional funding PAYG is discussed. From the longer perspectives the basic problem is in the PAYG itself and the solution is not in its modifications. Economists speak often about the necessity to change PAYG partly into a three pillars pension system.

How the Czech standard pension looks like? The replacement ratio (average pension divided by average salary before taxes multiplied by 100) is about 45 % (2000 – 2003). This ratio is about 57 per cent, when a net average salary is used (pensions are not taxed in the Czech Republic). This means that monthly pension is now about 8000 Czech crowns (CZK), which is equal of about 300 USD. This is much lower if compared to Western European countries. The picture is slightly better than exchange rate shows because of a higher purchasing power parity of CZK (price level is still much lower than in EU, about 50 % of EU average). The pension claim has a person, who paid to the pension insurance for minimally 25 years and is older than a requested age.

How the Czech PAYG is financed? The rate of insurance payments to the pension system is 26 % from the personal income. From this sum 6,5 % pays employee and 19,5 % pays employer. Technically the money for pension scheme from both sources employer transfers to the pension security account. This is a Czech traditional and quite reliable system. Payments for the social security and pensions reduce the incomes for taxes (for individuals and legal entities too).

A second pillar of the Czech pension system is in voluntary (supplementary) pension schemes of pension funds with the state sponsoring (contribution). The third pillar of obligatory pension savings, which is now frequent in the many other countries, is not yet in the Czech republic, and still it is not planned by the government.³⁵

³³ Czech Statistical Office. The number was slightly better in 2003 (1,19). But the predictions are not optimistic. Also the new immigration policy could only partly help with the pension problem.

³⁴ Every child lowers the pension age of woman.

³⁵ Obligatory pension savings in private pension funds are among the ideas of the Czech political opposition. Obligatory pension saving was accepted in Slovakia and it will start there from 2005.

2. 2. Czech pension funds – problems and perspectives

Private Czech pension funds were implemented by the State-contributory supplementary pension insurance act from 1994.³⁶ The target of this act was to stimulate savings and modify the Czech pension system by the first step. Every individual over 18 who has a permanent residence in the Czech Republic (not only citizen!) is entitled to sign a written contract for a supplementary pension insurance with a pension fund and can become a *planholder*. Only licensed pension funds can supply supplementary pension insurance in the Czech Republic. Every fund has several notional defined pension plans, which has to be approved by the regulation and supervisory organ (Ministry of Finance, Ministry of Labour and Social Affairs, Securities Commission). Minimal length of pension saving is five years and pensions could be paid to the people older than 60 only. Pension savings could be paid to the heirs of the participants, could be paid in the case of participant's disability and the contract is terminated, when a permanent residence of individual is not in the Czech Republic etc.

The government sponsors savings (contributions) in the pension funds (under many pension schemes). Government motivates the participants by the payments of contributions to these, which meet the requirements of the pension scheme. Participants (planholders) have also additional advantages from the tax view, because payments to the pension funds reduce incomes before taxes.

Structure of the state contribution payments

Planholder's saving (contribution in CZK)	State contribution (in CZK)
100 – 199	50 + 40 % of the amount over CZK 100
200 – 299	90 + 30 % of the amount over CZK 200
300 – 499	120 + 20 % of the amount over CZK 300
400 – 499	140 + 10 % of the amount over CZK 400
500 and more	150

Structure of the state stimulation contributions shows the first problem of the Czech pension funds. Pension savings in this scheme are relatively very low, and the lower payments are the more advantageous are too (the relatively bigger is the state contribution). This pension scheme attracts only small savings and it is relatively costly for the state and for administrators of the funds. The economic efficiency of the system is small. The system administers huge numbers of participants with extremely small contributions. The average personal pension contribution in the scheme is only about 10 USD monthly. Pension saving is announced as a very attractive, because of the state motivation payments to the individual pension accounts of the participants. It really is attractive after 2000 when the interest rates of comparable bank deposits decreased dramatically. But problem is that it attracts small sums of individual contributions only. If 100 % of all pensions from the supplementary insurance (pension fund) pillar could create only 3 % of the total sum of pensions in the country we can evaluate its share as negligible for solving the whole pension problem in the Czech Republic. But experiences collected here could be used for further development.

³⁶ Act no. 42/1994 Coll. The act was amended several times.

There are no doubts, that the new pension fund scheme attracted many people. From this point of view pension funds could be evaluated quite successfully. But the structure of the participants is much worse. Scheme attracts mainly older generation. About 17 % of all participants are pensioners who only use the scheme as a relatively safe and advantageous form of personal saving. Another 32 % of participants is older than 50. Relatively bigger group is 40-49, which has a share about 28 %. The youngest generation has only a minimal interest. Number of participants under 40 is only 23 %. The participants pay about 60 % of the individual contributions and their employers pay about 40 %. Only the possibility that employers pay contributions attracts younger generation.

Planholders in the state-contribution supplementary pension insurance scheme

Year	Number of participants
1994	317 331
1995	1 290 126
1996	1 564 250
1997	1 637 584
1998	1 720 000
1999	1 783 000
2000	2 534 106
2001	2 508 264
2003 3 rd Q	2 617 096

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Although the Czech pension funds started in a relatively bad time, when the confidence of the financial institutions was seriously damaged by the behaviour of some subjects in privatisation, their development was a bit more healthy in comparison to the other financial institutions. There were serious doubts about the effectiveness of the whole system and many economists worried. Economists were also afraid, if managers and owners misuse their posts like in investment funds, banks and many other enterprises. But surprisingly the system was more stabile than expected. On one hand the initial cost for the entering the industry were relatively high and this did not attract too many competitors.³⁷ Pension funds were a long-term business. Practically all funds were in losses for the first three years, and from 1998 profits are created.

Another reason why was in the fact, that pension funds started their activities bit later than other financial subjects did. So the supervision and regulation of these funds was bit better than in investment funds.³⁸ Also the investors (participants) were more conservative than in other cases. They oriented to the well-known institutions and mainly to the funds founded by big banks or insurance companies, because they expected a better controlling there. And

³⁷ Administration costs per one new participant were estimated in hundreds of CZK. Funds, which stimulated their dealers for hunting new planholders by higher bonuses, paid even more.

³⁸ Regulation and supervision of pension funds is shared by three institutions. Ministry of Labour and Social Affairs approves the pension plan. Investment into securities is supervised by SEC. Supervision of other affairs is made by the Ministry of Finance.

maybe they expected also an implicit guarantee of the state there, which also was not a bad calculation.

A mushrooming of pension funds started just after an implementation of the scheme. 44 pension funds were founded and approved by the Ministry of Finance. Many of pension funds could not survive because of small numbers of their participants. The process of mergers started and now only 11 pension funds are active in the Czech Republic. And the concentration process is not finished yet. We expect that in the near future less than 10 funds could survive. The fund must have more than 100 000 participants to survive economically in the Czech Republic, and more than 250 000 to be really effective. This is an experience under existing scheme. In statistics we can find some smaller effective funds, but we have a suspicion (or it is understood as a public secret) that these funds had hidden sponsoring from their founders not to show their bad effectiveness, which could be a serious disadvantage in market competition.

Investment of the Czech pension funds is extremely conservative.³⁹ In average 85 % of all investments are bonds or T-bills and about 8 % are term deposits in banks. Investment into shares is below 5 %. Other investments are quite rare, fund could e. g. invest to immovable assets (about 0,5 %). Foreign investment represents about 12 % of all assets. The most important investment instruments of the pension funds are bonds issued by the Czech government.

With about 80 billion CZK of total assets (3 billion USD in the beginning of 2004) and three quarters of all investments in government bonds, Czech pension funds are still not key players on the Czech capital markets even if their investment strategy is so conservative. They formed a stabile sector but with a quite exploited potential to growth. Czech Republic still does not follow other countries where pension funds now control the biggest stake of assets on financial markets. The only chances for a more dynamic development are in significant changes of the state policy in this area.

Could such policy changes also help to the existing pension funds? Of course they could, but they also could have an opposite effect. Examples of such negative policy are the e. g. in ideas of the founding of employees pension funds organised by companies or by their trade unions. The first problem of such ideas is the effectiveness of such entities, because Czech enterprises are too small to create big funds, which could only survive in the markets. The second problem is, that such funds will transfer part of planholders from the old stabilised funds to the newly established, which could be more dangerous.

Czech pension funds expect that sooner or later an obligatory pension saving will be implemented also in the Czech Republic. In such case these pension funds, which operate for several years in the country will have a significant advantage if compared with the funds, which are newly founded. The probability that the planholders from a supplementary scheme will continue their co-operation with the fund they knew from the past in a new obligatory scheme (if implemented) is relatively high. That is why a current pension fund activity could be also seen as an important investment for the future.

3. Conclusion

After many painful experiences Czech capital markets fill their function in the fields of the bond market and surprisingly also in collective investment, which was reborn after voucher

³⁹ The law restricts investment of pension funds only to the assets like government bonds or securities traded on the stock exchange.

privatisation. The role of the stock market is still unsatisfactory and only less than 10 shares are really traded on the PSE. Legal framework of Czech capital markets is harmonised with EU now, but the courts still did not work efficiently as well as some other formal and informal economic institutions. A deeper integration of Czech capital market with European markets is expected in a near future.

The role of Czech pension funds is still negligible in comparison to the general needs. Czech Republic still waits for deeper pension reforms. However funds have a negligible share on the pension system; Czech pension funds formed a relatively stable sector. The concentration process in the pension fund industry will be terminated soon. More than one quarter of all inhabitants participates in the Czech pension funds. Further development depends on the final shape of the Czech pension reforms.

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