The Capital Market in the Czech Republic: Development, Regulation, Supervision and Corporate Governance

Vladimír Tomšík

Bank Board Member, Czech National Bank

Sustainable Compliance Seminar GRC Oracle
Prague, 18th March 2008
Outline

• Integration of financial market supervision
• Capital market: History and current arrangement
• Capital market: Corporate governance
Financial market supervision

• No blueprint for supervision existed at beginning of 1990s ⇒ gradual and spontaneous development
• Supervision developed in response to liberalisation, privatisation and other transformation steps
• Four-tier sector-based supervision emerged over time:
  ♦ CNB (since 1990): banks
  ♦ Czech Securities Commission (since 1998): capital market
  ♦ Ministry of Finance: insurance + pension funds
  ♦ Office for Supervision of Credit Unions (since 1997): credit unions
1st phase of integration of supervision: 1st April 2006
**Why in the Czech National Bank?**

- Bank-based financial system in the Czech Republic (banking assets account for ¾ of total financial sector assets)
- Capacity and cost efficiency
- Know-how (accumulated in the field of banking supervision)
- Comparative advantage in the labour market (CNB offers more competitive and performance-related salaries)
- Financial stability issues (strengthened links between supervision on microeconomic level, role of lender of last resort and macroprudential analysis)
  ⇒ favourable conditions for dealing with possible crises
- Independence of the CNB
- CNB is respected by market players

Supervision integration
1st phase of integration of supervision

- Banking Regulation and Supervision Department in CNB had its remit enlarged (credit unions)
- Two new departments were created:
  - Capital Market Regulation and Supervision Department (whole capital market including pension funds without government contribution)
  - Insurance Companies Regulation and Supervision Department (insurance companies, reinsurance companies, insurance mediators and independent adjusters)
Experience from the 1st phase

- Easier communication between supervisors (enhanced importance of informal communication on all levels)
- Transfer of know-how by means of joint teams
- Convergence of procedures (licensing, on-site supervision, off-site supervision, analyses, reporting, etc.)
- Uniform approach to publishing (regular reports on activity of individual departments)

Although the 1st phase of integration was implemented successfully, questions about how to deepen the integration started emerging
2nd phase of integration of supervision

Sectoral model

Banking Regulation and Supervision Department

Capital Market Regulation and Supervision Department

Insurance Companies Regulation and Supervision Department

Functional model

Financial Market Supervision Department

Financial Market Regulation and Analyses Department

Licensing and Sanctions Procedures Department

1 January 2008

Supervision integration

V. Tomšík: Capital Market in the Czech Republic
Reasons for switch to functional model

- Unification of relevant support activities (data availability, information and systemic support)
- Unification of procedures and approaches to regulatory framework and update of legislation (application of identical principles)
- Unification of licensing and administrative procedures (including sanction procedures)
- Unification of supervisory and analytical procedures for producing internal and public documents
- Better allocation of experts in organisational units ⇒ better use of sectoral experience ⇒ smoother convergence of regulation and supervision

Under the “old” sectoral model, department managers were responsible for a “given sector” only; responsibility for the whole financial sector lay with the Bank Board.
Capital market
Czech capital market: Modern history

- 1989: political revolution
- 1992-94: two waves of coupon privatisation (more than 1,700 national enterprises were transformed into joint-stock companies, whose shares were publicly traded)
- 1993: Prague Stock Exchange re-opened and RM-System started

In the 1st half of the 1990s the capital market suffered from: 1) a lack of experience (both management and retail shareholders), 2) little public interest
Czech capital market: Modern history (cont.)

- 1997: exclusion of about 500 issues in March and about 400 issues by mid-year
- 1998: trading in SPAD started (blue chips)
- 1992-98: supervision of capital market by Ministry of Finance
- 1998: Czech Securities Commission established

Starting from 1997, efforts were directed at achieving higher capital market transparency and introducing the principles applied on exchanges in developed countries.
Czech capital market: Modern history (cont.)

- 2001: Prague Stock Exchange became member of FESE (Federation of European Securities Exchanges)
- 2004 (May 1): entry to EU ⇒ adjustment of laws (Act on Business Activities on Capital Market, Act on Collective Investment, Act on Bonds, amendments of several other laws)
- 2005 (May + September): adoption of squeeze-out principle
- 2006 (April 1): establishment of single financial market supervisory body (capital market supervision: CSC ⇒ CNB)

The capital market has transformed from a spontaneous by-product of coupon privatisation initially, to a more organised, more transparent and better regulated system today
The Prague Stock Exchange has clearly dominated the Czech capital market in recent years.
Capital market regulator: Four types of activities

- Supervision of prudential behaviour and conduct of business of capital market participants
- Supervision of listed securities issuers with regard to their disclosure duty
- Supervision of takeover bids, squeeze-outs and buy-outs
- Fight against illegal practices (insider trading, market manipulation); monitoring of markets
**Trade volumes of shares and units and bonds (in bn CZK)**

While the share trade volume has increased, the volume of bond trades has declined in recent years.

Source: PSE

*Capital market: statistics*

V.Tomšík: *Capital Market in the Czech Republic*
The capital market had been enjoying growth since 2004 until a recent drop.

Source: PSE

V. Tomšík: Capital Market in the Czech Republic
Capital market regulation and corporate governance

- No comprehensive discussion of corporate governance on Czech capital market occurred in past
- Capital market still suffers from legacy of 1990s – two kinds of companies traded on PSE:
  - Most companies entered PSE without really wanting to be there
    - stay there because it would be costly to leave
    - fulfil only the minimum requirements
  - Blue chips traded on SPAD – most of them comply with all required transparency standards
Two Codes of Corporate Governance (based on OECD Principles) were published: 2001 and 2004

Since 2002, former Czech Securities Commission (and since 2006 CNB) have recommended compliance with Code

However: compliance is voluntary and cannot be enforced (is in companies’ own interest)

So far only 15 companies (out of 82 which were checked) have declared compliance with Code

PSE accepts securities for trading without insisting on compliance with Code

Unfortunately, the principle of “comply or explain” has its limits on the Czech capital market
Current challenges for capital market regulation

- Basel II (into effect in July 2007)
- MiFID (delayed transposition into Czech law – possible implementation in 3Q08)
- Takeover bids and squeeze-outs (new legal framework will be ready within weeks)
- Creation of Central Securities Depository
- Future of pension funds (scope of their engagement in capital market)

Despite all the progress made, the PSE needs many years to become a source of capital for firms
Summary

• The Czech capital market has been through a long, painful and costly process of learning by doing
• A crucial segment of the capital market (SPAD – blue chips) complies with high standards of corporate governance
• The segment of unlisted issues still stands as a legacy of coupon privatisation
• A comprehensive legal framework consistent with integrated supervision of the financial sector has to be developed
Thank you for your attention.

Vladimír Tomšík, Ph.D.
Česká národní banka
Na příkopě 28
115 03 Praha 1

e-mail: Vladimir.Tomsik@cnb.cz
Tel: 2 2441 2010