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The World Bank's Czech Capital Market Assessment

A Strategy for a 'Top Tier' Capital Market?

Disappointingly, publication of the World Bank's detailed assessment of the Czech Capital Market has been greeted with deafening silence. The timing of the report's publication[i], last September, just ahead of the general elections and more recent Presidential elections, undoubtedly didn't help attract attention. That only the main recommendations, rather than the body of the report, were translated into Czech language probably didn't help either. That is a pity because the World Bank's report, which utilised input from market participants, provides not only a comprehensive overview of the Czech capital market but also gives numerous insights and constructive suggestions. In particular, how a 'top tier' capital market can be developed.

The report addressed, 3 issues:

(1) The importance of developing the capital market.

(2) The characteristics of the Czech capital market.

(3) Concrete suggestions to develop the Czech Republic's capital market.

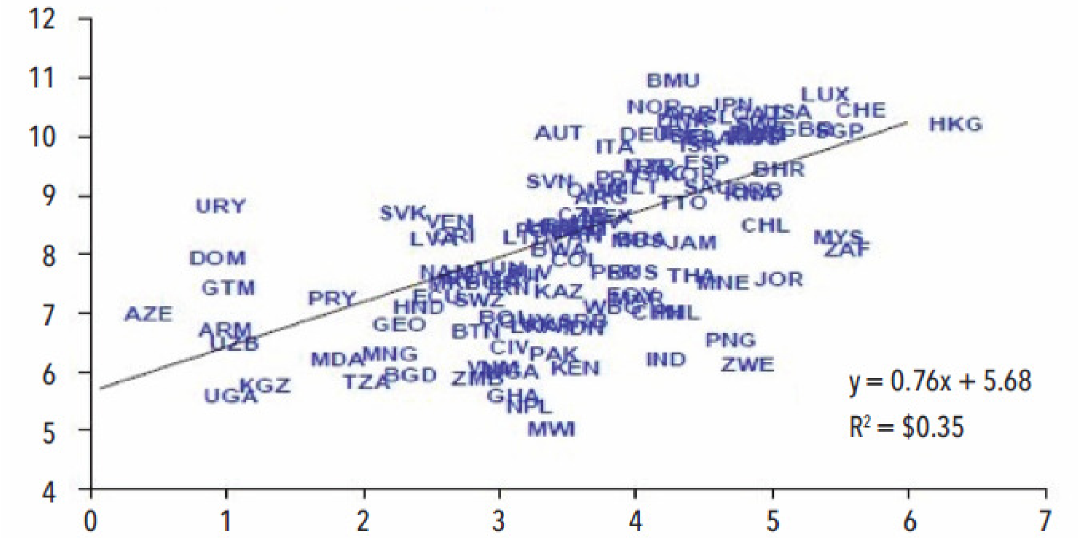
Why is the development of the Czech capital market important?

It is also disappointing that the World Bank should have even felt the need to address this question. That the World Bank did reflects the ***''concern consistently expressed…that high-level policy-makers do not view developing the Czech capital market as a priority item.''***

In justifying the need to develop the Czech capital market, the authors of the report note that there is a direct correlation between a country's capital market and economic growth. In particular, that there is clear evidence that ***''broader and deeper capital markets lead to better investment, more growth, increased employment and higher material standards of living.''*** Chart 1 shows the correlation between the size of a country's stock market (measured by market capitalisation) and income of a country's citizens (measured by GDP per capita). There would indeed appear to be a positive correlation between these two variables. Compared to other EU Members States, the World Bank observes: ***''The Czech Republic may be a leader in capital markets development among the new entrants, but its capital market lags almost by a power of ten behind the leading economies of the UK, Germany, France, Spain, Italy and the Netherlands.''***

Chart 1: Global Correlation: Market Capitalization to GDP per capita

Real GDP per capita (US$)
(avg. 1990–2010, log-scale)



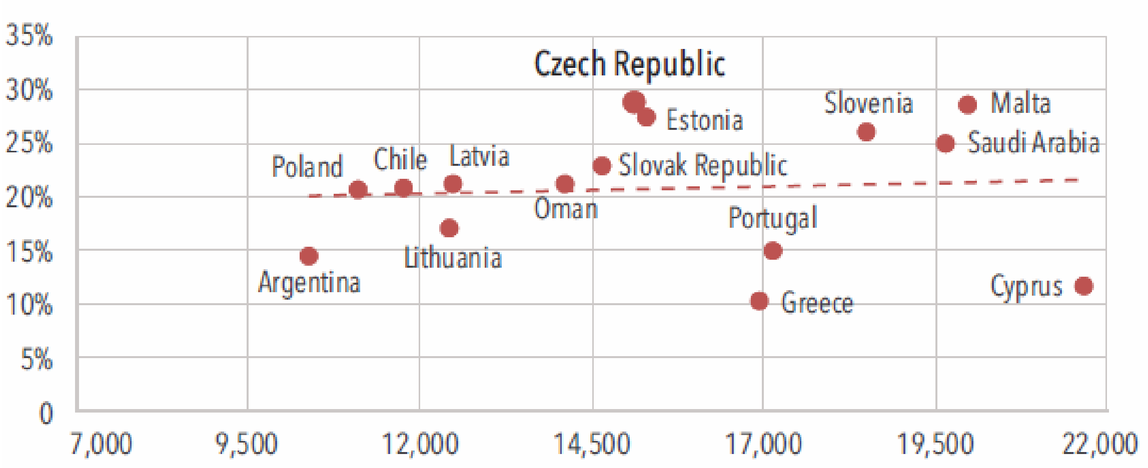
Market capitalization (%GDP) (avg. 1990–2010, log-scale)

Sources: World Bank Development Indicators; Financial Development and Structure Database; Milken Institute.

Furthermore, it was noted that ***''capital markets create economic opportunities for the ordinary citizen that would otherwise be denied to him/her. Capital markets provide the chance to participate in a wide range of investment opportunities.''*** Without access to a well-developed capital markets ordinary citizens have few choices other than to invest into bank deposits paying minimal yields (often below the rate of inflation). With a savings rate of 28.71% of Gross National Income (GNI), higher than other countries with similar GNI (Chart 2) and the 3rd highest of all EU member states, there would appear a huge unmet demand by Czech investors for investment products.

Chart 2: Savings Rates Comparisons to GNI per capita Peers

Savings Rates (2015)



GNI per capita (EUR)

Source: World Bank Development Indicators; Financial Development and Structure Database.

Finally, in a related point, it was also noted that [broad and deep] ***''capital markets serve to spread systemic risk. They are an antidote to bank-centric structures where the great majority of credit risk rests within the banking system itself and exposes the Government to high levels of fiscal risk in the case of bank failures''.*** As an example, when corporate bonds are issued (as opposed to bank loans), banks are essentially disintermediated. The risk of borrower default is then borne directly by the end savers [and not the banks].

What are the Key Characteristics of the Czech Capital Market?

To address this question, the World Bank Report focuses on the key actors in the Czech capital market and identifies the significant characteristics governing their participation in the capital market. Encouragingly, World Bank staff noted that the Czech Republic ''possesses a well-developed securities market infrastructure''.

Competent Authorities

Oversight of the Czech capital market is split between the Ministry of Finance (MoF) and the Czech National Bank (CNB). While the MoF is the lead ministry in creating the legal framework for the Czech capital market, the CNB acts as the capital market regulator/supervisor. Interestingly, in addition to its supervisory role, **the CNB is also charged with *'' the development of the capital market, investor protection and encouraging investor awareness (perhaps to be read as financial literacy)''.*** The inherent contradictions of the MoF's[ii] and CNB's[iii] multiple mandates are diplomatically not discussed. Furthermore, and somewhat surprisingly, neither CzechInvest nor the City of Prague are mentioned in the context of capital market development.

In terms of EU regulations: *''A consistent theme running throughout technical discussions with market participants was that **the regulatory costs imposed on the Czech capital market, mostly through EU rules, are damaging its growth.''*** In particular, these costs are more difficult to absorb in a small market such as the Czech Republic, placing the Czech capital market at a competitive disadvantage. *[Author's note: the EU's recent flagship MiFid II legislation runs to a more than 1.7m* *paragraphs creating a huge regulatory burden for legislators (who must transpose the directive into national laws), regulators, and market participants alike.]*

Banks

The World Bank notes that a 'striking' but not 'surprising' feature of the Czech Republic's financial system is that it is ***highly bank-centric.*** A feature attributed, at least in part, to the inherited financial system of former eastern-bloc countries. By bank-centric, the authors are alluding to the dominance of commercial banks in terms of both savings and lending.

A second, related, characteristic is the high level of 'liquidity' in the Czech financial system. An analysis of the financial statements of 18 Czech commercial banks shows a substantial portion of idle, unused resources. Applying different methodologies, the World Bank asserts that ***Czech banks lend only between 56%-68% of their available funds to their customers***. In other words, somewhere between Eur19.7bn-Eur36.8bn in funds are sitting idly in Czech banks, representing a whopping 11.6%-22% of Czech GDP. So what do the banks do with the money which isn't lent out? Once, inter-bank lending and holdings in government securities are excluded only 6.3% is invested into non-government securities (Table 1). The clear implication being that the current bank-centric capital market may not be the best way to turn savings into investment.

Table 1: ''Idle Funds?'' Banks' Use of Available Funds (CZK)

	Amounts (CZK thou)	% of Total
Available Funds	4,039,374,631	
Lending to Customers	2,284,121,160	56.55%
Purchases of Government Securities	625,092,451	15.47%
Idle Funds at CNB (non-reserves)	416,844,166	10.32%
Lending to Other Institutions	454,356,117	11.25%
Investments in Non-Government Securities	254,242,509	6.29%
Total		**99.88%**

Source: World Bank staff calculations based on 2015 bank financial statements

The World Bank also noted a third ''striking factor'' related to the Czech interest rate environment, namely the **low interest rate environment**, both in absolute and real (inflation adjusted) terms. As of writing, however, it should be noted that post the CNB's currency 'cap' interest rates have surged higher.

Factoring

The report notes the importance of ***factoring*** in the Czech Republic, i.e. the ability to use 'receivables' from customers as collateral for credit. This market is dominated by the banks with only one non-bank factoring firm. Contrary to the experience of some other countries, **'factoring' enjoys clear legal status** in the Czech Republic.

Investment Funds

The dominance of banks is also apparent **in investment management. It is noted that foreign and domestic banks have, between them some 76% of clients and 80% of total client funds**. The market is also highly concentrated, with ***the top 3 Fund Management Group's accounting for about 65% of total fund assets.*** Including the top 7 Fund Management Group's, this figure reaches an astonishing 87%. Despite this high degree of concentration, the World Bank asserts that it ''it would not appear that this raises competition issues'' due to the cross-border nature of the investment fund industry in the EU. Of course, the World Bank's reassuring assertion only holds true if one ignores the fact that many Czechs understandably wish to hold Czech Crown denominated funds rather than the Euro denominated funds typically offered from elsewhere in the EU.

The World Bank does, however, raise an important issue with regard to the taxation of investment funds. Unlike an investor who invests directly in a security and pays tax only once upon receipt of dividends, tax or capital gains, **an investor who invests indirectly via an investment fund pays tax twice, once at the fund level (5% profits tax) and then again upon any distributions.** While domestic investors benefit from a capital gains tax exemption on both direct and indirect (i.e. fund) investment after 3 years, foreign investors do not. This anomaly, places Czech domiciled funds at a competitive disadvantage. Despite this handicap, one 'bright spot' has been the strong investment flows into domestic investment funds, albeit from a low base.

Pension Funds

A key feature of the pension fund market is that **some 95% of pension assets are held in so called 'Transformed' funds which are required by law to prohibit negative returns**. As a consequence, investments are invested very conservatively, with some 78% invested in government related securities[iv]. Although the regulatory limit for equity investment is some 70% of the portfolio, the need to always produce a positive return means on average ***only 0.12% is invested by these funds in equities***. Reflecting this very cautious investment mix, in recent years, rates of return on Czech pension funds has averaged less than 2% p.a.

Despite the poor returns, individuals are encouraged to invest into pension funds by 'matching' contributions from the State and the ability to offset pension contributions from taxable income. However, the amounts contributed by the State, and the amounts which can be offset against tax, are capped at somewhat low levels.

Retail Investors

There is widespread mistrust in the Czech capital market by the public. The World Bank notes that this stems from the mass privatisation programs during the 1990's. Though roughly 1,700 companies were listed, over time most companies failed, delisted, or were 'taken private' ''often through less than transparent means. The practical result, for the ordinary investor, was a loss of the investment. Understandably, **''the Czech public are risk averse in their investment choices.''**

Venture Capital (VC) /Private Equity (PE)

Significantly, according to the Czech Private Equity and Venture Capital Association, ''***the Czech Republic lags behind not only Western European countries, but also some CEE countries with regard to the level of VC/PE investment relative to GDP.''*** The absence of large institutional investors in VC/PE funds was highlighted; as was the fact no VC or PE funds are actually domiciled in the Czech Republic. The 5% profit tax at the fund level was cited as an issue.

Potential Issuers (Companies)

In the past, this author has commented on the dwindling number of companies on the Czech Stock Market[v]. Despite this disturbing trend, **the World Bank identifies no less than 1,640 large enterprises[vi], which are potentially able to support broader participation in the Czech capital market.** The number of potential issuers of securities (companies) would therefore not appear to be a constraint.

In terms of mid-sized companies, 6,794 companies are identified which could potentially grow to a scale where they can access the capital market directly[vii]. These medium sized companies are also able to access the capital market indirectly through private equity and venture capital firms.

Currently only listed companies are required to report IFRS (International Financial Reporting Standards) while most companies use Czech Accounting Standards (CAS) for their records and tax reporting. A listing therefore involves the extra costs of maintaining 'two sets of books'. The MoF is currently working on a schema that will allow for the adjustments to me made directly from the IFRS for tax reporting purposes.

Leasing Companies

Once again, the leasing industry in the Czech Republic is dominated by the banks. Given that these groups enjoy credit lines supplied by their parent banks, they are not regarded as potential issuers of either asset-backed bonds or securitisations.

Government Securities

As already discussed, responsibility for the development of the Czech Capital market is shared between the MoF and CNB. However, the MoF also acts on behalf of the government in the issuance of government debt. Meanwhile, ''the CNB, acting as fiscal agent for the government, is both the creator, operator and regulator of the government securities market.''

The World Bank questions whether the distribution of tenors (maturity profile of the government's various debt issues) helps or hurts the wider capital market. This is important, because in practice, the Government bond market forms the starting point upon which other securities are priced. However, **numerous small bond issues (there are 23 tenors outstanding) from the government have made Czech bond market a somewhat illiquid market with limited trading, with the associated uncertain pricing**. The World Bank questions whether fewer but larger bond issues might be desirable with emphasis on *''benchmark maturities that government security traders like to see''*, e.g. 1, 2, 5, 7 and 10 years.

Surprisingly, no explicit discussion appears with regard to the extremely short maturity profile of Czech debt compared with other OECD countries (though a chart showing maturities is presented). This bunching of debt issuance, towards short-dated maturities, requires large amounts of debt to be continually refinanced and has resulted in a clustering of debt around short maturities. Immediately post the September publication of the World Bank's report, this became an issue with October's failed auction of shorter-term debt. Against this backdrop, the MoF may be reluctant to adopt measures that might further reduce appetite for Czech government debt.

The World Bank's Recommendations

The World Bank emphasises that there is no single ''magic'' solution. Nevertheless, numerous constructive suggestions are made. A list of recommendations in English can be found on pages 20-22 of the report (see link at endnote). In Czech language, the recommendations can be found here: http://www.mfcr.cz/assets/cs/media/Zprava_2017-10-02_Table-1-Translated.pdf

Organisationally, it is suggested that the MoF form a working group, drawn from a broad group of interested parties, to address these reforms. Readers may review the entire list of recommendations at their leisure. In this author's opinion, the following recommendations are particularly noteworthy:

- Encourage the Czech Republic's participation in EU-wide committees impacting capital market regulation. Though note explicitly sated, the suggestion seems to be that the Czech Republic's participation may act as somewhat of a restraining influence against over-zealous regulation.
- Look at ways to eliminate unnecessary regulatory burdens applied at the local level.
- The potential privatisation of remaining State Owned Enterprises (SOE's). Where SOE's cannot be privatised, their financing needs could be met via the corporate bond market. There could be as many as 7 SOE's or State Agencies able to issue such bonds.
- The need to build trust and confidence in the market is stressed, as is the need to ensure a better information flow.
- Consider an Individual Savings Account (ISA) Regime. ISA's are common in many developed markets and usually provide tax incentives to encourage individuals to invest, with account holders able to make their own investment decisions.
- Creation of a web-based ''Securities Information Centre''. Currently, information related to securities is often ''scattered in various places around the web''. Furthermore, many important documents are found only in Czech language inhibiting investment by foreigners. [viii]
- To encourage VC and PE firms to domicile in the Czech Republic authorise the use of the tax-transparent Limited Partnership (LP) legal entity.
- It is not recommended to change the current tax treatment on investment funds. While the 5% profits tax on investment funds could be reviewed, the World Bank stresses not if that meant the removal of the exemption from capital gains after 3 years. Removal of the capital gains tax exemption would have the net effect of making the capital market less attractive to domestic investors.
- Eliminate taxation of foreign investors on Czech income.
- The regulations governing the use of direct internet marketing and sales of investment funds should be reviewed with a view to encouraging such marketing. Offering clear and attractive investment choices, with little or no commissions to agents, would help the investment fund industry grow and mitigate the dominance of banks in investment management and fund distribution.
- Modify the Minimum Return Guarantee Provision. The "no loss" guarantee should not exist on a year by year basis during the contribution / accumulation period. Instead gauge this at longer, stated intervals; or apply the guarantee only from retirement age onward to preserve the capital paid out to the pensioner.
- Perfect and finalise the Translation Tables for using IFRS to generate tax reports. A standard and official method to turn IFRS to CAS tax reporting would lessen the burden of reporting under IFRS.

Concluding Remarks

The World Bank's report represents a very positive development. Drawing from the input of capital market participants, the report highlights the key issues which need to be addressed before a 'top-tier' capital market can emerge. For participants in the Czech capital market, many of the observations made will not be new, however, it is one of the few occasions where a broad overview has been published. As such, it represents an excellent starting point for policy discussion.

The recommendations themselves are generally incremental in nature. That is probably the right approach. The current structure of the Czech capital market, with its 'bank-centric' nature and 'repressive' regulations, is clearly sub-optimal. However, sudden liberalisation could be extremely damaging both to the capital market and the wider economy[ix]. In particular, while the development of the non-bank sector and the non-governmental issuance of securities, i.e. corporate, is to be encouraged, policy makers would be 'shooting themselves in the foot' if their actions ultimately provoked a banking crisis or undermined support for the government bond market (against which other securities are priced).

So what then of the World Bank's Report? The lack of reaction to the publication of the report is a disappointment. However, it may just be the case that the report has a 'slow fuse' and that its impact will be felt later. Hopefully, once the Czech Republic's domestic political situation settles-down, more attention will be paid to the report and many of the recommendations implemented. In this way, perhaps some positive momentum can develop and the Czech Republic will find eventually find itself not only with a top-tier capital market but also as a regional financial centre.

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[i] Capital Market Assessment/ Market Development Options Czech Republic. World Bank Group. September, 2017 http://www.mfcr.cz/assets/cs/media/Zprava_2017-10-02_CZ-CM-Assessment-Report-Final.pdf

[ii] Author's note: as we have seen, the MoF somewhat benefits from the current status quo due to the large holdings of government debt, issued by the MoF, held by Czech banks and pension funds.

[iii] In the UK, there is an active debate whether the UK's Financial Conduct Authority (FCA) should lessen the requirements for a 'premium' listing on the London Stock Exchange to attract Aramco to float in London. Some commentators argue that relaxing regulatory requirements is the wrong way to attract business.

[iv] It is a classic example of so-called 'financial repression' – rules and regulations that favour investment into government securities. It therefore represents a hidden 'tax' on savers.

[v] https://www.akatcr.cz/public/vypisNovinku.do?id=3923 ''Investiční banky ztrácejí zájem o český akciový trh'' 21st November, 2017. http://cfasocietycz.blogspot.cz/2017/11/investment-banks-lose-interest-in-czech.html ''Investment Banks Lose Interest in the Czech Stock Market''

[vi] A company is defined as large if it meets any two of the three criteria: More than 250 employees, revenues above Eur50m and assets above Eur43m.

[vii] A company is defined as medium size if it meets any two of the three criteria: between 50-250 employees, revenues between Eur10m-Eur50m and assets between 10m-Eur43m.

[viii] A major motivation for this article was that the World Bank's report wasn't translated into Czech and therefore didn't attract the attention it deserved.

[ix] Historically, financial liberalization or innovation has also been a recurrent precursor to financial crisis. For example, Kaminsky and Reinhart (1999) have presented evidence of a link between crisis and financial liberalization. For the period since 1970, they noted in eighteen of the twenty-six banking crisis they studied, the financial sector had been liberalised within the preceding five years.