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Emergence of a Private Banking Sector in the Czech Republic

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EMERGENCE OF A PRIVATE BANKING SECTOR IN THE CZECH REPUBLIC AND THE ROLE OF CORPORATE GOVERNANCE IN TRANSITIONAL ECONOMIES

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I. "THE CZECH MIRACLE" OR THE PRIME MINISTER'S NEW CLOTHES?

In 1989, the Czech Republic[1] emerged from the specter of communism not at Karl Marx's end of history,[2] but rather, at Adam Smith's beginning.[3] The challenges facing the Czech Republic, and all of the former Soviet Bloc Central and Eastern European nations (CEEs), were enormous. In determining how best to transition from a command economy to a free market economy, most CEEs chose to undertake a slow and cautious march towards a capitalist free market economy.[4] The Czech Republic was the lone exception.

Under the leadership of Vaclav Klaus,[5] the Czech transitory economy operated under the precept that faster is better. As a result, both Klaus and the Czech Republic were rewarded.[6] In 1995, the Czech Republic's rapid transformation from the most socialized of any economy in

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[1] The author recognizes that the Czech Republic and Slovakia were a single Federal nation until popular election split the Federation in 1993. The split, popularly referred to as the Velvet Divorce, was largely due to the perception that post-Soviet Czechoslovakia remained a nation in which the Czechs politically dominated the country and the Slovaks. See ABBY INNES, CZECHOSLOVAKIA: THE SHORT GOODBYE (2001), for an in depth analysis of the causes behind the Velvet Divorce. The post-Divorce governments continued the reforms taken by the Federation. As a result of the Czech political dominance before 1993, and the continuation of reforms after 1993, this author will use the terms "Czech" and "Czech Republic" to refer to the region that is now the Czech Republic without regard to whether that geo-political area was, at the time, a part of Czechoslovakia.

[2] KARL MARX & FREDERICK ENGELS, THE COMMUNIST MANIFESTO (1872).

[3] ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776).

[4] *See* John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons From Securities Market Failure*, 25 J. CORP. L. 1, 9-16 (1999).

[5] Czech Finance Minister (December, 1989 to June, 1992) and Prime Minister of the Czech Republic (June, 1992 to November, 1997).

[6] Thomas W. Hazlett, *The Czech Miracle: Why Privatization Went Right in the Czech Republic*, REASON, Apr. 1995, at 28.

the Warsaw Pact to an advanced market economy was heralded as a miracle.[7] Two years later, the praise evaporated amid scandal and the resignation of Prime Minister Klaus.[8] The pundits declared, " 'the Czech Miracle of low inflation, low unemployment and a growing economy was illusionary.' "[9] But by the close of 1998, the Czech economy had stabilized and had once again outperformed the other CEEs.[10]

An analysis of the banking systems in any of the CEEs is important in determining the viability of a specific nation's economic reforms. Horton,[11] in his note on banking systems in the CEEs, argued that "[c]entral to the success of these transitions [to market economies] will be the ability of the region's banks to act as financial intermediaries between debtors and creditors. The banks will need to facilitate payments between emerging actors in the growing capitalist economies."[12] The application of this theoretical framework, specifically to the Czech Republic, is an appropriate means to explain the fluctuations in the transitional Czech economy. Such an application will show that the Czech banking system, which is based on the German Universal Bank system (GUBs),[13] is the entity charged with the responsibilities of being a financial intermediary, facilitating payments between parties, and providing the majority of finance capital.[14] However, the Czech banking sector's ability to adequately effectuate these responsibilities was hampered by the Czech government's exclusion of the

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[7] *Id.*; *see also* Steve H. Hanke, *The Right Kind of Problem*, FORBES, Mar. 27, 1995, at 97.

[8] Lee Hockstader, *Czech's Downfall Shatters Hope for Economic Miracle: Outgoing Prime Minister's Failed Reforms Viewed as Too Absolute, Arrogant to Succeed*, WASH. POST, Dec. 7, 1997, at A31.

[9] *Id.* (quoting Mark Sanders).

[10] *See* Coffee, *supra* note 5, at 16.

[11] William L. Horton, Jr., Note, *The Perils of Universal Banking in Central and Eastern Europe*, 35 VA. J. INT'L L. 683 (1995).

[12] *Id.*, at 683-84.

[13] The German Universal Banking system is typified by a banking sector that is wholly unified across the various banking disciplines. Fragmentation between investment and personal finance banks does not exist – unlike in the United States. Instead GUBs permit a single bank to offer a wide variety of banking services, including checking accounts, exchange brokerages, and investment services. Thus, GUBs permit a powerful banking system that heavily relies on agents within the system to monitoring themselves. *See* Mark E. Nance & Bernd Singhof, *Banking's Influence Over Non-Bank Companies After Glass-Steagall: A German Universal Comparison*, 14 EMORY INT'L L. REV. 1305, 1349-79 (2000), for an excellent review of the history and function of GUBs.

[14] *Id.*

four largest state banks from privatization plans until 1998.[15] This absence of a privatized banking sector and, consequently the state-run banking institutions, perpetuates a lack of democratic corporate governance in the banking sector.[16] Without appropriate levels of corporate governance, the banking sector's ability to succeed in its responsibilities is greatly diminished, because "[a]lthough there are some rewards for succeeding in managing a bank, there may not be sufficient incentives not to fail. In the state-controlled banks . . . . the manager does not risk losing any of his own capital."[17] Additionally, as there are so few trained bank managers available, an inept manager may not even lose his job.[18] The problem with such a system is largely that "the CEE bank corporate governance structure largely lacks two of the most persuasive 'sticks' in the Western monitoring system – loss of fortune and loss of job."[19] Thus, a lack of a privatized banking sector leads to a diminishment of effective corporate governance, which weakens the ability of the banking sector to perform its crucial responsibilities in a transitional economic system. This translates into a less successful transitional economy.

This article explains the fluctuations of the Czech economy regarding corporate governance in the Czech banking institutions. Part II will explain the history of the banking systems in the Czech Republic and what role those systems played in the transitional economy of the Czech

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[15] See THE BANKER, CZECH REPUBLIC – BETTER LATE THAN NEVER (2002), *available at* http://www.cnb.cz/en/_media/articles/020201.htm, for an excellent discussion on the privatization of the Czech Republic's four largest banks, Komercni Banka, Ceska Sporitelna, Investicni a Postovni Banka, and Ceskoslovenska Obchodni Banka.

[16] Democratic corporate governance is a fairly nebulous term for which it is difficult to provide an exact meaning. That being said, the author takes democratic corporate governance to mean a system of controls over a corporate body that permits shareholders to have actual control over the functions of the corporation. The alternative to democratic corporate governance is control of a company by another force (e.g. the state or a few directors). The superiority of a system within which democratic corporate governance is allowed to flourish is that the owners of wealth direct the businesses that create wealth; as such, those companies operate in a manner that is in the best interests of the owners. The breakdown of an effective system has such catastrophic effects as can be seen in Savings & Loans scandals of the 1980s and the corporate meltdowns of 2001-02 (i.e. Enron and World-com). Theoretically, when a strong system of corporate governance is in place, such catastrophes would not occur as such scandals only hurt shareholders and not the directors who caused them.

[17] Horton, *supra* note 12, at 709.

[18] *See id.*

[19] *See id.*

Republic. Part III will examine the numerous reforms of banking institutions employed by Klaus in 1998. Part IV will address the prospective question of what the future holds for the Czech Republic banking system in light of the recent installation of democratic corporate governance.

II. BANKING ON A FREE MARKET

Free markets are characterized by the exchange of capital for goods and services. As shown above, the banking sector plays a crucial role in holding, distributing, and increasing that capital. Under the Soviet state-run, or command economy the goal was the elimination of all capital.[20] Naturally, the banking sectors of CEEs in the former Soviet bloc were retarded compared to their western neighbors. Those CEEs were typified by having one central bank whose responsibility was to distribute wealth from the State to industry pursuant to a plan established by the State.[21] Under this system, corporate governance is lacking. Under a free market system, the banking sector, like any corporation, has shareholders who possess a series of controls over the bank managers;[22] however, in the state-run system, the banking sector does not have supervisory shareholders,[23] nor does the sector have an adequate replacement that establishes some form of corporate governance. As the Soviet system reduces and attempts to eliminate the importance of capital, the role of the bank is also reduced. There is no need for the banking system to be successful if the role of the bank is reduced by the Soviet attack on capital. The banking sector will also quickly lose effective corporate governance because of a lack of a purpose to succeed.

The government of the Czech Republic, in transitioning from a state-run economy to a free market economy, had the task of translating its sole state-run bank into a functioning banking sector. The importance of a banking sector is that the sector is able to finance the growth of an emerging private sector. This was not an easy task. The Klaus government began

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[20] *See generally* MARX, *supra* note 3 (for a theoretical discussion of Soviet goals with regard to the place of capital in a Communist utopia).

[21] *See* Carolyn Brzezinski, *Competition and Antitrust Law in Central Europe: Poland, the Czech Republic, Slovakia, and Hungary*, 15 MICH. J. INT'L L. 1129, 1130 (1994); *see also* Horton, *supra* note 12, at 703.

[22] *See, e.g.*, Helen A. Garten, *A Political Analysis of Bank Failure Resolution*, 74 B.U. L. REV. 429 (1994) (discussing the general role of bank shareholders); Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 60-61 & n.280 (1987) (discussing the need to protect bank shareholders from free market forces).

[23] *See generally*, Patricia A. McCoy, *Levers of Law Reform: Public Goods and Russian Banking*, 30 CORNELL INT'L L.J. 45 (1997) (describing the banking system in Soviet Russia).

reform by eliminating the monopoly of the Czech National Bank (CNB) and by issuing sixty-three (63) banking licenses.[24] These bank licenses permitted foreign banks to open branches and allowed small private banks to take hold.[25] The CNB still remained to dictate financial policy, but its monopoly was broken down and vested into several large state-run banks.[26] Komercni Banka (KB), Ceska Sporitelna (CS), Investicni a Postovni Banka (IPB), Ceskoslovenska Obchodni Banka (CSOB), and Zivnostenska Banka (ZB) controlled two-thirds of the total assets of the banking sector and accounted for nearly three-quarters of the total credits and deposits in the Czech Republic.[27] In 1992, ZB was sold with 52% going to foreign banks.[28] However, the reforms of the banking sector stopped at this point. According to the Minister of Privatization, Thomas Jezek, "the status of bank privatization is just where it was 'when I left the Privatization Ministry in June 1992. Klaus made no change – nothing.'"[29]

Numerous problems arise from halting reform and preventing further privatization of the banking sector. The stifling of effective corporate governance under this system has already been discussed; however, in addition to lacking "the two largest 'sticks,' "[30] the Czech state-run banking system seems to reward managers for making bad business decisions. Horton reports that "in some cases the CEE bank governance system actually rewards [inefficient managers]. Managers . . . are not free to make completely independent credit allocative decisions. It is not politically feasible right now to allow the failure of all of the state firms that would collapse were their credit to be restricted."[31] Marek Pol, Poland's Minister of

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[24] *See* United States Department of Commerce, *The Central and Eastern European Business Information Center: Market Research: Analysis of the Czech Banking System*, *at* http://www.mac.doc.gov/eebic/countryr/czechr/market/CZ-BankSysAnal.htm (last visited January 7, 2003).

[25] Karel Fiala & Filip Hruska, *Current Financial and Investment Environment in the Czech Republic*, 49 CONSUMER FIN. L. Q. REP. 296, 299 (Sum. 1995).

[26] *See* United States Department of Commerce, *supra* note 25.

[27] *Id.*

[28] The International Finance Corporation (IFC) purchased 12% and the Berliner Handelss-und-Frankfurter Bank (BHF-Bank) purchased 40%. It is important to note that between 1992 and 1998 the dominant shareholder, BHF-Bank increased its ownership to 47%; however, control of the bank was not vested in a sole shareholder until 2000 when Bankgesellschaft (BG), who had purchased BHF-Bank's shares in 1998, increased their shares to 85.16%. *See* THE BANKER, *supra* note 16.

[29] Thomas W. Hazlett, *Is the "Czech Miracle" Over? Or Still to Come? A Report From Prague*, REASON, Mar. 1, 1998, at 40, *available at* http://reason.com/9803/fe.hazlett.shtml (last visited Nov. 2, 2002).

[30] Horton, *supra* note 12, at 709.

[31] *Id.*

Industry and Trade, indicated this concern, stating that "of course we can say 'Let's not reduce [state firms'] debts, let them go under!' But the problem is, their collapse would lead to the collapse of the whole country, because no one would be able to maintain such a huge army of unemployed."[32] Thus, for political reasons the state-run banks in the Czech Republic continue the old role as mono-banks in an effort to support the inefficiency of the state supported industrial complex. Horton continues,

> [t]here is evidence that some bank managers are voluntarily rolling over interest payments into new loans to maintain the stability of their banks. Not only does this potentially increase the size of the nonperforming loan pool, but it also allows [state owned enterprises] to avoid paying their debts for a longer period of time.[33]

Normally it would be difficult to determine whether a banking sector was actively seeking to prop up failing industries without obtaining some form of documentation. In the Czech case it is possible to infer that the state-run banking sectors were performing such a task. By 1995, unemployment in the Czech Republic was stabilized around 3.5%.[34] Comparatively, the unemployment rate of the United States in April of 1995 was 5.8%,[35] and during the dot-com boom the unemployment rate of the United States was between 4.2% and 4.3%.[36] The Czech Republic unemployment rate was phenomenal. Given the Czech economic crash that came in 1996 to 1998, it is reasonable to infer that the low unemployment rate partially resulted from the state-run banks helping to prop up failing industries.

The lack of corporate governance and the resulting poor management of the state-run banks are only one problem that the banking sector experienced in the early half of the 1990s. The rapid privatization of Czech industry was achieved through the use of a voucher system. Under the voucher system, "[a]dult citizens would bid for companies with voucher coupons, with each entitled to buy one booklet of 1,000 'points' for a nominal sum."[37] The voucher system could have been expected to create a framework in which shareholders would quickly establish democratic

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[32] *Id.*
[33] *Id.* at 709-10.
[34] Hazlett, *supra* note 7.
[35] United States Bureau of Labor Statistics, *Employment Situation: April 1995* (May 5, 1995), *available at* ftp://ftp.bls.gov/pub/news.release/History/empsit.050595.news.
[36] United States Bureau of Labor Statistics, *Employment Situation: July 1999* (August 6, 1999), *available at* ftp://ftp.bls.gov/pub/news.release/History/empsit.08061999.news.
[37] Hazlett, *supra* note 7.

corporate governance over the privatized sectors of the Czech economy. Corporate governance failed to materialize primarily because of the Czech Republic's use of the GUBs, which invested the role of exchange brokerages in the state run banks. Professor Coffee, a renowned professor of corporate law at Columbia, argues that the rapid privatization method utilized by the Czech Republic has the potential to create a system of corporate governance because "they aggregated large stakes in Czech corporations and thereby potentially solved the collective action problem that the dispersed ownership resulting from voucher privatization necessarily implied."[38] Coffee goes on to reason that this did not happen because the investment funds, which managed the newly dispersed ownership, were "established by the principal Czech commercial and savings banks, which had the obvious reputational advantages in convincing Czech citizens to deposit their vouchers with them."[39]

A conflict of interest arose for the Czech government. The state wanted to remove their influence over the newly privatized stock, but the state was not prepared to sacrifice its' control over the banking sector. Thus, a conflict emerges between the state's desire to remove itself from the privatized companies and the desire to retain control over the banks (which, under the GUBs, is the only investment firm available to the owners of the dispersed stock). The solution to this conundrum was troubling. In an effort to remove government control, the state-run banks restricted themselves to owning only small stakes in their investment funds.[40] The banks did not seek to improve the profitability of their investment funds, because there was only a limited financial gain to be had from owning such small amounts of their funds.[41] Instead of seeking limited financial gain by improving the profitability of their funds, the banks sought the greater financial gain in using their *investment funds* to acquire *corporate banking clients*. "Rather than concentrating their holdings (and thus maximizing their influence), most bank-administered funds sought to diversify their holdings in order to hold stakes in as many firms as possible – in part to solicit banking for their parents."[42] Thus, control of the banks by the state, and a lack of democratic corporate governance, led the banks' portfolio managers to purposefully avoid increasing profits of the investor's portfolios because the banks only owned small stakes in their investment funds. Additionally, the implementation of the GUBs into the Czech banking sector led directly to the institutional problems of vesting the majority of the exchange brokerage

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[38] Coffee, *supra* note 5, at 12-13.

[39] *Id.*

[40] *See id.*

[41] *Id.*

[42] *Id.*

responsibilities into the state-run banks and not into the smaller privatized investment houses.

Although the banking sector diversified away from being consolidated into the CNB, there was still the same lack of democratic corporate governance, in the five major banks, that plagued the CNB under Soviet leadership. Without the privatization of those banks and the subsequent democratic corporate governance that follows the insertion of shareholders, the banking sector did not possess any forms of control and thus, shackled the economic growth of the Czech Republic's transitory economy. The names of the banking players may have changed and grown, but the underlying problems of the monopolistic state-run economy remained entrenched in the banking sector. The result was a general recession and failure of the Czech economy as predicted by Horton in 1995.[43] "Capitalism, one might easily conclude from all this, had been as much a bust in the Czech Republic as communism."[44] If the Czech economy was going to continue its transition into a free market economy, something would have to change.

III. A LITTLE REFORMATION

Banking sector reforms were needed in 1998. In looking at the above examples of banking failure, there were two different methods by which the Czech government could fix their bank sector. One option was to replace the GUBs with a system similar to the American system, where shareholders would be required to buy and sell stock through an exchange brokerage. This would have the benefit of consolidating the dispersed stocks, resulting from the voucher system used during the mass privatizations, in exchange houses whose brokers have only one purpose – to increase the value of their clients' portfolios. The exchange houses would therefore have a vested interest to *improve* the companies that make up their portfolios. This would, in turn, spurn economic growth throughout the Czech Republic by bringing democratic corporate governance directly to corporations through the brokers. By shifting to either a modified GUBs, or totally abolishing the GUBs, the Czech government would move governance from the state, whose modus operandi is political and not fiscal, and place it into an organization whose purpose is to increase capital wealth. However,

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[43] While Horton's prediction was not specifically made about the Czech Republic, its application can easily be established (as this article did earlier). *See infra* pp. 2-3. Moreover, after the boom of 1995 ended and the subsequent economic bust began, many pundits were specifically saying what Horton had generally theorized three years earlier. *See generally*, Horton, *supra* note 12.

[44] Hazlet, *supra* note 30.

the Czech government did not opt to utilize this method of reform. Instead the government chose the second option – to focus on, and fix, the existing problems in the GUBs.

The predominant problem with the banking sector, aside from the institutional faults of a GUBs, was the lack of democratic corporate governance. Without such governance the Czech banking sector did not answer to anyone for implementing failing business practices. Quite the opposite, a state-run bank system is geared towards intentionally not implementing smart business practices if those practices might lead to an increase in unemployment or the loss of an important industrial sector.[45] Sound corporations must make business decisions in light of what is best for the shareholders. Comparatively, a state-run banking sector must make business decisions in light of what is politically correct instead of what is fiscally correct because their shareholders, the central government, are not interested in fiscal returns, but rather, in political currency.

In 1998, the Czech Parliament attempted to introduce true shareholders to their banking sector and they sold a majority share of IPB, the third largest bank, to the Japanese corporation Nomora.[46] For the first time since the failure of communism a majority share in one of the top Czech banks was held by a private organization. Numerous problems existed with this first deal;[47] but despite these problems the Czech government continued to rapidly privatize the banking sector. In 1999, a majority interest in the fourth largest bank, CSOB, was sold to the Belgian KBC Bank.[48] In 2000, a number of bank sales took place. The second largest bank, CS, had a 52% interest sold to the Erste Bank; the fifth largest bank, ZB, had the minority shareholder BG increase their shares from 47% to 85.16%; and IPB merged with CSOB and thereby replaced KB as the dominant Czech bank.[49] The

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[45] *See infra* pp. 3, 6-7.

[46] The transaction involved the direct sale of 36% of IPB from the state to Nomora and a subsequent new capital submission increased Nomora's shares to a majority of IPB. *See* THE BANKER, *supra* note 16.

[47] IPB quickly returned to the Czech Parliament after it became apparent that IPB was laden with numerous debts incurred by providing loans, at the bequest of the Czech government, to inefficiently run industries. Additionally, Nomora did not attempt to fix the problems in IPB; but rather, wished to hold the company in its portfolio for many of the same reasons the Czech banking sector acted as exchange houses in the early privatization schemes. In 2000 IPB was again sold by Parliament to CSOB, who was at that time owned by the Belgian KBC Bank, and the subsequent merger of IPB and CSOB made CSOB the largest bank in the Czech Republic. *See id.* for a thorough discussion of the problems facing both IPB and the privatization of a major state run bank.

[48] *Id.*

[49] *Id.*

privatization of the banking sector was complete with the sale of 60% of KB to Société Générale in 2001.[50] With complete privatization at last true corporate governance could pierce the veil of indifference that was so pervasive under the state-run banking system.

The lack of experienced managers was a recurring problem in the Czech banking sector. Existing managers knew their positions were safe, since the bodies governing the Czech banks could not fire the managers despite their ineptitude for making savvy business decisions. The Czech government overcame this crucial problem by involving only foreign corporations in the privatization of the banking sector. By selling the banking sector to foreign corporations based in the western countries of France, Germany, Japan, and Belgium, it is reasonable to expect that the new parent corporations had the personnel resources to bring in qualified managers to replace failing Czech managers, and to train future Czech executives. Thus, the privatization solution proved superior to the proposed GUBs deconstruction solution because privatization was the only solution that permitted an easy influx of experienced managers.

The Czech Parliament also undertook several other reforms in 1998. First, the nation was preparing to enter the European Union, but in order to do so, the Czech Republic's fiscal rules had to come into accord with western Europe. This meant adapting to the principles regarding competition laid out in the Treaty of Rome.[51] Also, the Czech Parliament attempted to combat earlier problems of a lack of transparency by establishing a Czech version of the American Securities and Exchange Commission to oversee all transfers and regulation of stocks.[52]

Shortly after the implementation of these reforms, the Czech economy rebounded and began to climb out of its recession.[53] While the short term effects of the banking sector reforms seem positive, it will be important to see whether they are able to withstand future challenges as the Czech economy becomes integrated into the European Union and leaves the ambit of a "transitory economy" in favor of being a full free market economy.

IV. WHAT NOW?

With the 1998 Czech banking reforms, new life has been given through democratic corporate governance. With shareholders directly overseeing the business decisions of the Czech Republic's banks, new

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[50] *Id.*
[51] Treaty on European Union, Mar. 25, 1957, 298 U.N.T.S. 11.
[52] *See* Coffee, *supra* note 5, at 11.
[53] *See id.* at 16.

transparency in the Czech stock market, and qualified and experienced bank managers available from western free market economies, the future should be bright for the Czech Republic. The largest remaining problem from the banking sector is a large public debt as a result of the government taking responsibility for the numerous bad loans the state-run banks made to failing industries at the bequest of the Czech government. The IMF currently estimates this debt is currently at 11.8 billion USD.[54] While this is a large debt for a country of thirty million people, entrance into the European Union could feasibly help alleviate the cost of transitioning the Czech economy into a free market based economy.

The Czech Miracle was shrouded in unseen problems when the shift to a market economy first began. The lack of democratic corporate governance in the banking sector clearly hindered the ability of the Czech economy to make a successful transition to a free market. The lesson that can be learned is the importance of the banking sector in emerging economies. If other nations attempt to shift to a capitalist system though a rapid privatization of state-run institutions, then one of the first industries that must make the switch is the capital managing banking sector. By employing the principles of democratic corporate governance early in the transition process, a government can insure that the tools will be present to support a growing private sector. Markets do not develop without a need, but by employing democratic corporate governance through shareholders, then that need will emerge as they demand higher revenue from their corporations. The need of shareholders to increase their profit will build markets and those markets will in turn build a successful capitalist economy.

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[54] *See* THE BANKER, *supra* note 13.