The European capital market is undergoing dynamic integration, which is presented as one of the key priorities of the EU. It is expected that the elimination of financial market fragmentation will result in a greater allocation and operation efficiency of financial markets (greater competition between brokers and stock exchanges, economies of scale associated with project evaluation, convergence of revenues to assets of equal risk), in all-European mobilization of savings (it will be possible to finance greater and longer-term projects) as well as in a better diversification of investors’ risk. Further, positive development on financial markets should contribute to greater economic growth and employment. In recent years a relatively high number of studies have been written about the positive impacts of integration on capital markets. To a lesser or greater degree, these studies tried to quantify possible benefits1.

The Czech Republic cannot close itself to the very dynamic development on the European capital market. Taking into account the upcoming EU accession and the subsequent adoption of a common currency, the Czech capital market companies find themselves in a situation where they have to formulate their strategies of further development, primarily depending on what is happening in the Union. The aim of this study is to inform the reader in brief about the development on the European capital market (the development of integration tendencies). In relation to this we will then describe the situation and main tendencies in the Czech Republic, and formulate general recommendations. We will focus in particular on the capital market and the banking sector, i.e. on two types of financial market where companies usually obtain their capital. As regards the capital market, we will discuss significant legislative changes, the position of the Czech Securities Commission, future development opportunities of the Prague Stock Exchange and of the RM-SYSTEM, and issues connected with clearing and settlement of securities transactions. As far as the banking sector is concerned, we will concentrate on the role of Czech banks on the integrated European capital market.

The study is not aimed at making a precise analysis of the Czech capital market: rather, its objective is to formulate basic, general questions and to outline problems associated with the integration of the Czech capital market into the common European capital market.
The integration of European capital markets

The integration of European financial markets is presented as one of the EU’s top priorities. However, efforts to create an integrated capital market with a high allocation and operation efficiency are nothing new. Integration of financial markets across Europe was discussed in the "Completing the Internal Market" White Paper from 1985, although the integration has not become top political priority until the Cardiff summit in 1998. Heads of states agreed at the summit that despite all efforts there still exists room for integration deepening. Therefore the Risk Capital Action Plan was adopted in 1998, which focused on eliminating today’s institutional, regulation and tax barriers and on support for financing of dynamically developing small and medium-sized enterprises. Further, the Commission was given the task to concentrate on the possibilities of further deepening of integration on the capital market. Thus, at the 1999 summit in Cologne the Financial Services Action Plan was adopted, containing a draft of a great number of particular steps towards the deepening of the financial service market integration. This draft, above all, determined the main priorities:

- **Completion of a single wholesale financial service market**
  To facilitate securities issuing and trading by supporting market processes (alliances between stock exchanges, modernization of payment and settlement systems), thus ensuring greater liquidity of markets and the emergence of risk capital markets. The proposed measures focus in particular on the elimination of barriers that prevent "raising capital" on an EU-wide basis (the Directive on Regular Reporting; the Directive on Prospectuses), on supporting cross-border securities trading (Directive on cross-border use of collateral), on the establishment of a single set of financial statements for listed companies (amendments to the 4th and 7th Company Law Directives), etc.

- **Development of an open and secure retail financial service market**
  To ensure greater awareness, transparency and security of cross-border provision of financial services. To eliminate a number of legal and administrative barriers that prevent "common clients" from purchasing "common financial services" (such as leasing or mortgages) across the border. Measures in this field include, among others, a proposal for a directive on the distance selling of financial services.

- **Ensuring continuous stability of European financial markets**
  To enforce cooperation in supervising and to identify systemic and institutional risks.

- **Elimination of tax obstacles to integrating the capital market**
  For instance, the directive on the minimum effective taxation of cross-border savings income.
Integration – especially on the money market – was supported by the adoption of the euro in 1999. In 2001 fully integrated, efficient financial markets became one of the Lisbon Process priorities. In Lisbon, the end of 2003 was determined as the deadline for the implementation of all Risk Capital Action Plan measures and of selected sections of the Financial Services Action Plan. Due to the slow implementation of the Financial Services Action Plan, the "Committee of Wise Men" led by Alexandre Lamfalussy was established in 2000. Its main task was to identify the reasons for the slow implementation of the new standards, to account for the persisting fragmentation of financial markets, and to propose appropriate measures. In February 2001 the Committee published a Final Report in which it recommended establishing a European Securities Committee (ESC; see Box 1: Institutions) and modifying the legislative process in the field of the Financial Services Action Plan. According to the proposal, the new legislative process should be based on four basic levels of activity:

1) Level 1 – framework legislation
   At the first level, agreement should be reached regarding the basic principles that will become part of the directive proposal. The proposal will be prepared by the Commission, and approved by the Council and the European Parliament.

2) Level 2 – implementation legislation
   After consulting the ESC the Commission will ask the CESR (Committee of European Securities Regulators) for an opinion on the implementation measures of the directive. The CESR's task is to prepare a proposal based on discussion with market participants, end users and consumers. The Commission will review CESR's position and propose an implementation measure to the ESC, which will vote on it in three months' time. In the end, the Commission will either approve or reject the particular measure. Throughout the whole period the European Parliament needs to be kept informed in case that implementation competencies are infringed.

3) Level 3 – interpretation
   The CESR will formulate a common interpretation and ensure consistent implementation and application.

4) Level 4 – enforcement and verification
   The Commission verifies conformity of national legislations with the EU legislation, and can take action against the country that infringes the Community law.

Further, the Committee of Wise Men proposed that the following issues should be seen as priorities: modernization of the issuing process, registration of securities, extending of the "single passport" principle, and implementation of common accounting standards. The Committee of Wise Men measures were discussed at the spring 2001 summit in Stockholm.
The European Parliament had certain reservations about the limitation of its role in the legislative process, so the final compromise was not reached until February 2002. It is difficult to evaluate the new implementation mechanism, taking into account its relatively short history. Until today, no Level 2 measure has been approved. Nevertheless, after the March 2002 summit in Barcelona, during the Spanish and Danish presidency, there has been an overall speedup of legislative work.

Institutions

The European Securities Committee (ESC): newly-established committee of the European Commission, in which each Member State has a representative and which has co-decision making competencies.
The Committee of European Securities Regulators (CESR): an association of European capital market regulators, which performs an advisory function in the measure implementation process. It has replaced the FESCO (Forum of European Securities Commissions), whose competencies were more limited.

At present it is assumed that the general conditions for the development of integration on financial markets are favourable, in particular thanks to significant legislative activity. Persisting problems include an insufficient common infrastructure, which is a result of the fact that for a long time domestic institutions developed so that they covered domestic needs above all. Therefore, and compared with the United States, European financial markets cannot be considered as integrated.

The best integrated is the European money market, where the adoption of the single currency (1999), the introduction of the TARGET payment system, and the Directive on Settlement Finality meant a major breakthrough.

The securities market (stocks and long-term bonds) – compared to the money market – still remains considerably fragmented, although the euro has induced strong pro-integration tendencies on this market, too. On the treasury bond market, treasury bonds were re-denominated in euro at the beginning of 1999; all new issues have been denominated in euro. Further, issuing schedules have been synchronized. The elimination of the exchange rate risk has caused a significant approximation of treasure bond yields. The persisting differences are due to the fact that there are eleven treasury bond issuers using different issuing methods and techniques. In the area of corporate bonds there is a prevailing trend towards greater issuing activity. Unlike in the USA, finance brokers (banks, in particular), who enter between the investors and the issuers, play an important role in Europe.

The key European subjects on the stock market are the London Stock Exchange, Euronext and Deutsche Börse (the German Stock Exchange). Since the adoption of the euro growing integration on stock markets has been observed, which manifests itself by greater correlation between stock price movements across the EMU. There is an overall increase in the number of cross-border purchases as well as in their concentration, especially because of horizontal and
vertical mergers and the establishment of alliances between the individual stock exchanges (vertical concentration = putting the individual activities related to securities trading "under a single roof", i.e. integration of trading, clearing, settlement and custody into a single institution; horizontal concentration = consolidation at the same level, i.e. stock exchange mergers or integration of national settlement systems). A perfect example of these tendencies is the establishment of the Euronext in 2000.

**Euronext**

In 2000 stockholders of the Amsterdam, Brussels and Paris stock exchange obtained the new Euronext shares in exchange for their existing shares. Before 2001 a single trading platform (NSC) was created based on the Paris Stock Exchange system, where members of the three above-mentioned stock exchanges can access all registered securities, in accordance with the unified rules. For every share a common order book has been created, which has greatly contributed to the transparency and liquidity of the market⁶. Further, a unified clearing system Clearnet SA (based on the Clearing21 software) was established in Paris, in which net positions of all members are calculated every business day. Clearnet SA comes between the two transacting parties (central counter-party) and thus guarantees their settlement. Financial settlement is done through a system of central banks while transfer of securities is handled by national depositories. With the second highest market capitalization (after the London Stock Exchange)⁷, Euronext has become one of the key players on the European capital market. The Euronext strategy is simple: to expand, to extend the product range and the customer base, and to increase the overall market capitalization of registered securities by means of an organic growth. In 2002 Euronext was extended to cover the Lisbon Stock Exchange, acquired the LIFFE⁸, concluded agreements on mutual membership with the Helsinki and Warsaw Stock Exchanges, and is planning a joint venture with the Euroclear international depository. In 2003 LIFFE CONNECT was established as a single cross-border derivatives market.

However, Euronext is far from being a rare example of supranational cooperation between stock exchanges. The interconnection between the Helsinki and the Tallinn Stock Exchange can be of interest to the Czech investing community. On the other hand it should be understood that cooperation (especially regional) does not always have to be successful, taking into account the high costs associated with most projects (the NEWEX Central-European stock exchange project, for instance). Neither the Euronext is trouble-free in all respects; there are persisting problems especially as regards settlement of transactions.

Despite the positive influence of greater concentration, stock markets remain fragmented to a considerable extent. A single passport for issuers (the Prospectus Directive) could help many European investors to extend their horizons. The main and still-persisting problem of the stock and securities market is the fragmentation of settlement systems. There are seventeen different national central depositories (settling transactions especially at the national level). While at the
American NSCC’ by everyday calculation of all members’ net positions about 97% of all transactions are settled, in Europe only 40% of transactions are settled this way on average. Although in the EU domestic transaction costs are often lower than in the USA, transaction costs associated with cross-border transactions can be several times higher, depending on the country. The EU’s efforts in this area are heading towards the establishment of conditions under which market forces themselves would initiate a single clearing and settlement system. According to the Giovannini group’s conclusions, the integration of clearing and settlement can basically be achieved in three ways: first: single European clearing (one central counter-party) and a single settlement system; second: single clearing (one central counter-party) and settlement at the national level (through national central depositories and central banks); and third: a higher number of mutually interconnected clearing and settlement systems. Since 1968 there is Euroclear, the all-European supranational settlement system for securities transactions. It is based on electronic settlement (delivery/payment), and is currently planning a joint venture with the Clearnet SA (Euronext clearing). A similar principle is utilized by the Clearstream, another depository and settlement centre. Its customers include also the Czech UNIVYC (General-Purpose Settlement Centre), which settles transactions at the Prague Stock Exchange.

In the banking sector, wholesale trading with interest products and currencies between European financial centres seems to be relatively homogeneous and efficient. The area of wholesale banking is the domain of the biggest European banks.

The majority of smaller national banks concentrate on the associated retail market, within which companies and consumers usually obtain loans, open current accounts, obtain mortgages etc. This market, however, remains fragmented to a great extent. This is due to the insufficient synchronization of legislation in the field of consumer protection, non-existence of a single retail payment system, different banking cultures, and language differences in the individual Member States. Unfortunately, few subjects seek consumer credits, current accounts or mortgages outside the national market (beyond the country’s borders), and banks put little effort into obtaining cross-border clients. Due to the low intensity of international competition (monopoly of the domestic banking sector) in retail service provision, despite the existence of the common currency there are differences in retail interest rates between the individual members of the Union. National mortgage markets remain completely different, as far as both framework regulation and convenience are concerned.

At the national retail level there is a prevailing tendency of banks to deepen the comprehensiveness of the provided services, i.e. to provide (through subsidiary companies) possibilities to invest in shares funds, to conclude building savings contracts, or to join pension plans. In the 1990s the market concentration increased and a lot of bank mergers took place in the EU; however, few of them were between banks from different Member States.
The Czech capital market

Compared with the other transitional economies, the Czech Republic has a relatively large financial sector; the value of financial assets exceeds 160% of the GDP. Its characteristic features include, above all: high market concentration, strong position of the banking sector, underdeveloped capital market with a low level of corporate governance, and high foreign participation.

The high market concentration manifests itself in all areas of the financial sector. The banking sector is practically controlled by the three biggest players with about 60% of all banking assets. On the securities market there exists a very small number of highly liquid "blue chips", with which most transactions are done and in which a limited number of big dealers play a major role.

In the Czech Republic, just like in most European countries, banks have a key role in the allocation of savings between investment projects (financial brokering), while the significance of the capital market remains low with a low level of corporate governance. According to the "Corporate governance risk survey in the Czech Republic", the Czech Republic has (after Slovakia) the lowest CGR index, the greatest shortcomings in the area of law enforcement, and a business environment with low ethical standards.

The banking sector

The size of the Czech banking sector exceeds most banking sectors of the new Member States. Banking assets in the Czech Republic represent about 130% of GDP and credits 60% of GDP; in Hungary and Poland the proportion is about 60% of GDP. It is because in the former socialist Czechoslovakia there actually existed a certain form of banking system; therefore it was not necessary to start from scratch. On the other hand, compared with the EU average (where banking assets represent about 260% of GDP and credits 130% of GDP) the level of Czech banks’ financial service provision is still rather low. The reasons for such a big difference between the transitional economies and the EU are, above all, the short history of traditional banking and the second wave of transformational crises (in the Czech Republic 1997-99), which revealed a great number of bad loans. The subsequent growth in the number of classified loans in the Czech Republic caused distrust of the Czech corporate sector, and led banks to purchasing more treasury bonds and other liquid securities and to a slowed-down loan activity. The possibilities to invest in alternative treasury bonds grew with the growing deficit of the state budget, which was – to a considerable extent – caused by the costly stabilization of the banking sector. The banking sector saw the highest number of classified loans in 1999; see Chart 1. Classified loans were gradually transferred to the Czech Consolidation Agency, banks were stabilized (the overall cost of stabilizing the banking sector exceeded one fifth of the annual GDP) so that they could be sold to strategic partners.
The transformation of the Czech banking sector did not begin until banks were privatised by strong foreign owners. In Komerční banka, the French Société Générale has focused on risk management; in Česká spořitelna, the owner Erste Bank enforces transformation of all spheres through project management; and in ČSOB, the Belgian KBC wants to create a strong group with focus on bank insurance19.
At the beginning of the transformation process, under rather lenient regulatory conditions, a good number of banks were established – and they gladly offered loans to almost anyone. The development of the banking sector structure towards greater concentration is shown in Chart 2.

The greater concentration, bank rescue operations and foreign ownership have stabilized the banking sector. This is why after entering the EU no significant ownership or structure changes can be expected. Banks continue to pursue their careful strategy, which usually expresses itself as over-capitalization (greater than 13.5% proportion of capital in risk-weighted assets)21 and high liquidity (on average greater than 35% proportion of liquid assets). All these facts suggest that the banks’ loan activity should increase in the long term. At the present time, the banking sector needs to improve its competitiveness in the European context. Retail service fees charged by Czech banks are often significantly higher than services provided by their parent companies in Europe22. And domestic retail services that make use of the knowledge of the domestic environment are the activities Czech banks will especially concentrate on after entering the EU. The big Czech banks will increasingly coalesce with their parent companies and act as their branches23. Therefore, thorough transformation of the banks, greater comprehensiveness of the provided services, and lower fees are necessary. The subsidiary companies of the KBC, Erste Bank and Société Générale that have their own shares funds are slowly becoming integrated with investment trusts of ČSOB, Česká spořitelna and Komerční banka.

The capital market
In the Czech Republic, just like in the other new member countries, the capital market is scarcely used as a source of investment project funding. There are several reasons for it. One of the most important factors is the fact that the history of the Czech capital market is relatively short. During its existence the corporate sector underwent restructuring, and the legal and regulatory framework for investors (corporate governance and shareholder protection) was established "on the way". In this respect the privatisation method was important as well, which to a considerable extent predetermined the future ownership structure and, therefore, the capital market culture and a lower level of corporate governance24. It is also necessary to mention that in the Czech environment an important role has been played by the inflow of foreign direct investment, which has in many ways replaced domestic sources of capital. The relative importance of the Czech capital market in Europe depends, of course, also on the given country’s economic strength and on the number of domestic "blue chips", which create the liquidity of the capital market.

Stock and bonds
The Czech (as well as the Polish and Hungarian)25 capital market is among the few accessing country markets that can be meaningfully compared with capital markets in the European Union.
In the Czech Republic stock is handled on two organized, fully electronic markets – the Prague Stock Exchange (PSE) and the RM-SYSTEM (RMS) – or on the OTC (off-the-counter) market. The majority of stock transactions take place on the OTC market or at the PSE, between a small number of big investors with few liquid stocks. About 80% of securities transactions at the PSE are realized between the ten biggest stockbrokers. In 1997, when the Prague Stock Exchange registered stock of about 1,700 companies, the PSE began to exclude stocks with poor liquidity or with a low market capitalization. Further exclusion of securities took place after the amendment to the Securities Act (amendment no. 362/2000), which has changed the concept of a publicly tradable security to the (common in the world) concept of a registered security. Securities that failed to meet the requirements stipulated by the law had to leave the public markets within a year’s time period. Thus, in 2001 there remained only 102 companies registered at the PSE. In comparison with the rest of Europe, the market capitalization and the number of transactions done at the PSE are of marginal importance. The market capitalization of European stock exchanges is compared in Chart 3. According to the chart, the PSE’s market capitalization represents just one-half percent of the overall market capitalization of the biggest European stock exchange (Euronext). The liquidity level is incomparably lower, too, which is connected with a lower number of actively trading subjects and with a lower ratio of transaction volume to the market capitalization. The low liquidity of the market is also contributed to by the relatively costly final settlement of transactions (see the chapter on the Prague Securities Centre below). The low liquidity of the secondary market, together with administrative obstacles, make primary issues more difficult and expensive. Unless there is increase in the number of market participants and in the market’s liquidity and efficiency, issuers of the most liquid "blue chips" (such as Unipetrol, Telecom and _EZ) will leave the Prague Stock Exchange because issuing stock on foreign markets will be more profitable to them.

Bond transactions, although they are largely registered at the PSE, are usually realized through
the OTC market. Trading activity on the bond market greatly exceeds – in terms of turnover – the stock trading activity. Bond transactions contribute to the overall transaction volume by more than 90 percent. In particular, the treasury bond market is very liquid; its importance grows with the growing public debt. The corporate bond market is relatively less liquid. On the other hand, the overall value of corporate bonds is more than two times higher. As the adoption of the common currency is getting near, together with interest rate convergence treasury bond yields will converge to a considerable extent as well, which is also true (though to a lesser extent) of corporate bonds.

In 2001 the Prague Stock Exchange obtained a licence to trade in derivatives. However, it is becoming evident that there is not enough interest in derivative instruments (futures and options). Funds and insurance companies already use OTC market derivatives for security but the legislation forbids them from investing in derivatives for speculative reasons. The new law on collective investment should enable the emergence of new derivative funds.

The PSE and possible scenarios for its future development

Taking into account the low volume of transactions, relatively small number of members, and liquidity concentrated in a narrow market segment, the isolated existence of the PSE will probably be difficult to maintain in the future. This, however, does not mean that there do not exist numerous other mutually interconnected ways to improve the liquidity of the PSE and of the whole capital market. For instance, the establishment of the SPAD system at the PSE was a successful liquidity-supporting project. The transparency of the market has increased after a large number of poor liquidity stocks were excluded from trading. On the other hand, there is still a problem with the relatively costly final settlement at the Prague Securities Centre (PSC), or with the absence of primary issues on the capital market as such. Nevertheless, we believe that the cultivation of the domestic capital market, the policy of transaction cost reduction, and adaptation to European and world standards alone will not be enough for the PSE in the long-term perspective. The EU’s strong efforts to establish a single capital market encourages growth in the number of horizontal and vertical alliances and mergers between European stock exchanges. Despite the unsettled issues, competition between stock exchanges is getting stiffer and stiffer with the growing concentration, which suggests that on the future single European capital market there will be no room for a small, isolated stock exchange. An alternative to its independent development is an alliance with another stock exchange, bigger or smaller. The alliance can take several forms: sharing the same information channels and common acting (strategic partnership), integration of trading (a common trading platform and order book), or a full integration of all activities (trading, clearing and settlement) "under a single roof". We believe that the PSE can develop in the following ways in the future:

1) Joining the system of a big and well-functioning stock exchange (or alliance) through outsourcing

Outsourcing is a relatively new method: the owner of a certain well-functioning system makes the system available to a customer for a low installation fee and a share in future profits. This way, with relatively low costs involved, the PSE would obtain a proven trading platform and would become part of a large system. As free partnership would be established, PSE members would have access to the service provider’s stock exchange
(because of sharing the same system), and the PSE would not be forced into merging with another stock exchange. The exchange would not have to spend time and resources on the continuous development and maintenance of the system; instead, it could concentrate on harmonization, improving the quality of regulation, and product development. An example of such software is XETRA, the virtual trading system of the German exchange, which is installed at the Irish stock exchange. Another indisputable advantage is a quick implementation of state-of-the-art technologies. The domestic capital market participants could easily access foreign capital markets. Establishment of such a partnership with a respected stock exchange would naturally draw the attention of foreign investors, whom may have never thought of trading at the PSE. To registered companies this solution would bring better opportunities to obtain capital on the European capital market. However, it is necessary to consider that transactions would still be settled at the national level, which would greatly increase the cost of cross-border transactions.

2) Cooperation (merger) with a well-functioning stock exchange (or alliance)
This possibility presumes that the PSE first establishes a loose partnership with a respected European stock exchange. As part of this solution all major decisions would have to be coordinated, the structure and communication would be unified, and both stock exchanges would publicly act as one. In the second phase the partner exchange would buy out PSE’s stocks, or would pay for them with its own stocks. Realization of this solution would bring similar benefits as the outsourcing variant, the difference being that the PSE would ultimately (in case of merger) lose its autonomy and decision-making independence. Further, the big European stock exchanges and alliances are trying to put clearing and settlement "under a single roof" as well. Although these efforts are still hindered by numerous obstacles at the national level, in the future they could bring great savings on costs associated with cross-border demand for securities trading.

3) Establishment of a regional alliance
Initiating cooperation with the stock exchanges in Warsaw and Budapest (or, in addition, in Vienna, Ljubljana and Bratislava), possibly with a common trading platform, would bring both risks and benefits. The risk of this alternative lies in the low significance of all three markets. Their integration could lead to overall isolation and lower attractiveness to investors. It is very likely that the costliness of the project of an interconnection of small stock exchanges would not correspond with the low cross-border demand of the individual exchange members. It would represent a relatively big investment, which would still be a mere sub-step towards real integration into a single European capital market. The unsuccessful NEWEX project can serve as a warning against a single-minded orientation towards the establishment of an integrated Central European stock exchange. On the other hand, beneficial and advantageous can be cooperation in outsourcing of a common technology or in a common negotiation regarding strategic partnership or integration with a respected European stock exchange. The positive effect of common practice is difficult to quantify. Nevertheless, a common technology and system for Central Europe will – on the one hand – create a Central European capital environment (possibility of mutual interconnection), and – on the other hand – will link all relatively small stock exchanges to an important European exchange.
The question is: why has the PSE not taken one of the three ways already? This question is largely answered by Chart 3, which compares market capitalization of European stock exchanges. The comparison of the trading volume in the Czech Republic and in other European countries shows how lucrative the PSE is for developed European stock exchanges. Another topical issue is the costly way of settlement of securities transactions in the Czech Republic, which to a great extent hinders the possibilities of an effective interconnection with foreign settlement centres. When seriously considering the project of a close cooperation between the PSE and another European stock exchange, it is at any rate necessary to compare project costs and benefits (greater volume of transactions, larger member base). Costs have to be covered by the expected stockholder benefits. The integration itself requires installation of the same trading system and dealing with the problem of settlement, which may turn out very costly in the end. As far as settlement is concerned, the new law on capital market enterprising could help a great deal. It is important that the Prague Stock Exchange takes the way of full compatibility with the developed European stock exchanges (especially as regards legislation, trading procedures and open trading system) and actively seeks possibilities of effective cooperation. At first the cooperation will probably be rather loose and will not require great investments. Whether it results in a full integration, a buyout or just a loose partnership (for example through outsourcing of software) will depend especially on the particular benefits the project will bring to the stockholders. However, it is evident that the PSE will have to establish some kind of cooperation in the end. What we consider necessary is that the negotiations should not primarily concentrate on the Central European region, where costliness may prevent the project from keeping up with the latest business and technical trends, which might eventually result in isolation.

**Legislative changes**

The main legislative changes regarding the capital market are contained in the new laws on capital market enterprising and on collective investment. These laws replace the existing legislation, harmonize most of it with EU directives, and become main standards regulating the Czech capital market.

Among the numerous changes, the single passport principle represents a fundamental new principle adopted and incorporated into our system of law. Its main idea is that service providers in the EU will have to go through just one licensing procedure. First, service providers have to inform the domestic regulator (the Securities Commission) that they intend to provide services, establish a branch or issue/off er investment instruments in one of the Member States. Then they are required to document certain facts (extent of activity, equipment prerequisites, etc.). The licence is issued by the domestic rather than the foreign regulator, who is nevertheless informed about the issue of the licence. The foreign regulator then informs the passporting company about regulations that are different from the common legal regulation. The domestic regulator sees if "prudential rules" are observed. The passporting company is fully subject to all rules of conduct that the particular foreign country stipulates. Observance of these rules is monitored by the foreign regulator.
The new law on registration and settlement of securities transactions brings fundamental changes, too. The bill covers establishment of a new central depository and two-level registration of securities. The new central depository will register recorded securities, keep documentary securities and operate a settlement system. The new central depository will therefore function as a settlement system, too. These records will be linked to a register of stockbrokers and investment companies that are permitted to manage customers' property or to administer investment instruments (custodians). They will be able to open a "nominee account" at the central depository, on which securities of the account owner's customers may be registered only (not securities owned by the account owner). Thus, the final settlement of securities transactions will not have to be connected with making changes to the central depository records: the custodian will make the appropriate changes in his records (on owner accounts) "linked to the central register". It will no more be necessary for every recorded security owner to have an account at the Prague Securities Centre. Unlike the PSC (which is a subsidized organization), the new central depository will be a joint stock company, whose stockholders will include not only the Ministry of Finance but also banks, securities brokers, regulated market organizers etc.

Another legislative change (which will not be included in the bill but is part of the prepared amendment to the Investment Services Directive – ISD) regulates the organization of trading. After the amendment has been adopted at the European level and incorporated into the Czech system of law, it can be expected that transactions in the Czech Republic will be allowed either on a regulated market (stock exchange) or in a multilateral trading system operated by a licensed securities broker. The European Commission has decided, on the one hand, to support establishment of multilateral trading systems in order to increase competitive pressure on stock exchange organizers. On the other hand, the Commission plans to make multilateral trading systems subject to a higher degree of regulation so as to eliminate (at least partly) the comparative disadvantage of highly regulated stock exchanges. In the Czech Republic the new rules will affect the RM-SYSTEM above all, which will have to be transformed into either a stock exchange or a multilateral trading system. It will not be possible anymore to operate an organized unregulated market on a non-member basis. That is why RM-SYSTÉM will lose a significant portion of its current customers base.

As far as collective investment is concerned, terminology changes and establishment of new types of fund are expected: real estate, derivative and other funds. Czech shares funds will not have to pay the 15% tax but, as it is with foreign funds, their tax liability will continuously decrease towards zero. Investment companies will be allowed to issue and offer participation certificates through their organizational authority, or through another authorized person in a Member State who has received permission from the Czech Securities Commission. Foreign investment companies will be allowed to offer their participation certificates through domestic investment companies, which will support closer cooperation between investment companies of the big Czech banks and investment companies of their foreign owners.

It is important that should their rights given by the Community Law be infringed, Czech companies would be able to complain at the European Court of Justice. Thus, in the future it will be theoretically possible for clients of bankrupt investment companies (to whom
appropriate compensation was not paid from the Securities Brokers Guarantee Fund) to make a complaint at the European Court of Justice.

**The Czech Securities Commission**

In connection with the EU accesion, the Czech Securities Commission will have to start licensing Czech passporting companies and inform foreign regulators about them, supervise their activities with regard to the prudential rules, and monitor activities of foreign companies on the domestic market. The degree and quality of regulation and supervision of the capital market, together with tax provisions, will increasingly influence decisions of capital market participants as regards the location of domicile, branches, issues of securities etc. The Commission should also take active part in CESR and ESC activities and cooperate in the preparation of new directives and their implementation – within Levels 2 and 3 (see above at the beginning of this paper). Thus, the Czech Securities Commission will have to meet stricter qualification and material requirements in the future, and will have to take a more active part in the legislative process at the European level. Unfortunately, proposals to partly finance the Commission’s operation by the market participants have not been successful. We nevertheless believe that this would contribute to a greater financial stability and ensure sufficient finances for effective functioning of the Commission. The Commission would also become less dependent on the political power, and would make the capital market participants more involved in the regulation process. The particular way of financing by the market participants is, however, subject to a broader, nationwide discussion, and assumes a number of structural changes.

Generally speaking, supervision of financial markets is currently undergoing significant changes in the world. There is a prevailing tendency to integrate supervision into a single, specialized institution – FSA (Financial Supervisory Authority). There are several reasons for integrated supervision of the financial market. One of the most important ones is the changed structure of financial markets, within which striking differences between the individual types of financial institution are eliminated. As a result of this, requirements regarding supervised institutions overlap, which brings risk of non-uniform regulation. Integration should ensure consistent supervision on a consolidated basis as well as unified supervision with regard to the individual market segments. In the Czech Republic the following three subjects perform financial market supervision: the Czech Securities Commission (CSC), the Czech National Bank (CNB), and the Ministry of Finance. The Ministry of Finance is considering establishing a single supervisory body for financial markets in the Czech Republic. However, establishment of a new institution is a long-term project, and it is far from clear whether it represents the most suitable solution. Therefore it is likely that – rather than full integration – it will take the form of cooperation in supervising and division of responsibility between the CSC and the CNB as regards supervision of pension funds, cooperative banks and insurance companies. The CSC’s share of responsibility for supervision will probably increase, and the Commission will have to intensify its cooperation with the CNB.
The RM-SYSTEM

The RM-SYSTEM, as an organized market based on a non-membership principle, allows a relatively broad public to directly perform securities transactions. According to the prepared ISD amendment, the RM-SYSTEM should start considering transformation into a stock exchange or an alternative multilateral trading system operated by a licensed securities broker. Either way, according to the new European regularization, membership will be limited and current widely opened access to direct trading in the system will have to be restricted. As far as the RM-SYSTEM is concerned, the multilateral trading system might be a better solution. It would be subject to a relatively less strict regulation and relatively wider access to various customers could be maintained. Also, now that the PSE is negotiating about possible alliances with major European stock exchanges, the establishment of a second exchange on the Czech capital market is difficult to imagine.

Transaction settlement and the Prague Securities Centre

At present the Prague Securities Centre (PSC) is a depository for all recorded securities. An owner of a PSC account is also the legal owner of the securities on this account. There were 3,095,337 accounts as at 1 January 2003. The PSC makes it possible to settle transactions by direct, physical account-to-account transfer. Another possible way is to perform transaction settlement through the UNIVYC (General-Purpose Settlement Centre), which is a subsidiary company fully owned by the Prague Stock Exchange. Transactions are settled using the purchase/delivery versus payment model, in order to minimize the counter-party’s risk. However, according to the current legislation it is necessary to make the final transfer at the PSC because the legal owner of recorded securities is the owner of the PSC account on which the securities are registered.

Direct settlement through the PSC is associated with a considerable risk for the counter-party, as at the PSC money is not transferred together with securities transfers. Money is usually transferred the following day via the Czech National Bank’s inter-bank clearing system. Thus, the Prague Securities Centre is not a traditional settlement centre (as practised in foreign countries) but rather a mere register of recorded securities. This also means a narrower range of provided services. Currently, the main problem of the PSC is the costliness of its services, which is a logical consequence of the current decrease in transaction volume and of high fixed costs associated with the operation of the Centre. The trend towards increasing fees without appropriate improvements in the range and quality of services (combined with the Centre’s monopolistic position) poses danger for the entire Czech capital market because settlement costs are becoming disproportionate.

The new law on capital market enterprising replaces the PSC with a new central depository, and introduces two-level registration of securities. The possibility to keep a register of securities that is linked to the central register will minimize transfers between central depository accounts, which will help to make the settlement of securities transactions less costly. Further, foreign companies will have easier access to the Czech capital market. Foreign custodians will be able
to keep their customers’ investment instruments on a single account in the central depository. According to the new legislation, the central depository will be a joint stock company and will operate – in addition to the central register – a settlement system as well. Such legislation provides the opportunity to interconnect the PSC and the UNIVYC (the settlement centre of the Prague Stock Exchange), which could help to increase the range and quality of provided services. On the other hand, additional investment costs associated with the establishment of a central depository could initially affect settlement costs.

The integration of the European capital market will increase competition between settlement systems. The European Commission plans to support integration of the individual systems. Despite the fact that fragmentation still exists, competitiveness and compatibility of the settlement system is essential for the Prague Stock Exchange and its outlook for a future alliance with a foreign stock exchange. The services provided by the Prague Securities Centre are currently very expensive; the costliness of settlement further grows because of the one-level securities registration system used at present.

Conclusions and recommendations

The above-presented analysis of tendencies on the European capital market and of the situation on the Czech capital market leads us to the following conclusions and recommendations:

• Taking into account the current integration of European stock exchanges, the European Commission’s efforts to create a single capital market, and the low liquidity and importance of the Czech capital market, it is not possible for the Prague Stock Exchange to exist on its own in the long-term perspective. Although reducing transaction costs and providing more services is a good policy, the growing competition between European stock exchanges does not create conditions suitable for the existence of a small, isolated stock exchange. Isolation on the integrating European capital market would make the most liquid Czech securities and the key market makers leave for foreign markets. The particular form of cooperation will depend on the particular advantages the project will bring to PSE stockholders. Costs associated with the establishment of cooperation (be it a relatively free form of cooperation or a full integration) have to be matched with the expected benefits (a higher volume of transactions). Both the free alliance and the full integration of the Prague Stock Exchange can go in three directions: a) direct negotiations and an alliance with a respected European stock exchange (the German Stock Exchange, the Euronext); b) outsourcing software of an important European stock exchange (the virtual trading system XETRA, for example); and c) a regional alliance or cooperation. Taking into account the costliness of the entire project we do not find it sensible to pursue the strategy of establishing a Central-European stock exchange: the low importance of these markets in the European context could result in isolation from the newest European trends.
and in the loss of competitiveness. Either free-form cooperation or full integration, both should primarily focus on a more important European stock exchange. On the other hand, a common strategy of the Central-European region for negotiating with a leading European stock exchange (for instance, the German Stock Exchange in Frankfurt) could result in adopting a fully compatible trading model. Thus, a Central-European capital environment (exchange) connected to an important European stock exchange would be created. This strategy will give the exchange members direct access to the European capital market and to the neighbouring markets, and will enable Czech securities to be traded at the all-European level. Therefore we believe that this is the most advantageous strategy. Before the "time is ripe" for the final decision, it is necessary that the Prague Stock Exchange takes the way of full compatibility with the developed European stock exchanges (especially as regards legislation, trading procedures and open trading system) and actively seeks possibilities of effective cooperation.

- After the ISD amendment has been adopted and incorporated into the Czech system of law, the RM-SYSTEM will have to undergo transformation. Whether it gets transformed into a new stock exchange or into a multilateral trading system, small investors will no more have direct unlimited access to the public market. We believe that the transformation of the RM-SYSTEM into a multilateral trading system represents a more advantageous solution. On the relatively small Czech capital market (see Chart 3) there probably will not be enough room for two autonomous stock exchanges. When transformed into a multilateral trading system, the RM-SYSTEM will be subject to relatively fewer legal obligations and will maintain wider access to its users, which may be its comparative advantage.

- The Czech Securities Commission will have to start licensing Czech passporting companies and inform foreign regulators about them, supervise their activities with regard to the prudential rules, and monitor activities of foreign companies on the domestic market. Further, it will take part in CESR and ESC activities and cooperate in the preparation and implementation of new directives at the European level. As the government plans to establish unified supervision of the financial market, cooperation between the Czech Securities Commission and the Czech National Bank will grow as well. We believe that in connection with EU accession there will be much stricter requirements as regards the quality of work at the CSC, which will increase operation costs. Thus, an appropriate (and permanent) financing resource for the CSC has to be found. One of the possible ways to obtain the necessary resources would be partial financing by the market participants. However, the particular implementation of this concept, i.e. to what extent the CSC will be financed by the state and by the market participants, is subject to a broader, nation-wide discussion.
• The services provided by the Prague Securities Centre (PSC) are currently too expensive, and the costliness of settlement further grows because of the one-level securities registration system used at present. The costly settlement decreases the liquidity of the market. Fundamental changes will come with the new law on capital market enterprising, which will replace the PSC (a subsidized organization) with a central depository (a joint stock company), and which will introduce two-level registration of securities. The new central depository is legally obliged to operate a settlement system, which suggests cooperation with the UNIVYC settlement centre, a subsidiary company of the Prague Stock Exchange. This cooperation could bring a wider range and better quality of services. The two-level system of registration alone should contribute to settlement cost reduction. Should the PSE become integrated with another European stock exchange, competitiveness and compatibility of the transaction settlement system is very important.

• In the banking sector we expect that Czech banks will function rather as retail branches of their big strategic owners. Thus, in the future there will be "banks in the Czech Republic" rather than "Czech banks". They cannot be expected to provide their own, competitive services on the European market; conversely, they will more and more play the role of agents offering their owners’ products. With regard to this retail orientation, the banks should concentrate on thorough transformation, lowering fees, more comprehensive services (shares funds, leasing, building savings, pension plans etc.) so as to be able to profit from their comparative advantage – good knowledge of the domestic environment.

Notes

3 Akční plán finančních služeb (Action plan for financial services), Bankovnictví 4/2003, p.10
5 OECD Economic survey 2002-EMU, p.74-113: Policies to boost financial market integration
6 The Euronext portal: http://www.euronext.com/editorial/wide/0,4504,1732_4427342,00.html
7 2,420 billion euro
8 London International Financial Futures and Options Exchange
9 US National Securities Clearing Corporation
13 Česká spořitelna, ČSOB, Komerční banka
14 Vychodil Ondřej, Sedláček Tomáš, Kudrná Zdeněk, Katová Ilona, Corporate Governance risk survey in the Czech Republic, Merit Research working papers No. 2, May 2002
15 Corporate governance index
17 The Czech Consolidation Agency not included.
18 Ročenka Hospodářských novin 2003
19 Ročenka Hospodářských novin 2003
20 Ownership changes could possibly take place at the European level. If the foreign owners of Czech banks themselves entered larger global groups, the biggest Czech banks could be affected as well. However, until now within the EMU increased market concentration in the banking sector has been taking place more or less exclusively at the national level. It is therefore difficult to predict whether we can expect foreign mergers or acquisitions of the biggest domestic banks’ parent companies.
21 The capital adequacy rules require just 8%.
22 Dubská Drahomíra, Bankovní sektor zdevastoval české veřejné rozpočty. Jaký je po velké sanaci? (The banking sector has ruined Czech public budgets. What is it like after the great stabilization?) Ekonom 12, June 2003, p. 32.
23 For example the subsidiary companies of the KBC, Erste Bank and Société Générale that have their own shares funds are slowly becoming integrated with investment trusts of ČSOB, Česká spořitelna and Komerční banka.
24 In the "coupon privatisation", most companies were privatised by investment trusts in which big non-privatised banks had a majority share. Thus, the privatised companies have been taken over by the state again.
25 Another important exchange is the Tallinn stock exchange, which has merged with the Helsinki stock exchange.
27 Twenty-five members of the Prague Stock Exchange compared to 360 international members of the stock exchange in Frankfurt.
28 On the other hand, it is necessary to consider that the introduction of trading through market makers was seen as a step backwards by foreign investors (controlled insider trading).
29 The absence of public subscriptions is caused by (besides other factors) Czech legislative obstacles, which greatly delay the subscription process itself (from recording the stockholders meeting resolution regarding increase of capital stock to registering stocks at the Prague Securities Centre or entering the public market) and thus block the investor’s resources for a long time. Therefore, investors cannot time their decisions very well.
The persisting non-uniformity and costliness of final settlement across Europe; see the Giovannini Report.

See for example the Euronext efforts.

Costliness associated with the introduction of a single trading system, unification of trading rules, etc.

See the section on the Prague Securities Centre and settlement, where the Czech settlement issues are discussed in more detail.

At the time of finishing this paper the final version of the law was not available yet – just the bill.


For example, for securities brokers passporting to the EU it means requirements for certification, capital adequacy, suitability of persons, qualified participation, etc.

The central depository will be a licensed business and thus can be operated by several companies.

See Section 99 of the capital market enterprising bill.

Also of foreign persons with the same permission, foreign central depositories, and foreign persons authorized to keep a register of securities (see Section 91 of the capital market enterprising bill).

The bill recognizes two types of account, according to the relation between the account owner and the owner of the investment instruments (Section 107): a) owner account – the account owner also owns the investment instruments registered at this particular account; b) client account – the account owner does not own the investment instruments registered at this particular account.

On client accounts, only investment instruments can be registered whose owner has concluded a property management agreement with the account owner (in accordance with the Commercial Code), or whose foreign owner has concluded an agreement on management of investment instruments with the account owner.

At the time of finishing this paper, the final version of the directive approved by the Council was not available.

The European Parliament gave support to the first reading of the ISD amendment bill on 25 September 2003. On 7 October the bill received political support from ECOFIN. The final amendment was adopted at the European level at the end of April 2004, after the closing date of this paper.

A good example is the establishment of integrated supervision in Germany in May 2002 (by integrating three originally independent authorities: the Credit Institutions Supervisory Authority, the Insurance Supervisory Authority, and the Capital Market and Securities Supervisory Authority), the establishment of integrated supervision in Austria (May 2002), or the adoption of the project for establishing integrated supervision in Slovakia (before 2004).

An example of activity overlapping in the Czech Republic is the fact that the Czech National Bank assesses managers nominated to the bank’s Board of Directors, and further
assessment is done by the Czech Securities Commission, even of the Board member in charge of securities trading (Michl Alés, Reforma dohledu potrvá několik let. Supervision reform will take several years. Hospodářské noviny, 12 August 2003, p. 209).

A quick transfer of responsibility for supervision to a single independent institution could disrupt the continuity of supervision of the individual financial market segments.

Above all, establishing supervision of the banking sector could be very costly.

In February 2003 the Czech National Bank, the Ministry of Finance and the Czech Securities Commission signed an agreement regarding cooperation in providing banking supervision and state supervision of the financial market. The new agreement allows flexible formation of workgroups composed of employees of the above-mentioned institutions, to deal with problems that exceed the individual scopes of responsibility. Thus, it will be possible to assess risks better for a group of mutually interrelated persons (CSC news release from 17 April 2003, http://www.sec.cz/script/web/PressDetail.asp?ID=2047&).

A system of two institutions supervising the financial market is a common solution in foreign countries (Finland, for example).

Transformation into a stock exchange would make it necessary to greatly increase the capital stock of the RM-SYSTEM (with the current requirements, from 23 million CZK to 100 million CZK – which means fivefold increase).

Settlement through the UNIVYC can take place only if the securities are blocked at the Prague Securities Centre on behalf of the broker, and if the broker has signed an agreement with the bank that will perform clearing from the CNB.

The Centre has built its pricing policy on the overall nominal value of the securities on the owner’s account.

Accumulation of instruments on a single account is widely practised nowadays, however, without appropriate legal regulation.

According to an estimation made by Mr Šticha from PVT it is about 100-200 million CZK.

Now that the Prague Stock Exchange is negotiating about international cooperation we do not consider the Czech capital market large enough for the existence of two stock exchanges. For example, the transformation of the RM-SYSTEM would necessitate fivefold increase in the RM-SYSTEM’s capital stock.

It is still quite difficult to predict how much extra work the Czech Securities Commission will have to do in this area.

Establishment of a single institution responsible for the supervision of the financial market is not very likely in the forthcoming months. A quick transfer of responsibility for supervision to a single independent institution could disrupt the continuity of supervision of the individual financial market segments. Rather it is more probable that for the time being, the financial market will be supervised by two cooperating authorities: the Czech National Bank and the Czech Securities Commission.

A lot of foreign regulators are fully or partly financed by the market participants (for instance, the German BAFin, the British FSA, the Italian CONSOB, and the Slovak ÚFT).