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**Article**

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# **Institutional Arrangement of Financial Markets Supervision: The Case of the Czech Republic<sup>#</sup>**

*Petr MUSÍLEK\**

## **Introduction**

Banking, capital and insurance markets have been going through dramatic changes in the Czech Republic over the last years. International competition, offer of new financial instruments, expansion of modern information technologies and demographic changes have been considerably changing the Czech financial markets functioning. Financial institutions specialized particularly in national operations have been gradually transforming in multinational-oriented financial supermarkets carrying on business simultaneously in banking, capital and insurance markets. The changes of the Czech financial markets have been promptly noticed by supervisory authorities. Consequently, the targets, forms, and instruments of supervision have been adapted and institutional structures of financial supervision have been transformed. This paper aims at analyzing the development of institutional arrangement of financial markets supervision in the Czech Republic in 1990s and at the beginning of the new millennium.

## **Models of financial supervision**

In advanced countries, financial supervision is performed by various authorities and institutions benefiting from different level of independence and financed in different ways. Literature on financial supervision [e. g. Abrahams – Taylor (2000), Revenda (2001), Carmichael

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– Pomerleano (2002), Hall (2003), Čihák – Podpiera (2006)] has not so far provided an outstanding and conclusive research evidence allowing us to establish an ideal model of institutional arrangement of financial supervision. Due to national differences (historical development, tradition, financial system structures, size of economy and financial market, political situation), in advanced countries, there are various models of institutional integration of financial market supervision. Although a unique approach cannot be found, we may state that in the last decade the worldwide number of sectional supervision institutions tends to decrease, unified integrated supervisory institutions are emerging, the role of central banks in prudential supervision is shrinking, the role of central banks in **financial stability assurance and development of financial consumers' protection tends to be more and more important**. Main models of institutional arrangement of financial supervision (g. e. Carmichael, Fleming and Llewellyn 2004) in advanced countries are as follows:

- sectional financial supervision model,
- integrated independent financial supervision model,
- integrated financial supervision within the framework of the central bank,
- functional model of financial supervision.

**Sectional financial supervision model** is a traditional model of institutional arrangement of financial institutions supervision. The model assumes the existence of relatively non-interconnected financial market segments and operation of specialized financial institutions. This kind of model is applied for example in the USA, in France or Turkey. These specialized financial market segments are supervised by a sector-specialized supervisory authority. **The central bank** supervises activities of banks or other financial institutions **and specialized supervisory institutions** focus mainly on securities and insurance market.

Since 1980s specialized financial institutions have been transforming in the financial markets into financial supermarkets, offering a large variety of deposit, credit, investment and insurance products (e. g. Dvořák, 2005). Financial supermarkets operate simultaneously in several financial sectors with different supervision. The supervision is therefore performed by diverse institutions leading to overlapping supervision activities as well as to gaps (non-supervised areas) within the supervision system. Creation of financial supermarkets results in creation of a more

efficient model of institutional structure of financial markets supervision (e. g. Heffernan, 2006 or Bessis, 2007). Gradually, the sectional model fades away and the **integrated independent financial supervision model** takes its place. This model ensures a complex and coordinated approach to the supervision of financial groups. Institutional changes result also from other factors, such as failure of financial institutions, advancement of financial consumers' protection, financial innovations, diminishing importance of banks, financial markets internationalization. Integrated independent financial supervision comprises not only **prudential supervision**, but also **rules of conduct towards customers and markets above the banking market, securities and insurance markets**. The integrated independent financial supervision model started to put across at first in Europe. In 1986 Norway became the first country to integrate all supervision activities into one authority (Kredittilsynet). Since that time, substantial number of advanced countries has taken over this model [e. g. Great Britain (Financial Services Authority), Japan (Financial Supervisory Agency), Germany (Bundesanstalt für Finanzdienstleistungsaufsicht), Austria (Finanzmarktaufsicht), Sweden (Finansinspektionen), Hungary (Hungarian Financial Supervisory Authority), Denmark (Finanstilsynet)].

**The model of integrated financial supervision within the framework of the central bank** is characterized by integration of monetary policy and all supervisory activities. Within this model, the supervision of banking, securities, and insurance market is fully integrated into the central bank activities. This model is characterized by a very close personnel and information connection between the monetary policy and supervisory activities. The Central bank is mostly managed by a collective body responsible for monetary policy as well as for supervisory activity. The supervision is usually financed from central bank's budget. This is not a standard model and at present it is applied only in Slovakia, Czech Republic, Singapore and in some off-shore centres (e. g. Bahrain, Bermudas, Macau, Netherlands Antilles). **Specific position of the supervisory body within the central bank** is conceived as a particular alternative within supervision integrated into the central bank. Decision-making power within supervisory process is held by supervisory department management. Monetary policy and supervisory activities are strictly separated. Supervisory activities are financed from the central bank's budget. Co-financing by financial institutions subject to supervision is also possible. This model of institutional structure of financial supervision is currently applied in the Republic of Ireland.

The idea of **functional model of financial supervision** is based on general microeconomic grounds justifying state interventions into the market (expansion of negative externalities and resulting financial system instability, presence of information asymmetry, unfair business practices, imperfect competition). Instead of financial institutions supervision, the model aims at supervising individual functional elements of the supervision and control system, amending thus the regular market failure. This model first arose in Australia, where the Wallis' Committee published final report in March 1997. In 1998, based on the recommendations of the Wallis' Committee, the Australian government accepted new institutional arrangement of financial supervision based on following agencies: The Australian Competition and Consumer Commission (responsibility for supervision of the competition), The Australian Securities and Investments Commission (supervision of the conduct of business), The Australian Prudential Regulation Authority (prudential supervision of the financial institutions) and The Reserve Bank of Australia (responsibility for financial stability). In some countries, the functional model is implemented in a simplified form. It is based purely on a **two-pillar system**, the first pillar (usually the central bank) is responsible for prudential supervision of financial institutions business activities, supervision of payment system and monitoring of financial system stability. The second pillar (institutions for financial consumers' protection) accounts for consumers' protection including market abuse, edification and financial education. This model is recommended for example by Goodhart (1998) or Taylor (1995, 1996). Twin Peaks Model uses g. e. Netherlands. De Nederlandsche Bank (central bank) and Pensioen- and Verzekeringkamer are responsible for the prudential supervision of the financial institutions. Autoriteit Financiële Markten (AFM) acts as supervisor of the conduct of financial business.

### **Czech financial supervision arrangement in 1990s**

At the beginning of 1990s the Ministry of Finance was the sole supervisory body over the newly established financial market in the Czech Republic. The banking and insurance sectors played a crucial role over this period, other sectors were not existing at all or started just to develop. At the beginning of 1990s, the structure of financial supervision may be compared to **integrated financial supervision model**, although unconventionally positioned within the Ministry of Finance. This

approach did not comply with the demand for independent supervisory body. It is recommended not only by the leading regulatory theory, but also by international financial organizations, that the supervisory body has clearly defined competences and targets and that it is independent from the government as regards human resources and operation. Human resources independence means that nomination and dismissals of collective body members are independent from government change, political cycles or current distribution of political forces. Principle of operational independence assumes independence of the supervisory institutions in decision-making regarding issues legally delegated to this body, the institution performs activities without any external influence and is competent in the sphere of secondary regulation. The supervisory institution is not a part of the central bank, neither another public administration body. The financing system of the supervisory body has to ensure its financial independence so that the institution can recruit qualified employees and acquire up-to-date technical instruments for supervisory activities performance.

Following a gradual development of the Czech financial market in 1990s, individual sectors start to separate from the legislative point of view quite promptly and supervision competences detach from the Ministry of Finance to newly established supervisory bodies. In 1994 a new section of banking supervision came into existence in the Czech National Bank. This section focused on supervision of prudential banking regulations and on remedy of revealed failures. Gradually, this body took over all the supervisory competences in the banking sector from the Ministry of Finance.

The Ministry of Finance performed all the state supervision over the capital market till the end of March 1998 when the Securities Commission was established. An excited discussion regarding creation of specialized supervisory body for capital market took several years and for a long time there was not a sufficient political support for establishment of this institution. Only the insufficient protection of minority shareholders, wave of scandals at the evolving Czech capital market after the end of voucher privatization in the second half of 1990s, political crisis in 1997, and initiative of Prague Stock Exchange encouraged the establishment of a supervisory body for capital market independent in terms of human resources and operation, nevertheless financially dependent on the state budget. Descriptive analysis the development of the Czech market in the 1990's is done by many Czech authors [e. g.

Musílek (1998), Revenda (2001), Dvořák (2005)]. The insufficient protection of minority shareholders after voucher privatization in the Czech Republic describes the box A.

***Box A: The insufficient protection of outside shareholders***

*Czech financial market has not undergone a classic financial crisis (breakdown of the securities market, massive sellout of assets, collapse of market prices of traded instruments, collapse of majority of financial intermediaries) in the last two decades. The field of Czech capital market showed characteristic signs of the emerging market in the 90's with some of the defining characteristics being: financial liberalization, high level of information asymmetry, low predicative potential of financial statements, significant oscillation of fundamental factors, little effective transfer of savings from surplus units to deficit ones, disproportionately high risk adversity of surplus units, low liquidity of secondary securities markets, high transaction volatility of securities markets, dysfunctional system of not only private and juridical but also of regulatory enforcement of private financial contracts and insufficient protection of outside investors. A selected model of privatization – voucher method – was a specific aspect of the newly emerging Czech financial market. It consisted in “artificial” initial public offer of more than 1 700 joint-stock companies whereas most of them were non-marketable joint-stock instruments from the economic point of view. However, the aim of the selected privatization model probably was not to create a liquid secondary market, but, rather, to prepare the companies into a “privatizable” shape. While the subsequent process of spontaneous privatization and concentration of ownership rights (the 3<sup>rd</sup> wave of the voucher privatization) led to quick creation of a new ownership structure of the Czech companies, the cost was insufficient protection of rights of outside investors (violation of rights of minority owners and creditors, price manipulation, trading and investing based on private information, misusing and stealing managed assets), which broke the trust of the wide investment public in the emerging Czech securities markets and, simultaneously, limited the inflow of free financial resources into this emerging segment of the financial system. The overwhelming majority of savings was allocated through an oligopoly banking market with the decisive role of semi-state banks in the 90's. The capital market played larger role in the Czech financial system only in the middle of the 90's when not only the investment firms but also banks were active in mediating such investment trades that aimed at concentrating ownership*

*rights. The “third” wave of the voucher privatization took place in the period when the institutional environment was still very imperfect (mechanism of enforcing private financial contracts, information systems, regulation). The textbook example of the imperfect institutional framework was especially Czech collective investing. The case of Czech privatization funds is a deterring example of failure of effective protection of outside investors due to the ineffective enforcement of rights via private, court or regulatory ways. It is, however, very surprising that designers of the Czech model of privatization funds did not learn a bit from American experiences from the 30’s or European experiences from the 80’s when they were designing an institutional environment in the field of collective investing.*

*We believe that the neglect of care in the field of creating the Czech institutional investment environment in the first half of the 90’s was not intentional and purposeful, but that it followed from incomplete theoretical and practical knowledge of designers of the economic reform about functioning of world securities markets.*

*It was clearly proven on the newly emerging Czech securities market in the 90’s that minority shareholders and creditors are exposed to enormous risk of being dispossessed by majority shareholders. If outside investors finance a private deficit unit (company) they are exposing themselves to significant risk that the yield of their investments will never be effectively realized because insiders (majority shareholders and managers) will usurp it illegally. Dispossession can take one of the following forms: alienation (theft) of profit and assets, sale of assets to associated person for non-market price, overpaying managers or installing associated or unqualified people in administrative bodies of the company.*

*The above-mentioned forms of dispossession mean, however, that the insiders use profits and assets of the company to their own advantage and at the expense of the outside investors who are entitled to them. If massive dispossession of profits and assets of outside investors takes place on securities markets the trust in financial investing completely disappears. If the rights of investors (e. g. voting rights of shareholders, reorganization and liquidation rights of creditors) are extensive and, simultaneously, if they can be enforced effectively by private institutions, regulatory bodies or courts outside investors are willing to finance deficit units. However, if the legal system does not sufficiently protect*



*outside investors then securities markets do not develop sufficiently. We believe that it was precisely the second scenario that was characteristic for the Czech investment environment in the last decade. The reaction of risk-averse surplus units (households) is then quite rational: citizens allocate the overwhelming majority of their financial assets in bank-deposit instruments, which contain implicit or explicit state guarantees.*

State supervision in insurance was performed by a special division of Ministry of Finance over all the 1990s. Since September 1<sup>st</sup> 2000 this division has been renamed to Office of the State Supervision in Insurance and Pension Funds but remained in the organizational structure of the Ministry of Finance.

In 1996 saving and credit cooperatives start to emerge readily in the Czech Republic and within several months 45 cooperative banks were set up. This financial sector developed at the beginning without any supervision. At the beginning of 1997 Office for the Supervision of Cooperative Banks was set up as an administrative body financed from charges paid annually by its members and from potential reimbursable state financial subsidies.

With respect to the above briefly described structure of financial market supervision in 1990s, it is obvious that a **sectional financial supervision model** has been gradually constituted in the Czech Republic based on four independent supervisory bodies operation. At the beginning of the new millennium, disadvantages of this structure started to emerge, such as:

- fast development of financial market structure, sector-oriented structure of the supervision did not correspond to high level of integration and interconnection of individual financial market segments;
- intricate supervision of financial conglomerates;
- high costs of close cooperation and communication between sector-oriented supervisory institutions;
- risk of non-consistent approach of the supervision towards the regulated entities in various financial system domains;
- non-consistent supervision enhanced the risk of regulatory arbitrage between various financial segments leading to possible threat to competitiveness of a more strictly regulated segment, in direct proportion to the level of financial market integration;

- increased stress on market participants with financial supermarkets characteristics that can be subject to multiple supervision.

Although the sectional model started to be criticized not only by market participants but also by financial theorists [e. g. Revenda (2001), Čihák and Podpiera (2006)] this model proved some of its advantages:

- specialization in supervision activities;
- explicitly designated responsibilities for supervision performance, although the final effect depends on structure and overlapping of financial market sectors;
- competition between individual approaches to supervision activities;
- risk of diversification of supervision authority failure and mutual complementary performance of supervisory activities;
- the possibility to reflect some anticipated future changes in financial supervision in global or regional scale (e. g. single passport principle and supervision by the home state, creation of integrated supervision within EU, transition to functional model).

### **“Big bangs” in new millennium in the Czech Republic**

Since 2002 experts in the Czech Republic have discussed supervisory authorities' integration. Various models of financial supervision institutional arrangement and advanced countries' experiences have been examined. After several rounds of non-public discussion among experts of the supervisory bodies, in June 2003 the Ministry of Finance unexpectedly announced that an **integrated independent financial supervision model** shall be set up in the Czech Republic starting in 2005 by creating a brand new independent integrated office for financial supervision responsible for supervision of banking sector previously performed by the central bank, accountable for supervision of insurance and pension funds formerly supervised by the Ministry of Finance, and Securities Commission and Office for the Supervision of Cooperative banks shall be dissolved and its competences taken over by a new authority. Management of the Ministry of Finance decided without prior consultation with the experts to switch swiftly from the sectional model to the integrated independent financial supervision model characterized in the Czech financial system chiefly by the following advantages:

- the model responds to financial supermarkets creation by dealing with overlapping competences of specialized (sector-oriented) supervisory institutions or by preventing occurrence of gaps within the supervisory activities;
- achievement of economies of scale and scope during supervision activity performance;
- enables to coordinate stipulation and enforcement of regulatory requirements in relation to various kinds of financial institutions from different financial sectors;
- elimination of conflict of interest risk between the monetary policy implementation and banking supervision in the framework of central bank;
- preservation of central bank's reputation which is indispensable for efficient monetary policy performance;
- the model assures a more efficient international cooperation,
- central bank is able to specialise its activities entirely in monetary policy and management capacities are not dispersed which results in improved performance of the main central bank's activity.

The integrated independent financial supervision model is linked to some disadvantages, as follows:

- complex management of distinct sector-oriented approaches, mainly when establishing the integrated supervision;
- prudential supervision and consumers' protection requires distinctively different supervisory methods;
- definition of targets within the supervisory activity for individual sectors becomes difficult;
- competences to central bank's instruments are fragmented. Their use may be initiated by monetary purposes as well as by pursuit of prudential business activities of financial institutions;
- unsatisfactory instruments used to assure financial institutions stability, resulting in increased costs for monetary and supervisory policies coordination<sup>1</sup>;
- communication noise and information rigidity between the monetary policy and financial institutions;
- enhanced political pressure arising from responsibility for the complete financial system including banks;

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<sup>1</sup> E. g. non-efficient cooperation between central bank (Bank of England) and supervisory authority (Financial Services Authority) in the case of the Northern Rock.

- higher financial demand for the state budget in case of missing co-financing by market participants;
- insufficient experience, mainly over the period of financial crisis;
- recent history and low credibility in general public view.

Czech National Bank's management came strictly out against the Ministry of Finance management's proposition and succeeded in convincing the government not to create a new authority and to choose a moderate strategy of supervisory bodies' integration. In 2004 the Czech Republic government decided to divide the process into two phases: in 2005 (the first phase of integration process), 4 supervisory bodies shall be integrated into 2 bodies, that is Office of the State Supervision in Insurance and Pension Funds shall be integrated into Securities Commission (renamed to Financial Market Commission) and Office for the Supervision of Cooperative Banks shall be integrated into the Czech National Bank. In the next phase (determined to start one year before Euro implementation in the Czech Republic) the second stage of integration should start, however further details have not been defined yet. Pursuant to government resolution from 2004, legislative, organizational and technical works, related to the first phase of supervisory bodies' integration, were initiated. In spring 2005 the Chamber of Deputies of the Czech Republic approved in the first reading a package of financial laws enabling the Securities Commission to take over the competences related to supervision of insurance and pension funds, to transform this Commission into Financial Market Commission, and enabling the Czech National Bank to supervise Cooperative banks. Securities Commission's management devoted for more than one year most of its efforts to the preparation of Financial Market Commission. Nevertheless, on July 19<sup>th</sup> 2005 the Ministry of Finance management surprisingly declared that based on an agreement with the Czech National Bank's management, the former scenario, approved by the government and envisaging integration of supervisory authorities, shall not be implemented, and all the supervisory competences shall be transferred to the Central Bank in April 2006. Within several weeks, a comprehensive parliamentary act constituting an amendment of roughly 200 pages was prepared for the second reading of the negotiated package of integration financial laws in the Chamber of Deputies of the Parliament. This act was consequently – despite of heavy protests of the financial and legislative experts – approved.

The Securities Commission was dissolved by the end of March 2006 and all the financial supervision competences (including insurance supervision, supervision of pension funds and cooperative banks) were taken over by the Central Bank.

Therefore, since April 2006 the **integrated financial supervision within the framework of the central bank** is implemented in the Czech Republic and monetary policy is closely related to supervisory activities performance. We do not consider the designed alternative to be a long-term and efficient model of institutional arrangement of financial market supervision with regards to the following disadvantages:

- risk of conflict of interest between the monetary policy and supervisory activities of the Central Bank as described in detail for example by Goodhart (2000);
- fragmented capacities of the Central Bank's management leading to the risk of lower performance (mainly over the period of financial problems);
- Central Bank is an active participant in bond market where the bank exercises at the same time its supervision;
- risk of damage to reputation of the Central Bank and efforts to maintain the monetary authority credibility constitute limitations of supervisory activities, mainly regarding supervision of financial institutions dealing with clients and markets;
- considerable concentration of power outside direct sphere of the government/parliament activity;
- limited liability and supervision including low level of information obligations towards public;
- conflict between the Central Bank's independence, necessary for monetary policy performance, and executive competences within financial supervision (e. g. taking administrative decisions);
- risk of moral hazard because the financial consumers may wrongly assume that all financial property entrusted to financial market subjects is protected at the same level as bank deposits;
- the model is insufficiently widespread in advanced financial markets.

On the other hand it is essential to mention the advantages of this model of institutional structure of financial markets' supervision. In the Czech financial system conditions we should underline the following ones:

- Independent financing, separate from state budget. That was the fundamental malfunction of the previous sectional model, particularly in the form of insufficient financial independence of the Securities Commission.
- Usage of Central Bank's infrastructure not only for the monetary policy, but also in terms of financial market supervision.
- Increased competitiveness of the supervisor as an employer making it possible to attract experts with relevant market experience, contributing to enhanced quality and efficiency of the supervision.
- Achievement of economies of scale and scope in supervisory activities.
- Efficient information flows between the banking supervision and monetary section of the Central Bank.
- Elimination of risk of communication noise and information rigidity.
- Compensation for the loss of Central Bank's competences in monetary policy after the expected admission to the monetary union (2012 – 2015), while the main orientation of the Central Bank shifts from maintaining price stability to provision of financial system stability.
- Compensation for the loss of Central Bank's competences in prudential supervision with respect to the EU principle of home country supervision and potential transfer of the supervisory activities and part of the financial system stability protection to the Community level.
- Financial market structure is reflected provided that commercial banks play the crucial role.
- More efficient international cooperation.

Supervision of the financial market within the framework of the Czech National Bank is assured by sector-oriented organizational structure, namely by three departments (Banking Regulation and Supervision Department, Insurance Companies Regulation and Supervision Department, Capital Market Regulation and Supervision Department). Starting from the beginning of 2008, the Central Bank's management changed the sector-oriented organization, to regroup the departments internally and create three new departments (Financial Market Regulation and Analysis Department, Licensing and Enforcement Department, Financial Market Supervision Department) enabling thus to coordinate diverse supervisory approaches of individual departments. A

more significant integration of sector-oriented approaches to supervision may be only achieved provided that particular financial laws regulating business activities in different financial sectors are harmonized. The legislative process of financial laws harmonization in the Czech Republic is just at the very beginning.

## **Conclusion**

Creation of financial supermarkets is the most important trend in world financial markets which entails a more efficient model of financial supervision. Main models of financial supervision (sectional financial supervision model, integrated independent financial supervision model, integrated financial supervision within the framework of the central bank, functional model of financial supervision) have advantages as well as disadvantages. Gradual integration of supervisory institutions is a general trend with integrated financial supervision as the prevailing model. A similar evolution can be found also in the Czech Republic where the sectional oriented financial supervision transformed to integrated financial supervision. In advanced countries, central banks cease their involvement in supervision of banks and focus mainly on financial stability assurance. On the contrary, in the Czech Republic since April 2006 the Czech National Bank in addition to the monetary policy performance supervises all the financial market. The proper model is chosen not only based on national conditions, but also with respect to the structure and level of financial market development, central bank position, legislative environment and political situation. Whatever solution is selected, the supervisory institutions should first of all preserve their independence, efficiency, credibility, and transparency, and thereby contribute to the financial market development.

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## **Institutional Arrangement of Financial Markets Supervision: The Case of the Czech Republic**

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### **ABSTRACT**

The paper deals with institutional arrangement of financial supervision in the Czech Republic. Financial markets are composed of partial financial segments specialized in individual types of financial instruments and individual customer groups. Financial institutions gradually transform into financial supermarkets. There are several models of institutional arrangement of financial supervision (integrated financial supervision model, sectional financial supervision model, financial supervision within the framework of the central bank, functional model of financial supervision). Creation of financial supermarkets encourages integration of supervisory institutions, generally outside the central bank. In the Czech Republic, several versions of institutional structure of financial market supervision have been discussed in the new millennium. Final decision was implemented precipitately without deeper analysis. The supervision of the all financial market was entrusted to the Czech National Bank with close liaison between execution of monetary policy and supervisory activities. Institutional structure does not automatically guarantee efficient supervision. Efficient supervision is based on an independent and transparent institution, staffed with quality employees and enforcement competences, supporting financial market development.

**Key words:** Financial markets; Financial conglomerates; Financial supervision; Integration of supervision.

**JEL classification:** G2, G18.