

Heritage of the Czech Capital Market Failures



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1. Introduction



- The main goal of the paper is to analyse the phenomenon of corruption in its complexity, as it has been changing as a dynamic process during the Czech capital market development (1990-2016)
- “Heritage” = Remnants of the previous legislation still influence the present manners of thinking of market participants and affect their behaviour and ethics.
- Corruption in some of its forms was one of the “diseases” which has badly damaged the creation of the Czech capital market and scared its credibility.

A note on research methodology



- Three points concerning the methodology have to be explained: .
- **Firstly, a survey of “fundamentals” of corruption** was written to explain our approach to the analysis.
- **Secondly, our analysis focuses mainly on the *financial sector*.**
- **Thirdly,** stages of the Czech capital market development were defined in order to explain the prevailing types and forms of corruption.

2. Fundamentals of Corruption



- The “corruption” is defined in various countries in a different way; because *real* corruptions have diverse types and forms.
- The logical chain of “corruption”: (1) anti-social behaviour of individuals and/or organised groups, (2) corruption detection, (3) Penal Code = anti-corruption police actions (investigation), (4) courts, and finally (5) punishment.

An example



- In a country, where “bribery” (as a form of “corruption”) is defined as a criminal act by Law, bribery is a form of financial criminality,
- whilst in some other countries, where bribery is perceived as a “cultural habit”, it cannot be considered to be a criminal offense (unless defined by Law).

Note



- Undetected „corruption“ cannot be punished
- But: Undetected „corruption“ can be perceived by people
- It can be measured by the „Corruption Perception Index“ (= CPI)

3. Three stages of the Czech Capital Market

Development



- The goal = to identify specific forms of corruption typical for each stage of our capital market development.
- Three main stages were defined:
 - 1) Stage One from 1990 to 1992 (split of Czechoslovakia as a milestone, setting up of separate Czech and Slovak capital markets);
 - (2) Stage Two from 1993 to 2004, this can be divided in two parts – 1993 to 1997, when the Czech Securities Commission was finally set up,
 - and from 1998 to 2004, when the CR became the EU member;
 - (3) Stage three covers the years (2004-2016).

Common features



(period 1990-1998)

- (1) Ideological prejudice consisting in refusing market regulation as such; a myth of an unregulated and completely free capital market,
- (2) Technical, technological and organisational unpreparedness of pre-trade and post-trade services.
- (3) The non-existence of skilled workforce that could serve the capital market, PSE stock exchange, and practically all banks and related state services,
- (4) Financial illiteracy at all levels,

(continued)



(5) Practice of the Ministry of Finance and (later on) at the Governmental level (non-existence of a Securities Commission); “gaps” in majority of financial rulings enabling widespread “tunnelling” and attempts of a premature start of derivatives trading.

This vague set-up of capital market institutions has opened broad room for irregularities and shady practices of market participants.

Partial Conclusion:



- *3.1. Stage One from 1990 to 1992*

During the preparatory stage (1990 – 1992) the corruption concentrated primarily on the area of coupon privatisation.

- *3.2.1 The period from 1993 to 1998*

At the next stage from 1993 to 1998, **the bulk of corruption - as a part of a chain of other illegal activities switched - to capital market.**

4. The Heritage



4.1 Viktor Kožený Harvard funds

4.2 New cases of FC (Key Investments) 2012

Harvard funds



- Harvard funds have become a symbol of tunnelling of the international scale. We label it as “the old case” with difficult solution.
- In this special case of Czech corruption the corruption was defined as the „bribery, which is a voluntary exchange between economic agents, where a bribe is the price paid by an agent buying a particular service provided by another particular agent”

(Harvard - continued)



- The offenders have not been punished to date.
- The investigation is to a large extent disabled thanks to a broad amnesty granted by the former president Vaclav Klaus - one of the authors of the controversial coupon privatization method.



- The case of Key Investments 2011 was a classic deception and manipulation of - funds of badly informed shareholders
- An important role is played by interconnection of Key Investments with companies whose securities the company purchased. According to investigations the firm operated "more or less as in-house bank" financing group of interconnected companies

Key- investments - continued



- The convicted trio of managers was undergoing disproportionate risk in purchasing and management of non-marketable securities. The investors were not informed.
- Customers who have entrusted Key Investments with their money were not investing professionals. This was the reason why they used services of Key Investments.

5. Conclusion



- **First**, for the possibility of corruption/FC measurement quantitative data on FC are regularly released at the national level,
 - These data could be used to assess the extent to which the actual level of corruption differs from that of perception of corruption assessed by the CPI.
- This data could be used for differentiating forms of corruption in the logical chain of the pre-trade, (i.e. a wide range of activities necessary to be performed before a trade) and actual trading, and post-trade (i.e. a wide range of activities necessary to be performed after a trade)

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- **Second**, the results of measuring corruption through the CPI indices or other relevant models may not be usable in particular business decisions.—corruption can be reduced by different instruments especially in such situation where it does not pay in long period of time.
- When the environment is set up transparently with efficient anticorruption measures the dishonesty does not pay simply because fraud is more costly than honest behaviour.

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- **Third, both the perceived corruption and real corruption are primarily affected by the general financial literacy of relevant corporate and political representatives.**
- Governmental prevention plans should be based on the findings of corruption research and they should also include support for such research.
- This is still is not current in general perhaps because of lack of political will and general failures of democratic two- party system, where politicians are competing and striving for repeated re-elections

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- **Fourth, the corruption is perceived as harmful for economy in different periods and in different way and intensity.**
- Information about corruption from different and often unverified sources is purposefully used by the media. It serves as a tool to spread sensational news to attract the interest of readers and increase sales.
- It also serves as a tool to divert public interest from some "undesirable" information and it leads on the contrary to over - saturation with banal issues.

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- Allegation of corruption is also often used as a tool to defame political rivals.
- In the business sector the corruption is demonstrably abused as an instrument of unfair competition among entrepreneurs.
- **Fifth, Corruption has newly shifted primarily to pre-trade and post-trade activities, where the detection is still lagging due to insufficient infrastructure.**

Points of interest for further investigation



- **1. to analyse the prevailing types of corruption in all areas of financial markets - not only capital markets;**
- **2. to search which products were the most often involved in FM/criminal**
- **3. to identify the most „infected” subjects on the market i.e. which particular institutions are most affected**
- **4. Market infrastructure: pre-trade and post-trade perspectives need to be screened and evaluated in details as it has been discovered that the most activity is now taking place in pre-trade and post-trade activities - initiation and settlement.**

(continued)



- **5. to study not only the differences between financial or economic criminality and corruption, but also the differences between lobbyism and corruption and how do these phenomena affect institutions in economy at large.**

The End



- *Let us thank you for your interest!*