

Univerzita Karlova v Praze
Fakulta sociálních věd
Institut ekonomických studií

BAKALÁŘSKÁ PRÁCE

Governance Through Debt in the Czech Republic

Vypracoval: Petr Řehoř
Vedoucí: JUDr. Tomáš Richter LL.M., Ph.D
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Autor práce: Petr Řehoř
Vedoucí práce: Tomáš Richter

Téma: Creditor as a participant in corporate governance process – governing through debt in Czech context

Jazyk: anglický

Cíl práce:

Analyzovat postavení věřitele v procesu správy akciových společností v kontextu současné právní úpravy v ČR. Autor si klade za cíl odpovědět na otázku, zda současná situace na poli insolvenčního práva vede k efektivní správě akciových společností. V návaznosti na odpověď na výše zmíněnou otázku si autor také klade za cíl identifikovat ty problémy, která se jeví z pohledu existující teorie Corporate Governance jako nejzásadnější pro efektivní správu akciových společností.

Odůvodnění pro volbu tématu:

1. Úvěrový proces je ekonomickou teorií standardně chápán procesně či mechanicky. Pohled ze strany efektivity správy korporací či ekonomického procesu na úvěrový proces a postavení dlužníka obzvláště s ohledem na kontext české ekonomiky do značné míry chybí.
2. V českých podmínkách značně převažuje dluhové financování nad financováním prostřednictvím akciových trhů. Postavení věřitele tak nabývá na významu ve vztahu k efektivitě procesu správy akciových společností.

Předpokládaná osnova:

- Přehled teorie
 - o teorie Corporate Governance s důrazem na teorii správy prostřednictvím dluhu
 - o teorie týkající se úvěrového procesu, konkurzu, ...
- Formulace relevantního teoretického rámce pro analýzu
- Přehled a analýza právní úpravy v ČR

Abstract

International comparative studies Private Credit in 129 countries and Doing Business: Removing obstacles to growth are analysing the situation of creditors in large group of countries. Both are based on common and well known methodology how to assess the quality of creditor rights and their enforcement. Both are coming to general conclusions, which are based on statistical analysis or comparison of observed country specific findings.

However, after confronting the country specific findings for the Czech Republic in both studies with data from other sources and with other research studies, I came to conclusion that these country specific findings are partially wrong and misleading. This is partly caused by constrains comparative nature of the research imposes on the level of detail of the studies and partly by errors in primary data.

Abstrakt

Mezinárodní srovnávací studies Private Credit in 129 Countries a Doing Business: Removing Obstacles to Growth analyzují postavení věřitelů v rámci velkých skupin zemí. Obě studie shodně stavějí na prověřené metodologii pro posuzování práv věřitelů a jejich vymahatelnosti. Obě následně na základě dat získaných za každou zúčastněnou zemi dochází prostřednictvím statistické analýzy, nebo srovnáním těchto dat k obecným závěrům.

V případě obou studií dochází nicméně k rozporu mezi daty pro Českou Republiku na, kterých obě studie staví a situací ve výzkumných studiích a datech specificky zaměřených na Českou Republiku. Tento rozpor je částečně způsoben omezeními, která na přesnost dat klade povaha mezinárodní srovnávacích studií velkého rozsahu, ale také chybami v prvotních datech se, kterými studie pracují.

Prohlášení

Prohlašuji, že jsem bakalářskou práci vypracoval samostatně a použil pouze uvedené prameny a literaturu.

V Praze dne 10. 1. 2006

Petr Řehoř

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1 INTRODUCTION

My first goal is to take a look on the situation of creditor rights and creditors as participants of the Corporate Governance processes in the Czech Republic, through the looking glass of two respected comparative studies.

The studies I have chosen are *Private Credit in 129 Countries*¹ and *Doing Business – Removing Obstacles to Growth*².

Both of them well known and respected and especially the *Private Credit in 129 Countries* is very often cited as a source of information on the quality of Creditor Rights in the world.

These two studies have common origin - their main authors are Simeon Djankov and Caralee McLiesh and both studies are based on the same basic methodology. Thanks to these common aspects, both studies are coming with quite similar findings, but due to different goals, they are presenting their findings in different ways. Also the scope of these two studies is different. Therefore by including both of them in this thesis, I gained the possibility to approach the topic from different viewpoints.

The methodology, these two studies are resting on, has been developed in other publications and has been already used in research and subjected to discussion. In

¹ Djankov, Simeon D., McLiesh, Caralee and Shleifer, Andrei, *Private Credit in 129 Countries* (January 2005). NBER Working Paper No. W11078. <http://ssrn.com/abstract=652366>.

² *Doing Business in 2005: Removing Obstacles to Growth*. Washington: The International Bank for Reconstruction and Development / The World Bank, 2005. ISBN: 0-8213-5748-4.

my opinion, it can be argued that the methodology and criteria used in the research are based on the best practices as viewed by scholars in the Western countries.

On the other hand, both of these studies are of comparative nature and therefore their results and conclusions are in one way or another simplified or subjected to various assumptions. Anyone working with research of this kind has to bear in mind their limitations.

Nevertheless, comparative nature of such research offers opportunities otherwise unachievable. It is surely very appealing for everyone who is doing research on one particular subject, to use findings of a comparative study as an argument, or to back up his or her own findings by conclusions of such comparative studies. However, this assumes that conclusions of a comparative research are correct and limitations of such research are taken into account.

Comparative studies reviewed in this thesis are based on “back bone” methodology used in order to compare level of Creditor Rights on international level. Conclusions of both studies are in line with theoretical approaches to Credit and Corporate Governance. General findings of these studies are also in line with conclusion from other research that used the same methodology. On the “macro” level everything seems to be alright.

But when I confronted the particular findings and data that represent the situation in the Czech Republic with other data sources and reports or research papers specifically focused on the Czech Republic, I came to the conclusion that comparative studies are not depicting the actual situation truthfully.

On the following pages, I will confront findings of Private Credit in 129 Countries and Doing Business report in order to support this conclusion by defining particular differences.

My second intention is to find out some of the causes of such discrepancies. in the two papers and objective reality. I will mainly focus on areas and topics that were left out from the consideration and which are, from my point of view, necessarily to be taken into account to analyze the situation in the country credibly.

2 THEORETICAL BACKGROUND

2.1 Definition of Corporate Governance

There is no universal definition of Corporate Governance. Here are few examples of definitions that can be found in the literature:

“Corporate governance concerns the ways joint stock companies are directed, controlled and monitored.”³

Corporate governance is “... a process by which directors control and direct the management of a company to achieve the best returns to its owners.”⁴

“Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.”⁵

“Corporate governance is a field in economics that investigates how to secure/motivate efficient management of corporations by the use of incentive mechanisms, such as contracts, organizational designs and legislation. This is often limited to the question of improving

³ Howard, A., Private authority in liberal-market corporate governance: Global advance but domestic retreat?, 2004. Page 6.

⁴ WONG, D.W.K., YEUNG P.S.L., Corporate Governance in Hong Kong, in: Lethbridge, D.G, and S.H., *The Business Environment in Hong Kong*, 4th Edition, Oxford University Press (China) Limited, Hong Kong, 2000.

as cited in Chan, Y. S., Schneider, J., *A Comparison of four Corporate Governance Factors in Four Countries*, p. 24–25.

⁵ Schleifer, Andrei, Vishny, Robert, W. *A Survey of Corporate Governance*. Cambridge (MA): National Bureau of Economic Research, 1996. Working Paper 5554.

financial performance, for example, how the corporate owners can secure/motivate that the corporate managers will deliver a competitive rate of return.”⁶

“Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.”⁷

Definitions span from narrow focus on inner controlling and monitoring processes in corporations (Howard) to quite wide definitions stipulating relations between the corporation and its management, and large group of other stakeholders (OECD).

For the purposes of this thesis I have chosen the definition used by Schleifer and Vishny:

“Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”

This definition corresponds the most with the thesis topic. Other definitions are either too wide or do not specify the relationship of the corporation to outside actors – investors.

⁶ Mathiesen, H., *Managerial Ownership and Financial Performance*, Ph.D. dissertation, series 18.2002, Copenhagen Business School, Denmark, 2002.

As cited on www.encycogov.com.

⁷ OECD, *OECD Principles of Corporate Governance*, 1999.

Corporate governance mechanisms are legal and economic institutions. In theory, in the long run the competition on the product markets would make sure, these institutions are working in efficient way.⁸ In such situation, there would be no need to study these mechanisms apart from the knowledge itself.

However in the actual situation, the production capital is highly specific and sunk and therefore the investors are seeking assurance that their investments will be repaid. Corporate governance mechanisms are therefore being influenced through the political process, which does not necessary leads to better results.⁹ Here comes to play corporate governance as part of Economics science.

2.2 Creditors and Corporate Governance

Main focus in Corporate Governance lies in the interaction of shareholders among themselves (e.g. rights of minority contra majority shareholders) or shareholders and the company and its statutory organs. There exists vast amount of theoretical literature as well as extensive empirical evidence on the role and position of shareholders of different sizes, on the impact of different legal and statutory provisions and ownership structures on performance of corporations, rights of the shareholders, etc. Main part of this literature, both theoretical and empirical is focused on Anglo-Saxon economics, especially United States. When we take in account the fact, that in the USA, the general Corporate Governance model is characterized by widely dispersed ownership, well developed stock markets that

⁸ Schleifer, Andrei, Vishny, Robert, W. *A Survey of Corporate Governance*. Cambridge (MA): National Bureau of Economic Research, 1996. Working Paper 5554. Page 3.

⁹ IBID. Page 3.

play major role as sources of finance for corporations, the overall focus on shareholders is understandable.

Nevertheless, in recent years, interest in Corporate Governance has raised also outside the USA. Today, we have already quite extensive body of literature aimed on corporate sphere in major west European countries, Japan, and to lesser extent on emerging markets and transiting countries.

This shift of interest, or maybe more precisely we should say extension of the field of interest, because United States remain arguably in the center of the process, faced the scholars and practitioners in the field of Corporate Governance with need to extent the theoretical base Corporate Governance. The main focus of Corporate Governance so far has been the model of corporation with dispersed shareholders. But this model is not sufficient for analyzing corporate sphere in countries outside the Anglo-Saxon world. In corporate sphere in West European countries as well as in Japan are very important role playing banks – both as creditors and investors in equity – the shareholders structure is much more concentrated. Other stakeholders also come to play a role in Corporate Governance – e.g. mandatory participation of employees in supervisory board. Stock markets in general do not play as important role as in USA. Overview of main differences between Relationship and Arm's-length Finance is in the Table 1.

Table 1: Characteristics of relationship based and market based finance

	Type of Financial System	
	Relationship Finance	Arm's-length Finance
Share of control-oriented finance	High	Low
Financial markets	Small, less liquid	Large, highly liquid
Share of all firms listed on exchanges	Small	Large
Ownership of debt and equity	Concentrated	Dispersed
Investor orientation	Control-oriented	Portfolio-oriented
Shareholder rights	Weak	Strong
Creditor rights	Strong for close creditors Weak for arms length	Strong
Dominant agency conflict	Controlling vs. minority investors	Shareholders vs. management
Role of board of directors	Limited	Important
Role of hostile takeovers	Very limited	Potentially important
Role of insolvency	Potentially important	Potentially important

Source: Zhuang, Juzhong. *Some Conceptual Issues of Corporate Governance*. Asian Development Bank, Economics and Development Resource Center, 1999.

2.3 Governance Through Debt

Joint-stock companies have two sources of external financing - equity or debt. Each of these options has its own specifics. There are important differences between position of owners and creditors towards a company and their claims on assets and cash-flows of the company. These differences together with structure of financing of the company (share of equity and debt on total assets) bear important implications for Corporate Governance.

Shareholders are residual claimants. They have claims on all assets of a company after bearers of fixed claims are satisfied. They have no possibility to demand their investment back, during the existence of the company.¹⁰

On the contrary, creditors are bearers of fixed claims to assets and cash-flows of the company. They can also demand repayment of their claims at the latest at the date of maturity, but if the debtor is not fulfilling her duties, even sooner. This gives creditors a strong position for governing the debtor. Every creditor can ask for the repayment of her credit, lead the execution on the property of the debtor or to institute the bankruptcy proceeding.¹¹

Monitoring costs for the debtor are approximately the same as in the case of shareholders with the same free-rider problem. On the contrary the cost connected with enforcing the claims of the creditor are incomparable lower than in the case of shareholders, because of minimization of problem with collective action.¹²

It can be assumed that increasing leverage ratio (amount of debt divided by the equity) will have disciplining effect on the behaviour of both managers and large shareholders, because in the case of bankruptcy they both lose considerably.¹³

On the other hand, the disciplining effect of debt financing is effective only to the extent to which it is possible to enforce claims of creditors. This includes efficient execution on the property of the debtor or possibility to initiate bankruptcy procedure. The disciplining effect is therefore dependent on the quality of the

¹⁰ Richter, Tomáš. *Kupónová privatizace a její vlivy na řízení a financování českých akciových společností*. Dissertation thesis. 2002. Page 50.

¹¹ IBID, Page 50.

¹² IBID, Page 50.

¹³ IBID, Page 50.

institutional framework in the country – mainly on the quality of law and law enforcement.¹⁴¹⁵

Also creditors as investors into the capital of the corporation have in general higher aversion to risk than shareholders. This is due to the different nature of their claims after the company. Creditors are bearers of fixed claims and so they prefer fixed returns. They are not willing to bear additional, residual risk connected with the activities of the company that is bore by the shareholders. It is therefore probable that creditors will prefer projects with relatively low risk and so with low returns, which has been also proved by empirical research. Their inputs in Corporate Governance may then lead to sub-optimal level of risk in business decisions.¹⁶

There are two main views on what determines the amount of credit that is exerted towards borrowers from the creditors¹⁷One view emphasizes the importance of information, while the other legal creditor rights. These two approaches define two main conditions from which at least one must be fulfilled if the creditor should be willing to lent his or hers money¹⁸.

The power and information theories of credit are focal point of both comparative studies examined in this thesis. The approach of both theories is outlined in following illustrative example.

¹⁴ Richter, Tomáš. *Kupónová privatizace a její vlivy na řízení a financování českých akciových společností*. Dissertation thesis. 2002. Page 51.

¹⁵ Posner, R. A.. *The Economical Analysis of Law*. Boston, Toronto, London, 1992.

¹⁶ Richter, Tomáš. *Kupónová privatizace a její vlivy na řízení a financování českých akciových společností*. Dissertation thesis. 2002. Page 51.

¹⁷ Djankov, Simeon D., McLiesh, Caralee and Shleifer, Andrei. *Private Credit in 129 Countries*, 2005. NBER Working Paper No. W11078. <http://ssrn.com/abstract=652366>.

¹⁸ Schleifer, Andrei, Vishny, Robert, W. *A Survey of Corporate Governance*. Cambridge (MA): National Bureau of Economic Research, 1996. Working Paper 5554. Pages 18 – 19.

Illustration of Power and Information theory effects¹⁹

We can imagine a situation, when a person with financial resource for lent is approached by certain potential borrower for the first time. If we will also assume that our creditor does not have any means how to enforce the repayment of the loan (in other words absence of creditor rights or their enforcement) and there is also no way how to get truthful information regarding this borrower, it is most unlikely that our creditor would be willing to lend any money at all²⁰. Furthermore, if it is not possible to let anybody else know any information, there are almost no incentives for the borrower to repay the investment. The only “incentive” in play would be his own honesty. Since there would be no higher force that could enforce the repayment, nor is there any way how the creditor could potentially let other subjects on the market know about behaviour of our defecting borrower²¹.

So there is not any obstacle that could prevent the borrower in “playing” long series of “one-shot” games with all the individuals offering their funds that would be present on the market, without any need to ever fulfil any of all the obligations. Of course, only under condition, he would be able to find anybody willing to do so. Most probably the amount of credit on the market would be nearly zero.

Interestingly, the situation outlined above, would prevent even the most honest borrower (who would be actually willing to repay his debt) from gaining credit, because due to the absence of information, there is no reputation and also no option how prove his honesty.

As outlined above there are two ways from this deadlock situation.

The first solution is relying on information availability. If we would change the situation above and allow timely and accurate flow of information, we would obtain substantially different results. In case of default, the information about this would

¹⁹ The illustrative example is based on following works:

Schleifer, Andrei, Vishny, Robert, W. *A Survey of Corporate Governance*. Cambridge (MA): National Bureau of Economic Research, 1996. Working Paper 5554.

And

Stiglitz, Joseph, Weiss Andrew. *Credit Rationing in Markets with Imperfect Information*. American Economic Review, 1981, Issue 3.

²⁰ Ulen, T., Cooter R.: *Law & Economics*. Addison Wesley Longman, 2000.

²¹ This type of behaviour during transformation in the Czech Republic was analysed in Benacek, O. *Efficiency of Contracts: Theoretical Approach in Law and Economics*. Umea, 2004.

be available to other creditors and it would render any other attempt to gain credit much more difficult, costly, if not directly impossible.

Still, borrower who would try to play “one-shot” game with the creditor and it would be the first instance of such behaviour from his side, would be most likely able to carry out his plan without fear of any potential punishment²².

²² Benacek, Ondrej. *Decision Making in Efficient Investment Contracts and Its Determinants*. Charles University. Prague, 2006.

3 REVIEW OF THE METHODOLOGY AND FINDINGS OF COMPARATIVE RESEARCH STUDIES

Aim of this chapter is to give overview of the methodology used in two comparative studies that are subject of the analysis of this thesis. I will not review critically either the methodology or the findings at this point. This will be part of the following chapter 4.

The study Private Credit in 129 Countries has been created by Simeon Djankov (The World Bank), Carelee McLiesh (The World Bank), and Andrei Schleifer (Harvard University). The aim of the study is to analyse the importance of the power and information theories of private credit in explaining the variation in the size of private credit around the world.²³ Beside this main point, authors analyse stability of institutions of credit over time and also whether countries whose law origins from different legal traditions exhibit convergence of the position of the creditors.²⁴

²³ Djankov, Simeon D., McLiesh, Caralee and Shleifer, Andrei. *Private Credit in 129 Countries* 2005. NBER Working Paper No. W11078. <http://ssrn.com/abstract=652366>, Page 2

²⁴ IBID. Page 3

The authors gathered data on 129 countries for the period from 1978 to 2003. These data are afterwards used in cross-country regression analysis for assessing the validity of original hypotheses.²⁵

The study is not aiming on direct comparison of particular country results or on building inter-country standing.

The Doing Business in 2005 – Removing Obstacles to Growth²⁶ is project of the World Bank and the International Finance Corporation. The team preparing the report was led by Simeon Djankov and Caralee McLiesh. Findings of the project are available either in the form of publication Doing Business in 2005: Removing Obstacles to Growth or on the website www.doingbusiness.org.²⁷

Doing Business in 2005 is the second annual report investigating the scope and manner of regulations that either enhance or restrict business activities. It contains quantitative indicators on business regulations and their enforcement in 145 countries. The report contains indicators in 7 topics: starting a business, hiring and firing workers, closing a business, registering property, protecting investors, enforcing contracts and getting credit. From these, the last two – enforcing contracts and getting credit – are relevant for the subject of this thesis.²⁸

²⁵ IBID. Page 3

²⁶ *Doing Business in 2005: Removing Obstacles to Growth*. Washington: The International Bank for Reconstruction and Development / The World Bank, 2005. ISBN: 0-8213-5748-4. Further on will be referred to as Doing Business in 2005.

²⁸ *Doing Business in 2005: Removing Obstacles to Growth*. Washington: The International Bank for Reconstruction and Development / The World Bank, 2005. ISBN: 0-8213-5748-4.

Pages 1-9.

The report aims to analyse the economic and social outcomes and identify, which reforms have worked and which not. The report also includes country standing for each of the seven categories as well as overall general standing in Easy of Doing Business index.

3.1 Data Gathering

Both studies are using the same methodology for the data gathering. Standardized questionnaires have been sent to local partners, who are law or business professionals. The following data gathering allowed multiple interactions with the respondents in order to avoid misinterpretations.²⁹

3.2 Private Credit in 129 countries data and findings overview

The main data used for purposes of the analysis is Creditor Rights index, which has been originally developed by La Porta et al.^{30, 31} The index measures the rights of creditors against defaulting debtor and is also interpreted as index of creditor power.

The index consists of 4 characteristics or powers that can be attributed the position of secured creditors within particular country legislative framework. One is added to the score for each characteristic present. Hence the index has the scale from 0 to 4. The four characteristics are automatic stay on assets; respect for the priority rights

²⁹ Dtto. Page 79.

³⁰ La Porta, Rafael, Lopez-de-Silanes, Florencio, Shleifer, Andrei. *Legal Determinants of External Finance*. Journal of Finance, 1997, Issue 52, pages 1131–1150.

³¹ La Porta, Rafael, Lopez-de-Silanes, Florencio, Shleifer, Andrei, et al. *Law and Finance*. Journal of Political Economy, 1998. Issue 106, pages 1113–1155.

of the secured creditors; restrictions on entering reorganization and removal of management.

According to overall findings of this study, two of above cited components have higher ability to predict amount of private credit. These are no automatic stay on assets and respect for the priority rights of the secured creditors. Restrictions on entering reorganization and removal of management are less important from this point of view.

Djankov and his team have gathered values of the creditor rights index for the period from 1978 till 2003. This time series has been used to analyse the impact of legislative reforms on the position of the creditors.³²

The next two binary variables used in the analysis are existence or non existence of Public or Private credit bureaus inside each country. Also joint variable covering existence of any of the two types has been used. This data was used to analyse the importance of information sharing – in other words for the analysis of importance of information theories on private credit. The conclusion to this question is that credit registries have effect on the amount of credit in the country. To assess the size of the country credit market and its level of development, Djankov et al are using relative share of the amount of Private Credit to the country GDP.³³

³² Interesting finding from this analysis is, that from 169 reforms of insolvency or credit legislative only 30 affected the creditor rights index.

³³ Description of the data used: Ratio of credit from deposit taking financial institutions to the private sector (IFS lines 22d and 42d) relative to GDP (IFS line 99b). Line 22d measures claims on the private sector by commercial banks and other financial institutions that accept transferable deposits such as demand deposits. Line 42d measures claims on the private sector given by other financial institutions that do not accept transferable deposits but that perform financial intermediation by accepting other types of deposits or close substitutes for deposits (e.g. savings and mortgage institutions, post office savings institutions, building and

To assess quality of the enforcement, in this study, Djankov et al used standard example of defaulting debtor case where the amount of debt in question is equal to 50% of national GDP per capita. The variable Contract Enforcement Days itself than states number of days it takes to enforce the contract.

The regressive analysis conducted using the Credit/GDP ratio has confirmed the hypothesis that both the Creditor rights index and the incidence of Credit Bureaus influence the amount of private credit in the economy. Interestingly, effects vary among countries according to the GDP per capita. In richer countries creditor rights matter more, while in poorer countries public credit registries are more important. Private credit registries increase credit in every country.

loan associations, certain finance companies, development banks and offshore banking institutions). Source: *IMF International Financial Statistics September 2004*.

Results for the Czech Republic

Table 2: Entry data – Private Credit in 129 Countries

Country	Private Credit/GDP	Creditor Rights	Public Registry	Private Bureau	Contract Enforcement Days
Austria	1.04	3	1	1	374
Belgium	0.78	2	1	0	112
<i>Czech Republic</i>	<i>0.42</i>	<i>3</i>	<i>1</i>	<i>1</i>	<i>300</i>
Denmark	1.23	3	0	1	83
France	0.87	0	1	0	75
Germany	1.18	3	1	1	184
Greece	0.6	1	0	1	151
Hungary	0.34	1	0	1	365
Italy	0.79	2	1	1	1390
United Kingdom	1.36	4	0	1	288
Poland	0.28	1	0	1	1000
Portugal	1.4	1	1	1	320
Slovenia	0.38	3	1	0	1003
Slovak Republic	0.43	2	1	0	565
Spain	1.06	2	1	1	169

Source: digest from Appendix A: Data in Djankov, Simeon D., McLiesh, Caralee and Shleifer, Andrei. *Private Credit in 129 Countries*, 2005. NBER Working Paper No. W11078. <http://ssrn.com/abstract=652366>.

The countries represented in the table have been chosen by the author.

As we can see, Czech Republic scores 3 from maximum 4 points in creditor rights category. Also public registry and private bureau are noted to be present.

We can compare the ratings for the Czech Republic with outcomes for some other countries in the Table 1³⁴.

From the Central European countries, Czech Republic has the best overall score. The Private Credit to GDP ratio is the second highest and the Corporate Governance mechanisms are the best according to this survey. No other country from the Central European foursome has score of 3 for Creditor Rights and both types of debtor registries in place. Also the average time needed for contract enforcement is the lowest.

Further on, comparing Czech Republic and other CE countries to the rest of Europe, we see that the score of three for Creditor Rights is quite high. Actually according to Djankov et al, the only European country that boasts maximal score is United Kingdom³⁵. Number of days for contract enforcement is interesting as well. 300 for the Czech Republic is not a low value, but it is not exceptionally high as well. For example Austria has 374, Poland has whopping 1000.

According to Private Credit in 129 Countries, there are implemented following laws of secured creditors in the Czech law. There exists “no automatic stay on assets” after the firm has entered reorganization, secured creditors are paid first and management does not lead the company after it entered bankruptcy proceeding. Also both public and private credit registries are active in the country.

³⁴ The selection made by the author.

³⁵ Interestingly the total number of countries that scored 4 on the Creditor Rights index from the sample of 129 countries is 9. Even more interesting is the list of these countries – these are Kenya, Zimbabwe, Nigeria, Lebanon, Panama, Nicaragua, Hong Kong, New Zealand and United Kingdom.

3.3 Corporate Governance through debt in the Czech Republic according to the Doing Business – Removing Obstacles to Growth

The publication Doing Business provides data on 145 countries³⁶. The database measures 10 topics from which 2 are directly relevant to the subject Corporate Governance through debt. These are “Getting Credit” and “Enforcing Contracts”.

The Getting Credit topic follows the same basic methodology as Private Credit in 129 Countries. Nevertheless indexes in Doing Business database are tracking more information. The Getting Credit topic is divided in 4 sub-indexes described below.

The Creditor Rights sub-index has scale from 0 to 10 (compared to 0 to 4 in Djankov). One is added to the overall score, when one of the characteristics from following list is fulfilled by the national legal environment³⁷:

- Secured creditors are able to seize their collateral when a debtor enters reorganization -- there is no “automatic stay” or “asset freeze” imposed by the court.
- Secured creditors, rather than other parties such as government or workers, are paid first out of the proceeds from liquidating a bankrupt firm.
- Management does not stay during reorganization. An administrator is responsible for managing the business during reorganization.

³⁶ In the Internet version of Doing Business there are available data on 155 countries in total. www.doingbusiness.org; 12/2005.

³⁷ *Doing Business in 2005: Removing Obstacles to Growth*. Washington: The International Bank for Reconstruction and Development / The World Bank, 2005. ISBN: 0-8213-5748-4. Pages 83, 84.

- General, rather than specific, description of assets is permitted in collateral agreements.
- General, rather than specific, description of debt is permitted in collateral agreements.
- Any legal or natural person may grant or take security in the property.
- A unified registry that includes charges over movable property operates.
- Secured creditors have priority outside of bankruptcy.
- Parties may agree on enforcement procedures by contract.
- Creditors may both seize and sell collateral out of court.

The first three points are used also in Private Credit in 129 Countries. Fourth item, which is counted for restrictions as creditor consent or minimum dividends, for the debtor to file for reorganization, is not used in Doing Business. The next seven items has been added for the purpose of the Doing Business survey.

The first three points are dealing with the rights of creditors during the bankruptcy, the other seven aspects are connected with collateral law.³⁸

The other three sub-indexes are dealing with availability of information. This has been covered in Private Credit in 129 Countries by very simple binary variables for existence or non-existence of Public or Private Credit registries. Nevertheless, in Doing Business, these features are analyzed in much greater detail.

The Credit Information Index works in the same way as the Creditor Rights index. One is added for each feature that is contained by the national credit registries. The

³⁸ www.doingbusiness.org - Methodology; 12/2005

index tracks 6 features. The score of the Czech Republic in Credit Information Index is 5. The features and the results are summarised in the table below:

Table 3: Doing Business - Credit Registries index for Czech Republic

Are both individuals and firms listed in credit registry?	Yes
Are both positive and negative data distributed?	No
Does the registry collect credit information from financial institutions as well as retailers and utilities providers?	Yes
Is five or more years of historical data preserved?	Yes
Is data on all loans larger than 1% of income per capita recorded?	Yes
Is it guaranteed by law that borrowers can inspect their data?	Yes
Public registry coverage (borrowers / 1000 adults)	28
Private bureau coverage (borrowers / 1000 adults)	379

Source: www.doingbusiness.org, 12.12.2005

The coverage of population by both public and private registries is expressed in relation to the country adult population. The scores are 2,8% for the public registry and 37.9% for the private registry³⁹. These data are taken from the Internet Doing Business database, which is in this respect more up to date. For comparison, the scores in the publication *Doing Business – Removing Obstacles to Growth*, which contains data for January 2004, records 2.1% and 24.9% respectively.

The ease of Doing business index ranks economies from 1 to 145. The index is calculated as ranking on simple average of country percentile rankings on each of the 10 topics covered in Doing Business in 2005. The ranking on each topic is simple

³⁹ *Doing Business in 2005: Removing Obstacles to Growth*. Washington: The International Bank for Reconstruction and Development / The World Bank, 2005. ISBN: 0-8213-5748-4. Page 106.

average of percentile rankings on its component indicators.⁴⁰ In other words, it is relative standing among other countries and it does not rely to any absolute standard of quality of creditor rights.

Czech Republic is placed on 21st position in both Enforcing contracts and Getting credit indexes in the Doing Business database. Interestingly, standings of the Czech Republic in both indexes are sharply better than in the other ones. In the overall standing for the whole Doing Business index, Czech Republic is ranked on 41st place. In Dealing with licenses it is even ranked 87.

In the Getting Credit index, Czech Republic left behind not only all the CE post-communist countries, but also countries like Denmark, Switzerland, Sweden or Finland. The values of each sub-index in Getting Credit category are as follows:

Table 4: Doing Business - Getting Credit index

Indicator	Czech Republic	Region	OECD
Legal Rights Index	6	5.6	6.3
Credit Information Index	5	2.5	5
Public registry coverage (% adults)	2.8	1.4	7.5
Private bureau coverage (% adults)	37.9	6.6	59

Source: *Doing Business in 2005: Removing Obstacles to Growth*. Washington: The International Bank for Reconstruction and Development / The World Bank, 2005. ISBN: 0-8213-5748-4

Note: maximum score for first two indexes is 10.

⁴⁰ *Doing Business in 2005: Removing Obstacles to Growth*. Washington: The International Bank for Reconstruction and Development / The World Bank, 2005. ISBN: 0-8213-5748-4. Page 79.

According to Getting Credit category, we can see Czech Republic being almost on par with average of all the OECD countries in Legal Rights Index. Credit Information Index value is the same as average for the whole OECD and substantially higher than the average for other countries in the region. Substantially lower is just the coverage of population by the credit registries.

Enforcing Contracts is second topic out of the ten in Doing Business that is relevant for this thesis. It covers, as the name of the topic suggests, the problematic of contract enforcement. It covers this topic to greater detail than the study Private Credit in 129 countries and the definition of standard contract is different as well.

The following assumptions were made, to make the data comparable⁴¹:

- The debt value equals 200% of the country's income per capita.
- The plaintiff has fully complied with the contract (the plaintiff is 100% right).
- The case presents a lawful transaction between businesses residing in the country's most populous city.
- The bank refuses payment for lack of funds in the borrower's account.
- The plaintiff attempts to recover the debt by filing a law suit or going through an administrative process, if such a process is available and preferred by creditors.
- The debtor attempts to delay service of process but it is finally accomplished.
- The debtor opposes the complaint (default judgment is not an option).

⁴¹ *Doing Business in 2005: Removing Obstacles to Growth*. Washington: The International Bank for Reconstruction and Development / The World Bank, 2005. ISBN: 0-8213-5748-4. Page 87.

- The judge decides every motion for the plaintiff.
- The plaintiff attempts to introduce documentary evidence and to call one witness. The debtor attempts to call one witness. Neither party presents objections.
- The judgment is in favour of the plaintiff.

To measure the quality of the enforcement itself, Doing Business is introducing three measures. These are:

Procedures measure:

Number of required interactions between the parties, or between the judge, administrator or court officer.⁴²

Cost measure:

The costs of enforcing the contract expressed as percentage of the debt value. Includes court costs, attorney fees, or the costs of an administrative debt recovery procedure.⁴³

Time measure:

This measure is similar to the time to enforce contract from the Private Credit in 129 countries. It measures in days the time it takes from the point the plaintiff fills in the lawsuit in court until settlement or payment.⁴⁴

⁴² *Doing Business in 2005: Removing Obstacles to Growth*. Washington: The International Bank for Reconstruction and Development / The World Bank, 2005. ISBN: 0-8213-5748-4. Page 87.

⁴³ *Doing Business in 2005: Removing Obstacles to Growth*. Washington: The International Bank for Reconstruction and Development / The World Bank, 2005. ISBN: 0-8213-5748-4. Page 87

The scores of the Czech Republic in the Enforcing Contracts measures are:

Table 5: Doing Business – Enforcing Contracts

Indicator	Czech Republic	OECD
Number of procedures	22	19.5
Time (days)	300	225.7
Cost (% of debt)	9.6	10.6

Source *Doing Business in 2005: Removing Obstacles to Growth*. Washington: The International Bank for Reconstruction and Development / The World Bank, 2005. ISBN: 0-8213-5748-4.

The standing of Czech Republic in Enforcing Contracts index leads to similar situation as in case of the Getting Credit category, only the list of countries in front of and behind Czech Republic has slightly changed. Scandinavian countries are now leading the index and behind Czech Republic we can now find not only all four CE post-communist countries but also United Kingdom (position 30), Germany (position 25) or Canada (position 34).⁴⁵

⁴⁴ *Doing Business in 2005: Removing Obstacles to Growth*. Washington: The International Bank for Reconstruction and Development / The World Bank, 2005. ISBN: 0-8213-5748-4. Page 87

⁴⁵ *Doing Business in 2005: Removing Obstacles to Growth*. Washington: The International Bank for Reconstruction and Development / The World Bank, 2005. ISBN: 0-8213-5748-4. Pages 89-97

4 CZECH REPUBLIC – CREDITOR CORPORATE GOVERNANCE IN CONTRASTS

4.1 Chapter introduction

In this chapter, I will examine step by step the three main areas that are covered by both comparative studies. That is the quality of the law itself, the question of law enforcement and credit registries as a Corporate Governance tool. At the beginning of each part, I will shortly repeat the findings of Credit in 129 countries study and Doing Business database. Afterwards, I will confront these findings with other sources and empirical data that are relevant to each topic.

Furthermore I will add some topics that are not directly connected to the data, findings, or methodology of the two studies in the focus of this thesis. Instead these topics will be dealing some of the country specific aspects, which in my opinion might influence the result of such comparative study like Private Credit in 129 Countries. I believe that there are strong arguments for including this dimension into the analysis. Czech Republic is the country, which is still in the process of transition from the hard core socialist regime to a standard democratic society. Even though the visible or we may say tangible features of the socialist order have been already removed or changed substantially to be in line with democratic conditions and market economy. This includes also the law in the books, establishing institutions like stock exchange, etc. But still there is the 60 years deficit in the development of democratic and market institutions as well as the moral deprivation of the whole society incurred by the German occupation and

subsequent Communist regime. These are conditions that distinguish Czech Republic to the large extent also as the other CEE transitive countries from West European and North American countries. In Western societies, democratic and market institutions have been developing at least since the end of the World War 2 till now without any major obstacles. Even the pro-socialist heading of some of the Western countries in past decades (e.g. Scandinavian countries) has not harmed democratic institutions or market institutions in any way comparable to what we have witnessed in countries of the Eastern block.

I believe that this essential discrepancy in development between post-communist countries and Western democracies might give us some clues on the cause of difference between the results of the two international comparative studies and locally perceived facts.

4.2 Assessing quality of the Creditor Rights and their enforcement

La Porta⁴⁶ as well as later on Djankov in *Private Credit in 129 Countries*, both using the same basic methodology, came with the observation that there is a strong link between level of creditor protection, and the size of capital markets. In other words, higher score in creditor protection index leads to higher amount of credit in the economy expressed as amount of private credit in the economy divided by GDP.

Djankov used in *Private Credit in 129 Countries* the same basic data for 49 economies as La Porta, but these have been reviewed and amended, and additional countries have been added to total number of 129.

⁴⁶ La Porta, Rafael, Lopez-de-Silanes, Florencio, Shleifer, Andrei, et al. *Legal Determinants of External Finance*. *Journal of Finance*, 1997, Issue 52, 1131-1150.

As already said, both studies came with the same empirical finding that higher level of creditor rights promotes development of a financial system. Additionally, Ross⁴⁷ using the same data and methodology as La Porta came to the conclusion that quality of Creditor Rights not only promotes development of financial system but through it, it leads to higher rate of financial growth. All these findings seem to be quite intuitive and are in line with the theoretical assumptions of the theory on Corporate Governance.

As already mentioned, Djankov in his study has recorded 3 out of 4 in the Creditor Rights index for the Czech Republic.

The rank of the Czech Republic in Getting Credit index of the Doing Business database is 21 of 145, which is covering quality of legal rights and quality and coverage of credit registries. This is on par with the average of OECD countries, and higher than the average of other countries in the region. This score however includes also the information on Credit Registries. The Legal Rights index, which is comparable with the Creditor Rights index in Private Credit in 129 Countries, scores 6 out of 10 for the Czech Republic. In total, there are 31 countries with score 7 or higher and 24 countries with score 6. From the CE countries, the highest score reaches Slovakia – 9. Followed by Slovenia, Hungary that has 6 and Poland with score of 4.

According to both studies, Czech Republic boasts quite high level of Creditor Rights. The conclusions of the Private Credit in 129 Countries and the other studies on the topic of Creditor Rights suggest the high score in Creditor Rights index is

⁴⁷ Ross, Levine, Norman, Loayza, Thorsten, Beck. *Financial Intermediation and Growth: Causality and Causes*. Washington: The World Bank, 1999.

positively correlated with the level of development of the financial markets. These conclusions result from the analysis of the relative share of private credit to GDP.

To verify this conclusion for the case of the Czech Republic, I will use compare development of the private credit / GDP ratio to the development of the Creditor Rights index. This is something that has not been done in any of the studies working with the Creditor Rights index.

In Private Credit in 129 Countries is used the value for the private credit / GDP ratio only for the end of the analysed period. For this reason I will use another source of data for the credit/GDP ratio. In particular, I have decided to use data from A New Database on Financial Development and Structure by The World Bank team lead by Thorsten Beck⁴⁸. This database includes already computed the private credit / GDP ratio. According to the description and to the source of the data, both Private Credit in 129 Countries and A New Database on Financial Development are using the same base data. The source is statistics of the IMF. Unfortunately the values in the Financial Development database are not comparable with the value from Private Credit in 129 Countries. Nevertheless this still leaves us the opportunity to analyse the development of the ratio versus the Creditor Rights index value.

⁴⁸ Thorsten, Beck, Deirguc-Kunt, Asli, Levine, Eric, R. *A New Database on Financial Development and Structure (1960 - 2001)*, Washington: World Bank, 2003, revisited March 14, 2005. Finance research, Report number WPS2146. Available on <http://econ.worldbank.org>.

Table 6 Private Credit to GDP – Czech Republic

Year	Private Credit/GDP
1994	0.692462
1995	0.6651782
1996	0.6668084
1997	0.6765555
1998	0.6355651
1999	0.5584462
2000	0.4992335
2001	0.4268117
2002	0.3420468
2003	0.2951458

Source: Thorsten, Beck, Deirguc-Kunt, Asli, Levine, Eric, R. *A New Database on Financial Development and Structure (1960 - 2001)*, Washington: The World Bank, 2003, revisited March 14, 2005. Finance research, Report number WPS2146. Available on <http://econ.worldbank.org>.

Additional information needed for the analysis is scores of the Creditor Rights index in time. This type data has been used to analyse changes of the insolvency / bankruptcy legislation in time and influence of these changes on the level of creditor rights, so it is available.

The Creditor Rights index for the Czech Republic records score of 3, for the whole recorded time period from 1993 till 2002 it has not changed.⁴⁹ Interestingly, this would suggest that the level of creditor rights in the Czech Republic have been the same and quite high through out the whole 10 years period. Unfortunately, validation of this information through comparison with Doing Business database is

⁴⁹ The time span of the whole database used by Djankov for the analysis is much longer – first record is for the year 1978. But for most of the transition countries, the data are available from the beginning of the 90's of the wwwwww20th century.

not possible, because the part of the database dealing with creditor rights was constructed for the year 2004 for the first time.

As mentioned above, the Creditor Rights index in Private Credit in 129 Countries records score of 3 for the whole period. In theory, other things being equal, the higher the creditor rights the higher the credit / GDP ratio. Also when the Creditor Rights index remains equal, the ratio – assuming there are no outside influences – should remain stable or grow.

Nevertheless, the credit / GDP ratio was stable and then declining considerably through the examined period (see the table Private Credit to GDP above).

We can see that from the peak in the year 1997 when the value was 68%, the index fell down as low as 29% in 2003. This is after Poland the lowest value from all the CE transition countries – this is quite different situation than the one presented by the original data used in Private Credit in 129 countries, where the presented value is 42%.

Of course, there exists wide variety of influences that shape the value of credit / GDP ratio. These are for example economic growth, reforms in information sharing (credit registries and accompanying regulation), quality of enforcement or the legal family to which the particular country belongs⁵⁰.

The steep decline in credit / GDP index seems to be caused by some outer influence – the Creditor Rights index is constant for the period.

⁵⁰ All mentioned influences have been proved to be statistically significant by Djankov et al. in the Private Credit in 129 Countries.

One influence was most probably the economic crisis in 1997 followed by government packages of fiscal remedies combined with restrictive steps towards the banking sector conducted by Czech National Bank.

For another very important reason for the decline in private credit / GDP ratio, we have to look among the remedies used in later stages of privatisation. Most of the state owned banks were privatised after the bad assets (classified loans) were transferred to the Konsolidační banka⁵¹. These loans that originated mostly in early stages of transformation as part of the privatisation process then ceased to influence the statistics on private credit⁵². This topic will be covered to greater detail in 5th part of this chapter.

4.3 On Enforcement

The intrinsic quality of legal rights that are granted to creditors and the quality of enforcement of these rights are sides of the same coin. More or less we can say that for players on the market, there is no difference whether the flaw in legal environment lies in the law itself or in the way it is enforced. It is therefore very hard to analyse separately legal rights and enforcement using empirical data. One rare opportunity to do it lies in the analysis of data for court case proceedings.

Both empirical studies are using data on proceedings of court cases dealing with debt contracts with certain standardised characteristics. This standardised type of court case is than used as proxy for assessing overall level of enforcement in the country.

⁵¹ Konsolidační agentura, <http://www.kobp.cz/>. As seen on 15.12.2006.

⁵² The private credit statistics covers the claims after non-financial sector by financial institutions - World Bank financial database.

In case of Private Credit in 129 Countries, the standard case used to assess the quality of enforcement is a credit contract worth of 50% of national GDP per capita. The variable is then the number of days it takes to enforce the contract. Czech Republic is situated on 48th rank from total 133 countries⁵³. More interesting are the neighbours around this position. From all of them, USA is situated on 32/33 place together with Belarus. Number of days is 250. In United Kingdom, it takes 288 days to enforce the contract and so the UK is situated on 46 position.

Doing Business is, as mentioned before, ranking Czech Republic on the 21st place from 145 in Enforcing Contracts index. However the methodology used by the team of the World Bank is little bit different. The Enforcing Contracts index is composed of three characteristics compared to one in case of Private Credit in 129 Countries. These are the time for enforcing a contract, the number of administrative steps needed to do so and the cost expressed as a percentage of the debt in question. According to the index, in the Czech Republic 290 days, 21 administrative steps and the cost is 9,1% of the debt value.

Another difference is the size of a contract. For needs of the Enforcing Contracts index, standard contract is debt between two businesses of value 200% of national GDP per capita.

Both studies are working with these data as with proxy variables for assessing the overall quality of the legal enforcement and in both cases, the overall result is above average and close to results for countries we might envy their quality of

⁵³ The total number of countries present in the study is higher than 129, but only for those 129 there are all the data available. Djankov, Simeon D., McLiesh, Caralee and Shleifer, Andrei. *Private Credit in 129 Countries*, 2005. NBER Working Paper No. W11078. <http://ssrn.com/abstract=652366>

enforcement. However as a person living in the Czech Republic and following quite closely the development in the past 10 years, I feel to be little bit surprised by these results, and actually we can find on proceedings of economically relevant cases.

Bankruptcy proceedings may serve as an example of other relevant type of court case. From the year 1992 till 2000, there have been filled 24,830 of bankruptcy cases in total. From all the filled bankruptcy cases, at the end of the year 2000, there have been 42% or 10,416 cases still pending - majority of them for more than 1 year and 35% percent of these cases pending for more than 3 years. Using conservative estimate we get to average length of bankruptcy proceeding around 459 days and it is most probably even higher^{54, 55}

This is very rough estimate, but it gives us certain a clue on the ability of the Czech institutional environment to enforce right of creditors to reclaim their property through one of the main legal rights or remedies they possess. In essence the insolvency framework is regarded as unsatisfactory, it takes very long time to close the case, and the returns to the creditors tend to be as low as 5% of the debt. The use of other options as reorganisation or debt-equity swap is limited due to the restrictive regulation. Infrastructure for insolvency proceedings including capacity and proficiency of courts, administrators and other professionals is also considered to be inefficient and unsatisfactory. Nevertheless, data and results from Private Credit in 129 countries and Doing Business database seem to contradict this locally perceived seriousness of the situation.

⁵⁴ Assuming that the average length of successfully closed cases has been 270 days and that pending cases are on average pending for 2 years.

⁵⁵ Johnson, Gordon, W. Report on Observance of Standards & Codes Insolvency and Creditor Rights System: Czech Republic. Washington: World Bank, 2001. Page 6.

In developed countries, secured lending offers tremendous benefits to the borrower. Compared to the situation, when a borrower asks for an unsecured loan, he or she can expect that the loan secured by real estate offered to him or her will be nine times larger, repayable over eleven times as long period of time and the interest will be about 50% lower. In case the security would be in the form of movable assets, the terms would somewhere in-between the secured and unsecured loan. More than that, 70% of all bank loans in USA are secured.⁵⁶

Clearly, both parties in the lender-borrower relation in developed countries must see clear benefit in secured lending, because the differences in terms between secured and unsecured loans are substantial.

The reason why this is interesting for this analysis is that the Creditor Rights index used in Private Credit in 129 Countries is fully dealing with the position of secured creditors. It is used as a proxy to assess the overall position of a creditor inside the national institutional framework and as such it might not be fully depicting the situation, but in case of secured creditors its explanatory capability has to be higher. As already said, the score for the Czech Republic in this index is quite high and the enforcement capabilities of Czech institutional framework are not, according to both studies, substantially worse than capabilities of developed nations, but again looking at the actual situation this does not seem to be in line with the real life.

⁵⁶ Fleisig, Heywood. *Integrating the Legal Regimes for Secured Transactions and Bankruptcy: Economic Issues*. CEAL ISSUES BRIEF, No. 1. Washington: Center for the Economic Analysis of Law, 2000. Page 2.

Secured lending is also widespread, but instead of being a way how to get more favourable terms, it is on many occasions the only way how to get a credit⁵⁷. This was felt hard especially by SMEs and start up businesses that are to large extent deprived of access to credit at all. This can be documented by relatively low level debt-equity ratio of 100% for medium sized, profit making industrial firms, when value this is equal to industrial average and SMEs tend to have higher debt-equity ratio.⁵⁸

Secured creditors are facing difficulties to get their collateral both on themselves outside the bankruptcy as well as during the bankruptcy proceeding. More than that, they are obliged to give up, up to 30% of the collateral in favour of the secured creditors.⁵⁹

4.4 Information Sharing

As mentioned in chapter three, the score of the Czech Republic in Credit Information Index is 5. The list of features of the index, the results for the Czech Republic and credit registry coverage are stated in table 3.

In the case of these recorded results for the Czech Republic, there seems to be problem with their accuracy. The second point – “Are both positive and negative data distributed?” is stated as No. In other words, the credit indexes in the Czech

⁵⁷ *Report of Working Group on Debtor Creditor Rights*. The World Bank, Debtor Creditor Rights Working Group (1999), paper presented at the Washington, D.C. Symposium on 09/29/1999. Available on <http://web.worldbank.org>.

⁵⁸ Johnson, Gordon, W. Report on Observacne of Standards & Codes Insolvency and Creditor Rights System: Czech Republic. Washington: World Bank, 2001. Page 2.

⁵⁹ Balcerowicz, Ewa, Hajshi, Iraj, Lowitzsh, Jens, et al. *The Development of Insolvency Procedures in Transition Economies: a Comparative Analysis*. Warsaw: CASE – Center for Social and Economic Research, 2003. Page 26.

Republic should be collecting only negative information about the borrowers. However the biggest of the credit registries operating in the Czech Republic, the Bank Register of Client Information (Bankovní registr klientských informací, BRKI), which contains data on more than 3.19 million of clients⁶⁰ is tracking both negative and positive information⁶¹.

The binary variables that are used in the Private Credit in 129 Countries are stating yes for existence of both private and public credit bureaus.

According to theory, we should experience increase in the amount of credit due to the availability of credit information. However this would require profound analyses focused purely on the influence of information sharing, because for so detailed judgement, the credit/GDP is too general tool. The potentially positive effect of credit registries might be compensated or even overridden by other influences, so of which are also mentioned in this chapter.

Interestingly, the coverage of population by credit bureaus is quite impressive especially if we take in account that the overall usage of bank services is lower in the Czech Republic than in developed countries and this holds also for the use of credit services. Only 6%⁶² of Czech inhabitants have credit compared to 19% in Austria and 21% in Slovenia.⁶³

⁶⁰ Müllerová, Kateřina. *Mají banky strach z našich dluhů?* [online]. 25. 1. 2005, cited on 12.12.2005. <http://www.mesec.cz/clanky/maji-banky-strach-z-nasich-dluhu/#1537>.

⁶¹ *Fact Sheet BRKI* [online]. Not dated, cited on 12.12.2005. <http://www.creditbureau.cz/Tisk/Factsheet.aspx>.

⁶² The credit register tracks information for other products besides ordinary loans – therefore the number of individuals covered by the registries is higher.

⁶³ Nováková, Jolana. *Češi a osobní finance: jak si stojíme?* [online]. www.idnes.cz. 5.1.2005, cited on 12.12.2005. http://fincentrum.idnes.cz/fi_osobni.asp?r=fi_osobni&c=A050103_155049_fi_osobni_zal.

However in my opinion, what needs to be mainly considered is the time for which the registers are operating. The biggest registry – the BRKI – has started its operations on June 2002. But the latest data we have available for the credit/GDP, are for the year 2003. It is questionable whether one and half year of operations could have any profound impact on the amount of credit.

4.5 Path dependency

The development of institutions in Czechoslovakia was heading for almost 60 years in opposite direction than is a democratic society and working market economy. First German occupation and then communist regime have not contributed to preparedness of institutions and society as a whole to the repeated establishment of democratic principles. The fall of communist regime in 1989 meant beginning of unprecedented changes in the whole society.

Main institutions of democratic state were quite quickly established, but this was mainly “nominal” change. Institutions were not necessarily working in the same as they are supposed to work at least from the viewpoint of developed nations. This was caused by missing experience and knowledge how institutions of democratic state and market economy should work. In the end, after 60 years of totalitarian regimes, there was virtually no one who would have such experience. On the other hand, Czech citizens had 60 years of experience living in a state, where one of the most famous sayings was approximately like this: “who does not steal, is robbing his own family”.

Corruption

To change life values and “philosophy” of citizens is probably the most difficult of all the tasks the Czech transformation faced and I dare to say it is the one that is

impossible to achieve (under the assumption we are trying to build the democracy) in coordinated manner.

Corruption, bribery used to be standard way of behaviour and was virtually omnipresent during the past regime. Interestingly, according to the Transparency International Corruption Perceptions Index⁶⁴ the corruption is bigger problem nowadays then it used to be shortly after the Velvet Revolution.

Table 7 TI Corruption Perception Index

Year	Rank	Value of CPI
2005	47	4.3
2004	51	4.2
2003	54	3.9
2002	52	3.7
2001	47	3.9
2000	42	4.3
1999	39	4.6
1998	37	4.8
1997	27	5.2
1996	25	5.37

Source: Transparency international, www.transparencyinternational.org. Cited on 12.12.2005.

Another interpretation might be that corruption began to be considered to be non standard behaviour after eight or nine years after the change of the regime.

Change of thinking and with that connected development of controlling and institutions and procedures that help to tackle corruption is a long term task. Recently we have witnessed one blatant example that fighting corruption is long term task and that corruption can directly and strongly influence the situation of all

⁶⁴ Transparency international, www.transparencyinternational.org. Cited on 12.12.2005.

the players on the market – regardless if they are creditors, shareholders or in some other position. We have seen Mr. Jiri Berka, to make it to the headlines of all the newspapers for his malpractice as a judge of the court dealing with bankruptcies. Mr. Berka had apparently manipulated the bankruptcy proceedings in order to facilitate asset stripping of the affected enterprises.

The discovery of malpractices of Mr. Berka happened fifteen years after the revolution, in other words after fifteen years of building institutions that should counter such a behaviour. It is not hard to conceive how the situation looked like during first stages of the transformation when democratic and market institutions as well as consciousness towards corruption and other malpractices were still in diapers.

Privatisation and corporate sphere restructuring

Privatisation was major part of the transition in all post-communist countries. The way the privatisations in different countries were conducted, shaped to great extend further development and character of the economics of these countries.

In case of the Czech Republic, specific Czech way of voucher privatisation resulted in very problematic composition of ownership structures of privatised companies where the shareholdings were extremely dispersed. The new shareholders were seen more like appointed owners than investors and suppliers of finance.

This combined with weak institutional framework of Shareholder Rights and their enforcement lead to mass misappropriation of the assets by management, large shareholders or other concerned characters. The scope of this behaviour was such, that as result Czech language gave to the World another word. But this time, contrary to ROBOT, “tunelování” or tunnelling will not usher in new era of progress and scientific achievements.

The other way of privatization through direct sales without participation of the foreign investors and without domestic capital lead to another effects and defects.

The state kept control of most of the main banks throughout the whole process of the privatisation. The state controlled banks, without needed experience and proper management and control where functioning as the financiers of the privatisation. Subsequently they were also financing the restructuring of the corporate sphere and lastly but not least they were subjected to fraud and other activities leading to misappropriation of bank credit. The effect was accumulation of huge amount of classified loans which constituted around one third of all the loans⁶⁵. This troubling experience together with gradual change of owners of the biggest banks and with restrictive steps made by the central bank in 1997 and 1998 lead to subsequent decline in lending activities. This is above all doubts one of the main reasons for the steep decline in amount credit as seen on the development private credit / GDP ratio documented before.

⁶⁵ Srholec 2001

5 CONCLUSION

Comparative study in its essence can not depict the reality to every detail. This is intrinsic characteristics of such research approach. In order to compare and get generalised conclusions, we have to omit part of the complexity of the real world. On the other hand, this simplification should not result in findings deviating from the observed situation.

Private Credit in 129 Countries as well as the Doing Business are, when it comes to the way they depict the situation of creditors in the Czech Republic, very optimistic. The documented level of Creditor Rights and their enforcement is on par with OECD average. This observed quality should manifest itself into the positive development of credit markets.

However, the development of credit markets during past years goes the opposite way with major decline in amount of credit in the economy in the Czech Republic. The steep decline in amount of credit and low amount of credit when compared to other economies is, in my opinion, the best proof of insufficiency of the framework essential for creditors' functioning.

There are several reasons for the discrepancy between the observed and depicted situations.

The time dimension

In case of credit registries, reports are recording their presence and their high quality. Also the coverage is not insignificant.

On the other hand, in order to become facilitating lending, players on the market must learn how to use the information the registries offer. Especially they must learn how to use and work with the positive part of the information that is available

in the registries. The registries, especially the one with the biggest coverage, have been operating for quite a short time – one or two years at the point the studies were made. In this aspect I consider the effect of the registries to be overrated by both studies, but with positive prospect to the future.

Data errors

There are some errors in data presented in the studies. The credit / GDP ratio in Private Credit in 129 Countries does not correspond with the IMF statistics it should originate from. Also the information that credit registries in the Czech Republic are collecting only the negative information is wrong.

The main problem does not lay within these errors itself, but the possibility that other data in the studies might be wrong.

Especially the data for quality of Creditor Rights and enforcement, which are fully based on the answers from local participants to the research and which I have not subjected to scrutiny, might be biased with obvious impact on the overall result of the research.

Limits of the Methodology

The methodology to measure the Creditor Rights and enforcement developed by La Porta and subsequently used in the two research studies in question seems to have its limits. It is not taking into account certain intrinsic characteristics of the institutional framework inside analysed countries. It seems to emphasise more the “nominal” level of the Creditor Rights than on their actual impact on the position of creditors. Apart from the questionable outcomes for the Czech Republic, this can be seen and documented on very good placement of some obscure countries like Belarus or some distressed African countries on the top places in the Creditor Rights index or in the level of enforcement.

Overall

Both studies are for various reasons overrating the quality of the environment, creditors are facing in the Czech Republic.

Partly this is caused by the local specifics, which are not registered by the methodology the studies are using.

However, part of the difference comes from what seems to be errors in data gathering (misleading information in case of the credit registries) or in the selection of data used in the analysis (value of private credit/GDP ratio that does not correspond with the actual statistics).

Both problems make country specific information contained in both studies doubtful and unusable for further use in country specific research. Furthermore, the discrepancies between the findings of the comparative studies and the actual situation potentially challenge the validity of the general conclusions of both *Private Credit in 129 Countries* and *Doing Business: Removing Obstacles to Growth*.

For Further Research

Potential for further research and study based on findings of this thesis, I see mainly in the possibility to check the accuracy of the primary data both studies are using. It would be interesting to gather again the primary data, using this time different and potentially wider group of respondents.

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