

COOPERATIVE SAVINGS ASSOCIATIONS IN CZECH HISTORY AND THEIR POSITION IN THE MODERN CZECH FINANCIAL SECTOR

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Abstract: *The article first describes the history and legal regulation of cooperative savings associations in Czech lands since the second half of the 19th century. The initial regulatory issues were resolved by the Cooperatives Act No. 70/1873 ř.z. [Imperial Code], complemented by Act No. 133/1903 ř.z. [Imperial Code]. Historically there were two types of cooperative savings associations: (a) the Schulze-Delitzsch type and (b) the Raiffeisen type, or “Kampelička” [savings and loan association].*

Cooperative savings associations expanded throughout central Europe, and in Czechoslovakia they existed also between the world wars. The communist regime after 1948 cancelled the cooperative savings associations and transferred their assets to a single state-owned financial institution. In the middle of the 1990s the efforts to restore the sector of cooperative savings associations culminated in the enactment of Act No. 87/1995 Sb. [Collection of Laws]. Lack of continuity of ownership relations, poor legal regulation and insufficient supervision resulted in the cooperative savings associations not being a positive complement to the sector of financial services similarly to Austria and Germany; on the contrary they represent a risk to the development of the Czech financial sector. In 1999 there were 127 cooperative savings associations, and later there was the first wave of insolvencies. In 2004 the rules for operation of cooperative savings associations became much stricter, and since 2006 they are under supervision of the Czech National Bank. Currently there are 12 cooperative savings associations active in the Czech Republic and they cover less than one per cent of the entire banking sector, however in case of possible financial difficulties they may jeopardise the trustworthiness of the entire financial sector and draw from the Deposit Insurance Fund.

Keywords: *cooperative savings associations, cooperatives Act, František Cyril Kampelík, Friedrich W. Raiffeisen, czech financial sector, moral hazard*

INTRODUCTION

World Council of Credit Unions¹ brings together more than 71 thousand cooperative savings associations from 87 countries. The European countries with the highest numbers of cooperative savings associations include Germany and Austria (Raiffeisen systems), Great Britain, France (Crédit Mutuel), the Netherlands (Rabobank), and in North America Canadian Québec (Desjardins). The Czech banking sector also includes cooperative savings associations operating side by side with banks and branches of foreign banks.

The article analyses the historical legal regulation of cooperative savings associations and specific deficiencies of the current Czech legal regulation of cooperative savings associations and the effort to rectify such deficiencies. The aim of the article is to show in the context of historical and institutional development the specific legal, institutional and economic features of this type of financial institution, which was restored on the Czech financial market in the middle of the 1990s and still exists today.

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¹ See World Council of Credit Unions at www.woccu.org.

1. HISTORY OF COOPERATIVE SAVINGS ASSOCIATIONS IN CENTRAL EUROPE AND IN CZECH LANDS

The second half of the 1860s marks the beginning of an economic boom in the Czech lands when there was lack of capital available to smaller businesses and sole traders in towns. The solution for this situation in Austria and the Czech lands was strongly influenced in theory and in practice by a Prussian lawyer and liberal politician named Hermann F. Schulze-Delitzsch (1808–1883), who in 1850 founded in Delitzsch a cooperative savings association. As a result of his campaign and practical treatises dealing with national economy (such as “*Vorschuss- und Creditvereine als Volksbanken*” [Savings and loan associations as popular banks] from 1855), savings cooperatives were founded in towns throughout Germany on a voluntary basis without state influence. The first Czech self-help civil savings association inspired by Schulze-Delitzsch was founded in Vlašim and soon was followed by others.² The self-help civil savings cooperatives provided services primarily to sole traders and craftsmen, made short-term loans to their members (non-members were only able to make deposits of their savings); there was usually limited liability and members were only liable up to the amount of their deposits.

At this time, in the 1860s, in rural areas, František Cyril Kampelík (1805–1872) came up with a model self-help financial association to support agricultural businesses, but his model did not expand and fell into oblivion.³ At the end of the 1880s and in the 1890s the opinions of Bavarian populariser of farmers’ loan cooperatives Friedrich W. Raiffeisen (1818–1888) became popular and his practical examples of forming farmers’ savings associations resulted in the formation of similar farmers’ savings cooperatives in Bohemia and Moravia. Raiffeisen’s ideas and suggestions concerning loan cooperatives and loan conditions were concentrated in brochures, such as “*Die Darlehnskassen als Mittel zur Abhilfe*” [Savings associations as a remedy] (1866), “*Instruktion für Geschäfts- und Buchführung der Darlehnskassenvereine*” [Instructions for business management and accounting of savings associations] (1883), “*Kurze Anleitung zur Gründung von Darlehnskassenvereinen*” [Short introduction to formation of a savings association] (1893). Raiffeisen’s self-help loan cooperatives⁴ were limited to small rural areas and communities and members of the cooperatives had unlimited joint and several liability for the deposits and loans that were secured by debentures. Loans were made only to members and loans secured by promissory note were excluded. Membership shares had low values, nobody was allowed to be a member of more than one savings association and every member had one

² Towards the end of the 1860s the sector of self-help civil savings cooperatives expanded to such an extent that in 1868 Živnostenská banka was founded as a central joint-stock bank of Czech and Moravian cooperative savings associations. Whereas in 1870 in Bohemia and Moravia there were 153 cooperative savings associations with 20 m of “stříbrný zlatý” [silver guldens] of deposits, in 1878 Czech and Moravian cooperative savings associations managed 88 m of “stříbrný zlatý” [silver guldens], out of which 397 Czech savings associations managed over 70 m. Cf. NOŽIČKA, J. *Hospodářský a měnový vývoj našich zemí*. Praha: Orbis, 1946, p. 189.

³ For more details see BAŽANTOVÁ, I. *Družstevní a svépomocné koncepce v českém ekonomickém myšlení*. Praha: Prospektrum, 2002, pp. 74–88.

⁴ Raiffeisen had a slightly different concept of loan cooperative compared to the unappreciated Kampelík; in spite of that, in Bohemia the Czech village savings associations of “Raiffeisen type” used the popular name derived from the name of Kampelík, the so called “Kampelička”. In Moravia they used the popular name of “Raiffeisenka” and the same name was used in Bohemia for German savings associations.

vote at the general meeting. Dividends were excluded as a matter of principle, interest on shares could not exceed interest on deposits and the difference between the interest on loans earned by the association and the interest on deposits paid out to the depositors could not be higher than 1,5 %. The offices of the members of the board of directors were offices of honour with the exception of the treasurer. As these institutions were active in small areas where the members knew each other, the scope of transactions was not high and the risk of bad debts or loan fraud was relatively low.

1.1. Legal regulation issues and the cooperatives act

Until 1873 there was no appropriate legal form for financial and business cooperatives in the entire Habsburg monarchy. In general the cooperative business, including formation of cooperative savings associations, was governed by the Act to Regulate Associations No. 253/1852 ř.z. [Imperial Code] from 26th of November 1852. This Associations Act required the cooperatives to gain special permission from the state administration in order to be formed and they were subject to state supervision also in terms of financial management and activities. There were also other legal issues, such as the fact that the most important legal relations had to be regulated on an ad hoc basis by articles of association which did not have a standard template, the legal relation to creditors was not quite clear, and the position of cooperative savings associations in bankruptcy was not clearly regulated. In addition to that, on 6th of May 1865 ministerial decree no. 54867 was issued which cancelled the exemption of cooperative savings associations as benevolent and not-for-profit associations from paying duty stamps and fees. As a result, there were numerous disputes and financial discrepancies between cooperative savings associations and the state financial administration.⁵

Antonín Randa (1834–1914), a lawyer and founder of Czech civil law, university professor in Prague and later rector of the Czech part of Prague University and a minister in the Austrian Koerber government intended to resolve these issues and discrepancies. Randa was not only an academic lawyer, but for many years he was also an advisor to “Jednota českých záložní” [Union of Czech Savings Associations] and supported the formation of Czech savings associations. In 1866 Randa wrote an article published in the journal *Právník* (established in 1861) titled “*Vyhovuje-li nynější zákonodárství rakouské potřebám našich záložní?*” [Does Austrian law meet the needs of Czech savings associations?], which among other things resulted in the Assembly of Czech Lands requesting the Council of Czech Lands (and specifically A. Randa) on 20th December 1866 to create an outline of an act to regulate cooperatives. An outline and explanatory report⁶ of the new act was drafted, however the Austrian government rejected further discussion of the act because in their opinion this area fell under general Austrian jurisdiction of the imperial council, rather than the jurisdiction of the Assembly of Czech Lands.

The government bill was submitted to the imperial council as late as 1872. It was based on the principles underlying the German act to regulate cooperative associations effective as of 1868 co-authored by H. Schulze-Delitzsch, and also the principles underlying the

⁵ VENCOSKÝ, F. et al. *Dějiny bankovníctví v Českých zemích*. Praha: Bankovní institut a.s., 1999, p. 108.

⁶ Outline of the act and explanatory report in *Právník*, 1867, Vol. 6, p. 289, 333 and subseq.

Bavarian cooperatives act from 1869. The act was approved on 9th April 1873 under no. 70 ř.z. [Imperial Code] and entered into effect on 1st July 1873; in legal history it is generally referred to as “cooperatives act”. This act had a decisive influence on all countries of central Europe for many years including the years after disintegration of the Habsburg monarchy.⁷ With the mass development of cooperatives there was a need to tighten the statutory supervision and Act No. 70/1873 ř.z. [Imperial Code] was complemented by Act No. 133/1903 ř.z. [Imperial Code], to regulate reviews (see below).

The cooperative savings associations for sole traders of Schulze-Delitzsch type with registered address in small towns and “Raiffeisenkas”, or “Kampeličkas”, for farmers with registered address in rural communities (cooperatives with unlimited liability focusing on the agricultural sector) were the prevailing types of cooperative savings associations that expanded in the last third of the 19th century throughout Germany, the then Austro-Hungarian empire,⁸ Switzerland and North Italy and operated for many decades without any major issues.

1.2. Administration of cooperative savings associations and supervision

In the Czech lands sound operation of cooperative savings associations was made possible by both practical examples and well-drafted Act No. 70/1873 ř.z. [Imperial Code], which stipulated the obligatory bodies and administration of cooperatives and, due to its directory provision, made it possible to choose either limited or unlimited liability as appropriate.⁹ Sound operation was also facilitated by appropriate set-up of reviews of cooperative savings associations.

Under Act No. 70/1873 ř.z. [Imperial Code] and in accordance with the provisions of the articles of association the cooperative savings associations had full autonomy once they were registered in the commercial register. Compliance with the articles of association and laws was monitored by the commercial court, as in the case of other cooperatives and business legal entities. Administration and management of the cooperative savings association was executed by the general meeting as the supreme body, the board of directors as the body authorised to act on behalf and in the name of the association and the supervisory board (or auditors); the treasurer was the executive body.

The board of directors met at meetings announced in advance – minutes of these meetings served as proof of the activity of the board of directors and were submitted to the supervisory board, audit and possibly the court. The minutes were to be taken directly at the meeting and record the meeting in a matter-of-fact and correct manner so that they could be signed by the present members after they were read. The members of the board of directors had to be registered in the commercial register, and the manner of their acting

⁷ See e. g. VITEZ, M. *Budući zakon o zadrugama i neke savremene tendencije u uporednom zadružnom pravu*. In: ŠEVARLIĆ, M. (ed.). *Stanje i perspektive zadrugarstva*. Beograd: DAES – Društvo agrarnih ekonomista Srbije, 2011.

⁸ Only in Bohemian rural areas there were approximately one hundred district agricultural savings associations formed by conversion from the contributory funds. These savings associations were declared public institutions by Act No. 128/1924 Sb. z. a n. For more details see BAŽANTOVÁ, I. *op. cit.* in note 3, pp. 67–69, 175–177.

⁹ For more details see BAŽANTOVÁ, I. *Z historie finanční svépomoci. Právněhistorické studie*. 2007, No. 38, pp. 337–338.

on behalf of the association and signature authorisation was determined by the articles of association. Their duties involved regular keeping of books, closing of the books of accounts for a year, maintenance of the register of members, compliance with the articles of association and supervision over records of protocols. If the board of directors breached the articles of association or law, it had personal and joint and several liability for the sustained damage. It was authorised to grant a power of attorney and to convene a general meeting. The board of directors worked for free, however the members of the board were compensated for extraordinary work associated with special efforts or outlays. The cooperative savings association had a duty to submit the articles of association and a duplicate of approved closing of accounts to the administration of the country through the district office.

The supervisory boards had six to nine members and supervised financial management of the cooperative savings association and had an advisory role to the board of directors; if needed, it remedied any errors and was responsible for control and supervision of the interests of the cooperative savings association and its members. The resolutions of the board of directors, supervisory board and the general meeting were executed by the treasurer, who had to be elected irrespective of his membership in political parties, family or other relations. The treasurer was usually elected for a longer period than other bodies in order to maintain continuity. He had the same liability for the obligations of the cooperative savings association as other members and in addition to that he had personal liability for administration of the cash-box. Further control was carried out by the so called statutory review (see below), the results of which were included in a written report of the cooperative which had to be read aloud in public at the next general meeting of the cooperative savings association.

Sound operation of the cooperative savings associations was also ensured by the supervision of a self-governing regulatory body. For civil cooperative savings associations of the Schulze-Delitzsch type a union was founded in 1884 called “Jednota českých záložen v Čechách, na Moravě a ve Slezsku” [Union of Czech Savings Associations in Bohemia, Moravia and Silesia], which drafted a template articles of association, procedure for formation, guidelines for keeping of books and so on, which were easy to follow. In 1896 another union was formed for “Raiffeisenkas” (“Kampeličkas”) called “Ústřední jednota českých hospodářských společenstev v království Českém v Praze” [Central Union of Czech Agricultural Communities in Prague]. In 1897 a union called “Ústřední jednota českých hospodářských společenstev úvěrních v Brně” [Central Union of Czech Agricultural Loan Communities in Brno] was founded. Accession to the unions was voluntary for all cooperative savings associations.

Act No. 133/1903 ř.z. [Imperial Code] stipulated among other things obligatory periodical reviews of financial management of the cooperative savings associations.¹⁰ Performance of these reviews was delegated by the act to the unions of cooperatives (Sections 2 and 3). If a cooperative savings association was not a member of any of the unions the review was carried out by the commercial courts. If the cooperative savings association re-

¹⁰ The act was executed by Decree no. 134/1903 ř.z. [Imperial Code], regulating the methods of reviewing, mandatory fields of inspection, duties of the reviewers, manner of keeping records and other documents.

ceived public financial support (Section 14), the act stipulated that it was subject to review also by the public administration of the individual lands (the councils of the lands). A union could perform reviews providing that it had at least 50 member cooperatives, or irrespective of the number of members if it associated all cooperatives of one land administration, or if it associated all cooperatives within the land with the same economic role and the same official language. Performance of review activities had to form an explicit part of the articles of associations of cooperatives.

The reviews were to be carried out every second year by external reviewers (Section 1), appointed by the unions of cooperatives, commercial courts, offices of the lands or the ministry of interior. The review focused primarily on legal compliance and compliance with the articles of association. The reviewer had the right to inspect the trading and accounting ledgers and documents, request reports and explanations from the bodies of the cooperative and inspect the balance of the cash-box, review the cash as well as securities. The supervisory board of the cooperative savings association participated in the review (Section 6). The board of directors was responsible for rectification of any defects and proceeded in accordance with the review report (Section 8). The reviewer was entitled to reimbursement of his costs and to a fee for his work paid by the cooperative savings association. In case of breach of regulations procedural fines were imposed (Section 11).

Cooperative savings associations could receive public financial support (from the land administration) – when formed they could apply for returnable financial support amounting to 300K which had to be returned once the reserve fund reached an amount stipulated by law or by the articles of association. A contribution was provided also to unions of cooperatives to cover costs of review activities performed in the public interest. The state provided to cooperative savings associations also tax reliefs under Act No. 91/1889 ř.z. [Imperial Code]: if the cooperative savings associations wanted to be exempt from gains tax and from some administrative fees they had to have unlimited liability, make loans only to their own members, it was prohibited for such institutions to trade in promissory notes and bills of exchange, the interest rate for loans could exceed the interest rate on deposits only by 1.5%, the maximum interest rate on shares could not exceed the interest rate on deposits and any surplus (profit) had to be allocated to the reserve fund.

1.3. From Czechoslovak inter-war boom to post-war liquidation

On 28th October 1918 the Czechoslovak Republic was formed and within the framework of legal continuity stipulated by Act No. 11/1918 Sb. z. a n. [Collection of Laws and Ordinances] it took over also the Cooperatives Act No. 70/1873 ř.z. [Imperial Code], as amended including Act No. 133/1903 ř.z. [Imperial Code]. These legal regulations (including the amendments) applied to the cooperative savings associations throughout the period of the first Czechoslovak Republic up to the ascension to power of the communist regime.

The structure of the cooperative savings associations remained similar to the previous period, however the balance sheet totals of the associations increased.¹¹ Czechoslovak cooperative savings associations of the Schulze-Delitzsch type provided primarily loans secured upon promissory notes, Lombard credits, mortgage and personal loans secured by guarantee, and they also discounted notes and bills and provided for money transfers. The savings associations of the Raiffeisen type (“Kampeličkas”) provided cheap loans for farm-

ers, because they had the lowest overhead costs and the lowest risk. The members of the bodies authorised to act on behalf of these institutions were usually members of the local educated class and performed their work for symbolic remuneration.

The first more substantial expansion of the legal regulation of the banking and monetary sector including the cooperative savings associations was carried out by Act No. 238/1924 Sb. z. a n. [Collection of Laws and Ordinances], which established the General Fund of Financial Institutions managed by Zemská bank, into which all financial and loan institutions including cooperative savings associations (Section 3 (1) (b) of the Act) had to contribute 3% of all paid-out or deposited financial amounts. The resources of the General Fund of Financial Institutions were used for financial assistance to the members of the Fund as a simple loan, however only after five years of membership (Sections 13 and 14). The maximum compensation for the depositors in case of bankruptcy of a financial institution was stipulated as 80% of the deposited amount (Section 16). Another legal regulation added was Government Decree No. 169/1933 Sb. z. a n. [Collection of Laws and Ordinances] which in reaction to the economic crisis modified and harmonized the definition features of a financial business.

The movement of cooperative savings associations experienced a promising development in the Habsburg monarchy and was firmly integrated in the first Czechoslovak Republic in spite of the fact that the backbone of the Czechoslovak financial sector consisted of banks and savings banks. During German occupation in the course of the Second World War the German administration of the protectorate carried out steps directed at reducing the influence of cooperative savings associations within the state-managed war economy. In 1942 two large groups of savings associations were created, the so called general savings associations and agricultural savings associations, which had consistent internal organisation. Within these groups there were obligatory mergers between individual loan institutions, some savings associations were persecuted, their activities were terminated and their assets were confiscated. The classification into general and agricultural savings associations remained in place after the war. From November 1945 all financial deposits of citizens in banks, savings banks as well as cooperative savings associations became tied deposits, i.e. all withdrawals of cash and money transfers were limited and made conditional upon special permission of the state administration. In spite of that in the year 1947 there were still over 4,000 loan cooperatives with more than 1,300,000 members in Czechoslovakia.¹²

The change of the regime in February 1948 had an impact also on the sector of financial services: as a result of Act No. 181/1948 Sb. [Collection of Laws] to organise the financial sector, all former savings banks and cooperative savings associations of various types were transformed to have the same legal form of a cooperative and were called “ústavy lidového

¹¹ For an overview of the totals of deposits and loans see VENCOVSKÝ, F. et al. op. cit. in note 5, pp. 368–369. As of the end of 1919 there were 1,413 cooperative savings associations of the Schulze-Delitzsch type, and in 1937 the number grew to 1,983; as of the end of 1919 there were 3,798 Raiffeisenkas (Kampeličkas), and in 1937 the number grew to 2,919; in 1918 there were 145 district agricultural savings associations and by 1937 the number grew to 173. In addition to territorial classification (rural areas – towns) and sector classification (agriculture – industrial sole proprietorships) the cooperative savings associations were also structured on nationality principle (Czech – German – Utraquist) and on the political party membership of the institution's members.

¹² Data from the material of the Museum of the Cooperatives, Prague.

peněžnictví” [popular finance institutions]. As of 1st January 1953 all these popular finance institutions were transformed into a single state-owned savings bank based on Act No. 84/1952 Sb. [Collection of Laws] which allowed for existence of only one state financial institution, and served only for collection of savings of citizens.

2. COOPERATIVE SAVINGS ASSOCIATIONS IN THE CZECH REPUBLIC AFTER 1989

In the first half of the 1990s, in the period of transformation from a centrally planned economy into a market economy, there was again a need to provide flexible loans of lower amount to small businesses. During the discussions of the proposed¹³ legal regulation and elsewhere those involved mentioned the positive Czechoslovak tradition of cooperative savings associations as well as the current examples of continuous existence of cooperative savings associations in Austria and Germany.

2.1. Rise and systematic errors of Gründerzeit of loan cooperative system

Provision of financial services in the legal form of a cooperative was enabled by Act No. 87/1995 Sb. [Collection of Laws], to regulate savings and loan cooperatives which entered into effect on 1st January 1996 (hereinafter “the Act”). The Parliament of the Czech Republic approved the standard “historical” European model, which required the people to become members of the cooperative savings association before they could use the full range of its financial services. By paying a membership contribution the member became a co-owner of the cooperative savings association and ownership share was determined as a ratio of the membership contribution to the total of all membership contributions of all members.¹⁴ Under Section 2 of the act every cooperative savings association had to have at least 30 members, who had to be natural persons, and a registered capital of at least 100,000 CZK was required, which was a low amount even for that period.¹⁵ The bodies of the cooperative savings associations included the general meeting of members, the board of directors as the body authorised to act on behalf of the association, the audit committee and under Section 6 of the act a loan committee of at least three members. Every member had one vote in the bodies of the cooperative savings association (Section 6(8) of the Act). Members of the cooperative savings association were not liable for debts of the savings association, and in case of losses of the savings association the members had a payment duty stipulated by the articles of association of at least double the amount of their membership contribution (Section 4(3)). In practice though the membership contribution amounted to several hundred crowns and as the articles usually were not clear enough

¹³ See e.g. Parliamentary Print Ref. No. 1197, 1st term of the Chamber of Deputies of the Parliament of the Czech Republic – explanatory report concerning private member’s bill no. 87/1995 Sb. [Collection of Laws], retrieved from <http://www.psp.cz/eknih/1993ps/tisky/t119700.htm>.

¹⁴ Unless Act No. 87/1995 Sb. [Collection of Laws] stipulated otherwise the cooperative savings associations were governed by the provisions of the Commercial Code (Act No. 513/1991 Sb. [Collection of Laws]), and after the 1st January 2014 by the provisions of the Business Corporations Act (Act No. 90/2012 Sb. [Collection of Laws]) – see Section 6 of Act No. 87/1995 Sb. [Collection of Laws].

¹⁵ The banks in the mandatory form of a joint stock company were required to have a minimum registered capital of 500 million CZK.

concerning the payment duty (or the payment duty was not stipulated at all) the members did not pay anything.

A cooperative savings association could accept deposits and make loans to its members, grant guarantees and render monetary services and other services in various forms. Under Section 3 (2) (f) of the act the cooperative savings associations were authorised to form subsidiaries for the purpose of doing (any) business almost in an unlimited scope in relation to the deposited money of the members. This turned out to be rather problematic.

Act No. 87/1995 Sb. [Collection of Laws] further stipulated the manner and amount of insurance of deposits of the members. The deposits were insured up to 80% of the deposit including the interest in the maximum amount of 100,000 CZK per member and association (Section 18). For this purpose the act established a Security Fund into which the savings associations contributed annually 0.3% of the total volume of deposits of the members of the association (Section 16).

The act tried to regulate the supervision over the activities and financial management of the cooperative savings associations in Section 22 and subsequent, which authorised the Ministry of Finance to establish within a statutory period of 1 year of the date of effect of the law an Office for Supervision of Cooperative Savings Associations. The Office was established on 1st January 1997 and the emerging sector of cooperative savings associations remained for one year without any supervision or regulation. Even after establishment the supervision carried out by the Office was ineffective because it did not have sufficient powers.

In the first year of effect of the act, the year 1996, a total of 45 cooperative savings associations were formed and registered in the commercial register (with 7,092 members and 176 m CZK of deposits), and in 1999 a total of 144 associations were formed and 133 were registered in the Commercial Register (with 126,486 members and 10.48 bn CZK in deposits).¹⁶ In the second half of 1999 systematic errors in the operation of the cooperative financial sector started to show and in 2000 17 cooperative savings associations administering more than 85% of the total volume of deposits were in official receivership – at that time eight billion CZK “evaporated” out of the total of 11.3 billion CZK of deposits in the cooperative savings associations.¹⁷

In the opinion of the author of this article, the basic systematic error consisted in the legally unfounded and naive expectation of the lawmakers, that the cooperative savings associations will operate in the same manner as at the end of the 19th century, i.e. they would not enter into large monetary and loan transactions, and will apply their openness and personal attitude to the members. Sound operation of the savings associations was supposed to be based on the fact that the members knew each other and on the members’ voluntary engagement and honesty, the cooperative savings associations were supposed to take a simpler and more personal attitude, and offer their members tailored financial products as lower operating costs should have enabled the associations to offer higher interest on deposits. At the beginning of the 21st century after the interruption the newly

¹⁶ Zpráva o činnosti a hospodaření Úřadu pro dohled nad družstevními záložnami za rok 2000 [Report on the activities and financial management of the Office for Supervision of Cooperative Savings Associations for the year 2000]. Praha: ÚDDZ 2001, p. 4.

¹⁷ Ibid., p. 2.

formed cooperative savings associations behaved like small banks in an environment of a minimum level of legal regulation by the Office for Supervision of Cooperative Savings Associations and without any codes of ethics or informal rules. Another problem consisted in the minimum registered capital of the cooperative savings associations amounting to a mere 100,000 CZK and the membership contribution of several hundred crowns appeared to be only another financial “fee” and it did not create a responsible co-ownership relation between the members and the association. So the members too perceived the cooperative savings associations as “another bank” offering higher return on deposited financial resources than traditional banks. Statutory insurance of deposits of natural persons (individuals) was the same in terms of amount insured and conditions both for the cooperative savings associations and for banks (see Section 41e (2) of Act No. 156/1994 Sb. [Collection of Laws]). The members of the cooperative savings associations were not forced to behave like co-owners, and many of them were granted blanket power of attorney for general meetings of members and were not interested in the operation of the cooperative savings association.

The legal regulation was poor, as it enabled the board of directors of the cooperative savings association to transfer assets and financial resources primarily to subsidiaries which were usually exposed to a disproportionate risk. The cooperative savings associations had unlimited access to the financial sector while the body authorised to act on their behalf and their audit body was not required to have appropriate expert knowledge. There were no binding regulations setting out elementary principles of sound business for the cooperative savings associations.

In addition to the systematic errors in legal regulation there were also economic errors consisting in poor or insufficient management of property, investing the financial deposits in high-risk assets, primarily making subprime higher-risk loans, inadequate costs for advertising and promotion and purchase of very costly equipment and furnishings for the savings associations themselves.

In order to attract sufficient capital the cooperative savings associations offered high interest on deposits compared to the return they gained on the deposits when they invested them, which in itself could have resulted in factual economic collapse.¹⁸ Last but not least, there was also intentional crime where some cooperative savings associations operated like Ponzi schemes.

2.2. Efforts to improve legal regulation and the moral hazard of the law-maker

The issues of the cooperative savings associations sector were to be resolved by amendment of Act No. 87/1995 Sb. [Collection of Laws], by adopting Act No. 100/2000 Sb. [Collection of Laws] which entered into effect on 1st May 2000. According to the explanatory report for the bill it aimed at resolving the main defects of the existing legal regulation.¹⁹

¹⁸ For example in 1998–1999 the cooperative savings association PRIA offered its members up to 20% interest on deposits while the bank interest rates were at that time between 5 and 10 %. In 2000 PRIA was under official receivership and the bankruptcy proceedings started in 2004.

¹⁹ Print Ref. No. 244, 3rd term of the Chamber of Deputies of the Parliament of the Czech Republic, retrieved from <http://www.psp.cz/sqw/text/tiskt.sqw?O=3&CT=244&CT1=0>. It was a private member's bill again.

Finally the act at least in general features defined the elements and duties that were common in the banking sector and increased the regulatory role of the Office for Supervision of Cooperative Savings Associations. The sanction powers of the Office for Supervision of Cooperative Savings Associations were strengthened and the Office could actually withdraw the licence to operate as a cooperative savings association.

The new legal regulation required that after formation of the cooperative savings association at the establishing meeting, before it was deemed existing from the legal point of view and before it could start operating, it was necessary under Section 2a to gain a licence²⁰ from the Office for Supervision of the Cooperative Savings Associations. New conditions under Section 2a (6) for granting the licence included the following:

- persons who were elected members of the bodies of the cooperative savings association were required to have professional competence and to be without criminal records;
- material and organisational pre-conditions for performance of the proposed activities of the cooperative savings association; and
- feasibility of the business plan and the ability of sound development of the cooperative savings association with respect to general knowledge and experience.

It was no longer possible to constitute someone a proctor (Section 1 (8)) and the cooperative savings associations had to have a registered office in the Czech Republic which prevented them from moving the registered office to a “tax haven”. The amendment increased the minimum registered capital to 500,000 CZK, which had to be paid up before the association filed an application for the licence (Section 2 (2)). The payment duty of the members was more precisely defined in Section 4 (3) as a statutory duty, where the articles could increase the duty above the legal requirement, which was double the member’s contribution. Other changes included obligatory audit of the closing of accounts (Section 8a), ban on assigning claims to other persons than the members of the given cooperative savings association (Section 4 (9)) and more specific definition of securities that could be acquired by the cooperative savings associations (Section 3 (2) (c)). Anonymous deposits were prohibited.

The amended act no longer allowed for the cooperative savings associations to acquire any property interests in other legal entities or to gain control over other legal entities in any other manner (Section 1 (9)). The act stipulated that cooperative savings associations had a duty to terminate their existing property interests in other legal entities within 18 months and until the property interests were terminated the Act authorised the Office to carry out reviews of activities and financial management of these legal entities. With respect to the fact that the resources in the Security Fund were used up completely a contribution amounting to 0.5% of the average volume of deposits of authorised persons in the cooperative savings associations for the previous calendar year was stipulated (Section 16 (1)). In spite of that the Security Fund did not have enough resources to pay out compensation of deposits of authorised persons in bankrupt cooperative savings associations and the state provided through a government debt programme (Act No. 9/2001 Sb. [Col-

²⁰ More than 30 cooperative savings associations were terminated in accordance with the act, because they did not apply for a licence. See Zpráva o činnosti a hospodaření Úřadu pro dohled nad družstevními záložnami za rok 2000 [Report on the activities and financial management of the Office for Supervision of Cooperative Savings Associations for the year 2000]. Praha: ÚDDZ 2001, p. 2.

lection of Laws]) the Security Fund with a returnable financial assistance amounting to 6 bn CZK payable in 2021.

The amendment of the act was followed by Regulations of the Ministry of Finance No. 386, 387 and 388/2001 Sb. [Collection of Laws], which specified the legal regulation of prudent management of cooperative savings associations and Regulation No. 389/2001 Sb. [Collection of Laws], to regulate mandatory content of the annual report and thus creating conditions for increasing the available information to the members of the cooperative savings associations.

The period starting in 2001 was a period of optimism – the sponsors of bill No. 100/2000 Sb. [Collection of Laws] were convinced that this amendment would result in final consolidation, which would enable introduction of a concept of a consistent and self-governing system of financial cooperatives. The system was supposed to have its cooperative business headquarters and monetary headquarters having jurisdiction only over the relevant elements of the system, however externally acting similarly to a bank, hence a system similar to the “Raiffeisen system” in Austria or Germany would be created also in the Czech Republic. This is why Section 3 (4) of the amended act included authorisation for the cooperative savings associations to create their cooperative interest groupings for the purpose of protecting their interests.²¹ The Office for Supervision of Cooperative Savings Associations was similarly optimistic. The Office welcomed the legal possibility (in provision of Section 3 (2) (g)) for the cooperative savings associations with permission of the Office to be able to accept deposits and manage accounts for legal entities and make loans to municipalities which emphasised the regional focus and supported engagement of the membership.²²

The efforts to engage the membership of the cooperative savings associations and to strengthen co-ownership awareness that could contribute to stabilisation of the cooperative savings sector was obstructed by Act No. 212/2002 Sb. [Collection of Laws], which increased the compensation for insured deposits from 80 % to 90 % and increased the maximum amount of compensation from 100,000 CZK to 400,000 CZK like in the case of banks. Transitional provision of this amendment provided for retroactivity meaning that the compensations were paid out retroactively to all authorised persons since 1996. This change was the actual reason for the amendment, which was drafted as a private member’s bill and approved in spite of the opposing opinion of the government. According to the explanatory report concerning this act the increase applied to 92 % of the volume of all insured deposits, where the compensation fully covering the stipulated maximum percentage applied to 97.5% of the depositors, i.e. approximately 88,700 members. This resulted in the necessity to increase again the Security Fund by 1.2 bn from the state budget.²³ This represented a classical example of moral hazard caused by the lawmaker.

Moral hazard is a situation where a person behaves differently if he knows or believes (usually based on past experience) that the costs or adverse consequences of his behaviour

²¹ The Union of Cooperative Savings Associations was founded in 2001.

²² Zpráva o činnosti a hospodaření Úřadu pro dohled nad družstevními záložnami za rok 2000 [Report on the activities and financial management of the Office for Supervision of Cooperative Savings Associations for the year 2000]. Praha: ÚDDZ 2001, p. 9.

²³ Print Ref. No. 1058, 3rd term of the Chamber of Deputies of the Parliament of the Czech Republic, retrieved from <http://www.psp.cz/sqw/text/tiskt.sqw?O=3&CT=1058&CT1=0>.

or decision-making will not be borne by him, but will be borne by someone else, typically the state. The state protects practically all depositors-members who would otherwise run high ownership risk. In this manner the depositors-members of cooperative savings associations collected high interest on deposits without risk of loss, and in addition to that they often failed to properly provide for the operation and administration of the cooperative savings association. This blurred the borderline between a bank and a cooperative savings association and motivated co-owners and bodies of the cooperative savings associations to be less responsible and to take more risk. The depositors are sure that they will receive compensation paid out from the Fund and the board of directors can make risky loans and behave uneconomically because they are sure that “their” cooperative savings association is protected against mass withdrawals of deposits.

2.3. Accession of the Czech Republic to the European Union and the current sector of cooperative savings associations

On 1st May 2004, on the date of accession of the Czech Republic to the European Union, the so called harmonising laws of the financial sector entered into effect. This set of laws included among other things Act No. 280/2004 Sb. [Collection of Laws], a harmonising act to regulate savings and loan cooperatives which stipulated that before an application is filed for licence to operate as a cooperative savings association an amount of at least 35,000,000 CZK must be paid up, which represents the registered capital or risk fund and reserve fund if they are created upon formation of the cooperative savings association (Section 2 (3)). This practically ruled out operation of smaller savings associations unable to increase the capital to the required 35 m CZK. This was the reason why 6 cooperative savings associations terminated their operation in 2004, and one year later another 4 savings associations also went out of business. The new legislation enabled legal entities to become members of the cooperative savings associations, again the insurance of deposits was increased from 400 thousand CZK to 700 thousand CZK (Section 18 (2)). The obligatory annual contribution to the Security Fund of the cooperative savings associations was reduced from the original 0.5 % to 0.15 % of the average volume of deposits (Section 16). The cooperative savings associations were also allowed to operate in other countries of EU (Section 2c, Section 2d). The provision of Section 3 of the act expanded the objects to include among other things the possibility to lease safe deposit boxes, procuring collection for the members. The cooperative savings associations were allowed to trade in foreign exchange on their own account, and trade in exchange and interest rate instruments for the purpose of securing against risks arising from rendering of services to members.

The inefficiency and scattered character of the supervision²⁴ of the financial sector forced the lawmaking bodies to adopt a major change and on the 1st April 2006 based on

²⁴ The supervision of banks and savings banks including construction savings banks was performed by the Czech National Bank, the supervision of cooperative savings associations was carried out by the Office for Supervision of the Cooperative Savings Associations, the supervision of capital markets including the stock exchange was carried out by the Securities and Exchange Commission, the supervision of commodity exchanges was carried out by the Securities and Exchange Commission and also by the Ministry of Agriculture or the Ministry of Industry depending on the type of commodity, the insurance and re-insurance companies were supervised by the Ministry of Finance, the pension insurance companies and pension funds were supervised by both the Ministry of Finance and the Ministry of Labour and Social Affairs, and so on.

Act No. 57/2006 Sb. [Collection of Laws] the supervision of the entire financial market was fully integrated in the jurisdiction of the central bank – the Czech National Bank (hereinafter “CNB”). CNB took over the supervision of the cooperative savings associations and took a critical stance towards the savings associations because their control and audit mechanisms were not (and still are not) as efficient as those of banks.

Cooperative savings associations are now together with banks classified as “credit institutions” and in many cases particularly in the field of prudent management the same rules apply to them as to banks.²⁵ The cooperative savings associations are influenced by the cooperative character of their business or the membership principle which is currently the main element differentiating the cooperative savings associations from banks. Since the 1st April 2006 the insurance of deposits in cooperative savings associations started to be governed by Act No. 21/1992 Sb. [Collection of Laws], to regulate banks, as amended, and deposits are insured in the Deposit Insurance Fund in the same amount as bank deposits. (Currently deposits are subject to statutory insurance including interest up to the amount of the equivalent of 100,000 EUR converted using the exchange rate at the time of conversion per one client of one financial institution. The compensation is 100%, so there is no coinsurance on the part of the clients. Insurance of deposits arises automatically by entering into a contract with a financial institution and depositing the money.)

The problems of cooperative savings associations did not cease even under strict supervision of CNB: in 2012 the then fourth largest savings association Unibon lost its licence, in December 2013 Czech National Bank withdrew the licence of the largest cooperative savings association the *Metropolitní spořitelní družstvo*, and costs amounting to approximately 12 bn CZK to pay out guaranteed deposits of the bankrupt *Metropolitní spořitelní družstvo* represent almost half of all resources of the Deposit Insurance Fund into which all banks and cooperative savings associations contribute; at the same time the cooperative savings associations represent only a marginal segment on the Czech financial market and their share on assets of the sector continuously represents less than 1%.

The Czech National Bank has been pointing out the risks in the sector of cooperative savings associations for a long time. For example the Czech National Bank Report on Financial Stability 2010/2011 stated that the cooperative savings associations with quick growth of deposits and loans report compared to the banking sector twice as high share of non-performing loans, which may be identified as a potential risk. The Czech National Bank Report on Financial Stability 2011/2012 further stated that the sector of cooperative savings associations cannot be considered as resistant to increased risks and compared to the banking sector remains more risky. The International Monetary Fund warned of the risk related to the cooperative savings associations in the Financial Sector Assessment Programme in 2011. IMF pointed out for example that the sector of cooperative savings associations should undergo restructuring with the objective of reaching a balance between minimising financial and supervision risks of the sector and taking into account the social role of prudently managing cooperative savings associations.²⁶

²⁵ The rules of prudent management are based on Basel II and currently are stipulated in Regulation No. 23/2014 Sb. [Collection of Laws] to regulate the activities of banks, savings and loan cooperatives and stockbrokers.

²⁶ CNB financial stability reports, CNB supervision reports, IMF report in www.cnb.cz.

The Czech National Bank reacted to that and in 2014 submitted to the Government of the Czech Republic an outline of an amendment of the cooperative savings associations act. The rules should be tightened in three areas. First, the amount that the cooperative savings association would have to transfer to its risk fund would increase from the current 10% to 20%. Second, the level of mandatory contributions to the Deposit Insurance Fund would be doubled (currently it is the same as in the case of banks and insurance companies, that is 0.04 percent of granted outstanding loans). Third, there would be a restriction on the size of cooperative savings associations: if the volume of all assets of the company would exceed five billion CZK, the cooperative savings association would have to undergo a mandatory conversion into a classical commercial bank.

Conclusion

The cooperative savings associations have a long tradition in central Europe and the Czech lands. From the second half of the 19th century to the rise of the communist regime in 1948 they formed an integral part of the financial sector with particular importance in rural areas. They embodied irreplaceable values of cooperatives: economic cooperation and solidarity and beneficial work for the members and at the same time benefit for the society, they achieved low costs and overhead prices for their members, democratic management and control, independence of the management of the cooperative on the size of the member's share, voluntary membership and openness to new members.

The cooperative savings associations started to be formed again in the Czech Republic in 1996 for the purpose of carrying out financial activities for the benefit of their members. In 1999 there were 127 cooperative savings associations, though later there was the first large wave of bankruptcies. In 2004 the rules for operation of cooperative savings associations became much stricter and since 2006 they are subject to supervision of CNB, and in terms of prudent management practically the same rules apply to them as in the case of banks. Mandatory registered capital of the savings associations increased from the former 500 thousand to 35 million CZK. The problems of the cooperative savings associations have not ceased even under strict supervision and it is possible to state that the cooperative savings associations did not manage to correspond to their successful central European tradition. The reason for that consists mainly in unrealistic expectations in the 1990s with inappropriate legal regulation that failed to reflect the changed ownership mentality of members and insufficient control. Czech cooperative savings associations went through very specific development and we may say that the 40-year interruption in their activities and the subsequent less than successful restoration substantially distorted the entire sector. The awareness of cooperatives was devastated, which resulted in the contemporary misconception of cooperative savings associations as primarily capital institutions. The fact that the members gave up co-decision and control activities meant that not only were the savings associations unable to relate to their successful pre-war tradition, but as a result of the bankruptcies and intentional economic crime of some board members they discredited the idea of cooperative savings and loan associations, and this was combined with imperfect state supervision and the moral hazard arising from full insurance of deposits.

In the Czech Republic the associations are mostly based on regional links or purely for the purpose of gaining access to advantageous services,²⁷ less frequently the associations are based on professional or other relations.²⁸ Currently there are 12 cooperative savings associations covering less than one per cent of the entire banking sector, however the cooperative savings associations in case of possible financial difficulties put at risk the trustworthiness of the entire financial sector and may deplete the Deposit Insurance Fund. In the Czech context it is not necessary to protect, support and develop the cooperative financial sector because the cooperative savings associations do not fulfil the specific role they used to have in the past and still have in other countries. On the contrary they are a burden and a systematic risk for the entire sector of financial services.

²⁷ The only positive example is the cooperative savings association Fio, which applied for a banking licence and since 2010 operates as a bank.

²⁸ The foreign cooperative savings associations focus for example on medical doctors, attorneys-at-law and other professional or interest groups. We may mention as an example the Navy Federal Credit Union serving the US Navy or the savings association of the Pentagon.