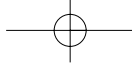


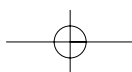
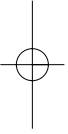
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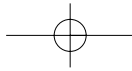
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3.1

Financial Services Sector

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Introduction

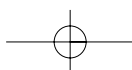
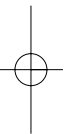
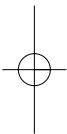
As with any sector in an emerging economy, the financial services sector has undergone massive change in recent years and this change is far from over. In the early 1990s, the Czech Republic was widely applauded for the rapid way in which it introduced privatization and the international banking community lined up to provide medium-term loans to Czech banks at extremely attractive rates.

Unfortunately, the voucher privatization scheme totally failed to achieve the two main benefits of privatization – namely, the introduction of external investment and external expertise. This might not have been so much of a problem if the banking sector had been privatized, but it was one of the few sectors that remained in government hands. As a consequence, banks did not act as commercial institutions but continued to make loans that were misused and had no real prospect of ever being repaid. These failures in turn undermined the whole of the Czech banking sector and influenced many aspects of the general financial services sector. The cost to the government in cleaning up the banks' balance sheets and trying to turn the sector around has been massive.

There is a common misconception that the Czech currency (crown, CZK) is in some form restricted. This is not the case as the Czech crown has been fully convertible for some years.

Banks

The Czech banking sector has some 40 banks, although just four hold 60 per cent of banking assets in the country. All four of the



main Czech banks have now been privatized, with the last one, Komerční Banca, becoming privately owned in 2001. All four banks were sold to international bank groups from Austria, Belgium and France. Foreign banks (as opposed to foreign-owned local banks) hold approximately 15 per cent of total banking assets.

As in other countries of this region, many of the banks are competing in the same sector and the majority of foreign banks initially focused on foreign companies operating in the Czech Republic and the larger local corporates. Competition has been fierce, particularly in the larger corporate sector, and has resulted in a number of the banks now looking at smaller corporates and the retail sector. It is this competitiveness and the 'over-banked' situation in the Czech Republic that is the driving force behind the change of focus, but some consolidation is the result of the mergers and acquisitions of the parent banks on a global or regional scale. Nevertheless, due to the level of historic bad debts and other factors, there has been a considerable credit squeeze in recent times, although this should ease in the future.

The level of bad debts continues to be a drag on the economy as a whole, despite the fact that most have been transferred to Konsolidacní Banca (the state-owned 'bad' bank). Konsolidacní is in the process of selling off large portfolios of debt, with the first such sale only achieving 7 per cent of face value, underlining the seriousness of the problem.

Overall, the banking sector is both well developed and sophisticated and offers the majority of products and services that would be expected in any developed market economy. Telephone banking is widely available and Internet banking is being introduced by many banks.

One part of the banking sector that has yet to make much progress is the provision of residential mortgages. There is no doubt that this market will become very important in the future but, due to factors such as legislation which makes it difficult for the lender to repossess the property when necessary, the continued existence of subsidized rents (which will be phased out shortly) and the lack of long-term loans, it will be some while before any major development is seen. It is unlikely that this part of the banking sector will develop as quickly as in some neighbouring countries.

Demand for commercial mortgages is high, however, being driven primarily by foreign companies investing in factory and office accommodation for their own operations. Foreign banks are the largest providers of commercial mortgages, while Czech banks predominate in the provision of residential loans, although a

number of foreign banks are beginning to take more interest having regard to the ultimate potential of the market.

While most sectors of the banking market are fully catered for, there has been a rapid expansion recently in a number of niche areas. The market for home-collected credit in the Czech Republic was created by a British company only within the last few years but has grown very rapidly and is expected to continue to do so for the foreseeable future. A similar pattern has emerged recently in the provision of consumer credit provided in-store at the point of sale. While this type of credit had actually been available for many years in the Czech Republic (even in the Soviet era), it has been transformed in recent years and continues to expand.

Financing trade and projects

Approximately 90 per cent of all trade in the European Union is conducted on an open account basis, although many companies have some form of credit insurance. Trade with the Czech Republic has not as yet reached this level, but already some 70 per cent of trade is conducted on this basis.

Over the years, there have been many successful projects financed on a non-recourse project finance basis. These have been structured both with and without assistance from the British Export Credit Guarantee Department (ECGD) and other export credit agencies. In recent times, the ECGD has changed its policy on financing projects in the region in order to secure more business and this means that projects that were previously unable to obtain cover can now do so. Perhaps the most important change is that, in many cases, the ECGD no longer needs a government guarantee but will accept municipality or large local corporate risk.

The trend towards financing major projects by way of partnerships established between central and/or local government and private companies has not been ignored by the Czechs. While the Czech Republic is far from being the leader in the region in this form of project finance, there is growing recognition of the impact that PPPs can have in developing infrastructure such as roads, rail, water treatment plants and many other large projects. Again, actual progress on this front has been slower than in neighbouring countries, but it is expected that momentum will start to build shortly.

Typically, laws need to change and attitudes and ideas need to become more flexible in order to make these projects happen.

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However, PPPs offer the most realistic way to finance the many projects required and, as this becomes more widely understood, the number of PPP projects in the country will increase dramatically. As Britain and British-based firms are world leaders in this type of finance, the development of this sector in the Czech Republic should be regarded as offering many opportunities in the future.

Investment funds

A small number of investment funds and providers of private equity have been active in the Czech Republic for many years, although their role is made much more difficult by the limitations on exit strategy which result from the inadequacies of the stock exchange described below. Some 10 or more funds exist and, in an effort to promote the sector, the European Bank for Reconstruction and Development (EBRD) has invested in most of them. In very simple terms, the preferred scenario for a fund is to invest between US\$2 million and US\$5 million in a joint venture company with a local partner and a foreign strategic investor. Clearly, this is an over-simplification and, for the right project, both smaller and much larger funds can be found and any commercially sound project can, in theory, attract funds.

A number of the locally based funds are effectively subsidiaries of the more global funds or linked to banks. As the market continues to mature and stabilize, the growing demand for this type of funding is being met by the creation of new funds and the expansion of existing ones. The sector remains difficult given the constraints in which it operates, but steady growth is expected to continue.

Insurance

Life insurance is underdeveloped as is the private pensions industry. In 1998, life insurance premiums represented some 1 per cent of GDP compared with an EU average of over 4 per cent, although sales of life insurance policies are now growing more rapidly than other forms of insurance.

The development of private pensions in the Czech Republic has lagged behind other countries in the region. As with every country, there is an urgent need to move away from the provision of pure state systems but the Czech government is the only one to have

rejected the implementation of the second pillar, ie mandatory contributions to a private pension fund. This decision will act as a brake on the whole sector, although a growing number of Czechs are making voluntary contributions as they can see that the state system will not be able to be sustained in the current form. As the situation becomes ever more urgent, the 'new' government (after elections in June 2002) will undoubtedly have to re-visit this problem.

The non-life and general insurance sector is, in general, reasonably well developed – but with a number of particular aspects. There are now over 40 insurance companies present, although the market is still dominated by Česká Pojist'ovna and other Czech companies.

Many of the more sophisticated products are still not generally available in the Czech Republic, even by the foreign companies that offer such products in other countries. This is largely due to the attitude towards making claims and the difficulty that the insurance companies have in verifying and adjusting claims. However, the level of competition continues to push back the boundaries.

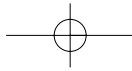
The provision of third-party motor insurance has provoked much interest recently as this type of insurance is legally required and was opened to competition from January 2001.

Legal

Part Two of this book is dedicated to legal issues, but given the impact of legislation on doing business in the financial services sector a brief outline is appropriate here.

Perhaps the legal sector, or more correctly the law, has undergone more change than any other sector. Most of the large international law firms are present and many have been instrumental in adapting old legislation and writing new laws. As the Czech economy moves ever closer to a market-driven economy, the need for change in legislation to allow the economy to expand and foreign companies to invest and trade in a safe environment becomes ever greater. The scope and depth of these changes has increased significantly as EU membership beckons. One recent example is the provision of a large EU grant to improve bankruptcy legislation.

It is true that many of the laws are not directly comparable with UK or EU legislation, but much progress has been made. However, implementing new legislation is only one aspect of changing laws.



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It is widely recognized that the interpretation of new laws can be questionable in the Czech Republic and it is also generally recognized that corruption undermines the system as a whole. In addition, the judicial system is lacking in experience, although this will of course improve over time.

Accountancy

One of the requirements for any company wishing to raise debt or equity funding, trade finance, or establish any form of partnership with a foreign party, has been the need to produce accounts to international accounting standards. Czech accounts are often not very transparent, rather brief and open to misinterpretation and, as such, are not very reliable.

All the large foreign accountancy firms are present and the trend towards international accounting standards continues to move down towards ever-smaller companies. However, as all companies are required to produce accounts conforming to Czech standards, many companies must now produce two sets of accounts.

Accountancy and audit issues are addressed in Chapter 3.2.

Prague Stock Exchange

The Prague Stock Exchange is very illiquid, which impacts on many other aspects of the financial services sector. For example, it is not an attractive home for insurance and pension fund assets, does not encourage long-term savings (thus reducing the possibilities of providing long-term loans), and is not able to act as a provider of fresh capital to fund the growth of local companies. For many historic reasons, the Prague Stock Exchange is among the worst of all the poor, illiquid stock exchanges in the region.

There is a cooperation agreement in place with the London Stock Exchange and four Czech companies are listed in London.

Corporate governance

The way in which business is conducted, the transparency of transactions and relationships, minority shareholder rights and general financial management are some of the main concerns behind corporate governance. As with many aspects of the financial services

sector in the Czech Republic, much has been done but more needs to be done – and in this respect a significant amount more.

Much effort is now being put into addressing many aspects of corporate governance, with the Securities Exchange Commission and other similar bodies both working together and in cooperation with external advisers.

Despite these advances, some rather questionable actions continue to be taken throughout the country and, regrettably, many of these seem to be at a government level. It is arguable whether matters have deteriorated in the Czech Republic, but as conditions improve elsewhere the difficulties there are certainly becoming more apparent.

Regulation

The banking sector is regulated by the Czech National Bank (CNB), which also has a duty to set interest rates and control inflation. Regrettably, the Czech government is trying to reduce the level of independence currently enjoyed by the CNB.

The pensions sector is supervised by the Ministry of Finance and the Ministry of Labour and Social Affairs, while the pension fund sector is supervised by the Securities Exchange Commission. The Prague Stock Exchange and other capital markets are also supervised by the Securities Exchange Commission.

Regulation and supervision of the various parts of the financial services sector is generally regarded as being relatively good and continues to improve, although it is recognized that the lack of experienced professionals is a limiting factor. However, it is most important that the government resists any temptation to interfere, as this will only be detrimental.

Summary

The financial services sector has been totally transformed over the last decade. While mistakes have been made and there is still much to be done, the progress made has nevertheless been remarkable and many of the past mistakes are now being recognized and rectified.