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FINANCIAL SERVICES VOLUNTEER CORPS

MISSION TO THE CZECH AND SLOVAK FEDERAL REPUBLIC

March 11 - 16, 1991

OBSERVATIONS, FINDINGS AND RECOMMENDATIONS

April 10, 1991

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MISSION TO THE CZECH AND SLOVAK FEDERAL REPUBLIC[*]

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BACKGROUND AND SUMMARY

At the request of the Czechoslovak Government, the Financial Services Volunteer Corps (FSVC) conducted a Mission to Czechoslovakia from March 11 - 16, 1991. The FSVC Mission was led by Cyrus R. Vance, senior partner at Simpson Thacher & Bartlett and former Secretary of State. Co-Chairmen of the Mission were E. Gerald Corrigan, President of the Federal Reserve Bank of New York, and John R. Petty, Chairman of the Czech and Slovak-American Enterprise Fund and former Assistant Secretary of Treasury. Executive Director of the Mission was Herbert S. Okun, former U.S. Ambassador to the German Democratic Republic.

Background

The Financial Services Volunteer Corps makes available the experience of senior financial-sector professionals drawn from the U.S. private sector to assist the emerging democracies of Central and Eastern Europe with their programs for transition from command economies to market economies. It was created in response to President Bush's initiative to encourage volunteerism. FSVC is comprised of specialists from U.S. commercial and investment banks as well as law, accounting and insurance firms. They provide their services on a volunteer basis. Missions to Poland, Hungary and Yugoslavia were undertaken in May, September, and December, 1990, respectively. FSVC is supported by grants, primarily from the Department of State/Agency for International Development.

Cyrus R. Vance and John C. Whitehead are Co-Chairmen of FSVC. The Board of Directors of FSVC is advised by a Steering Committee, the members of which are:

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[*] The Czech and Slovak Federal Republic will hereinafter be referred to as Czechoslovakia.

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Members of the Mission to Czechoslovakia

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Financial Services Volunteer Corps

Timothy T. Frost
Program Director

Objectives

The principal objectives of the Mission were to work with representatives of the Czechoslovak private and public sectors to identify areas for future cooperation with respect to:

- The privatization process;
- Restructuring the banking system, including increasing the effectiveness of the central banking system and strengthening the role of the commercial banking system, including supervision thereof;
- The creation of a capital markets system;
- Adopting internationally accepted accounting standards; and
- Reforming the insurance industry.

Meetings

During its stay in Czechoslovakia, in both the Czech and Slovak republics, the FSVC Mission met with members of the executive and legislative branches of the government, the central bank, and the financial, business and academic communities, including: President Vaclav Havel; Chancellor Karel Schwarzenberg; federal Deputy Prime Minister Vaclav Vales; Foreign Minister Jiri Dienstbier; federal Minister of Finance Vaclav Klaus; federal Minister of Economy Vladimir Dlouhy and the Minister's Plenipotentiary Znedek Drabek; Chairman of the State Bank Josef Tosovsky; First Deputy Minister of Foreign Trade Jiri Brabec; Director General of the Chamber of Commerce Vojtech Bures; Deputy Chairman Zdenek Jicinsky of the Federal Assembly; Vice Chairman Jan Sokol of the House of Nations of the Federal Assembly; Czech Republic Prime Minister Petr Pithart; Czech Minister of Economic Policy Karel Dyba; Slovak Deputy Prime Minister Kucerak; Slovak Ministry of Privatization Department Chief Marian Jenis; bankers in Prague and Bratislava; entrepreneurs and managers from throughout Czechoslovakia; and members of the academic community.

Summary of Findings

The situation in Czechoslovakia offers a picture of paradoxical potential: because Czechoslovakia was probably the most thoroughly communized and centralized of all Central and East European countries, the new, democratic government does not have to contend with hybrid, "socially-owned" or operated factories and businesses. The government intends to restore property rights and privatize the economy as quickly as possible and has already begun to do so.

The government and people of Czechoslovakia understandably face daunting challenges in this process: much of their industry was geared towards exporting to COMECON trading partners and those markets have now significantly diminished; inflationary pressures are rising; inevitable dislocations and unemployment are occurring as needed economic restructuring begins to take place; and increasing demands are being placed on an inadequate commercial banking system.

There is growing recognition that basic changes in the structure of ownership and management are required before a free-market economy can flourish. Therefore, the government, while aware of Czechoslovakia's multiple needs -- healthy, export-oriented industries; a strong central banking system with adequate regulatory and supervisory mechanisms; viable and profitable commercial banks that attract savings and make loans to creditworthy borrowers; internationally accepted methods of accounting and valuation; and attractive investment opportunities for domestic and foreign investors -- has put privatization at the forefront of the tasks to be completed.

In this process, structural reforms in the banking and financial systems are vital. Unless these systems work efficiently, the economy at large will not work well. The FSVC Mission was encouraged by the transformations achieved thus far in banking and finance, in spite of the difficulties encountered. We were also encouraged by the many clear manifestations we encountered of the lively entrepreneurial spirit of the Czechoslovak people.

The recommendations and offers of assistance contained in this report are derived from our view that Czechoslovakia can and will surmount the remnants of the past that currently impede its path to economic vitality and growth. We have made specific recommendations and are prepared to cooperate and assist in developing programs, plans and solutions with respect to the matters addressed in the report.

We are convinced that Czechoslovakia has the desire and capability to establish a successful free-market economy. There are no easy solutions but, based on our observations, we believe optimism is justified.

Principal Follow-up Projects

Banking:

- FSVC and the New York Federal Reserve Bank are prepared to establish a team to provide broad guidance and technical assistance in the development of the banking system, including the following components: payment system, short-term money markets, bank supervision, creditr origination standards, reporting systems and internal operating systems (page 12);

- FSVC will coordinate with and provide technical support to the bank training institution sponsored by the U.S. Treasury Department (page 13);

- FSVC is prepared to provide assistance in drafting banking legislation (page 13);

- FSVC is prepared to advise the banks directly regarding accepted principles and standards of safe and sound banking, particularly with respect to standards for asset valuation, reserving, loan charge-offs and capital (page 13);

- FSVC is prepared to advise banks regarding the development of deposit instruments (page 13).

Privatization, capital markets and insurance:

- FSVC has prepared a memorandum discussing the use of collective investment funds in the large privatizations program, and we are prepared to elaborate on any aspect thereof (page 16);

- FSVC has responded to a request of the federal Ministry of Economy and will provide a team to assist in the preparation of rules and guidelines for implementing the large privatizations program (page 16);

- FSVC is prepared to assist and provide guidance for the development of a modest regulatory framework for the following: financial intermediaries, collective investment funds, public issuance of securities,secondary markets, and a supervisory agency (pages 30-32);

- FSVC is prepared to provide advisors, conduct seminars, and assist the State Insurance Companies in gaining access to overseas reinsurance capacity (pages 41 and 42).

I. BANKING

A. Introduction

The Bank Team met in Prague and Bratislava with representatives of the federal Finance Ministry, the federal Ministry of Economy and its Agency for Foreign Investment, the federal Ministry of Foreign Trade, the State Bank of Czechoslovakia and its regional office in Bratislava, members of the Federal Assembly, the two commercial banks that were created out of the State Bank, the two foreign trade banks, the two savings banks, entrepreneurs and managers from throughout Czechoslovakia, and the academic community. The meetings were open and frank, and we appreciate the courtesy, patience and hospitality of our hosts. We believe these meetings provided a unique perspective on the banking system and we learned enough in our visit to enable us to make the findings and recommendations that are presented in this report.

The Team sought ways to help Czechoslovakia reform its banking system as the country moves to a free market economy and from a monobank to a multi-bank system. A healthy, competitive and ultimately privately-owned banking system is essential to the development of a free market economy. Reform of the banking system will not occur overnight. However, the manner in which challenges have been faced thus far is encouraging.

B. Requirements for a Banking System

The government of Czechoslovakia has given privatization of state-owned enterprises its highest priority. Privatization will succeed only with a viable and functioning banking system that can evaluate the creditworthiness of borrowers nd provide levels of credit consistent with macroeconomic objectives and the needs of the enterprises and individuals.

There are certain fundamental requirements for an efficient and profitable banking system. First, the banking system must instill depositor confidence. This requires efficient and capable bank management, prudent lending practices based on sound credit analysis, and a belief that deposits will be returned quickly and conveniently under the terms of the deposit contract. A strong, practical and effective bank regulatory and supervisory authority is necessary to ensure the safety and soundness of banks to support depositor confidence. A strong capital base provided by private investors is likewise critical to depositor confidence. These same factors are also required for investor confidence.

Second, a bank must lend to productive borrowers who will be able to repay the loan according to its terms. The ability to make correct credit judgments will require accounting, financial and other information that is reliable, readily available and understandable.

Third, there must be meaningful competition among banks -- each competing on a "level playing field" -- where the rules are applied fairly and in the same manner for all players.

Fourth, ownership of bank capital, and thus control of bank management, must be in private and not governmental hands.

Fifth, there must be modern and efficient information and money transfer systems. A free market economy functions through the banking system; money, in the form of cash, checks or wire transfers, is the lifeblood of the economy and must flow quickly and efficiently throughout the system.

It is against the backdrop of these fundamental requirements that we present our findings and recommendations.

C. Findings Regarding the Banking Sector

1. In general, the initial restructuring of the banking system has proceeded reasonably well.

(a) The basic roles of the State Bank and the commercial, foreign trade and savings banks are fairly understood by the respective parties.

(b) The State Bank has put into place reasonable interim procedures that allow it to maintain the broad thrust of monetary policy goals while leaving adequate room for individual banks to decide which firms and initiatives to finance and which not to finance.

(c) The leaders of the commercial banks seem to have a good working knowledge regarding their prospective role in the credit origination process.

(d) The use of banks by savers as depositories for savings appears to be more developed in Czechoslovakia than in the other emerging democracies of Central and East Europe.

(e) The process of re-cycling deposits from the savings banks into the commercial banks is working reasonably well.

(f) Elements of competition are beginning to take hold, especially with regard to the design and introduction of deposit instruments. There is differentiated pricing of deposits based on maturities. Foreign currency deposits in the two foreign trade banks have been well established and accepted.

(g) Some constructive steps are underway with regard to the development of an inter-bank market on a limited scale.

(h) There is some progress in the banks' ability to judge the viability of business plans of individual enterprises and also to adopt new methods for securing or collateralizing both consumer and business loans, although all of this is in the very early stages of development.

(i) There are limited, but encouraging, examples of the successful introduction of collective investment funds as savings and investment vehicles and of bond financing. One of the banks has already established several collective investment funds and others have expressed interest in establishing such funds.

2. Despite these encouraging developments, there are major opportunities for further improvements even in the near term.

(a) The credit origination process has come under enormous pressures. These pressures appear to be more acute than would be associated with the firm monetary policy that is necessarily in place. While the resulting scarcity of credit is based in part on uncertainties in the economic outlook, it is also being influenced by a number of other important institutional factors, including the following:

(i) The lack of well-established standards for lending;

(ii) Uncertainties about the timing and workings of privatization programs and the resulting "economic value" of enterprises;

(iii) Uncertainties about the development of a new commercial code, including its implications for collateral arrangements;

(iv) The lack of a clear concept of "mortgage";

(v) The lack of qualified lending personnel and of training in general;

(vi) The fear of making wrong decisions; and

(vii) The absence of internationally-accepted accounting standards.

(b) There is an urgent need for effective banking supervision. Training of State Bank personnel regarding supervisory and examination matters is essential. (Appendix A sets forth our understanding of the current status of banking supervision.) Further, there is a need for training of bank directors, officers and employees with respect to the principles and standards of safe and sound banking.

(c) The payment system, designed twenty years ago for a monobank system, is in disarray. (Appendix B sets forth our understanding of the current status of the payment system.) The establishment of a multi-bank system has obviously increased the number of transactions that are processed through the system. The length of time needed to complete "normal" transactions is much too long and uncertain:

   (i) This situation is a major obstacle in developing the confidence of the public in the banking system; and

   (ii) It imposes enormous costs on the emerging enterprises and on the economy at large.

(d) The absence of a well-defined plan and approach for the development of a short-term money market, including a market for government securities, represents a major barrier to the further evolution of financial markets. Generally, the absence of such markets, or at least a well-understood plan for the development of such markets, brings with it the following problems:

(i) Monetary policy must work essentially through administrative mechanisms;

(ii) Short-term financing of government cash needs and/or deficit financing occurs through the State Bank or some other rationing arrangement;

(iii) Liquidity cannot be well distributed across the financial and economic system;

(iv) The learning process regarding funding practices and the time value of money is impeded;

(v) The development of other forms of capital market instruments is impeded; and

(vi) There is no objective market-oriented indicator of pressures in the monetary and credit system.

(e) There is a need for the Czechoslovak business community to gain a better understanding of how a banking system operates in a free market and the factors that banks will take into account in evaluating the credit-worthiness of a borrower.

(f) The use of collective investment funds as savings and investment vehicles should be encouraged. There is a need for a regulatory framework for such funds, with the objective of providing sufficient safeguards to protect investors and prevent conflicts of interest.

D. Recommendations

A broadly-based and carefully-integrated strategy for banking reform should be set out for the banking system, so that it can play its necessary role in a free-market economy by facilitating the orderly flow of credit to creditworthy enterprises and households and by providing a framework in which monetary policy works more through market mechanisms and less through administrative guidance. We believe this strategy must operate on two fronts.

1. Administrative and Legislative Changes

A number of administrative and legislative changes are needed in order to clarify the basic ground rules within which the banks and the State Bank will operate. These changes are needed to reduce or eliminate the major uncertainties that are currently slowing down the development of the banking system. Among the more pressing needs are:

(a) A plan for the introduction of consistent bank accounting standards as a first step toward the larger goal of moving to internationally-accepted accounting standards for both banks and commercial enterprises. The government of Czechoslovakia should publicly announce its strong commitment to adopt such accounting standards.

(b) The enactment of legislation creating a commercial code that provides for the creation and perfection of security interests, including real estate mortgages and a bankruptcy code.

(c) The enactment of legislation describing the role and responsibilities of the State Bank, including its relationship to the banking system and the government.

(d) The adoption of rules and regulations regarding privatization of enterprises which clearly define the process. If privatization of enterprises is to involve the forgiveness of outstanding indebtedness, the losses that result should not be borne by the banks.

(e) The development of a plan to address bad assets on the banks' books, including the so-called "allocations" of credit made under the former regime. The State Bank together with the banks should set goals to address the appropriate timing of, and level for, reserving, charge-off, capital and other actions.

(f) A time-frame for the privatization of all banks in Czechoslovakia.

2. <u>Coordination</u>

After having identified the necessary prerequisites for needed reform of the banking system, specific steps must be taken to develop its essential elements, including:

- The payment system;
- Short-term money markets;
- The bank supervisory process;
- Training in credit origination and documentation;
- Reporting systems; and
- Internal operating systems in commercial banks.

There are already some positive initiatives underway in a number of these areas, including the numerous IMF-World Bank projects. We recognize that coordination of all these efforts will be a difficult task in any event, and particularly at this time when so many other critical problems are being addressed.

Since numerous projects are being undertaken that have a significant impact on one another, what is required is overall control and coordination of these various initiatives so that individual projects are developed in a context that is consistent with the overall development of the financial system. We believe that, because of its nature, this should be the responsibility of the State Bank.

E. Proposed Follow-Up Assistance

We are writing under separate cover to the Chairman of the State Bank to outline a proposal to establish a U.S. team to provide broad guidance as well as technical assistance in the development of the banking system. The primary focus of this effort would be to articulate the desired structure of the financial system; to develop a short-term money market, including a government securities market; to develop the payment system; to establish an effective bank supervisory and regulatory structure; and to provide credit origination and documentation training at the commercial banks.

We will work supportively with the bank training institution recently announced by the U.S. Treasury Department, described below, and are prepared to provide assistance to the universities and technical schools in Czechoslovakia to develop programs in banking and finance.

We are prepared to provide assistance to the government and the State Bank with regard to the drafting of necessary banking legislation.

We are prepared to advise the banks directly regarding accepted principles and standards of safe and sound banking, particularly with respect to standards for asset evaluation, reserving, loan charge-offs and capital.

We are prepared to advise the banks regarding the development of deposit instruments.

Czechoslovak entrepreneurs and managers may more readily accept and appreciate the factors that the banks will take into account in evaluating the credit- worthiness of borrowers if they learn this from non-Czechoslovak banking specialists serving in a volunteer capacity rather than from Czechoslovak bankers. We are prepared to provide assistance in the important effort to help educate entrepreneurs and managers in this regard.

With regard to the training of commercial bank employees, we will work with the above-mentioned training institution sponsored by the Treasury Department. It is our understanding that the proposed institution would provide:

1. Ongoing advice on curriculum development;
2. Instructors for basic, intermediate and advanced professional courses;
3. Training for the Czechoslovak instructor staff who will assume future responsibility for the program;
4. Materials for courses;
5. Professional and material support for a library or resource center;
6. A program coordinating internships at U.S. financial institutions; and
7. A program to assist entry into U.S. educational institutions to study banking and finance.

The United States government would support the training institution for approximately two years or until the institution is operating a sustainable professional program; support of the internship/educational opportunities could extend for several additional years. The possibility of G-24 joint financing is also being explored. We believe this is an excellent initiative and merits encouragement and, as stated above, we are prepared to provide support for this training program.

Our offers of follow-up assistance are directed to the government of Czechoslovakia, the State Bank, the banks in Czechoslovakia, entrepreneurs and managers, universities and technical schools, and the training institution proposed by the U.S. government. We look forward to responding to requests for such assistance and are optimistic about our ability to provide meaningful assistance.

II. PRIVATIZATION AND CAPITAL MARKETS

A. Introduction

The Privatization and Capital Markets Team met in Prague and Bratislava with government officials, members of the Federal Assembly, professionals, entrepreneurs and managers. The warmth, interest and enthusiasm of our hosts made these meetings rewarding for the Team. This section of our report contains findings and conclusions with respect to privatization, creation of capital markets and adoption of an internationally-accepted accounting system.

Immediately following our visit, the federal Finance Ministry requested a memorandum on collective investment funds. This memorandum, a copy of which is included as Appendix E to this report, was recently forwarded to the Ministry. In addition, the federal Ministry of Economy requested FSVC's assistance in preparing rules and guidelines for carrying out the privatization of large enterprises. FSVC has agreed to provide a team to carry out this project.

B. Privatization Policy

The privatization policy of Czechoslovakia has to be viewed as an integral part of a more comprehensive structural transformation of a centrally-planned economic system into a market economy in which the main engine of production, growth and investment relies on private initiative. The government will reduce its leading role in the production process and will concentrate on providing the appropriate framework within which the private sector can flourish.

Major transformations are already underway. Recognizing that the price system is the essential mechanism through which resources are allocated in a market economy, its recent liberalization is a fundamental and major step forward. Other major initiatives such as bankruptcy laws, liberal foreign investment regulation, the creation of a stock exchange, regulations for the development of a securities market, and major reforms aimed at restructuring and making more efficient the process of financial intermediation are currently under legislative discussion.

With respect to the privatization of enterprises, three pieces of legislation are already in place: the restitution law; the law regarding small privatizations; and the law regarding large privatizations, which was recently adopted at the federal level and is expected to be ratified by both republics shortly.

The philosophy of privatization held by the federal Finance Ministry is: "to privatize as much as possible in the shortest period of time." This philosophy requires the government to give higher priority to the rapid transfer of property rights from state hands to private hands than to maximizing the revenues derived from such transfers. Thus officials do not plan to spend undue amounts of time and resources in generating sophisticated and expensive valuation procedures to determine fair market value.

Small privatizations are being carried forward by auction for cash under a law enacted on December 1, 1990. The government is proceeding as quickly as possible to create a large class of small entrepreneurs, who could create a positive example for the rest of the citizens and foster support for the government's approach to privatization and the creation of a market economy. Since, in the short run, the transformation process will result in market dislocations, this political support for the economic reforms may be crucial.

Large privatizations will be carried out under a law enacted February 26, 1991, a summary of which is attached as Appendix C. The following discussion deals principally with the implementation of this law.

1. <u>The Use of Vouchers</u>

The large privatizations law contemplates the use of vouchers to provide a mechanism for achieving the government's paramount goal of quickly transferring property rights from government to private hands. How the vouchers are used is not dictated by the law and this aspect of the legislation is currently under discussion.

We suggest that the voucher system be designed not only to achieve rapidity of transfer but also to meet three additional goals: (a) to achieve the most efficient operation of the enterprises; (b) to achieve the maximum protection of citizen-investors consistent with a free capital market; and (c) to develop an efficient capital market, i.e., one that allocates capital efficiently to the privatized enterprises.

(a) The first additional goal -- efficient operation of recently-transferred corporate enterprises -- requires that shareholders, or financial intermediaries acting on their behalf, monitor the conduct of management to insure that management is working strictly in the interest of shareholders to maximize profits of the enterprise. Even in mature capital markets, this concept of corporate governance, or the responsibility and requirement of corporate management to act in the interest of shareholders, remains one of the biggest challenges of law and economic ordering. However, in mature capital markets there are many sources for the monitoring of corporate management:

- Large shareholder groups;
- Lenders;
- Professionally trained non-employee directors;
- Securities analysts;
- The financial press;
- Governmental regulatory agencies; and
- Self-regulatory agencies.

Although rapid privatization is the primary goal, implementation of a universal voucher system should seek to avoid the resulting inherent dispersion of ownership. A certain level of concentration of ownership is desirable in order that strong management may carry out the needed restructuring of companies. Restructured companies will in turn need an identifiable, responsible ownership structure.

(b) In a mature capital market the monitoring and reporting function helps to achieve the second additional goal -- to protect investors from making uniformed investment decisions. In Czechoslovakia, without these monitoring and reporting mechanisms and without established financial reporting requirements, it will be more difficult for citizens to decide what stock to exchange their vouchers for and then to know whether, or when, to sell or exchange that stock in one enterprise for stock in another. And if a citizen has the stock of only one enterprise, he is at much greater risk if that enterprise experiences poor operating results than if he were holding stock in a number of enterprises.

Diversification of investment risk, or the idea of not putting all one's eggs in one basket, has given rise to a huge industry -- the collective investment fund industry -- in mature capital markets.

(c) The third additional goal, the development of efficient capital markets, likewise requires a well-developed information base on corporate management performance, as well as professionally-trained and experienced financial intermediaries to interpret the information and to allocate capital accordingly. Sound credit evaluation is a fundamental requirement for efficient capital allocation, and requires the ready availability of information.

The role of the domestic banking system in supporting and financing the privatization process is essential, and banks must play the crucial role (see the Bank Team's report). It is important to recognize that in the historical development of the U.S. economic system, stock markets did not perform the main function of capital allocation. That was done by banks, and we believe this is mainly how it should be accomplished in Czechoslovakia until an accumulated informational infrastructure is established over several years. It is also helpful to recognize that stock markets in Western Europe even today are not the major source of capital allocation and the banking system is still the most important single element of the financial system.

We suggest that the best way to achieve the paramount goal of rapid transfer of property into private hands, while at the same time seeking to achieve the three important additional goals described above, is to interpose collective investment funds between citizen-investors and the privatized enterprises. Collective investment funds should be established by banks, insurance companies and others, and run by the most professionally-trained business/financial people available. These funds would invest in the stock of the enterprises, and they should be permitted to obtain vouchers for this purpose. Citizens should be encouraged to exchange their vouchers for stock in one or more of these funds, instead of exchanging vouchers for stock in a single enterprise. A detailed discussion and analysis of collective investment funds and their role in the privatization process is included as Appendix E.

The voucher system may prove useful in establishing the value of enterprises being privatized, at least where competitive bidding develops. In the absence of competitive bids, other approaches to valuation may become necessary. As background information we include in Appendix D an analysis of the different methods of valuing a commercial enterprise.

2. <u>Redefining Objectives of State-Run Companies</u>

State-run enterprises, as well as those enterprises which will be privatized at a later stage, will play a fundamentally different role in the context of a market economy. No clear policy has been established yet as to how these companies will be managed. In the new market context these entities should be given a clear mission: to maximize their long-term return on capital, <u>i.e.</u>, to maximize profits. Of course, special considerations will apply to capital-intensive natural monopolies (see 6 below).

All other objectives traditionally pursued through state-run companies, such as the granting of subsidies, the creation of jobs and the development of an economic sector or region, should be channelled through other means if those objectives are considered necessary. The productive role of the government should be separated from its social role. State-owned enterprises will have to be treated as if they were private and all decisions regarding profit distribution, investments, labor and the appointment of management, auditing and accounting standards will have to follow the same rules as entities in the private sector.

Adequate preparation of state-run companies that will be privatized is essential. Economic and financial restructuring should be applied as part of the privatization project plans of the individual entities. The government should recognize and assume the accumulated losses that are usually hidden in these companies. Efforts to sell nonviable, moribund enterprises that should be liquidated may slow or even discredit the entire privatization process.

3. Foreign Investment

Essential to the process of restructuring and privatizing government-owned enterprises is foreign investment to make up for insufficient domestic resources. Even though current legislation is liberal and open to foreign investment, the significant bureaucratic limitations that still prevail should be eliminated. In addition, the tax laws applicable to foreign investment lack clarity. Finally, legislation aimed at permitting the operation of foreign investment funds in the local capital markets should be developed.

4. Enterprise Managers and Consultants

The large privatizations law requires that the managers of each enterprise commence the privatization process by preparing a privatization project plan for governmental approval. But the manager may lack the skills required to prepare a sound plan and/or may also lack the objectivity to liquidate or sell the company if this were to mean personal unemployment. To deal with this problem, economic awards could be granted to managers meeting targets. Managers who privatize or liquidate fast and efficiently could receive a "success fee" while incompetent managers might even be replaced. A core team of successful managers could be formed to assume responsibilities in various companies.

Incompetence of managers, however, may also be the result of lack of skills. Therefore, the use of external consultants may be desirable. Because of the large number of companies involved, consideration should be given to creating a grouping system in which a consultant would work with a group of companies possessing similar characteristics.

5. Unemployment and Price Increases

An unavoidable by-product of the privatization and restructuring process will be labor unemployment and price increases as market forces are introduced, price equilibrium is established and long-term efficiency of companies is achieved.

Retraining is of fundamental importance in order for workers to acquire the new skills which will be demanded by the newly-restructured companies operating in a market economy. In cases where prices had been maintained below market equilibrium for a prolonged period of time, price rises may be inevitable. Higher monopoly or oligopoly prices may result from the maintenance of inefficient market structures such as monopolies or giant holding companies that may be transferred "as is" to private hands. Large conglomerates should be broken up into smaller units and be given the status of independent companies.

Existing monopolies should be restructured prior to privatization, by creating competing entities and by reducing barriers for potential local and foreign competitors to enter the industry. For the so-called capital-intensive, natural monopolies, such as communication, utility and transportation companies, appropriate government regulation should be applied to avoid monopolistic behavior and to stimulate competition.

6. Non-divestiture as a Transitional Alternative

Considering the massive scale of the privatization and restructuring program, it may be appropriate to consider non-divestiture options such as contracting-out through management and leasing contracts. Such alternatives may be particularly useful for separable, small units, such as maintenance departments, cleaning services, cafeteria operations, hotel operations, and the like. The existing work forces of these enterprises may form their own companies with the assurance of an initial employment contract for a transition period of a couple of years.

7. Openness of the Process

We believe openness is essential for the success of the privatization process; it will help to achieve efficiency and attract public support. A large-scale and complex process of property transfer such as the one being developed in Czechoslovakia gives room for irregular manipulations and even corruption. This has to be prevented through clear and well-publicized procedures for selling assets. There should be constant communication with the public and information provided for it through the press, government releases, and even seminars, workshops and newspaper advertisements. Supervision of the process by trained and diligent government officials is called for.

Exemplary sanctions against managers or public officials engaged in illegal behavior should be considered to maintain and foster public confidence in the propriety of the process.

C. Creation of Capital Markets

1. General Considerations

Private capital markets are virtually non-existent in Czechoslovakia. As noted, the government's primary and overriding goal is acceleration of the privatization process to achieve a rapid transfer of property into private hands. Accordingly, the federal government has focused on developing the recently-enacted privatizations and restitution laws. The federal and republic governments are now concentrating on implementing regulations and processing claims.

The creation of capital markets for the efficient allocation of capital is a secondary goal and, although it is contemplated that securities exchanges will be established in Prague and Bratislava, planning for the creation of capital markets is at an early stage. Draft securities laws for the creation of the exchanges, under the auspices of a securities commission to be created, are in a preliminary stage. Training of personnel to administer the securities laws and the exchanges is scheduled for later in 1991 and the opening of the exchanges is planned for 1992.

The proposed law will also regulate securities brokers and dealers.

We believe that the development and implementation of a comprehensive scheme for the regulation of the primary issuance of securities would significantly reduce the speed of privatization, and therefore should be left to future development. There is both a regulatory vacuum for investor protection and a current lack of sophisticated intermediaries. Although banks will be permitted to engage in securities transactions, at present many of the personnel at the existing banks do not appear to have the necessary skills. As already discussed, we believe that there is a market mechanism -- collective investment funds -- for helping to achieve protection for citizen and other unsophisticated investors through the interposition of these intermediaries between the citizen-investor and the privatized enterprises. The use of collective investment funds should be encouraged and training of personnel at the intermediary level should be accelerated.

Along with the creation of a sound banking system, we believe the creation of a new uniform, internationally-accepted system of accounting for enterprises on a country-wide basis should receive attention at the earliest possible time. In addition, we believe there are other areas that require attention, including: the creation of programs for educating a broad spectrum of the population regarding capital markets and for training professionals involved in capital markets; and, the establishment of a regulatory framework for those markets.

2. Regulation of Capital Markets

We recommend that, as the privatization process evolves, a regulatory framework for capital markets be developed. The purpose of regulation would be to create public confidence in the system by providing minimum investor protections without undue dampening of the spirit of free enterprise and initiative that must be allowed to flourish, even at the risk of some excesses as the market economy is established. It is important to note that the U.S. capital markets became vibrant without having to bear the heavy cost of regulation that now, in their mature condition, the U.S. markets can afford. At the outset what is called for is restraint in regulation.

With this caution in mind, we recommend the following:

(a) A modest regulatory framework for financial intermediaries, including brokers, dealers, underwriters and investment managers. The framework should include required disclosure as to education, experience and capital adequacy of intermediaries. To maintain confidence in the market place, we also recommend that substantive regulation be adopted, including at least a general anti-fraud provision and rules for safeguarding customer funds and securities. FSVC could provide examples of this form of regulation.

(b) For the reasons already noted, a regulatory framework for collective investment funds should be developed at the earliest opportunity. The creation of funds should be encouraged and worked into the voucher system. Included would be principles of fair dealing and good faith, fair disclosure and marketing guidelines. The model contemplated by the European Community's directives on the subject would provide useful guidance. FSVC could provide examples and guidance on the system of regulation.

(c) A regulatory framework for the public issuance of securities, including a general anti-fraud provision and minimum disclosure requirements. Here, too, FSVC could provide assistance.

(d) A regulatory framework for secondary markets, including the proposed stock exchanges. Included would be some form of annual reporting (including financial statements) for companies listed on the exchanges and rules prohibiting manipulation of the market.

(e) A supervisory agency to write, implement and enforce rules, and generally supervise markets and exchanges. This agency could, depending upon the government's preference, be an independent agency like the U.S. Securities and Exchange Commission, a separate agency within the executive branch of government, a department within the Finance Ministry or the State Bank.

3. Legal Framework for Debt Markets

As elaborated in the Bank Team's report, there is an urgent need to create an effective banking system with the ability to make credit evaluations and provide capital to the new private enterprises, as well as to be an efficient and safe repository for private savings. A legal framework for the creation of debt markets, as well as for equity, must be put in place for the banking system and for other sources of private capital, including pension funds and insurance companies.

The Bond Act, which governs the issuance of debt instruments by enterprises, requires the issuance of a permit by the appropriate federal or republic Finance Ministry upon the approval of the State Bank. Government decisions will be based on capability of repayment, financial policy of the state and conformity with the rules of the financial markets. The Ministry and the State Bank are empowered to establish maximum yields.

We are concerned that this law, in reserving to government agencies the power to control which private enterprises will be permitted to issue how much debt and at what maximum rates of interest, reverts to state planning for an essential component of capital markets. It will also interfere with market forces where they must be allowed to operate if capital markets are to develop successfully. This law creates a bureaucratic and time-consuming process that imposes unnecessary administrative costs for the public and private sectors. We also believe the Bond Act may discourage foreign investment. We urge that the debt market be left to market forces, and that the related laws merely create a system of enforceable obligations.

D. <u>Accounting</u>

1. <u>Observations</u>

Accounting practices within the COMECON economies, although double entry, were fundamentally different from accounting practices in a free-market economy. The former were primarily oriented to management accountability for asset deployment, while the latter are oriented toward measuring the performance of operations, particularly related to the equity holders. In the COMECON accounting system, deployment of an asset was offset by creation of a liability. Changes in recorded asset amounts resulted in offsetting changes in liability accounts. In a free-market accounting system, changes in assets result in profits and losses (and increases or decreases in the recorded value of equity ownership). These differences in accounting systems and financial reporting practices are fundamental and must be understood by decision-makers in order that the privatization process will be attractive to investors and lenders, both domestic and foreign.

2. Recommendations

We recommend that Czechoslovakia immediately adopt internationally-accepted accounting principles "IAAP", and internationally-accepted auditing standards "IAAS", either European Community or U.S., so that:

(a) Necessary training of ministries, company managers and accounting staff, accounting professors, independent auditors, banking management and staff, and other potential preparers and users of financial information can be focused and directed;

(b) Development of the necessary professional infrastructures for accounting and valuation can be accelerated;

(c) Transitional accounting principles for the company can be quickly developed and applied to calendar year-end 1991, and retroactively to 1990;

(d) Companies can begin immediately to develop reasonably reliable financial histories and statements on a consistent basis and, in so doing, increase their chances of attracting capital;

(e) The process of understanding and articulating the fundamental differences between free-market and

COMECON-oriented accounting and financial reporting concepts can be accelerated, thereby facilitating more effective decision-making.

Reliable and comparable financial information prepared in accordance with IAAP is basic to the establishment and maintenance of orderly capital markets in which market participants, domestic and foreign investors issuers, dealers, and lenders, will have confidence in their ability to assess company, industry and sector performance.

III. INSURANCE

A. Introduction

The FSVC Mission met with Directors of both the Czech and Slovak State Insurance Companies. Both companies operate as the exclusive insurer of life and general insurance within the respective republics. In theory, the two companies could compete with each other by operating throughout Czechoslovakia but each has geographically limited its operations by mutual agreement.

The Czech State Insurance Company, headquartered in Prague, has approximately 6,000 employees out of which 200 are employed in the foreign section. Contact with the foreign markets is concentrated in Prague, at least for the time being. The premium volume for 1989 was approximately sixteen billion Czechoslovak crowns.

The Slovak State Insurance Company, headquartered in Bratislava, has approximately 3,000 employees. The premium volume for 1989 was approximately 7 billion crowns.

B. Findings

1. Reform Program

Executives of both companies state that their monopoly will soon end and are preparing their companies for future competition. The following examples illustrate the Czech State Insurance Company reform program:

(a) Special reform teams have been formed in each department of the Czech State Insurance

Company to develop plans regarding what to do differently in the future.

(b) Business interruption and other consequential losses have not been insured in the past. Munich Reinsurance has been invited to hold courses on consequential loss insurance. The Czech State Insurance Company is interested in holding similar seminars on other subjects in the future.

(c) The largest profits have been earned on insurance of corporations, but the high tariffs applicable for corporations are being reduced to lower levels in anticipation of future competition.

2. Expense Ratios

The monopolistic position of the two insurance companies has allowed them to keep their expense ratios very low by the following methods:

(a) Most policies are insured only once with no renewal certificate and little renewal billing. The insured is required to pay the same premiums each year, each quarter or each month. The receipt for premium paid together with the original policy issued years ago are the only proofs of insurance in force.

(b) In addition, commissions are paid on new business only, not on renewal. The cost of maintaining the insurance are small payments to payroll accountants of corporations for deducting the premiums or to retired employees collecting premiums individually.

3. Profit

Premiums for life insurance products are not calculated to produce a profit, because life insurance is considered as a social service. The same is true of auto third party liability insurance. It is possible that profit is still being made on life insurance, as we heard comments on mortality tables being very old.

4. Reinsurance

There is inadequate use of the reinsurance mechanism within the insurance monopolies; even large industrial risks are not reinsured for catastrophic coverage.

5. Tariffs

Tariffs are uniform for the whole country. With the approaching termination of the insurance monopoly, consideration is being given to reissuing the tariffs according to the territorial differences in hazards.

6. Taxes

(a) There is no premium or stamp tax.

(b) Payments arising out of insurance policies are not subject to inheritance or other taxes.

(c) Insurance companies are, however, subject to dividend taxes and higher corporate income taxes.

7. Sales

There is evidence of widespread sales of insurance: 75% of the people purchase homeowners insurance, 45% purchase auto insurance, 97% of industrial enterprises purchase property/casualty insurance, and 60% of adults purchase life and accidental death and dismemberment coverage. All this suggests that the insurance sector has enormous potential to assist in the capital formation and economic expansion of Czechoslovakia.

8. Investment Philosophy

Questions regarding investment criteria and performance were generally greeted with the assurance that insurance company assets are kept as deposits in the State Bank with guaranteed principal and return from the government. The quality and liquidity of those assets and their role in the privatization process is not clearly understood.

The low reserve ratios and potential for insolvency partially explain the stated intent to delay the process of insurance company privatization and the exposure to foreign competition.

C. Recommendations

We recommend that the government devote sufficient resources to organizing a private insurance sector. In most countries, a healthy insurance industry plays an essential role in long-term investment financing. More than any other financial service, insurance and private pension companies gather widely dispersed individual savings that might never come together without an open market for life insurance.

We recommend that target dates be set for shifting government privatization and tax policies to allow for free and open private activity in the insurance sector.

We note that current policy makes it difficult for private investors to enter the insurance sector and imposes punitive taxes on profits and dividends; this may significantly inhibit capital formation for investment in the economy. This can adversely affect the country's personal savings rate and close off a major source of funding for the newly privatized small- and medium-sized companies in the country.

D. Follow-Up Assistance

FSVC is prepared to undertake the following:

1. Assist the State Insurance Companies in gaining access to overseas reinsurance capacity;
2. Attempt to have the State Insurance Companies included in one of the major, worldwide insurance pools for large multinational companies sending employees into the country;
3. Conduct seminars for executives of the State Insurance Companies on Western underwriting, pricing, and investment procedures;
4. Provide advisors to assist in establishing a regulatory body to define the rules under which newly-privatized insurance companies will be required to operate. This would include defining the oversight responsibilities of such a regulatory body.

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FINANCIAL SERVICES VOLUNTEER CORPS

MISSION TO THE CZECH AND SLOVAK FEDERAL REPUBLIC

March 11 - 16, 1991

APPENDICES

April 10, 1991

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APPENDIX A

CURRENT STATUS OF BANK SUPERVISION

The bank supervision function at the State Bank currently has a staff of six professionals and two clerks. There are plans to expand the staff to 25-30 professionals by December 1991, with additional expansion planned in 1992 and beyond. Primary responsibility for supervision will be delegated to the regional offices of the State Bank in Prague and in Bratislava; examiners will be placed in the branches of the State Bank.

The examination process currently consists primarily of monthly reporting requirements, which were instituted in January 1991. These reports include balance sheet and income statements; lists of outstanding credits in arrears by sector; and a list of assets and liabilities by category and by maturity. FSVC was given to understand that the banks were not completing the forms accurately.

To supplement these reports, the supervisory staff believes that on-site visits are necessary, and the first such visit took place during the week of March 11, 1991. It had the limited objective of reviewing foreign exchange operations at Obchodni Bank. Foreign exchange operations were a responsibility of the State Bank in the past and the staff is familiar with those operations. No other on-site

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reviews are scheduled. While it recognizes that review of the quality of assets at each bank is critical, the staff is not at present equipped and trained to perform this task. Preliminary prudential standards have been adopted with respect to capital requirements and liquidity, but most standards are lenient and general.

The World Bank and the National Bank of Belgium have been working with the State Bank to establish supervisory standards and to develop a supervisory program. Over the next few months, under the World Bank's direction, the State Bank intends to interview a number of consulting firms and to contract with several firms to establish a program to restructure the commercial loan portfolios of the banks and to train the State Bank staff in evaluating loans.

Based on our meetings at the banks, we can report that the bankers are concerned that the State Bank staff needs training in bank supervisory matters and is requiring the banks to fill out reports that they believe cannot be used effectively by the staff to understand the risk profile of the banks. The bankers have respect for the supervisory staff's ability to understand foreign exchange operations, but they believe the staff lacks training in other aspects of the banking business and that their own internal auditing processes are superior to anything that the State Bank is considering. There is a perception that the State Bank is concentrating its scarce resources on gathering numbers, and that not enough effort is going into learning the business of banking and how to examine the risk profile and quality of the assets of the banks.

There is also a perception that too little attention is being paid to developing regulatory policy. Several banks also mentioned the need for training at the State Bank and at the banks in country risk exposure, as credits in some institutions are highly concentrated in one or two countries and insufficient attention is being paid to these concentrations.

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APPENDIX B

PAYMENT SYSTEM AND OVERNIGHT CREDIT FACILITY

Three principal methods of payment are currently used in Czechoslovakia: cash, check (two million of fifteen million people have checking accounts), and an instrument that is equivalent to a money order. The State Bank operates a clearing center and plans are in place to require all transactions to be processed through the center once it is "fully automated" in December 1991, as discussed below. Several of the larger banks have set up informal bilateral clearing arrangements among themselves, but these are to be eliminated.

As an interim step in anticipation of the automation initiative to be implemented at year-end, new procedures at the clearing center were initiated in early March 1991. At the end of each day, the twenty-five banks with accounts at the State Bank deliver account transaction information for that day to the State Bank. This can be in the form of a computer print-out, magnetic tape, disk or handwritten ledgers, depending on the commercial bank's own computer capabilities which vary widely. This account information is then entered into the State Bank's computer by keypunch operators. By 8:00 a.m. the next morning the

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banks receive their account statements, which reflect balances as of the close of business the previous day. This is the first time they have any knowledge of the position in their account at the State Bank for the previous day.

Each bank has from 10:00-11:30 a.m. to adjust its position if it is in overdraft. This can be accomplished in the first instance by transferring money from its reserve account at the State Bank to its clearing account there. If there are insufficient balances in the reserve account or if a bank elects not to draw down on its reserve account, the bank in deficit can call the State Bank staff and request a list of banks that are in a positive position at the State Bank as of the close of business the night before. The bank in deficit can then telephone a bank on the list to arrange to borrow for one day a portion of its excess deposits at the State Bank. When the terms and conditions have been agreed to, both banks call the State Bank to confirm the transaction, and balances are transferred on the books of the State Bank. These transactions are then confirmed by the State Bank via fax. While this constitutes the rudimentary beginning of an inter-bank market, as of this writing the practice has been in effect for only a few weeks, and therefore has had only limited use.

To settle a previous day's account deficit, "last-resort" rediscount credit can be extended during the 10:00-11:30 a.m. settlement period at an interest rate of thirty

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percent per annum. Since banks have no ability to know their position until 10:00 a.m. on the morning after the close of business, the bankers are unhappy with this high rate and it is the subject of discussion at the State Bank. All settlement transactions are back-dated to the previous day and the books are closed by 11:30 a.m.

Another source of funds for the banks is the rediscount credit available from the State Bank. Rediscount credit can be obtained by a bank throughout the day up to an amount not to exceed of 3 to 4 times the amount of the bank's capital. An interest rate of ten percent per annum is charged. This rediscount credit cannot be used to settle a previous day's account deficit during the 10:00-11:30 a.m. settlement period. Under current policy, the total maximum rediscount credit allowable to all banks is 85 billion crowns; approximately 65 billion crowns are currently outstanding.

In December 1990, the State Bank entered into a contract with Unisys to establish by December 1991 what is described by operations staff of the State Bank as an "on-line, real-time" system for the clearing center in Prague. In fact, although capable of operating on-line and in real-time, the State Bank staff does not intend to use these features and will require banks to submit payment instructions in a batch mode, no more than twice a day, beginning in December 1991. Banks with the capability will

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connect to the State Bank on-line, and the larger banks are planning to do so. Branches of banks must be linked to their main office, and access to the State Bank clearing center will be through the bank's main office only. As we understand it, the clearing center in Prague will be replicated in Bratislava so that there will be two processing sites and these two sites will be linked. According to the State Bank staff, decisions on what type of hardware to purchase will be made by the banks, but all software for the State Bank and the banks is being developed by Unisys at the direction of the State Bank. There are no current plans to allow any account balance inquiry in real-time, although we understand that the Unisys system could provide this capability.

The explanation given by the State Bank staff for electing to process in a batch mode in the new system is that it would be easier to restart the system if there were a computer failure. There appears to be great concern among the technicians at the State Bank that developing an on-line, real-time system would be too big a step at this time and is not really needed. It was stated that there is "no hurry to be settled," so batch processing is just as good as real-time. It was stated that most payment transactions in Czechoslovakia are not time critical.

There is nonetheless strong resistance among staff at the State Bank to encourage the use of checks; in fact, they want to eliminate the limited number of checks that do exist and replace them with debit cards. Checks are considered a cumbersome instrument. A limited review of check processing shows that, while a process resembling check truncation is in place, a paper record is created to replace the check during the processing. The transaction is channeled through the clearing center twice before accounts are finally debited and credited on the books of the State Bank. Little information was obtainable on where the debit card initiative stood.

Both the commercial bankers and staff in the policy area at the State Bank, however, expressed some concern about the direction in which the State Bank is headed with respect to this project. First, several bankers stated that Unisys is experiencing some financial difficulty. Next, they questioned the decision to process in batch mode, which they consider to be not much better than the current arrangement. It was stated that there will not be an incentive to develop an active inter-bank market if commercial banks have access to their account balances only once or twice a day. Policy officials at the State Bank are also concerned about the ability of banks to manage their positions during the day. They indicated that they have only limited ability to influence the decision process with respect to the clearing center, however, since

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decisions on the structure of payment systems rest with the operating staff at the State Bank.

Finally, there was concern expressed by some commercial bankers about the linkages between the commercial bank computers and the State Bank computers. There is great skepticism that the linkages will be effective given the array of computers that will need to be connected.

LARGE PRIVATIZATIONS LAW

This law was enacted on February 26, 1991. It covers the transfer of large state enterprises to private ownership, which could be by natural persons, domestic enterprises, foreign enterprises or jointly-owned enterprises. Management of each entity to be privatized initiates the process by developing a so-called "privatization project," which is essentially a plan of privatization for that entity, to be submitted to the appropriate Ministry of Privatization for approval. The plan should include at least a description of the assets to be privatized, the manner in which the privatization will be conducted, a rough valuation, a description of the method to be used for dividing shares, a timetable for implementation, and facts and figures regarding the markets in which the entity operates or expects to operate.

After the project is approved, all assets and liabilities of the entity are transferred to one of three different National Assets Funds, depending upon which of the two republics and the federal government has jurisdiction. Except for certain industries of a public utility nature, jurisdiction will be exercised by one of the republics. Assets held by the Funds do not become part of republic or federal budgets but are deployed in the privatization process. The fact that such assets do not form part of any government budget allows the Funds to operate with more flexibility and autonomy than a state entity.

The sales of assets may be through private negotiation or public auction. Creditor consent is not required.

Investment coupons are contemplated for use in purchasing stock of privatized entities. The coupons will be issued by the federal Ministry of Finance and will be non-transferable. Only residents age 18 or older are entitled to the coupons. The net income from the sale of coupons will be transferred to the National Assets Fund of the republic where the permanent residency of the acquirer of the coupons is located. The federal government, in agreement with the republics, will determine by decree the method of issuance of coupons, the various types of coupons to be used, their purchase price, the method for expressing the extent of entitlement to stock in privatized entities, and the method for their use. This aspect of the law is currently under discussion.

The law has been approved by the federal government; it is expected that the republics will soon give their approval. Within three months of approval, the republics will have to draft the principles on the basis of which the appropriate central organ of state and

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municipality will submit for federal government approval lists of potential enterprises to be privatized. The lists will contain a preliminary general valuation of assets, number of employees and other relevant information about each enterprise. The federal and republic governments will determine the time period for drawing up the privatization projects.

In addition, after approval by the republics, instructions and operational procedures will follow, including instructions regarding the nature and expected use of coupons.

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METHODS OF VALUATION

Fair market value is typically defined as the price at which an enterprise can be sold between a willing buyer and a willing seller, each reasonably knowledgeable as to the relevant information, and neither under an extraordinary compulsion.

For any particular commercial and industrial property or enterprise, its current value in the market place will be determined by a number of factors, which may be characterized as intrinsic (pertaining to the property or enterprise itself) or extrinsic (pertaining to the market place).

A. Intrinsic Factors

There are two basic intrinsic factors that affect the value of a commercial property or enterprise: (1) future profitability expectation, and (2) desired return on capital for an investor.

1. Future Profitability Expectation

Value is directly related to the expectation of future cash profits that will be returned to the owner/shareholder.

For commercial properties and enterprises, such future profits arise as a result of effective management and operation of the enterprise. Future profitability will depend on many factors, such as the viability of the company assets, technology, management and worker capabilities, its future capital requirements, future availability of raw materials, and the most critically important, the market for its products (considering both price and quality in comparison to competitive products). All such factors must be objectively assessed and evaluated, and approximate assumptions must be made as to future intrinsic and extrinsic factors that will affect such future price, including future growth potential and future market demand for ownership of such an enterprise. For the majority of Czechoslovak commercial enterprises, this assessment will require involvement of experienced industrial consultants, in addition to competent valuation experts.

2. <u>Desired Return on Investment</u>

The second factor which affects the current value of a commercial property or enterprise is the return on investment that is required (or desired) by potential investors in light of prevailing cost of capital, their perception of (and appetite for) risk, and the availability of alternative investment opportunities.

In perhaps overly simple terms, cost of capital is governed by prevailing interest rates. Perception of risk is directly related to the degree of uncertainty in achieving the forecasted results. The greater the availability of reliable information about the various factors which can affect the forecasted income, as well as the potential for loss of capital, the lower the perceived risk. Risk perception is also related to the availability of alternative income producing investment opportunities perceived to be more or less risky.

B. <u>Extrinsic Factors</u>

Extrinsic factors relate to the supply and demand in the market place for ownership interests in commercial properties and enterprises. Thus in a sellers' market, where a large number of potential buyers are pursuing a small number of possible investment opportunities, it may be a relatively simple matter for a seller of a good enterprise to stimulate a competitive bidding process that will assure maximization of the selling price. Conversely, in a buyers' market, with a mediocre enterprise for sale, it may be impossible for the seller to stimulate competition for the enterprise.

Finally, the stability of the capital market infrastructure, including such components as a viable banking system, a stable government and stable currency, well defined commercial and tax laws, and reliable reporting

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of financial information will have an important effect on current values of ownership interests.

C. Valuation Methodologies

Given this background, there are three broad methodologies used to calculate values: market value of comparable enterprises; cost; and discounted cash flow (income forecast).

In preparing a comprehensive appraisal study, theoretically all three approaches should be attempted. However, since some approaches are not appropriate for certain situations, it is often sufficient to apply only one or two of the approaches depending upon the intended nature, purpose and use of the appraisal valuation.

1. Market Comparable Enterprises

This approach requires an active and competitive "free" market to be in operation with price and other relevant information readily available.

The valuation expert would identify recent transactions involving assets which are equivalent, or reasonably comparable, to the enterprise being appraised. Adjustments are made for perceived differences between the enterprises sold in the market ("market comparable transactions") and the actual enterprise being valued.

2. Cost Approach

This approach is based upon the determination of the replacement cost of an existing enterprise or used asset based upon the current cost of a similar new enterprise or asset. The new cost is reduced for physical condition (age, wear and tear), as well as functional and/or economic obsolescence of the used asset.

Functional obsolescence refers to aspects of the asset itself which render it less effective for its intended function than a more modern asset performing a similar function. Economic obsolescence refers to loss in value due to a change in external market conditions, such as increased fuel costs, which reduce the economic effectiveness of the asset.

3. Discounted Cash Flow Approach

This approach is based upon the concept that the value of an asset or economic enterprise is best measured by the cash flow that the asset or enterprise will generate in the future, discounted to its current value at the required rate of return on capital for a potential investor (often considered to be equivalent to the cost of capital). This approach is most widely applied in the United States to determine fair market values, intrinsic values and extrinsic values of economic enterprises, and does not necessarily require any knowledge as to the appraised values of underlying enterprise or assets. It does, however, require sufficient market information to objectively ascertain required ratio of return for potential buyers, as well as projected cash flows to be generated by operation of the enterprise.

Properly applied, this approach yields the aggregate value of all the operating assets used by the economic enterprise including the value of tangible assets and intangible assets, such as goodwill (the value assigned to an enterprise's reputation and perception of the quality of its goods or services in the marketplace) and going concern value.

D. Valuation Methodologies: An Example

As an example, assume that an economic enterprise manufacturing automobiles has the capacity to produce fifty automobiles per day. If the automobiles are not competitive with other automobiles available in the market place, then the automobile manufacturing enterprise may not be able to sell any of the type automobiles that it can produce. If the machinery and equipment of the automobile manufacturing enterprise cannot be readily modified to produce more competitive automobiles, the machinery and equipment may have no value, even though they would be very costly to replace. A valuation of the current replacement cost of the machinery and equipment would be a useless exercise under these circumstances.

This does not mean, however, that the automobile manufacturing enterprise itself would not be of value to a private investor. Perhaps there would be economic incentive for an investor to purchase the automobile manufacturing enterprise, install new machinery and equipment and, with some re-training, employ the factory workers and management to manufacture a more competitive automobile. Under such circumstances, the potential value of the automobile manufacturing enterprise would be determined by use of a Discounted Cash Flow analysis, perhaps in combination with a Market Comparable analysis. Clearly, neither the current replacement cost nor the fair market value (zero) of the machinery and equipment would provide any indication of the fair market value of the automobile manufacturing enterprise.

COLLECTIVE INVESTMENT FUNDS

Collective investment funds are becoming the primary investment and saving vehicles for a significant portion of the investing public in the West. They provide a means by which individual as well as institutional investors can invest in a diversified pool of securities that is professionally managed at relatively little expense to the investor.

This outline provides a general overview of what collective investment funds are and how they are organized and regulated. It also sets forth our views as to why the use of collective investment funds is appropriate for the Czechoslovak privatization process. We can discuss any of the subjects in much greater detail if there is an interest.

A. What is a Collective Investment Fund?

Collective investment funds can take several different forms, being organized as corporations, partnerships or business trusts. Any form can be used which satisfies its business needs.

In the simplest terms, the typical collective investment fund is an entity whose assets consist primarily of securities selected and managed by the fund's officers

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and directors or by a separate management firm under contract with the fund. The securities can represent debt, equity, and/or options to purchase debt or equity securities.

Collective investment funds are divided into two principal types:

1. An "open-ended" fund, meaning one that issues redeemable shares of stock that ordinarily are continuously offered to the public at the net asset value of the Fund. Shares of an open-ended fund, known in the United States as a "mutual fund," do not trade on any market, because any shareholder seeking to sell can simply have them "redeemed" by the Fund -- that is tender the shares to the fund for repurchase by it. The repurchase of shares is at the net asset value of the Fund, consisting principally of the portfolio of securities held at the time of tender, taken at current market prices. Thus, there is no discount from or premium over the market value of the portfolio.
2. A "closed-end" fund, meaning one that does not issue redeemable shares. Since shares of a closed-end fund can not be tendered to the fund for repurchase, a shareholder must sell in the secondary market at a price that may vary from the

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net asset value of the fund's portfolio (i.e., a discount from or premium over such value), depending upon various factors. In the United States, most closed-end funds sell in the secondary market at discounts from net asset value, and this fact is often disappointing to shareholders who purchased a fund's shares at the initial public offering, where no discount applied.

In all cases, the investors purchase an interest in the collective investment fund, rather than in the individual securities in the fund's portfolio, and gain or loss depends on the value of the entire portfolio.

A key aspect of a collective investment fund is its tax treatment. Typically, the fund itself is not subject to taxation but, under special tax rules, is permitted to pass all dividends, interest, gains and losses in respect of the fund's portfolio of securities through to its shareholders, who are treated as having received their pro rata share of such items. In this way the investors are not disadvantaged from the position they would occupy had they invested in the fund's portfolio directly.

B. Role of Investment Advisers and Other Parties

1. Advisers

Investment strategy is carried out by the manager of the fund. Usually, a separate management firm -- sometimes called an investment adviser -- is retained to provide professional investment advice to the fund. Typically, the adviser will have investment discretion, although the fund's governing body may retain that power. The adviser is responsible for fulfillment of the fund's investment objectives and adheres to the fund's investment restrictions and policies established by the fund's governing body. Frequently, the investment adviser or a broker-dealer affiliate is also the fund's organizer or sponsor and may perform a variety of other services, such as portfolio pricing, accounting services (including the valuation of the fund's portfolio of securities) and transfer agency services. It is possible, however, for the fund's own officers and directors to make and implement investment decisions.

2. Custodian

Investment funds typically use the services of a bank custodian for the safe keeping of the fund's securities, cash and other assets. As custodian, a bank will usually perform certain limited functions for the fund. Thus, the custodian settles portfolio purchases and sales, reports trades, identifies and collects portfolio income (interest on bonds and dividends on stock), makes and reports cash transactions and provides safe keeping of securities. The custodian may also report on performance of the fund as compared with other funds having similar purposes and indices against which the fund chooses to be measured.

3. Distributor

Distributors are often affiliated with the fund's investment adviser but the fund's shares are sometimes distributed by other financial intermediaries, such as broker-dealers. The distributor, either purchasing interests or shares in the fund itself for resale from, or as the agent of, the fund, sells through brokers, through its own direct sales organization or by marketing the fund's shares directly to the public.

4. Transfer Agent

A transfer agent is often employed to process purchases and redemptions of shares as well as dividends, to maintain all shareholder information, including names and addresses, to register the transfer of ownership of shares and to mail dividends, prospectuses and reports to owners. These functions are sometimes performed by the fund itself.

5. Board of Directors

Investment funds often have boards of directors responsible for oversight of the fund's operations. In some jurisdictions, such as the United States, funds are requested to have some minimum percentage of "independent" directors (*i.e.*, those not employed by or otherwise affiliated with the fund or its sponsors) who can serve as "watchdogs" for the fund and monitor the adviser's performance.

6. Independent Public Accountants

Typically, the financial statements of the fund are audited by independent accountants, who report to the shareholders.

C. Collective Investment Vehicles and Privatization

We believe that integration of collective investment vehicles into the privatization process would be of great value to the emerging Czechoslovak capital markets.

The government's primary and overriding goal is acceleration of the privatization process to achieve a rapid transfer of property into private hands. We believe that there are three additional goals which should be pursued in the privatization process:

-- First, achieve the most efficient operation of privatized enterprises possible;
-- Second, achieve the maximum protection of citizen investors consistent with a free capital market; and
-- Third, develop an efficient capital market that allocates capital efficiently to the privatized

enterprises through reasonably accurate valuations on a current basis.

We recognize that these goals are very hard to achieve if the primary goal is to privatize as many enterprises as possible in the shortest period of time. The first additional goal -- efficient operation of enterprises -- requires that shareholders or financial intermediaries acting on their behalf monitor the conduct of management to ensure that management is working strictly in the interest of shareholders, with undivided loyalty and care, to maximize profits of the enterprise. In mature capital markets, there are many sources of monitoring: large shareholder groups and founding families; lenders; non-employee directors who are professionally trained; securities analysts; the financial press; governmental regulatory agencies such as securities commissions; and self-regulatory agencies such as stock exchanges. However, rapid privatizations cannot wait for these developments.

Monitoring and reporting publicly on how management is doing also helps achieve the second goal -- protection of citizen investors from making investment decisions in the dark. It will be very difficult for citizens to make informed decisions on which enterprise shares should be acquired with vouchers or otherwise purchased in the market and then to know whether or when to sell or exchange particular shares for shares in another

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enterprise. And if the citizen has shares in only one enterprise, he is at much greater risk if things go badly for that enterprise than if he holds shares of a number of enterprises. Diversification of investment risk -- the idea of not putting all one's eggs in one basket -- has given rise to a huge industry of collective investment vehicles in mature capital markets.

The third goal -- efficient capital markets -- also requires a well developed information base on what managements are doing and the availability of a group of professionally trained and experienced financial intermediaries to interpret the information and to allocate capital accordingly. Sound credit evaluation is a fundamental requirement for efficient capital allocation and it cannot be accomplished without reliable financial information about the enterprises. It is important to note that at the beginning of the U.S. economic system, stock markets did not perform the main capital allocation function; it was done by banks. It should also be noted that in a number of Western European countries banks, insurance companies and pension funds, and not the stock markets, are the major source of capital allocation even today. One reason is that until an informational infrastructure is built up -- which will be a matter of years, not months -- a stock market system cannot function effectively or efficiently.

We have therefore concluded that the best way to achieve the rapid transfer of property into private hands and at the same time take steps to achieve these three additional goals is to interpose collective investment funds between citizen investors and the enterprises. Thus, collective funds would be created by banks, insurance companies and other knowledgeable intermediaries, run by the most professionally trained business and financial people available. The funds would invest in the shares of the enterprises, having been allocated vouchers (or having received them from citizen investors) for that purpose. Citizens would be encouraged to exchange their vouchers for stock in one or more of these funds instead of exchanging vouchers for stock in a single enterprise. In this way: enterprises would be operated more efficiently because funds, with large ownership in enterprises, would have a high interest in monitoring management and would be professionally qualified to perform that function; citizen investors would be better protected by this system because they would have diversified their risk across many enterprises and would have professional investors -- the collective investment funds' advisers -- working for them in monitoring enterprises and re-investing fund assets; and capital markets would be more efficient because the collective investment funds would be better informed and therefore better able to allocate capital where it is needed

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and at a price that better reflects true value, thereby reducing the chance of getting enterprise valuations wrong. This, in turn, would reduce political risks that arise if valuations are too high or too low.

D. Regulatory Framework

A regulatory framework for collective investment funds should be developed at the earliest opportunity. The degree of regulation of collective investment funds and their advisers varies significantly among the Western countries. We believe that for Czechoslovakia, at this stage, a simple system of regulation should be discussed to meet only the most basic regulatory needs without undue bureaucracy and complexity. As markets develop and experience is gained, more comprehensive regulation can be put in place.

The regulatory framework for the investment managers or "advisers" varies from country to country. A majority (including the EC) require registration for advisers that have discretionary portfolio management authority. The principal purpose of registration is to obtain disclosure about the adviser that is material to an investor's decision whether to use that adviser. In addition, many Western countries impose substantive regulation on the activities of funds and their managers. The trade-off between the benefits of regulation including

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investor confidenc and full disclosure and its costs is measured differently by different countries. In the early stages of capital market development, it is essential, we submit, to avoid imposing regulatory costs that go beyond what is clearly essential to growth and confidence in the system.

What follows is a brief outline of the basic regulatory framework for collective investment funds that we would recommend for Czechoslovakia at this stage of its economic transformation.

1. Registration of Funds and Investment Managers

Registration should be required of funds and their investment managers. Here the purpose is to compel complete and accurate disclosure of material facts regarding the fund's organization and management, including education and experience of the officers and directors and, if and when available, historical performance data. Compensation arrangements for the fund's officers, directors and managers and other expenses to be borne by the fund (thereby reducing the value of the investment) and conflicts of interest that may exist should be disclosed. Materials filed to effect registration should also be required to be delivered to shareholders and prospective investors. Amendments of filed material should be required to reflect any material changes.

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2. <u>Anti-fraud Provisions</u>

Funds should be prohibited from making false or misleading statements or concealing material facts in connection with soliciting potential shareholders of the fund, reporting to existing shareholders or in regard to any document filed pursuant to registration law.

3. <u>Market Manipulation</u>

Funds should be prohibited from any manipulating of the market price of shares (manipulation results in damage to investors who trade at inaccurate prices caused by the manipulation). Rules against insider trading should also be considered. This area is a very complicated one that does not cause the same kind of mispricing that manipulation does. However, trading by insiders on the basis of material information not available in the market can affect the public's perception of fairness and, therefore, a rule prohibiting such trading, at least in its most egregious forms, should be considered.

4. <u>General Conduct of Business Rules</u>

Funds should be subject to standards of fair dealing in regard to their shareholders, including standards for fair selling practices for their shares.

5. <u>Financial Reporting</u>

Funds should be required to make periodic (at least annually) financial reports, setting forth the valuation portfolios and results of investment.

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The foregoing is only a general overview of collective investment funds. This is a highly complex subject, and we would be pleased to provide further information and advice in response to any questions that you may have.