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CZECH REPUBLIC

Technical Note on Consumer Protection in Financial Services

June 2007



THE WORLD BANK

Private and Financial Sector Development Department
Europe and Central Asia Region
Washington, DC

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This Diagnostic Review is a product of the staff of the International Bank for Reconstruction and Development/ The World Bank. The findings, interpretations, and conclusions expressed herein do not necessarily reflect the views of the Executive Directors of the World Bank or the governments they represent.

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Abbreviations

AFAM	Association of Funds and Asset Management
AUCM	Act on Undertakings on the Capital Market
ADR	Alternative Dispute Resolution
CBA	Czech Banking Association
CNB	Czech National Bank
CRC	Central Register of Credits
CSC	Czech Securities Commission (now part of Czech National Bank)
CTI	Czech Trade Inspection
CZK	Czech Crowns
DIF	Deposit Insurance Fund
Ecofin	Economic and Financial Affairs Council
ESIS	European Standardized Information Sheet
EU	European Union
FA	Financial Arbiter
GBA	German Banks Association
MIT	Ministry of Industry and Trade
MOF	Ministry of Finance
NGO	Non-Government Organization
OECD	Organization for Economic Cooperation and Development
OFA	Office of Financial Arbiter
OPDP	Office for Personal Data Protection
PSE	Prague Stock Exchange
SOS	Consumers Defense Association of the Czech Republic
UK	United Kingdom

1 US\$ = 21.095 CZK (end May 2007)

1 Euro = 28.285 CZK (end May 2007)

Foreword

This report is the first in a pilot series of financial consumer protection assessments undertaken by the Financial and Private Sector Development Department of the Europe and Central Asia Region at the World Bank. The assessments focus on consumer protection in several parts of the financial sector including banking, consumer finance, insurance, private pensions and collective investment funds. The assessments attempt to identify key components of strong consumer protection in financial services—and stimulate debate on what reforms may be needed.

Strengthening the rights of financial consumers will not only build consumer confidence in the financial sector but also empower consumers to help reduce fraud and fight other forms of corruption in the financial sector. The assessments on consumer protection complement the World Bank's other work on financial governance. Both types of reviews are increasingly important as the industry offers more and more sophisticated products, particularly to the poor, who are the most vulnerable group to potential fraud and abuse.

The Czech Republic is to be commended for taking the lead on what will likely become an increasingly important issue for financial sector development in middle income countries worldwide.



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The drafters are grateful to peer reviewers: Fernando Montes-Negret, (Sector Director), Hormoz Aghdaey (Lead Financial Sector Specialist), Eric Haythorne (Lead Counsel) and Cally Jordan (Senior Counsel) of the Legal Department. Olga Puntus (Consultant) contributed valuable research assistance to the team. Can Atacik (Consultant) assisted in the finalization of the Note. Rozzy Garner, Jasna Vukoje, and Nasreen Chudry Bhuller provided editorial and organizational support. All are also with the World Bank.

The World Bank team expresses its appreciation to the Czech authorities for their cooperation during the preparation of the Note. The Bank team recognizes the strong commitment of the Czech Ministry of Finance team, led by then Deputy Minister Tomas Prouza, to the strengthening of the consumer protection framework in financial services in the Czech Republic, and thanks the MOF for all the organizational support received from it during the Bank mission to Prague, including the public dissemination seminar of the draft report in June 2006. The Bank team also thanks the numerous ministries, agencies and associations who generously contributed extensive detailed comments on the draft report. Valuable comments were received from the Ministry of Finance (MOF), the Czech National Bank (CNB), the Ministry of Industry and Trade (MIT), the Financial Arbiter (FA), the Czech Banking Association (CBA), the Association of Czech Insurance Companies (CAP), the Consumers Defense Association of the Czech Republic (SOS), and the Association of Financial Intermediaries and Financial Advisors of Czech Republic (AFIZ). The authors are grateful to all for their contributions.

Executive Summary

This Technical Note has been prepared by the World Bank at the request of the Ministry of Finance of the Czech Republic. Its purpose is to provide a review of the existing rules and practices concerning consumer protection in financial services in the Czech Republic and suggest recommendations.

The Note consists of four main sections supported by four annexes. The first section (Introduction) sets the work in context and describes the methodology employed. The second section (Importance of Consumer Protection in Financial Services) focuses on why consumer protection in financial services is important, provides an overview of pertinent literature, and raises issues that should be taken into account when considering government intervention. The third section (EU Framework & its Implementation in the Czech Republic) provides an overview of the consumer protection framework of the European Union (EU) and its implementation in the Czech Republic, analyzing existing legislation and the roles of the institutions that are involved in consumer protection. The final section (Key Findings & Recommendations) presents a diagnostic review of the sector based on six sub-topics: (1) consumer protection institutions; (2) sales practices and disclosure; (3) account handling, including privacy of financial information; (4) dispute resolution mechanisms; (5) compensation and other guarantee schemes; and (6) consumer education and financial literacy. Annex I summarizes the recommendations that emerged from this review. Annex II provides a detailed review of Czech practices in three financial sub-sectors: banking, insurance, and securities. Annex III presents a review of the ombudsman structures used in the United Kingdom and Germany. Annex IV summarizes the EU Directives related to consumer protection in financial services.

A caveat is in order. This Technical Note is the first in a pilot program of the World Bank aimed at identifying the key components of strong consumer protection in financial services in emerging markets. As the first pilot report, this Note focuses on the practices and laws for the primary regulated financial institutions, that is, commercial banks, securities firms and insurance companies, all of which fall under the supervision of the Czech National Bank as the integrated financial supervisory agency for the Czech Republic. A substantial and growing amount of consumer credit in the Czech Republic, however, is provided by commercial credit companies and other institutions not supervised by the Czech National Bank. Although subsequent reports in the pilot program will do so, this Note does not review the practices related to such unlicensed entities.

A second weakness relates to the absence of EU or other international benchmarks on protection of financial services. While the European Commission has announced a multi-year program to focus on financial consumer protection—including the development of suitable benchmarks—such guidelines are not yet in place. Indeed one of the objectives of the pilot program is to provide input, based on country-level analyses, into the development of international benchmarks on financial consumer protection. However in their absence, the report's recommendations are based on effective mechanisms for financial consumer protection as seen in other developed markets.

This Note is based on two visits by a World Bank team to the Czech Republic from January 25 to February 4, 2005 and from October 2 to 12, 2005. The Bank team's preliminary findings and recommendations were presented at a June 2006 workshop organized by the Czech Ministry of Finance. Following the workshop, an initial draft Note was circulated by the World Bank and detailed comments on it were provided by the Ministry of Finance (MOF), the

Czech National Bank (CNB), the Ministry of Industry and Trade (MIT), the Financial Arbiter (FA), the Czech Banking Association (CBA), the Association of Czech Insurance Companies (CAP), the Consumers Defense Association of the Czech Republic (SOS), and the Association of Financial Intermediaries and Financial Advisors of Czech Republic (AFIZ). This final Note reflects comments that were received as well as recent changes in EU legislation.

While the Czech Republic has made considerable strides in the development of consumer protection, particularly in goods and services, consumer protection in the financial sector is still in need of further development. As of April 2006, responsibility for primary legislation regarding consumer protection in financial services was moved from MIT to MOF. However financial supervision of consumer finance is not similarly integrated in one agency. Despite the consolidation in the CNB of financial supervision, responsibility for supervision of commercial credit companies remains with the Czech Trade Inspection (CTI). The CTI is highly active in consumer affairs related to food and apparel but lacks specialized expertise in financial issues. To date, the CTI had brought forward few cases of abuses of financial consumer protection. The Note recommends that consumer protection in the financial sector should be transferred from the CTI to the CNB. Alternatively the CTI could remain independent, but it should be obliged to develop extensive expertise in financial matters and strengthen its institutional capability to adequately review and investigate abuses of commercial credit. The test will be in the number of cases brought forward for prosecution. In addition, the CNB lacks an explicit legal mandate to ensure the proper level of consumer protection in the financial sector. Also no agency is responsible for authorizing providers of financial services such as commercial credit companies, which should be subject to at least minimal supervision (such as of business conduct) either by the CNB or other financial supervisors.¹ The entities that are active in the financial market and currently unregistered should be required to be registered, and preferably authorized, by the CNB to provide financial services.

Needing strengthening are truthfulness and accuracy of advertising as well as adequate disclosure of information before, during and after the sale. Financial institutions should be explicitly prohibited from providing misleading advertising. The prohibition against deceptive advertising should not be limited to the prohibitions in the Commercial Code but should be part of all relevant laws and regulations dealing with market conduct of financial institutions: banking, insurance, securities markets and the pension funds laws and regulations. Disclosure should be improved and special care should be taken to make disclosed information easy to understand and easy to compare. To avoid regulatory arbitrage, disclosure rules should be the same for similar products.

Privacy of personal information is important to retail customers and its protection needs improvement. Consumer confidence in such privacy is critical to encouraging them to place their savings in the financial system. The Czech Office of Personal Data Protection has identified banking and the entire sphere of provision of financial services, including leasing, as high risk areas for the improper disclosure and use of personal information. In the course of its controls in 2005, this Office noted a number of violations of the data protection rules by financial institutions. Financial institutions should pay increasing attention to ensuring the confidentiality of consumer information.

There are many open issues with distribution, especially relating to the wide use of multi-level networks. Significantly differing commissions for various types of products encourage distribution agents to skew their advice and sell the products with highest commissions,

¹ The responsibility for supervision of financial consumer protection remains under discussion by the Ministry of Finance, the CNB and the Financial Market Committee (which acts as an advisory body to the CNB Board.)

regardless of their value for the consumer. In addition, insufficient rules prohibit churning of insurance contracts products and in particular there is no legal requirement for an intermediary or insurer to inform a client about the potential costs of changing products. Multilevel selling is an important aspect of the insurance sector in the Czech Republic and the responsibility of insurers for the actions of their agents is not unqualified (but should be). New rules for distribution of financial products are needed to focus on the knowledge, and business ethics of distribution companies. In addition, multi-level selling should be discouraged for sophisticated products which demand highly professional expertise from intermediaries and extensive disclosure and financial education for consumers. For all financial products and especially where pensions and life insurance products with substantial savings components are involved, the intermediary should be required to disclose the commission or other forms of remuneration to the consumer upon request. In addition, the law should specify a minimum cooling off period² (with no conditions attached) for all contracts for credit and long-term savings, including pensions and other contracts with a savings component. It is recommended that the cooling off period be at least one week and preferably two weeks.

In addition, consideration should be given to reviewing the quality of training of intermediaries. The sophistication of products offered by the financial service industry has evolved considerably. Some of the industry's selling practices, however, do not reflect the level of consumer protection that may be needed. For example, in the case of the insurance sector, products that involve contractual savings components (such as life insurance) should be sold by intermediaries that are certified with higher credentials and subject to more stringent regulation than required for the selling of simpler products such as motor vehicle insurance. While tiering of qualifications for insurance sales goes beyond the explicit requirements of the EU Mediation Directive (but see footnote 23), such tiering would help to ensure that consumers receive complete information on their investments.

The Czech Republic has created a Financial Arbiter (FA) but its scope of jurisdiction and independence remain limited. Dispute resolution for consumers in the finance sector is particularly difficult, since the amounts in dispute for each consumer are usually not large enough to warrant the expense and time of litigation. Consequently, the role of an arbiter can be extremely useful for dispute resolution. The existing mandate and statutory authority of the FA, however, is quite limited. The FA should be converted into an ombudsman, covering all areas of the financial sector, including retail lending products (both mortgage and consumer loans), insurance and pension products, and securities market transactions. The office of the ombudsman should provide a mechanism for consumers to resolve small-scale disputes without going to the time and expense of a court case. Several European models are available in these respects. Following the approach used in Germany, decisions up to a certain maximum level would be binding on financial institutions participating in the ombudsman program. Customers would then retain the right to go to court if they do not wish to accept the ombudsman's decision.

Education and understanding of financial products by the public lags behind the expansion of the financial sector in the Czech Republic. Consumer education and transparency of information for consumers are the most critical aspects of consumer protection. The government should step up its educational activities, especially within the school system, and set required knowledge standards for various age groups. Moreover, the state should support the financial education activities of the financial sector and put in place a system that will evaluate the long-term effects of educational programs. In addition, the ombudsman could become active in educating the public about the rights of consumers of financial services.

² A cooling off period is a specified length of time during which the consumer may unilaterally cancel the contract from inception without penalty.

Consumer associations should also be strengthened. Consumer associations in the Czech Republic have recently become active in defending the rights of consumers of financial services. However, their activities should be focused on key areas (such as disclosure and financial education) to empower consumers when choosing financial products.

As a final comment, the recommendations of the Technical Note need to be carefully reviewed. Consideration should be given not only to the expected benefits of the recommendations but also the difficulties and implementation costs. While the Technical Note points to the benefits, it does not attempt to analyze the costs. In financial markets, the benefits of improved disclosure for consumers can be outweighed by the immediate additional costs imposed on service providers. Also different techniques can be used to solve the same problem and the approaches that are highly effective in one context but may be largely ineffectual in another. However taken together, the different approaches form a type of "toolkit" of different solutions to different types of issues. The recommendations in the Technical Note are focused on the need to provide increased transparency for consumers at little additional costs for providers. It is expected that the recommendations will help to strengthen financial consumer protection that will increase consumer confidence in financial products. At the same time, higher levels of transparency will likely increase competition among financial service providers and thus improve efficiency--and provide better services at lower costs for consumers. A careful analysis of the benefits and costs will ensure that this objective is achieved.

Introduction

As financial markets develop and deepen, one of the key issues for the fair, open and efficient operation of the markets is the protection of consumers' rights in financial services. Be they bank depositors or borrowers, insurance policy holders or investors in securities, mutual or pension funds, financial sector consumers need the ability to accurately understand the terms and conditions of their contracts—and to take action if the terms of their contracts have been violated.

This Technical Note focuses on the protections for retail consumers of financial services in the Czech Republic. It was prepared at the request of the Czech Ministry of Finance, which in the past has also asked the World Bank to prepare reviews of governance of the Czech financial sector, including banking, insurance, collective investment funds and private pension funds.³ This Technical Note (as well as four financial sector governance diagnostic reviews) is part of a pilot program of five reports which together identify the key elements of a strong framework to protect consumer and stakeholder rights in the financial sector of the Czech Republic. Each of these five reports presents recommendations for improvements. In some cases, suggestions are designed to assist the Czech Republic in meeting the requirements for implementation of EU directives or regulations. In other cases, recommendations aim to assist the Czech authorities in anticipating future EU requirements, based on international practices and the successes (or failures) of those practices.

Of the five reports now prepared for the Czech Republic, this Technical Note on Consumer Protection in Financial Services has presented the most challenges primarily due to the lack of international agreement on the need and framework for protecting the interests of financial consumers. The four previous reports, including those on governance of financial institutions, were based on basic principles established by international supervisory associations such as the International Organization of Securities Commissions (IOSCO), the Basel Committee for Banking Supervision and the International Association of Insurance Supervisors. In addition, for private pension funds, guidelines from the Organization for Economic Cooperation and Development (OECD) provided a useful starting point.

Few guidelines or other benchmarks are available, however, for consumer protection in financial services, which remains a new and developing area still lacking consensus even on broad parameters against which specific countries might be systematically analyzed and compared. Where they are relevant, the Note relies on the EU Directives related to consumer protection and makes reference to other relevant sources. In the United States, for example, the Federal Trade Commission, the Securities and Exchange Commission and other state, federal and self-regulatory agencies have developed laws, rules and guidelines to protect investors and consumers. In addition, the OECD Guidelines for Protecting Consumers from Cross Border Fraud and the United Nations Guidelines for Consumer Protection (1999) serve as useful reference points. However one of the major objectives of the pilot program in financial consumer protection is to address this weakness—and develop a set of benchmarks that would provide the basis for a systematic evaluation of different countries' systems of protection for financial consumers.

³ Consumer protection refers to a subset of the overall regulation of the financial sector which deals with the relationship between retail customers and financial institutions and their agents. This area does not extend to the entire depth of regulation of the financial sector which is covered in other Reviews, including Financial Sector Assessments, Reports on Standards and Codes regarding corporate governance and accounting, International Organization of Securities Commission's reviews and specialized governance diagnostics of investment funds, banks, insurance companies and other financial institutions.

As this is a pilot diagnostic review, the final report should be seen as no more than a “work-in-progress.” Nevertheless, it is expected that it will play a useful role in contributing to guidelines for strong consumer protection in financial services in both developed and emerging markets. It could also contribute to further governance reforms of the Czech financial sector.

Approach Taken

This Technical Note looks at consumer protection in financial services from the perspective of three key objectives. Each consumer should have:

- 1) access to sufficient information to make informed decisions as to whether or not he or she should enter into a contract with a financial institution—and whether he or she should maintain the contract;
- 2) recourse to cost-effective mechanisms to redress any violations of the contract; and
- 3) access to programs of financial education that ensure an understanding of the terms of contracts with financial institutions and knowledge as to how to enforce his or her rights as a result.

Achieving the three objectives requires well-written laws, regulations and voluntary codes of conduct, as well as well-functioning government and private sector organizations aimed at protecting consumers of financial services.

This Technical Note analyzes three important parts of the Czech financial sector—banking, securities markets, and insurance products.⁴ For each, the issues have been grouped into six key areas. They are: (1) consumer protection laws and institutions; (2) sales and disclosure practices; (3) account-handling, including privacy of financial information; (4) mechanisms for recourse in case of disputes; (5) compensation and other guarantee programs where a financial institution collapses before fulfilling the terms of its contracts, and (6) programs for consumer education and financial literacy.

The Note starts with the importance of consumer protection in financial services, a summary of key issues raised by the academic literature, and a description of the tools available for strengthening financial consumer protection. The Note continues with a review of the major EU Directives related to financial consumer issues and the status of their implementation in the Czech Republic, followed by a summary of the key legislation and reference to the primary agencies involved. Statistics on the size and growth of the retail financial sector in the Czech Republic are also presented. The Note ends with a section that presents and explains the key findings and recommendations. Annex I provides a summary of recommendations provided in the Note. Annex II presents a detailed analysis for each of the banking, insurance and securities sectors. Annex III summarizes the experience of the United Kingdom and Germany with financial ombudsmen and Annex IV provides, as a reference, a description of each of the key EU Directives related to financial consumer protection.

⁴ Although other areas, notably pension products and loans provided by consumer finance companies, are also important, they are beyond the scope of this Note.

Importance of Consumer Protection in Financial Services

Strong consumer protection ensures that financial services are provided to consumers on fair and transparent terms. Such protection also requires that consumers have access to the tools needed to evaluate the services offered by financial institutions and can take legal or other action if the agreed terms and conditions are not met.

Due to the uneven bargaining position which many consumers have when they attempt to access sources of financing, savings, and risk transfers, the creation of a consumer protection regime is critical to ensuring retail customers' confidence in the financial system and their willingness to use it. The creation of such a regime benefits the financial system by increasing its liquidity, deepening the financial sector, and increasing the ability of the sector to provide financial intermediation.

In contrast to relatively onerous prudential regulation and supervision activities aimed at guarding systemic stability and the soundness of financial institutions, consumer protection is characterized by light interventions that promote efficient and transparent functioning of markets for retail financial services. Consumer protection is not without cost but it is a sound investment to build consumer confidence in the financial sector and thus ensure that the sector plays its full role of financial intermediation.

Consumer protection affects developed and developing markets alike. In industrialized countries, abusive retail practices have obliged financial regulators to issue regulations on accurate and full disclosure of consumer fees and charges, particularly for credit cards and collective investment funds. For example, a 2006 study in the US found that of those consumers that use alternative financial providers, such as check-cashing centers, 58% actually either had a checking or savings account, but preferred not to use it.⁵ The main concern of these consumers, who are often low income earners, is that they cannot trust the system given the lack of transparency in fees and their own level of education about financial matters. The Consumers' Defense Association of the Czech Republic (SOS) found that when consumers decide to pay off loans earlier than originally agreed to in their contracts, they discover prepayment penalties of up to 100% of the total amount of the loan.

Similar issues arise in developing economies, where the poor (and particularly the poorly-educated) often have difficulty identifying the full charges for bank deposits and mortgages. Consumers may not be made adequately aware of the risks associated with the financial products they have received and the extent to which they can incur additional fees and expenses or lose the money they have placed with the institution that has provided the product. While the transparency of consumer activity and consumer education are the most critical aspects of consumer protection, until they are sufficiently developed, it is critical to ensure the effective regulation of financial distribution so that consumers have enough information to make informed decisions and are provided ethical and high quality professional financial advice through any distribution channel. Transparency also helps to ensure healthy competition and limits the scope for the emergence of oligopolistic markets.

Prudential regulation and supervision are related to consumer protection, because they increase the chance that the counterparty in the contract will exist—and will meet its obligation—when payment comes due. Prudential supervision and regulation, however, lie beyond the narrow scope of consumer protection. The focus of consumer protection is instead on the relationship and

⁵ See www.coalitionforfinancialchoice.org

interaction between a retail customer and a financial institution (or its agent or other intermediary) and should be subject to market-conduct, rather than prudential, supervision. Distinguishing between unsophisticated retail and professional customers is important when designing successful consumer protection. (This Note specifically addresses the former.) Transactions between professional parties are not subject to many of the identified problems, and the constraints imposed by regulation may often limit their ability to contract and thus prove counterproductive.

The potential for interventions to protect consumer interests arises when the markets for financial services fail to protect retail customers. The academic literature has identified six potential market failures that may affect financial services⁶:

- 1) **Inadequate information for consumers.** Information is costly for the individual consumer to obtain, and it may be difficult to ascertain the quality of financial contracts at the point of purchase. Imprecise definitions of products and contracts as well as infrequent purchases and high costs of switching in and out of some products exacerbate the information problems. The cost to consumers for gaining sufficient knowledge and understanding of the products may exceed the benefit they could obtain from the product. Excessive cost of acquiring information may lead consumers to select the wrong product for their needs or to select a product of poor value compared to other products available to them.
- 2) **Consumers' inability to assess the quality of financial products.** While some products are straightforward, for instance savings accounts, others such as life insurance that combine a payment upon death with an element of saving may be difficult to assess even when all relevant information is disclosed.
- 3) **Asymmetric information and the "lemon problem."** Financial institutions understand their products better than consumers do and many consumers recognize this asymmetric information. Out of fear of poor quality products, some consumers may therefore exit the market⁷. Reducing the uncertainty for consumers may therefore help build confidence in the financial system and help the market reach its potential. Furthermore, major personal financial decisions, such as taking out a mortgage loan, are rare events in an individual consumer's lifetime, while providing mortgages is a daily occurrence for banks and other loan providers who design these products. Wrong decisions by consumers can lead to major individual financial losses.
- 4) **Differing risk appetites in managing accounts.** For instance, a financial institution managing the funds of an investor may have an incentive to take excessive risk as the

⁶ There have been several seminal articles written on the importance and need for consumer protection in financial services, approaching the issue both favorably and unfavorably. The discussion in this section draws in particular on the following two articles: Benston, George (2000), "Consumer Protection as Justification for Regulating Financial Services Firms and Products", *Journal of Financial Services Research*, 17:3, pp. 277-301, and Llewellyn, David T. (1999) "The Economic Rationale for Financial Regulation.", *Financial Services Authority, FSA Occasional Papers in Financial Regulation (U.K.)*; No. 1:1-57, April 1999.

⁷ The information asymmetry leads to a well known economic efficiency problem, because economically sound transactions will sometimes not take place. The argument was formalized by Akerlof (1970). (See references.) A rational consumer understands that he has less information than the seller and he expects the seller to take advantage of that fact. Thus, even if the seller offers a product that allows the consumer an economic benefit, the consumer may reject it, simply because the buyer is aware that of his difficulty in differentiating between a good and a bad product.

investor participates in the downside risk while only the financial institution enjoys the upside potential.

- 5) **Conflicts of interest.** For instance, a financial institution managing the funds of an investor may have an incentive to place these funds in investments that benefit the financial institution to the detriment of the investor.
- 6) **Inadequate monitoring of providers.** If financial supervisory agencies are not active, consumer groups are needed to monitor the quality of financial services provided to the public.

The need for intervention should be evaluated against the structure and performance of the financial industry as well as consumers' familiarity with financial products and their ability to evaluate the terms on which financial products are being offered. For instance, competition and contestability in the industry determines whether problems are likely to arise in the first place. These factors affect firms' incentives to provide transparency for customers, to put in place structures that avoid potential for exploiting conflicts of interest, and to help customers evaluate their products against those being provided by competitors.

In emerging markets, the ability of consumers to gather information and effectively process information about financial services is generally not on par with that of consumers in developed countries, where financial market conduct is more evolved. Therefore, more protection is likely to be justified. Over time, however, as consumers gain familiarity with financial products, it may be appropriate to reduce the level of protection.

An effective consumer protection framework incorporates numerous aspects.

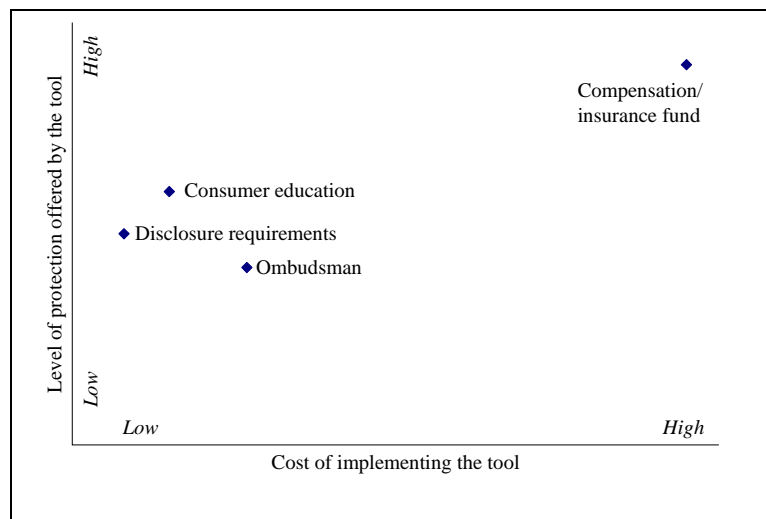
- A general consumer protection framework. Consumer protection is relevant to different degrees across most products and services, but most countries have broad frameworks in place to address disputes.
- Regulation on disclosure. Disclosure requirements and standardization of information can make it easier for consumers to evaluate and compare products. Excessive disclosure requirements may reduce the information value, because consumers have to spend excessive efforts to find the relevant information.
- Regulation of sales, marketing and advertising practices of financial institutions. Regulations also often require claims made in marketing material to be a legally binding part of the financial contract. Disclosure requirements often apply to the marketing stage, and regulation may prohibit certain channels such as telephone sales for certain types of products. In addition, minimum levels of training are often required for front line staff and intermediaries.
- Regulation of legal terms and conditions of financial contracts. These typically cover such matters as regulation of product structure (requiring simple products and limiting bundling), fee structure, consumers' right to withdraw from a contract during a cooling off period, and default rates. While these regulations aim to guard consumers against poor products and aggressive selling practices, they may also restrict the freedom to make contracts that may in some cases be more appropriate.
- Regulation on account handling and maintenance. These typically cover changes of terms and charges and notification of such changes, closing and moving accounts among financial institutions.
- Self-regulation by industry. The industry has two important incentives for guarding its customers against abuse. The sector may be faced with different objectives by individual firms. A few rogue businesses with abusive practices can do serious damage to the reputation of the sector and undermine public confidence in the sector. In addition, publicized scandals

and lack of self-imposed controls can create a demand for government intervention, which may be very costly to the sector.

- Guarantee and compensation funds. A fund, typically explicitly or implicitly backed by the government, partially or fully assumes the risk of financial institutions failing to meet their obligations vis-à-vis their customers. Bank deposit insurance funds are the most common example, but compensation funds for compulsory insurance also exist. Because a third party assumes liability for the failure of a contract, these funds can contribute to moral hazard problems, and the funds are therefore generally associated with tight and costly prudential supervision of the regulated entities.
- Dispute resolution mechanisms including the financial ombudsman function. The court system is a costly means of settling disputes, and alternative low cost methods (even if their decisions are not binding) can be effective in achieving the objective of protecting consumers.
- Court system. This constitutes a costly last resort to guard against abuse.
- Education of consumers. The inability to process information and evaluate the value of financial products is a common impediment to the provision of retail financial services, and equipping consumers to better make decisions about products that meet their needs is a non-intrusive intervention with easily measurable and moderate costs.

Chart 1 provides a summary of the conceptual trade-off between the costs of implementing different consumer protection "tools" versus the benefits to each tool. Note that the chart is meant to illustrate the trade off between costs and benefits—rather than identify the values for each.

Figure 1: Tools Offer Different Protection at Different Costs



Interventions other than by government can often mitigate market failures and in some cases provide a more nimble and efficient way of addressing the failure than would regulation. Government interventions should be evaluated against these alternatives that may easily be crowded out by over-burdensome regulation. Such interventions may include those of:

- Consumer advocacy groups. These are independent entities that aim to inform and educate consumers, monitor the performance and conduct of the industry, and help consumers in disputes with firms.
- Professional financial analysts. Such analysts include rating agencies, which help consumers evaluate the soundness and safety of institutions.

- The press. Dedicated financial press as well as general press coverage of consumer protection issues plays a particularly important role in monitoring firms by revealing abuse and publicizing scandals.

EU Framework & its Implementation in the Czech Republic

Consumer protection is particularly an issue in the EU, since 27 different types of consumer protection systems could undermine the integrity of the single market. As a result, the EU is proposing a joint program for community action in the field of consumer protection for 2007-2013. The objectives are to:

- 1) Protect citizens from risks and threats which are beyond the control of individuals and that cannot be effectively tackled by individual Member States alone (e.g. health threats, unsafe products, unfair commercial practices);
- 2) Increase the ability of citizens to take better decisions about their health and consumer interests; and
- 3) Mainstream health and consumer policy objectives across all European Community policies in order to put health and consumer issues at the centre of policymaking.

Similarly, on issues of banking and financial services, the EU program attempts to protect financial consumers from:

- Low quality of such services (protection from incompetent performance);
- Sale of inappropriate financial products due to low financial literacy on the part of consumers, at times coupled with misinformation and forced selling practices by providers (protection from misinformation and overselling); and
- Abuse and outright fraud by financial service providers.

Articles 153 and 95 of the Treaty establishing the European Community have set out the requirement for a high degree of consumer protection as a necessary feature of a genuine EU-wide internal market. Food safety, public health and consumer protection issues are covered by a single Directorate-General within the European Commission. In May 2002, the European Commission adopted a new Consumer Policy Strategy specifying its overall political approach for the five year period, 2002-2006.

Many of these focus on providing consumer protection through regulating the competence and financial strength of the providers. Others, such as the Consumer Credit Directive, aim at making it easier for consumers to make well-informed choices.

The European Consumer Consultative Group was established by the Commission in 2003 in order to constitute a forum of general discussions on problems relating to consumer interests and consumer protection, to advise and to guide the Commission when it outlines policies and activities having an effect on consumers, and to act as a source of information and a sounding board on Community action for relevant national organizations.

The European Commission has also recently started assessing financial markets of member states from the perspective of competition so as to identify market arrangements that the Commission believes increase costs and/or limit competition among providers. In its Conclusions on the Commission's White Paper on the Financial Services Policy 2005 – 2010 (adopted in May 2005),

the Economic and Financial Affairs Council⁸ stated that it welcomed the initiatives proposed by the Commission. In particular Ecofin noted that increased integration of retail financial markets would remain a challenge during the period of 2005-2010 and that, as a result, it will be necessary to strengthen competition and ensure an appropriate level of consumer protection.

With regard to insurance, Directive 2002/92/EC on insurance mediation sets out a legal framework intended to establish a high level of professional competence among insurance intermediaries. However much more remains to be done.⁹

A number of specific EU Directives relate to aspects of financial services and consumer protection. The key directives dealing with consumer protection (including issues of investor protection) are listed above in Table 2. A detailed discussion of the EU Directives regarding consumer protection is provided in Annex III. Except for the newer Directives, the Czech Republic has implemented them in its internal legal structure. Due to the general nature of the Directives, however, some issues regarding consumer protection remain outstanding, as is noted in the sections below.

Key Czech Legislation

- 1) Civil Code, Act No. 40/1964 Coll., as amended
- 2) Commercial Code, Act No. 513/1991 Coll., as amended
- 3) Act on Securities, No. 591/1992 Coll., as amended
- 4) Consumer Protection Act, No. 634/1992 Coll., as amended
- 5) Act on Banks, No. 21/1992 Coll., as amended
- 6) Act on the Czech National Bank, No. 6/1993 Coll., as amended
- 7) Act on Credit Unions, No. 87/1995 Coll., as amended
- 8) Act on Insurance, No. 363/1999 Coll., as amended
- 9) Act on the Protection of Personal Data, No. 101/2000 Coll., as amended
- 10) Act on Some Conditions for Concluding a Consumer Loan, No. 321/2001 Coll. (Act on Consumer Credit)
- 11) Act on the Financial Arbiter, No. 229/2002 Coll., as amended
- 12) Act on Insurance Contracts, No. 37/2004 Coll., as amended
- 13) Act on Insurance Intermediaries, No. 38/2004 Coll., as amended
- 14) Act on Collective Investments, No. 189/2004 Coll., as amended

⁸ This Council, known as Ecofin, is composed of the Ministers of Economy and Finance of all EU Member States, as well as any additional Minister of any EU Member State handling State budget matters (in the event not within the jurisdiction of the Minister of Economy and Finance) when budgetary issues are discussed.

⁹ For more information, see http://ec.europa.eu/internal_market/insurance/mediation_en.htm

15) Act on Undertakings in the Capital Market, No. 256/2004 Coll., as amended

16) Act on State-Contributory Supplementary Pension Insurance, No. 42/1994 Coll., as amended.

Primary Agencies Involved in Consumer Financial Services

Soon after beginning its transition to a market economy, the Czech Republic recognized the need for consumer protection legislation and activity. In 1992, the Consumer Protection Act was enacted and implementation was assigned to the **Ministry for Trade and Industry (MIT)**. The **Czech Trade Inspection (CTI)**, which is subordinated to the MIT, was given the primary responsibility for conducting inspections or “controls” of suppliers of goods and services in order to verify the observance of legal requirements. Most of the activity of the CTI relates to the quality of consumer goods provided in the Czech Republic. Additional responsibilities for inspection in the financial area were also given to it in the Act on Consumer Credit

The Ministry of Finance is the regulatory agency for the financial sector, with responsibility for preparing this sector’s primary legislation. Since April 1, 2006, MOF has also been responsible for the formulation of primary legislation regarding consumer protection in financial services.

The Czech National Bank was initially established under the Act on Banks in 1992 as amended by the Act on the Czech National Bank of 1993. Subsequently, in 2006, the CNB became the supervisory agency for the entire financial sector and assumed the responsibilities of the **Czech Securities Commission** for securities markets and the **Ministry of Finance** for the insurance and pension fund sector. CNB was also registered with the European Commission as the relevant supervisory authority under the rules of Regulation (EC) No. 2006/2004 on EU cooperation regarding consumer protection. As of February 2007, amendments to existing EU laws were under preparation in order to facilitate this cooperation.

The Financial Arbiter was created by law in 2003 for the sole purpose of resolving disputes in the electronic payment system of the banking sector. Under the Financial Arbiter Act, a complainant in this respect may institute proceedings before the Arbiter. Although the plaintiff may discontinue proceedings at his election, the institution named as defendant cannot do so. If the plaintiff continues to decision and award, the decision of the Arbiter is final and binding and enforceable as such by the courts. Since March 2006, the Arbiter has been part of the FIN-NET network.

The Office for Personal Data Protection (OPDP) was established in 2000 under the Act on the Protection of Personal Data. Under this Act, natural persons have a right to important information about the collection of personal data regarding them, including how it has been processed, the scope and nature of the information processed, the identity and location of who processed the data and the persons or organizations to whom the data has been transferred. In its 2005 Annual Report, the Office identified personal financial data as one of the high risk areas in the collection of personal data. The Office has limited supervisory responsibilities over the Central Register of Credits (CRC), which is maintained by the Czech National Bank, as well as over private credit bureau agencies.

Other agencies are also involved in financial consumer protection, including the **Ministry of Education, Youth and Sports**, which provides financial education at the grammar and high school levels and the **Office for the Protection of Competition (UOHS)**.

Table 1: EU Directives on Consumer Protection in Financial Services and their Implementation in the Czech Republic

CELEX Ref.	EU Directive	Supervisory Agency	Czech Law
3 1987 L 0102	Directive on Consumer Credit, 1987/102/CEE	CTI	Act 321/2001 Coll., Act on Consumer Credit
3 1998 L 0007	Directive On Consumer Credit, 1998/7/EC, amending Directive 87/102/EEC	CTI	Act 321/2001 Coll., Act on Consumer Credit
3 1993 L 0013	Directive on Unfair Terms in Consumer Contracts, 1993/13/EEC	Courts & CTI	Civil Code 40/1964 Coll., Sections 52-57 as amended
3 2005 L 0029	Directive concerning Unfair Business-to-Consumer Commercial Practices in the Internal Market, 2005/29/EC	CTI for general matters, CNB for financial markets	Draft amendment of Consumer Protection Act No. 634/1992 Coll., currently presented to the government,
3 1998 L 0027	Directive No. 98/27/EC, injunctions for protection of consumer interests	CTI	Consumer Protection Act No. 634/1992 Coll., as amended Civil Procedure Act No. 99/1963 Coll., as amended
3 1994 L 0019	Directive on Deposit Guarantee Schemes, 1994/19/EC	CNB	Act. No. 21/1992 Coll., on Banks
3 1997 L 0009	Directive on Investor Compensation Schemes, 1997/9/EC	CNB & MOF	Act No. 256/2004 Coll., on Capital Market Undertakings
3 1995 L 0046	Directive on the Protection of Individuals with regard to the Processing of Personal Data, 1995/46/EC	OPDP	Act No. 101/2000 Coll., on the Protection of Personal Data, as amended
3 2002 L 0058	Directive Concerning Processing Personal Data and Protection of Privacy in the Electronic Communication Sector, 2002/58/EC	OPDP	Act No. 101/2000 Coll., on the Protection of Personal Data, as amended
3 1997 L 0007	Directive on Protection of Consumers in Respect of Distance Contracts, 1997/7/EEC	CTI	Civil Code 40/1964 Coll., Sections 52-57 as amended
3 2002 L 0065	Directive on the Distance Marketing of Financial Services, 2002/65/EC	CNB	Civil Code 40/1964 Coll., Sections 54a-54d, as amended, sanctions in sectoral laws for financial market
3 1997 L 0055	Directive On Comparative Advertising, 1997/55/EEC, amending Directive 84/450/EEC	MIT, Radio & TV Council	Commercial Code 40/1964 Coll., Section 50a, as amended Act No. 40/1995 Coll., on Advertising Regulation, as amended Act No. 468/1991 Coll., on Radio and TV Broadcasting, as amended
3 1985 L 0611	Directive on UCITS 1985/611/EEC, as amended	CNB	Act No. 189/2004 Coll. on Collective Investments
3 2004 L 0109	Transparency Directive, 2004/109/EC	CNB	Draft law expected to be presented to the government by spring 2007
3 2003 L 0006	Market Abuse Directive, 2003/6/EC	CNB	Act No. 256/2004 Coll., on Capital Market Undertakings
3 2004 L 0039	Directive on Markets in Financial Instruments, 2004/39/EC (MiFID)	CNB	Draft law expected to be presented to the government by spring 2007
3 1992 L 0049 3 2002 L 0083	1992/49/EEC Non Life Insurance Directive 2002/83/EC Life Assurance Directive	CNB	Act No. 363/1999 Coll., on Insurance Act No. 37/2004 Coll. on Insurance Contracts Act No. 38/2004 Coll. on Insurance Intermediaries
3 2002 L 0092	Directive on Insurance Mediation 2002/92/EC	CNB	Act No. 37/2004 Coll., on Insurance Contracts Act No. 38/2004 Coll., on Insurance Intermediaries

Source: Report of MOF and CNB, updated and completed by World Bank

In addition, **financial institutions and their industry** associations play a role in consumer protection. Also numerous **consumer protection agencies** are active in the Czech Republic, with the Consumers Defense Association of the Czech Republic (SOS) and the Czech Consumer Association being the largest and most prominent. **The financial press** also informs consumers about how the financial markets work and consumers' legal rights.

Market for Retail Consumer Financial Services

Over the last five years, the Czech Republic has seen a substantial growth in consumer financial services. With the expansion of conventional consumer financial products such as bank and non-bank consumer lending, mortgages, credit cards, life insurance, brokerage accounts and collective investments.

Table 2 shows the sizeable growth in these areas for the years from 2002-2006. Despite a plateau in collective investment sales in 2002-2003, securities market activities and mutual funds have increased significantly over the last year.

The growth in the market for retail financial services reflects the improving economic position of Czech consumers and their desire to buy more and more expensive consumer items such as cars, white goods and real estate. At the same time, increased disposable income, continuing strong economic growth and low inflation increase their confidence and give them the opportunity to save increased sums of money for investment and to provide security through insurance and pensions.

Table 2: Growth of the Retail Consumer Finance Sector in the Czech Republic

	2002	2003	2004	2005	2006
Bank Consumer Lending	1.6 billion Euro	1.9 billion Euro	2.3 billion Euro	3.1 billion Euro	4.0 billion Euro
Consumer Finance Company Lending (turnover)	15.8 billion CZK	17.6 billion CZK	23.5 billion CZK	32.5 billion CZK	41.2 billion CZK (Q1-Q3)
Life Insurance (premiums written)	34.0 billion CZK	41.1 billion CZK	44.2 billion CZK	44.9 billion CZK	47.1 billion CZK
Non-Life Insurance (premiums written)	56.6 billion CZK	64.8 billion CZK	68.4 billion CZK	70.6 billion CZK	72.8 billion CZK
Mutual Funds (assets)	3.4 billion Euro	3.3 billion Euro	3.7 billion Euro	4.9 billion Euro	5.7 billion Euro
Pension Funds (assets)	68.9 billion CZK	82.1 billion CZK	102.1 billion CZK	123.4 billion CZK	145.9 billion CZK

Sources: CNB; MOF Office of State Supervision of Insurance and Pension funds Annual Reports; Czech Consumer Association; PricewaterhouseCoopers, Overview of Retail Banking and Consumer Finance in Central and Eastern Europe, July 2004; Czech Securities Commission Annual Reports, Czech National Bank, Czech Insurers Association, Czech Leasing and Finance Association, Association of Funds and Asset Management.

Notes: Mutual fund assets refer to UCITS and non-UCITS funds in all years except 2002, which covers only non-UCITS funds. Data are presented in Euros or CZK depending on the source report.

Key Findings & Recommendations

The Czech Republic has taken considerable strides in the development of consumer protection, particularly regarding goods and services. Most of the EU Directives have been transposed into national legislation with only a few recent pieces of legislation in need of further review. As it is throughout Europe, however, consumer protection in financial services is still under development and improvements are required. While consumers have strong rights, particularly regarding consumer loans from banks, their rights are not as powerful when obtaining a residential mortgage or investing in a life insurance policy. There is also significant work to be done in improving disclosure and educating consumers to make informed choices.

Consumer Protection Laws and Institutions

Existing regulations regarding client service and consumer protection in financial services in the Czech Republic are dispersed throughout its Civil Code, Commercial Code, and other legal acts. Many laws and regulations support consumer protection. However, they fail to cover all products and services that have consumer protection issues. For instance, CNB, the integrated supervisor of the financial system, does not have an explicit legal mandate (i.e. as one of the objectives in the Law on CNB) to ensure the proper level of consumer protection in the financial sector.¹⁰

Financial supervision is also dispersed. For example, under the Act on Consumer Credit, loans to consumers are supervised by the MIT and the Czech Trade Inspection rather than a financial supervisory agency. As the integrated supervisory agency, the CNB should be responsible for supervision of all providers of financial services in the Czech Republic, including those that provide services for retail customers.¹¹

In addition, enforcement of the existing consumer protection regulation is not adequate. Although the power to obtain an injunction prohibiting activity in violation of consumer protections rules is given to governmentally-sanctioned private sector organizations, the Consumer Protection Act does not give the CNB explicit authority to stop violations of consumer protection rights. Regarding insurance, the relevant Act permits the withdrawal of licenses but there exist no other statutory remedies against individuals who violate consumer rights. As the body responsible for primary legislation in the financial market, the MOF should ensure that the CNB is equipped with an appropriate range of possible sanctions.

Similarly, provisions similar to those of the Commercial Code and the securities market laws should be in place in all other legal acts regulating the market conduct of all financial institutions, whether banks, insurance companies or pension funds. Misleading advertising by financial institutions should also be explicitly prohibited in relevant laws and regulations dealing with market conduct of such financial institutions. In addition, the CNB or its delegates should promote good advertising practices in the financial sector.

The securities laws are the most comprehensive regarding consumer protection in the Czech Republic. Regarding suitability of transactions for customers, however, the rules need to be improved. Unsuitable trades which are requested by the customer should be permitted, upon

¹⁰ Draft legislation currently under consideration would give the CNB authority related to consumer protection issues.

¹¹ Note that even if CNB were responsible for supervising all financial service providers, this would not preclude the delegation of the settlement of small claims disputes to other bodies such as CTI or the Financial Arbitrator

proper warning by the broker. However unsuitable trades initiated by a broker should be strictly prohibited.

The consolidation of financial sector supervision in the CNB significantly centralized financial supervision and provided for coordinated supervision of financial conglomerates. At the same time, responsibility for primary legislation on consumer protection in financial services was moved to MOF. Enforcement of consumer protection, however, remains with the Czech Trade Inspection (CTI) under the supervision of MIT but the CTI enforces the Law on Consumer Credit. In order to consistently apply the policy of consolidating financial sector regulation in the CNB, consumer protection in the financial sector should be transferred from the CTI to the CNB as the central supervisor for the financial sector. Alternatively the CTI could remain independent, but it should be obliged to develop extensive expertise in financial matters and strengthen its institutional capability to adequately review and investigate abuses of commercial credit. The test will be in the number of cases brought forward for prosecution. Note, however, that discussions continue in the Czech Republic as to the allocation of responsibilities for supervision of financial consumer protection.

The existing regulatory structure, in dealing only with registered and regulated entities, leaves unregistered entities free of regulation. The CNB should therefore be given authority to pursue such entities in civil courts to prevent them from continuing their activities. The CNB should also be given the authority to freeze assets of unregistered entities. Moreover, unregistered entities should have certain reporting requirements to allow CNB to monitor and obtain injunctions prohibiting activity in violation of consumer protections rules. In addition, the CNB should have the authority to refer cases to the Prosecutor-General and to assist in bringing criminal cases where appropriate.

Similar problems exist for consumer loans where some unregistered financial institutions make loans to consumers with very unfavorable terms as far as consumers are concerned, such as high interest rates and unreasonable pay-back periods. Consumer finance companies have grown to a very large size in the Czech Republic (see Table 2) but are not licensed or regulated by any governmental entity. To the extent they are regulated, it is through the MIT and CTI under the Act on Consumer Credit. As mentioned above, however, MIT and CTI are generally concerned with consumer goods and services and not financial matters. Following good practice in EU states, notably Ireland, consumer finance companies should be registered and supervised by integrated financial supervisory body. In the Czech Republic, this could be done by the CNB or another supervisory agency with expertise in financial matters.

Unregistered activity in the financial sector, particularly related to securities and lending activities appears to be an important issue. During the 2005 missions, representatives of the securities industry expressed concern to the Bank Team about investment or securities “advisors” who are unregistered and unregulated. They alleged that such advisors encourage consumers to invest funds but that the funds were not always used for the purposes intended. Market participants also noted the presence of unregistered insurance brokers who allegedly engage in similar activity. To ascertain the validity of such complaints and take appropriate action, a system should be set up to receive complaints about unregistered financial service providers. Such a system could be established by the CNB or another agency but the agency should be empowered to investigate if such claims are valid.

Sales Practices & Disclosure

The information provided to financial consumers before and at the time of signing a contract (or opening a bank account) is critical to their understanding of the terms and conditions of the contract. Consumers need, at the outset, to be able to determine the true cost of repaying a loan,

opening and maintaining a bank account and obtaining any other financial instrument—and not be surprised, for example, by any subsequent disclosure of a mandatory fee. Particularly for investments that have substantial savings components (such as life insurance and pensions), supervisory authorities need to specify minimum “fact find” documentation and “key facts” consumer awareness literature, which are given to the consumer at the point of sale and through other channels, e.g. company websites.

The Czech regulations that cover sales and disclosure provide basic protection to consumers, particularly through the existing Commercial Code and voluntary initiatives by the industry. While regulations address some of the key issues, they fall short of specifying full consumer rights in financial services. Building on past achievements regarding principles of disclosure of basic information in selling financial products and services, similar specific standards can be set, possibly jointly by the Advertising Council, MOF and CNB, to ensure that the advertisement of financial products is made significantly more informative.

For the insurance sector, the insurance supervisor should issue a regulation specifying the format of basic facts to be collected from a customer at the point of sale and how this and other promotional or sales information can be used for possible recourse in the event of dispute.

Cooling off periods are perhaps the single most important measure in protecting financial consumers from high-pressure sales tactics, particularly in the insurance and pensions sub-sectors. While cooling off periods may marginally increase costs for service providers, the provision is an important protection in building consumer confidence. Article 15 of the Insurance Contract Act allows the policy-holder to terminate the insurance policy where an amendment has been made to the contract. However apart from contracts sold from other EU member states (“distance contracts”) unqualified cooling off periods for life insurance and pensions-related contracts, as well as consumer credit, are currently not specified in the law. Cooling off periods should be made explicit and should not contain any conditions. The cooling off period should be at least one week, and preferably two weeks.

In the banking sector, existing self-regulation is to some extent filling the need for a Code of Conduct, in the form of voluntary standards issued by the Czech Bankers’ Association (CBA). Also in September 2005, the CBA adopted the EU Code of Conduct in Mortgage Lending. At the same time, the CBA issued a Banking Activities Standard and banks that are members of the Association were invited to adopt both the Standard and the Code of Conduct. Banks that have adopted the Code of Conduct are obliged to deliver within six months an official notification to the central registry kept by the European Commission.¹² However one weakness is the CBA Standard is not mandatory on the member banks and, moreover, the CBA has no enforcement powers over its membership. Consequently, these standards do not constitute a substitute for formal regulation, such as those that exist for consumer loans.

The Association of Funds and Asset Management (AFAM) has an extensive set of conduct and disclosure rules for the distribution of mutual funds. Moreover, AFAM rules are enforceable on the association's members. The Association also has a powerful ethics committee.

¹² One of the drawbacks of the EU Code of Conduct is its voluntary nature and uneven implementation across the banks in member countries. The minimum standards set by the Code, adapted if needed to reflect country-specific circumstances, merit its mandatory application in those member countries which prefer to set up at least a minimum level of mortgage buyer protection. The UK, for example, has an extensive market conduct rulebook, issued and enforced by its Financial Service Authority, which covers mortgages among all other financial products and does not seem to reduce competitiveness of its financial sector vis-à-vis competitors from other EU countries in issuing mortgages.

With regard to the securities market, decrees now enforced by the CNB cover the basic areas of advertising conduct in the offer and sale of securities. However, a provision needs to be added which specifically deals with high pressure sales tactics and cold calls. Although there is a requirement in Sections 5 of Decree 258/2004 that sales calls can only be made during the day and cannot bother the customer, this is not strong enough to prevent harassing cold calls or high pressure sales tactics.

One of the difficulties in providing effective supervision, however, is the large number of intermediaries—over 42,000 in the insurance sector and more than 9,000 for securities. Care needs to be taken so that all intermediaries receive sufficient training (and certification) to ensure they are able to fully comprehend the risks and returns and other issues related to the types of products they sell.

Account Handling

Account handling issues focus mainly on the principal-agent relationship. While there are some provisions, particularly in regulations governing the securities and insurance sectors, the regulation of agents, brokers and intermediaries in the insurance sector needs improvement. The intermediaries' regulations currently do not provide for the specific products and services that each qualification level of intermediaries can sell. Pensions-related and advanced life insurance products should require “high” level qualifications and evidence of this should be provided directly to the supervisor.

Article 28 of the Act on Insurance Intermediaries requires that a premium paid by a policyholder through an insurance intermediary is be deemed to have been paid to the insurance company. However regulations are needed to specify the rules for handling premiums and premium adjustment related cash by intermediaries. These should require that moneys should be remitted to the insurer within a specified period (typically up to 90 days in the case of brokers).

The Czech Office of Personal Data Protection has identified the provision of banking and all other financial services, including leasing, as high risk areas for unwarranted invasions privacy regarding personal financial information. Although the legal structure for consumer protection in this area is in place, the primary problem appears to be the implementation of the rules in the financial sector. In the course of its controls in 2005, the Office noted a number of violations of the data protection rules by financial institutions. Increased attention should be placed on the implementation of existing rules to improve the protection of financial information of consumers.

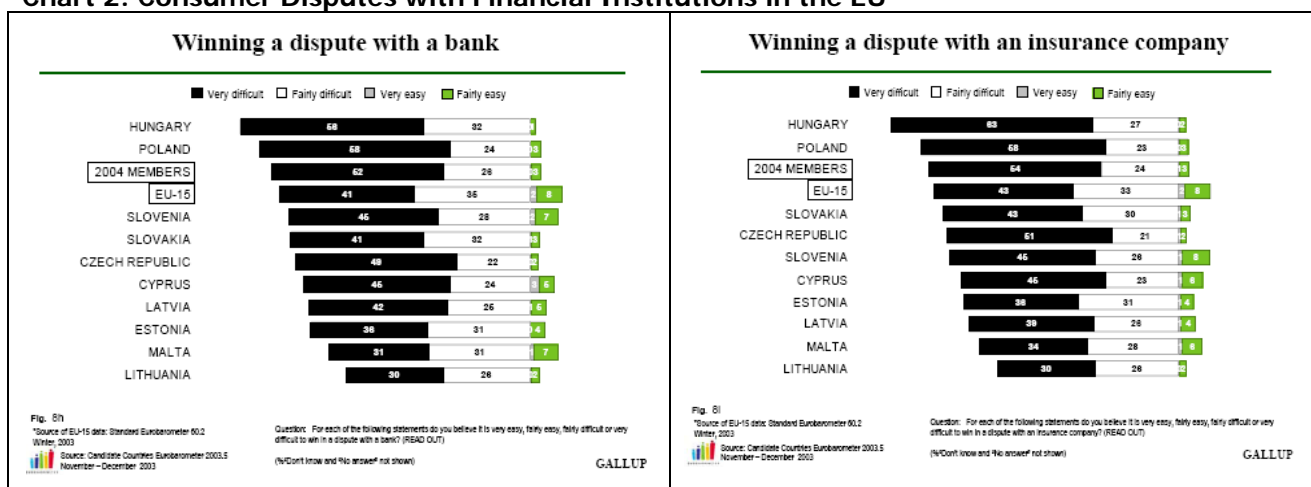
Dispute Resolution Mechanisms

Financial ombudsman/arbitrator institutions are set up with the specific purpose of easing the way for retail consumers to resolve disputes with financial firms, without requiring recourse to the more cumbersome and costly formal court system.

Eurobarometer, which examines public perceptions of financial services in EU candidate countries, identifies the most difficult task related to one's personal finances as winning a dispute with an insurance company or a bank.¹³ As shown in Chart 2, only a maximum of 9 percent of Eurobarometer survey respondents consider winning such a dispute to be easy, while roughly three-fourths think it difficult. On this basis alone, there is a need, therefore, for a financial arbitrator.

¹³ Eurobarometer, *Public Opinion in the Candidate Countries on Financial Services and Consumer Credit, 2004*, Magyar Gallup Intezet.

Chart 2: Consumer Disputes with Financial Institutions in the EU



The Czech Republic has one self-regulatory organization (the Prague Stock Exchange) and numerous industry associations, including the Czech Bankers Association, the Czech Insurance Association, the Association of Funds and Asset Management. The Czech Republic’s Financial Arbiter institution is somewhat similar to the German Ombudsman institution. The Financial Arbiter is elected by, and reports to, the Chamber of Deputies of the Czech Republic. None of these organizations, associations or institutions, however, provides the requisite mechanisms for the resolution of customers’ complaints.

For example, Article 72 of the Capital Markets Law provides for the creation of the Stock Exchange Arbitration Court which decides disputes arising from transactions on the exchange. This Arbitration Court, however, does not handle any other matters in the customer intermediary relationship unless the parties agree to allow it to do so. In addition, arbitration is expensive and not useful for claims that are modest in monetary terms. The Court has handled very few matters over the last several years. Perhaps to deal with this, Article 29 of the Membership Rules of the Prague Stock Exchange states that investors may file a complaint with the Exchange and the Exchange is then obliged to examine the complaint and inform the customer of the outcome. However, the customer has no opportunity to present a case or analyze and respond to the intermediary’s defense. Nor are there any remedies set forth for the customer if it is established that his complaint is correct. The other institutions are industry associations and are primarily engaged in lobbying for their sectors and, laudably, in improving the conduct of their members, but none of them have any mechanisms for the filing and resolution of customer complaints.

While the policy of the Government is that the Financial Arbiter should be independent, this office lacks an independent budget and, based on the Financial Arbiter Act, depends on the willingness of the CNB to cover its expenses. All fines from financial firms which are in breach of the Financial Arbiter’s Act are collected by it and then turned over to the CNB. This financing arrangement should be replaced with the financing of the Arbiter by all financial firms covered by the Arbiter’s mandate. Attention should also be paid to accountability of the Arbiter. The office of the Financial Arbiter would benefit from the establishment of a governing board to ensure its independent governance and accountability.

The jurisdiction of the Financial Arbiter is currently limited to certain types of payment cases. It should be given increased powers to hear complaints in the financial sector in all areas supervised by the CNB. This would require changes to the statutory authority of the Financial Arbiter. Also, the additional responsibilities of the Arbiter as ombudsman would require additional funding, which should be provided from fees levied on industry participants. (See Annex III for a summary of funding for the United Kingdom’s Financial Ombudsman.)

Boxes 1: German Bank Ombudsman¹⁴

Germany's private commercial banks voluntarily introduced an out-of-court conciliation procedure--the Ombudsman Scheme--in 1992 under the auspices of the German Banks Association (GBA) to settle disputes between banks and their customers as quickly and smoothly as possible. The Ombudsman Scheme is the centerpiece of the private commercial banks' overall consumer policy concept, which rests on three pillars: prior information, transparent contract arrangements and out-of-court dispute-resolution facilities.

The Ombudsmen are five respected former judges and judicial system officials, selected by the GBA, with a no-objection input from consumer protection organizations. The Ombudsman scheme's activity is delineated in the Rules of Procedure approved by the German Federal Ministry of Justice.

The benefits of this modern dispute-resolution scheme are numerous:

- It is free of charge to bank customers.
- If customers do not accept the Ombudsman's decision, they are still free to go to a court of law. The banks are obligated to accept Ombudsman decisions in disputes involving amounts up to € 5,000. Experience has shown that banks also usually accept Ombudsman decisions against them even where disputes involve amounts exceeding € 5,000.
- The complaint resolution procedures are widely accepted, effective, quick, and non-bureaucratic.

Compensation & Guarantee Schemes

Although compensation and guarantee schemes may give rise to consumer protection issues in some countries, they are not a source of concern for consumer protection in the Czech Republic.

Consumer Education & Financial Literacy

Consumer protection agencies aim to provide all consumers with basic information on their rights and recommendations on further steps they can take to obtain further information. Since 1993, the Czech Consumer Defense Association (SOS) has published its own magazine called "Shield of Consumer," leaflets, brochures and CD-ROMs and runs a website "World of Consumer¹⁵" in Czech as well as English, French and German languages. It also comments on draft laws and existing laws on consumer protection. Importantly, it strongly supports consumer education. All international consumer issues have to be addressed to the Association, since it is a member of Consumers International and the European Consumer's Organization (BEUC). In practice SOS is oriented to small retail transactions.

In 2005, another consumer organization, the Czech Consumers Association, initiated a wide-coverage campaign entitled "Read before you sign!" with the objective to warn consumers of the risks arising from paying inadequate attention while signing important documents with legal and financial implications, particularly in relation to financial services (consumer credit, mortgage etc.).

¹⁴ A comparison of ombudsman systems in Germany and the UK is presented in Annex III.

¹⁵ <http://www.spotrebitele.cz>

However human resource capacity remains limited. The Consumers Association appears to be largely concerned with the activities of small businesses and issues of products and services, and needs further capacity to deal adequately with complex financial matters, including securities, loans, insurance and pension products.

In view of the fact that consumer protection organizations are primarily financed by public funds, the government could use its resulting leverage to direct some activities of these organizations towards stronger involvement in financial services consumer protection. The MIT and MOF should cooperate in funding programs, to be implemented by consumer protection NGOs, which directly address consumer protection in financial services.

Financial advice is a key ingredient in the consumer education framework. Consumers should have access to information and advice on the choice of bank products not only from banks (which will always face a conflict of interest when advising consumers), but also from independent third party counselors. Public agencies, such as the Czech National Bank, the Financial Arbiter, and non-governmental organizations such as consumer protection organizations are all potential outlets for independent information and advice, written in easy-to-understand language and terminology in the form of pamphlets, information sheets, etc. Their work will be supplemented by private financial counseling once the latter grows into a self-supporting profitable line of business, providing customized advice for individual consumers. The public agencies should ensure broad dissemination of educational material for consumers, for example, through their websites, TV and radio, or by distributing the material through branches of financial institutions. (Note that individual counseling should be left for properly trained financial planners, a profession still in the early stages of development.)

To date, various initiatives have been organized by consumer associations, the Czech Banking Association, the Czech Securities Commission (part of the CNB from April 2006), the securities market trade associations, and government agencies, with the Ministry of Finance taking the lead. However, information from financial service providers and regulators on specific products and services can not substitute for basic understanding by consumers of personal financial management and planning. These skills need to be acquired from early youth. Schools and universities, supported by the financial industry, should be the prime providers of financial education for the growing generations of consumers of financial services. These providers should include personal financial management/planning issues as an integral part of their general/social studies curricula.

In the securities market, there have been a number of good initiatives spearheaded by the former Czech Securities Commission. The program for securities investor education was very well conceived and executed and should be continued. The agency regularly published information and educational material regarding the capital market and a range of notes and warnings, including a list of persons that the agency identified as providing investment services without appropriate authorization. Information, press releases, and warnings provided by foreign regulators were also placed on its web site. In addition various other publications and public broadcasts (discussed in detail in Annex II) provided useful learning channels. The agency was actively co-operating with professional organizations that represent participants in the capital market. The agency established a Help Desk and a toll free number for the public. (The telephone number remained available after the Securities Commission was merged into the CNB).

By contrast, there appears to be no effective public education in the insurance sector, although the basic law does provide scope for the CNB to take on this role (Art. 6a (e)). More should be done, particularly for insurance products that involve savings components.

Several industry-led initiatives could also improve consumer education. The CBA should contribute to higher consumer awareness by preparing information packages on the main groups of banking products, e.g., mortgage loans, consumer loans, and credit cards. The Association of Insurance Companies should similarly prepare information packages on different types of insurance to be made available to consumers through the internet, print media, radio, TV and in the branches of insurance companies. An insurance-industry funded public education program should be developed that concentrates on schools and deals with the role and benefits of insurance in a modern economy as well as with consumer rights.

In addition, more could be done by the mass media. The financial press informs consumers about the workings of financial markets and their rights in these respects. As in many countries, the press in the Czech Republic is subject to considerable pressure from the advertising departments of major financial institutions. (If the press prints an unfavorable article about a subject, company or financial institution, the fear of the press is that the institution will withdraw its advertisement and thus its all-important revenue in retaliation.) Nevertheless the press plays an important role in highlighting abusive practices in the financial markets. Journalists should be encouraged to develop additional expertise in financial issues in order to strengthen the impact of their reporting and help consumers to become familiar with their rights regarding financial matters.

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Annex I: Summary of Recommendations

Consumer Protection Laws and Institutions

- Provisions, similar to those of the Commercial Code and the securities market laws, should be in place in all other legal acts regulating market conduct of financial institutions, including banking, insurance, and pension funds, as well as for lending products.
- All consumer protection responsibilities in the financial sector should be transferred from the MIT and CTI to the CNB as the centralized regulator for the financial markets or to a newly established entity with adequate enforcement powers and funding. Alternatively the CTI could remain independent, but it should be obliged to develop extensive expertise in financial matters and strengthen its institutional capability to adequately review and investigate abuses of commercial credit. Consumer finance companies should be registered with the CNB.
- The CNB should be given authority to pursue unregulated entities in civil courts to prevent them from continuing their activity. The CNB should be given the authority to obtain the authority to freeze assets and obtain injunctions prohibiting activity in violation of consumer protections rules. The CNB should also have the authority to refer cases to the Prosecutor-General and assist in bringing criminal cases if appropriate. Moreover, these entities should have certain reporting requirements to allow CNB to monitor and analyze the whole financial market.

Sales Practices & Disclosure

- Full disclosure of financial products information before and at the point of sale should be formalized in the legislation and made mandatory for all sellers of retail banking products.
- Specific standards should be established---possibly jointly by the Advertising Council, MOF and CBA--CNB for advertisement of financial products which should, at a minimum, mandate disclosure of a source of full information (e.g., a bank's or insurer's webpage) on the advertisement message in every such advertisement.
- Truthfulness and accuracy of advertising by financial institutions should be explicitly required in all relevant laws and regulations dealing with market conduct of financial institutions. Provisions similar to those of the Commercial Code and the securities market laws and regulations should be put in place in all other legal acts regulating market conduct of individual financial sub-sectors, including the banking, insurance, and pension funds industry.
- Regulations should specify the “fact find” documentation and “key facts” consumer awareness literature to be given at the point of sale for life insurance and pension contracts as well as for investment products. This should include information on consumer recourse and cooling off periods.
- All promotional and illustrative material provided to a client by a financial institution or an agent (of any kind) should be deemed to be part of the insurance contract for determining the terms of sale with the consumer.
- For all financial products and especially where pensions-related and life insurance products with substantial savings components are involved, the intermediary should be required to disclose the commission or other forms of remuneration to the consumer upon request.
- The basic facts collected from a customer at the point of sale should be available to a court of law for at least 10 years after the contract is concluded.
- Cooling off periods for savings-type life insurance and pensions-related contracts, as well as consumer credit, should be specified in the law. Non-conditional cooling off periods should be available to the consumer. The cooling off provision should have no conditions attached to

it and simply provide for the parties to reflect on the contract after the intensity of the sales pitch. The cooling off period should be for at least one week and preferably two weeks.

- Regulations should protect the public from high pressure sales tactics and cold calls, creating a “do-not-call” list which allows consumers on a prior basis to refuse consent to cold calls.
- Securities regulations should require that brokerage houses, which are engaged in telemarketing/distance marketing, electronically record all communications with clients.
- Brokers should be prohibited from initiating unsuitable trades. A broker should not be allowed to accept orders from someone about whom he has no or insufficient information.

Account Handling

- Regulations should be promulgated specifying the rules for the handling of premiums and premium adjustment related cash by intermediaries. These should require that moneys should be remitted to the insurer within a specified period (typically up to 90 days in the case of brokers).
- Detailed regulations regarding the closing and transfer of accounts should be established to protect customers from delays in closing accounts and receiving their assets.
- A regulation mandating order tickets and the time stamping of orders would assist the CNB in conducting its inspections and audits of securities broker activity.
- Increased attention should be placed on ensuring the privacy of the financial information of consumers.

Dispute Resolution Mechanisms

- The Financial Arbiter should be given powers to hear and resolve complaints on any issue dealing with retail consumers in the financial sector.
- The current funding arrangements should be replaced with the financing of the FA by the professional financial firms covered under the FA’s mandate.
- A governing board of the Arbiter should be established to ensure its independent governance and accountability.

Compensation & Guarantee Schemes

- Compensation funds should be discouraged. However if they are in place, they should be designed so as not to distort the effective functioning of the market.

Consumer Education & Financial Literacy

- The capacity of consumers associations to deal with complex financial matters, including securities, loans and insurance and pensions should be strengthened. The MIT and MOF should cooperate in funding programs, to be implemented by consumer protection NGOs, which directly address consumer protection in financial services.
- The public agencies should ensure broad dissemination of educational material for consumers – e.g., through their websites, print, TV and radio, or by distributing the material through branches of financial institutions.
- A public education program should be developed with funding from the financial industry. The program should concentrate on schools and deal with the role and benefits of insurance in a modern economy and on consumer rights.

Annex II: Detailed Evaluation of Consumer Protection in Financial Services

Banking

Consumer protection in banking typically starts with enacting a set of prudential regulations and installing a deposit protection framework. The prudential and deposit protection regulations, however, are first of all geared to protect bank depositors and lenders. Bank lending side customers need a different set of market conduct rules regulating banks' relationship with the borrowing clients. For instance, in the US, which has the biggest and deepest mortgage market in the world, the purchase of a home is recognized as the most important and expensive financial decision for most of the US population, with laws that require full disclosure of the terms of those loans. The market conduct concepts and laws include Truth in Lending, Truth in Savings, Real Estate Settlement Procedures Act, Equal Credit Opportunity Act, Community Reinvestment Act, Home Mortgage Disclosure Act, Expedited Funds Availability Act, Right to Financial Privacy Act, and Fair Credit Reporting Act.

Consumer Protection Laws and Institutions

Existing Procedures and Practice

Certain types of relationships between the lenders and their clients in the Czech Republic are regulated by a number of legal acts, including the Commercial Code (current and deposit accounts, credit contract), the Civil Code (loan contract), the Acts on Banks and Payments System, etc. The Commercial and Civil Codes do include some consumer protection provisions (on credit contracts and some of banks' products). However the Codes do provide comprehensive provisions on consumer protection issues. The only product-specific legislation in the banking area which refers to market conduct issues (e.g., specific disclosure of annual percentage rates in consumer credit contracts) is the Act on Consumer Credit. In the area of complaint resolution, the Financial Arbitrator Act established the Financial Arbitrator Office in 2003 to settle disputes between financial firms and their customers (see more on FA and Dispute Resolution Mechanisms).

The Ministry of Industry and Trade (MIT) is the main governmental body in charge of general consumer protection policy and implementation while since April 2006 MOF has been responsible for consumer protection legislation in financial services. The Czech Trade Inspection (CTI) is the administrative/supervisory authority subordinated to the MIT. The activities of both institutions cover primarily manufactured goods and their quality issues. While CTI is responsible for the enforcement of the Act on Consumer Credit regarding consumer loans, it is not clear if CTI is responsible for enforcing the Act's provisions as they relate to other parts of the financial services sector. Furthermore, the Law on Consumer Credit does not cover other major bank retail products, such as mortgages, credit cards, and savings products. In addition, CTI has not been active in addressing consumer protection issues. While CTI has recently visited bank branches and inspected consumer lending and foreign exchange transaction practices, the level of CTI involvement in complaint resolution between banks and their customers has generally been low.

In addition CNB, as the integrated supervisor of the financial system, does not have an explicit legal mandate to ensure proper level of consumer protection in the financial sector, that is, consumer protection is not one of CNB's objectives under the Law on CNB. Self-regulation is somewhat filling this gap, in the form of voluntary standards of conduct issued by the Czech Bankers' Association (CBA) or by the Association of Funds and Asset Management (AFAM) for mutual funds or by the Association of Pension Funds of the Czech Republic (APF CR) for

pension funds. However, neither the CBA standards are mandatory on the membership, nor CBA has any enforcement powers on its membership. While the work of the CBA is a welcome attempt to set minimal service and consumer protection standards, CBA's activities are not a substitute for formal regulation. AFAM rules are enforceable on the association's members. The Association also has a powerful ethics committee.

Recommendations

The legislation should be amended to consolidate all consumer protection responsibilities for financial services into the CNB or a separate institution.

Sales Practices & Disclosure

Existing Rules and Practice

Good disclosure of financial product terms and conditions, especially in the area of mortgage loans (which usually are the largest financial products available for consumers), is crucial in order to reduce the informational asymmetry between the lenders and the borrowers and allow the borrowers to make an informed choice. In order for the consumers to understand the true costs of mortgage and other longer term loans, and be able to compare the mortgage and other consumer lending products across the competing lenders, a uniform way of disclosing relevant information is needed. Special attention should also be paid to the disclosure for long-term savings and investment products used for building retirement security. As retirees will be ever more dependent on these products, the government must ensure people understand the nature, terms and conditions, returns, and risks of these products fully and that there are no hidden facts that might endanger the financial health of the future retirees.

The Law on Consumer Credit is based on the existing EU Consumer Credit Directive and lists the principal disclosure items, such as the APR, interest rate changes, and the right for pre-payment, in a credit agreement. Czech Trade Inspection is the enforcement agency under the consumer credit legislation.

As for the disclosure of redress procedures, banks inform consumers about their complaint resolution procedures pursuant to the Act on Payment System (124/2002 Coll., Article 7, par. 1e), mentioning a possibility for consumers to refer to the Office of Financial Arbiter. Pursuant to the Act on Insurance Contracts (Article 66, 37/2004 Coll.), insurance companies must inform their clients about complaint procedures of the insurer, including the right of the customer to contact CNB.

Advertising of bank services and products falls under the general legal framework which regulates advertising across the economy, e.g., the Act on Regulation of Advertising, the Code of Advertising issued by the Czech Advertising Council, the Consumer Protection Act, and also the Radio and Television Act. All relevant EU Directives in this area also apply. The Czech Commercial Code and some other financial sector legal acts, such as the Act on Undertakings on the Capital Market and Decree 429/2004 on Conduct of Business for Investment Intermediaries are specific about prohibition of misleading advertisement. On the other hand, the Act on Regulation of Advertising, while quite specific on certain areas, such as food and health products-related advertising, has no special provisions on financial services. Moreover, the Advertising Council has no enforcement powers and lacks sufficient expertise to deal with advertising of financial products.

In addition, the Czech banking community has attempted to establish a set of minimum standards in the client relationship area, which also includes sales and advertisement, by adopting the

voluntary *Code of Conduct on Relations between Banks and Clients*. The voluntary code is an industry-led transposition to improve disclosure practices to consumers.¹⁶ In general, such self-regulation in a largely unregulated market conduct area of the industry should be continuously supported and encouraged by the Czech National Bank, as the prudential supervisor, and the Ministry of Finance. As of April 2006, 10 banks had decided to adopt the Code, and 4 banks have already started using it in practice. However, there should be certain minimal requirements for such codes, especially setting self-regulatory requirements above legal minimum standards (or defining minimum standards when there are no legal rules) and having clear and effective procedures on enforcement of the rules.

The *Code of Conduct on Relations between Banks and Clients* is voluntary and no independent enforcement is foreseen. If a bank client is not happy with a bank service/product and feels that the voluntary Code was breached, s/he can file a claim with the Czech Bankers' Association. However, the Code does not foresee any further action, and it is unclear what enforcement measure the CBA could undertake in such case. This highlights the necessity of a full-fledged Financial Arbiter which would deal with consumer complaints unresolved between the consumers and firms and be the enforcer of the standards of service.

In practice, banks provide fairly extensive information on their products and services, both on their websites and upon new clients opening an account with them. For instance, Ceska Sporitelna, Hypotecni, and Komerčni banks have exemplary clear and extensive information on their websites on mortgage and other products, including complaint resolution procedures. A few smaller banks have less information on their websites, but it is still nevertheless adequate for consumers to find the basic data on the nature of products and services.

In September 2005, the banking industry of the Czech Republic – the first among the new EU10 member countries -- has agreed to introduce the concept of a standard information disclosure form, along the lines of the benchmark EU-wide ESIS (European Standardized Information Sheet). The APR disclosure lies at the core of any such disclosure. The Czech Banking Association has issued the Standard of Banking Activities 18/2005 which introduced the EU Code of Conduct in the banking system. As of late February 2007, all six building-savings banks and eight commercial banks publicly acceded to the Standard/Code, with proposed implementation mostly in early 2007. Top mortgage players have adopted the Standard, with the exception of two major banks, Ceska sporitelna and Komerčni banka. However, both banks provide on their websites fairly extensive information on their products and services.

Disclosure for residential mortgages has generally been weaker than that of consumer credit. The voluntary EU Code of Conduct in mortgage lending has been in existence for several years but has not been fully applied in the Czech Republic, although Czech banks have been extending mortgage loans since 1995. Furthermore a review by the EU commission of the implementation of the voluntary Code found that the Code was not implemented and adhered to satisfactorily, both in terms of the quantity of subscribers and the quality of adherence.

On balance, retail lending in the Czech Republic has generally been tipped to the mortgage lending side – the latter makes about three quarters of the total retail lending.¹⁷ Nevertheless the existence of a law and an enforcement agency to regulate consumer lending contrasts quite sharply with voluntary self-regulation in the area of mortgage lending with no rules to be enforced by any effective agency. This reflects the situation with the EU legislation, where the Consumer Credit Directive regulates consumer lending.

¹⁶ http://ec.europa.eu/internal_market/finservices-retail/home-loans/code_en.htm

¹⁷ Czech National Bank data (2006)

Recommendations

The efforts of the authorities and bankers should be focused on full disclosure of financial products information at the point of sale. Such disclosure would serve consumer interests better if it was formalized in the legislation and made mandatory for all sellers of retail banking products.

The EU's voluntary Code of Conduct in mortgage lending should be adopted by all banks in the Czech Republic. The CBA should also take care to explain the effects of the Code to the public. Also the Code should be formally supported by the CNB.¹⁸

The Financial Arbiter should be converted into a full Financial Ombudsman with a wide mandate than it currently has. This will require changes to the statutory authority of the Financial Arbiter. It will also require additional funding, which should be provided by members of the financial industry. (See Annex III on approaches used for funding the United Kingdom's Financial Ombudsman.)

Misleading advertising by financial institutions should be explicitly prohibited in all relevant laws and regulations dealing with market conduct of such financial institutions. Provisions similar to those of the Commercial Code and the securities market laws and regulations should be in place in all other legal acts regulating market conduct of individual financial segments--banking, insurance, and pension funds as well as for all lending products.

Following on the principles of disclosure of basic information in selling financial products and services, there may be some merit to set more specific standards, e.g. established jointly by the Advertising Council, the MOF and CNB with input from the industry, for advertisement of financial products, in order to make such advertisement more informative. The standards could, at a minimum, mandate disclosure of a source of full information (e.g., a bank's website) on the advertisement message in every such advertisement. However, any additional new formal regulation of such type should be carefully weighted against the burden of a higher level of bureaucracy and barriers for business.

Account Handling

Existing Procedures and Practice

The Czech Office of Personal Data Protection has identified banking and the entire sphere of provision of financial services, including leasing as high risk areas for privacy of personal financial information. Although the legal structure for consumer protection in this area is in place, the primary problem appears to be the implementation of the rules in the financial sector. In the course of its controls in 2005, the Office noted a number of violations of the data protection rules by financial institutions. Consent by the consumer for transfer of information was considered flawed because when obtaining consent to transfer of banking information, the banks often violated the law, "particularly by combining and obscuring information on the purposes, scope and transfer of personal data of their clients in the general terms and conditions." Although the

¹⁸ One of the drawbacks of the EU Code of Conduct was its voluntary nature and uneven implementation across the banks in member countries. The minimum standards set by the Code, adapted if needed to reflect country-specific circumstances, merit its mandatory application in those member countries which prefer to set up at least a minimum level of mortgage buyer protection. The UK, for example, has an extensive market conduct rulebook, issued and enforced by the FSA, which covers mortgages among all other financial products and does not seem to reduce competitiveness of its financial sector vis-à-vis competitors from other EU countries in issuing mortgages.

legal structure for consumer protection in this area is in place, the primary problem appears to be the implementation of the rules in the financial sector.

Recommendations

Increased attention should be placed on the implementation of existing rules to improve the protection of financial information of consumers.

Dispute Resolution Mechanisms

Existing Procedures and Practice

Some banks in the Czech Republic have internal ombudsmen, but their function is primarily internal to that bank's operations. A Financial Arbiter for the banking sector was established in 2003 as a result of the need for Czech Republic, as an EU member, to have an out-of-court dispute resolution mechanism for payment disputes. Jurisdiction of the Financial Arbiter is, however, very limited. The Arbiter's office can only hear matters related to payments transactions (e.g., length of inter-bank payments) and electronic payment instruments (e.g., debit and credit cards and online payments). Hence, most retail financial services issues--such as mortgage and consumer loans, bank fees, deposits, insurance or investment products--are outside the Arbiter's jurisdiction.

One weakness is that the Czech Financial Arbiter's Office has no independent budget and, based on the Financial Arbiter Act, relies on the willingness of the Czech National Bank to cover the proposed expenses. All fines collected by Arbiter (from the covered financial firms which are in breach of the Financial Arbiter's Act on their duties to the Arbiter, as opposed to the fines set by the Arbiter in favor of the plaintiffs) are revenues of the CNB.

In addition the Czech Financial Arbiter is elected by the Czech Parliament. The Financial Arbiter has no governing board, which is needed to scrutinize the effectiveness of the Arbiter and establish public accountability for the Arbiter's operations.

Recommendations

Financial ombudsman/arbiter institutions are set up with a specific purpose to ease the way for retail consumers to resolve disputes with financial firms, by avoiding formal court system which is more cumbersome and costly for individual consumers to refer to. Financial ombudsman or arbiter institutions have an inherent advantage over the court system in that they are specialist institutions dealing solely with financial sector products and services, thus allowing for shorter dispute resolution time. With the Financial Arbiter office already set up in the Czech Republic, it should be expanded into an ombudsman office given broad powers to hear complaints in the financial sector. Broad powers and jurisdiction would make the Financial Ombudsman relevant in the modern Czech consumer protection framework. This could be modeled on the Financial Ombudsman Service (with specialist sections) set up in the UK. See also Annex III for more on financial ombudsman best practices in the UK and Germany. The financing arrangement for the Ombudsman should be based on fees paid by the financial firms covered by the Ombudsman's mandate. It would be helpful if a governing board was established for the Ombudsman and strong accountability rules were put in place.

Compensation & Guarantee Schemes

Deposit Insurance Fund (DIF, more at <http://www.fpv.cz/index00en.html>) of the Czech Republic was set up in 1994. It is managed by a Board of Administration appointed by the Minister of Finance. The DIF is well established and has proved its performance capabilities during the 13 years of operations. It has so far disbursed compensations in 16 separate cases to depositors of 12 banks, of which disbursements in 5 cases are still ongoing, among them the largest case in DIF history – Union banka. The maximum compensation level of €25,000 exceeds the minimum EU-recommended level of €20,000.

The insurance provided by DIF applies to all receivables from deposits in the Czech or foreign currencies, including interest. The insurance also applies to all receivables which are registered as a credit balance on accounts or in passbooks, or which are endorsed through a deposit certificate or other similar documents. Insurance does not apply to receivables from bank deposits, financial institutions, health insurance companies, and state funds. The system of insuring receivables from deposits does not apply to bills of exchange and other securities or any deposits considered to be part of bank capital.

Compensation for an insured receivable from a deposit is granted both to natural and legal persons up to an amount equal to 90 percent of all insured deposits made by one depositor with one bank, the maximum amount being, however, an equivalent of €25,000.

Deposits of clients at branches of foreign banks with a single license have been insured in the relevant system of the home state. The terms and conditions of insuring deposits of these states are based on the law of the European Community. A foreign bank is obligated to provide depositors with information about the system of insuring deposits, including the size and scope of coverage provided by the system of insuring deposits in which the bank and its branches participate.

Recommendations

There are no specific recommendations.

Consumer Education & Financial Literacy

In the banking sector, banks themselves provide a lot of information on the products and services they sell, both through written material and by advising clients as they seek the products and services. New bank clients receive informational packages with detailed descriptions of the products and services. Also, banks to a certain extent advise their retail borrowers on the available choices of mortgage and consumer loans, and on implications of one or another borrowing decision.

Recommendations

As financial products become more complex, banks should establish or support long-term educational projects that assist customers in understanding their options and improve their ability to plan their personal finances.

Securities

Historically, consumer protection in securities area has developed somewhat differently than in banking. Bank customers in most countries enjoy deposit protection and strong prudential supervision of banks – factors that create a solid safety net for the customers. On the other hand, investors in securities are not guaranteed any returns, and hence, on average, are usually more sophisticated and financially educated than average bank customers. The most important market conduct regulations protecting the investors are those dealing with disclosure of a variety of investment information by industry intermediaries.

In general, the consumer protection for securities account holders in the Czech Republic is quite good. This is largely due to the promulgation of numerous decrees to implement the new AUCM and to meet European Union guidelines in the capital markets. The major area that needs development is the area of non-judicial resolution of disputes regarding activities in securities accounts. This review strongly recommends the expansion of the role of the Financial Arbiter to cover securities accounts disputes along the lines of UK financial ombudsman set up by the Financial Services and Markets Act of 2000.

Consumer Protection Laws and Institutions

Existing Procedures and Practice

Many of the protections for customer protection for securities are contained in the law and the regulations that are administered by the securities supervision division of the CNB, the Act on Undertakings on the Capital Market (AUCM), N. 256/2004, the Act on Collective Investment N. 189/2004, as well as by different Decrees implementing the provisions of these Acts, particularly Decree 258/2004. In addition, other venues exist for investors to obtain information and redress for securities related matters, such as arbitration procedures and, to a limited extent, procedures for redress with the Financial Arbiter. With the integration of supervisory agencies, all decrees of the Securities Commission are considered to be decrees of the CNB.

Recommendations

The legal structure for the securities market is generally well developed in the area of consumer protection.

Sales Practices & Disclosure

Existing Rules and Practice

Under Section 15.2 of the AUCM, a securities dealer may not use in his promotional material any untrue or misleading information, may not conceal any important facts, and may not offer any benefits whose reliability he can not guarantee. The dealer that breaches these obligations is liable for damages.

Decree N. 258/2004 Section 22 further stipulates the rules for promotion of services by an investment firm which are in compliance with the Section 15.2 of the Act on Undertakings in the Capital Market (AUCM):

- the form of promotion must be in *clear words* and state which service is being offered and who offers it;

- the promotion must include a notification of risks associated with the provided services or investment instrument;
- the promotion can not include numerical estimates or projections of future revenues;
- the information in the promotion can not cause an impression that the investment services provided by the investment firm are a form of collective investment, a form of bank deposit, a form of pension supplementary insurance or insurance on special regulations;
- information on Guarantee Fund, or on the CNB or other financial market supervising authorities, cannot cause an impression that the revenues or recovery of the investment are guaranteed; neither can such information cause the impression that these institutions recommend the investment;
- direct promotions to clients should be done exclusively on working days from 8 am to 7 pm through the investment firm employees; and
- an investment firm must store, for a period of 3 years, records of clients addressed in promoting its services.

Decree No. 258/2004 Section 1 requires that a broker take into account a customer's individual condition in dealing with a customer. Presumably, this means that a broker must determine if an investment is suitable for a customer before recommending it. This is reinforced by Section 3(2) of the Decree, however it does not forbid the broker from executing the trade, but only requires that the broker disclose that the trade is unsuitable.

Decree No. 429/2004 on investment intermediaries' conduct of business rules specifies ground rules for advertising of investment services. Section 5 of the Decree mandates the intermediaries to ensure clear, fact-based advertising material which does not mislead in any way. The risks have to be clearly stated, while any reference which could create an impression of a guarantee of the investment should be strictly avoided.

In general, advertising by issuers is also regulated by the Commercial Code in Sections 44 and 50a, since the CNB in most cases does not supervise issuer activities not related to the offering of securities. Under these norms, comparative and misleading¹⁹ advertising are forbidden, as well as a conduct contributing to mistaken identity, manipulative use of the reputation of another competitor's enterprise, products or services, bribery, disparagement, violation of trade secrets are also forbidden under Section 44.2 of the Commercial Code.

Disclosure duties of investment intermediaries and investment firms (securities dealers) are also regulated by the AUCM in Sections 16, 29-32. No later than one month after the end of a calendar quarter, a securities dealer must notify CNB of:

- its economic situation;
- the types and scopes of investment services provided;
- all regulated markets, including foreign markets, and individuals/entities through whom it carried out customers' instructions, and any benefits received;
- transactions carried out or procured through regulated markets or other individuals/entities; and
- the volume of its customers' assets.

Part 2 of Decree No. 258/2004, as well as Decree 429/2004, stipulate in detail the rules of conduct of an investment firm in relation to its clients. An investment firm shall be obliged, among other notifications to the client:

¹⁹ The forbidding of misleading advertising is also a subject to the Consumer Protection Act, as well as to the Radio and television Act of the Czech Republic.

- to notify the client, prior to concluding a contract or accepting an order, and subsequently at any time on request, of the current rate or price of an investment instrument on regulated markets,
- demonstrably notify the client of the potential risks that could be associated with the requested service or order and of the potential hedging against these risks,
- notify the client that the anticipated or potential revenues are not guaranteed and that there is also no guarantee of recovery of the invested amount,
- notify the client of new facts that could materially affect an order that has not yet been executed,
- notify the client of any delay in settlement of a transaction and the reasons for this delay

Recommendations

The CSC/CNB decrees cover the basic areas of advertising conduct in the offer and sale of securities. However, a provision needs to be added which specifically deals with high pressure sales tactics and cold calls. Although there is a requirement for sales call to be placed only during the day in Sections 5 of Decree 258/2004 and not to bother the customer, the Decree by itself fails to prevent harassing cold calls or high pressure sales tactics. For example, the Czech rules do not provide for the creation of a do-not-call list which allows consumers on a prior basis to refuse consent to cold calls as provided in the regulatory structure in the United States administered by the Federal Trade Commission and applicable to securities sales as referenced in NASD Manual Section 2212. In addition, regulations should require that brokerage houses electronically record all communications with clients that refer to the consent to the call. As to suitability, the CSC/CNB may want to permit solicited unsuitable trades upon proper warning by the broker. However, unsolicited trades that are unsuitable should be strictly prohibited.

Regarding brokers, the AUCM and related Decrees generally cover the internationally recognized standards for disclosure of information by issuers. No major recommendations in this area.

Account Handling

Existing Rules and Practice

Under the AUCM an investment firm must point out to the client important facts connected with a deal while concluding a customer agreement.

An agreement between an investment firm and a client must contain a notice that the investment firm will refuse to provide the required service or part thereof if there is a danger of conflict of interests between the investment firm and the client or between one client and another, and a notice that the investment firm does not execute an order if the market could be manipulated due to its execution.

The account agreement or related documents should also disclose all methods of remuneration to the broker and the procedure for lodging complaints regarding the handling of the account.

Section 3(1) of Decree 258/2004 permits an intermediary to request information regarding a customer to determine their suitability for transactions. This is, however, not mandatory. The customer is not obligated to answer the questions. The consequence of failure to provide information by the customer is not clear, and it appears that the customer he can still open an account and trade.

Under Section 13 of the Decree N 258/2004, an investment firm that is not a bank or a branch of a foreign bank must keep cash funds belonging to clients in at least one bank account in which it does not keep its own cash funds. This firm must use cash funds belonging to a client to settle transactions with investment instruments concluded for the client and its own cash funds to settle transaction concluded on account of the investment firm.

Under Section 110 of the AUCM, investment instruments may be registered in customer accounts only where the account holder entered into an agreement for the custody of investment instruments. Moreover, the holder of customer accounts has to provide for separate management of cash funds belonging to clients from the management of its own cash funds. Without the consent of the customer, the holder of his accounts may not transfer investment instruments to a new owner. This section will become relevant only after the central depository will be licensed.

Under Decree 258/2004, an investment firm has to notify the client, prior to concluding a contract or accepting an order, (1) of the current rate or price of the subject investment instrument on regulated markets or (2) of the rate or price for which the investment instrument was last traded, if the investment was not been traded on regulated markets. In addition, the firm must notify the client of all material information that might influence his decision to buy or sell the security.

The firm must inform in writing the client accurately and without delay about deals concluded for him and of any use of investment instruments of the client. An investment firm must notify the client in writing at least once a year of the strategy of management of the client's portfolio.

The investment firm must also provide the client with a confirmation statement regarding the terms of a buy or sell transaction or explain why the transaction was not completed.

Recommendations

Generally, this area is well handled. However, the issue of suitability of a customer for the desired transactions is vague. The consequences of failure to give information by the client should be clear. The broker should not be allowed to accept orders from someone about whom he has no or insufficient information.

The regulation regarding accounting handling is comprehensive. However, detailed regulations regarding the closing and transfer of accounts would be useful to protect customers from delays in closing accounts and receiving their assets. In addition, a regulation mandating order tickets and the time stamping of orders would assist the CNB in conducting its inspections and audits of broker activity.

Dispute Resolution Mechanisms

Existing Procedures and Practice

Under the AUCM and Decree 258/2004, Section 14.2, securities dealers and investment companies which have licenses to manage clients' assets on the basis of contracts must notify their clients of the main principles of dealing with claims and complaints. This includes the manner of lodging a claim or complaint, the department and employees that are to receive them, and the deadlines for lodging the complaint. Dealers and unit trusts are also obliged to keep records of claims and complaints. According to the Collective Investment Act No. 189/2004 Coll., Section 75.4, and Decree 347/2004, Section 3.1.g, investment companies and investment funds must set, by means of internal regulations, administrative procedures relating to the internal

operation of the company. This includes the procedure for handling investor complaints and claims.

After the service provider, pursuant to his obligation, deals with a client's complaint and the client remains unsatisfied, he can ask the CNB to look into the complaint which is the most common procedure. If the complaint resolution goes beyond the powers of the CNB, then the client can file a civil complaint with a court. Alternatively, s/he can also approach the Czech Police, if s/he has suspicion that a criminal offence has been committed. Arbitration is also available. The Prague Stock Exchange's (PSE) rules were recently amended to allow arbitration for all claims.

A Financial Arbiter has been established, but with a very limited jurisdiction. He can only hear matters related to payments and payment cards, so most securities matters are outside his jurisdiction.

Recommendations

The Financial Arbiter should be given broad powers to hear complaints in the financial industry. This could be modeled on the UK Financial Ombudsman Scheme.

Compensation & Guarantee Schemes

Existing Procedures and Practice

Section 15.1.h and Sections 128 to 134 of the *AUCM*, as well as the Decree 258/2004, Section 21 regulate the obligation for all securities dealer to participate/contribute into the special Guarantee Fund²⁰. Each securities dealer is obliged to pay a contribution to the Guarantee Fund, Section 128.9 of the *AUCM*. The Fund's assets consist of the contributions of securities dealers, fines imposed on securities dealers and investment companies; the Fund may also accept a loan facility.

The Fund is established as a legal entity which is registered in the Commercial Register. This Fund is not a state fund and is not subject to insurance laws. The Chairman, Vice-chairman and other members of the management board of the Fund are appointed and removed by the Minister of Finance.

The money in the Fund may be used for (under Section 128.11 of the *AUCM*):

- compensation arising from the inability of a securities dealer to meet his obligations towards its clients due to reasons directly connected with his financial position;
- repayment of accepted loans facilities;
- payment of the costs of the activities of the Fund.

Monies of the Fund may only be invested in a safe manner.

Securities dealers pay a mandatory annual contribution to the Guarantee Fund equal to 2 percent of the volume of fees and commissions, which securities dealers had received by reason of investment services supplied within last year. It is at least CZK 10,000.

²⁰ Under Section 133.1/2/3 a foreign entity that provides investment services in the Czech Republic does not need to participate in the Fund if it is a member of a guarantee scheme in the state where it is registered; needs to participate in the Fund if it is not a member of any scheme in its state; needs to pay additional amount if the amount in its state is lower than in the Czech Republic.

Compensation from the Fund is provided to the clients of a securities dealer if the Fund receives a written notice from the Commission stating that the securities dealer is unable, due to its financial situation, to meet the legal and contractual obligations towards its clients and that there are no prospects that it will be able to do so within 1 year. Compensation will also be provided if a court has adjudicated a bankruptcy order in respect of this securities dealer.²¹

Compensation is paid to a customer in the amount of 90 percent of the sum calculated according to the AUCM, however no more than a Czech crown equivalent of 20.000 Euro is paid to any one customer of any one securities dealer /Section 130.10 of the AUCM.

The payment of compensation from the Fund will be paid within 3 months of the verification of the registered claims and the determination of the claim amount. This time limit could be extended in exceptional cases up to three months.

A customer's right to receive a compensation payment from the Fund lapses upon the expiry five years from the date of commencement of compensation payments from the Fund.

If the resources of the Fund are not sufficient for the payment of compensation, the Fund is to procure the necessary monies on the financial market. The assets of the Fund may not be declared subject to bankruptcy proceedings.

There are no compensation schemes relating to investment advisors and unit trusts.

Recommendations

The Guarantee Fund appears adequately set up *de jure*. However, it may have been set up too early; at the time the industry's standards of operation were still being strengthened. As a result, several bankruptcies of brokerage houses occurred soon after the set-up of the Guarantee Fund, and ended with unfavorable results to the clients of the bankrupt houses, mostly due to inadequate bankruptcy law and court decisions which violated the legal separation of the assets of clients and brokerage firms.

A securities dealer should be required to inform the client fully and in writing about the guarantee system provided by this Fund, particularly about the amount and extent of the compensation provided from it, and at a client's request, about the conditions for the payment of this compensation and its formalities. The securities dealer also has to point out unmistakably the persons who are not entitled to compensation from the Fund.

Consumer Education & Financial Literacy

In the securities market, there have been a number of good initiatives spearheaded by the former Czech Securities Commission (now part of CNB). The issue of education of the public in terms of financial services is discussed within the Annual Report 2003 of the CSC in the Chapter on International Relations and Relations to the Public. The long-term project "Investment Advisor" for the years 2003-2005²², which the Commission launched in 2002, continued to operate during the year 2003 and to the time period during which this review was conducted. The main content of the project consisted of the organization of seminars for professionals and the general public as

²¹ The Fund will suspend payment of compensation to an individual suspected of a crime that caused the inability of a securities dealer.

²² When drafting this project the Commission drew from the experience and knowledge of foreign regulators, mainly the FSA in the UK and the SEC in the US.

well as *lectures* on investing in the capital market for high school and university students of economic subjects. As part of the project the agency amended its *web site* and prepared a printed educational brochure for the public entitled “*The Art of Investing*” which explained basic concepts from the area of the capital market and provided information on the options for and risks of investing in the Czech Republic. The agency regularly published information and educational material regarding the capital market and a range of notes and warnings including a list of persons that the agency identified as providing investment services without appropriate authorization. Information, press releases, and warnings provided by foreign regulators were placed on its web site.

In addition to other useful publications, the textbook “*Guide to the Capital Market*” 2004 was particularly helpful. It was designed for students of secondary schools and vocational colleges focusing on economics and is a part of the educational project: Guide to the Capital Market. The issue of the educational publication named “*Portfolio Management*” continued as part of the seminars mentioned. In autumn 2004 and winter 2005, the CSC (now the CNB) started broadcasting a seven part series called “*Investment Advisor*” on Czech Television and radio. The series was also issued on DVDs and distributed to schools as teaching materials.

The CSC (now CNB) was actively co-operating with professional organizations that represent participants in the capital market. These organizations were participating in the education project of the agency and in particular in the seminars for high schools and the public. The agency established a Help Desk and toll free number for the public (continued after the merger with CNB). They were used by the agency to receive suggestions, answer questions and provide information on current events on the capital market. Looking into the individual financial industries, the program for securities investor education was well conceived and executed and should serve as an inspiration for future programs.

Information from financial service providers on specific products and services can not substitute for the basic understanding by the consumers of personal financial management and planning. These skills need to be acquired from early youth years. Schools and universities, supported by the financial industry, should be the prime providers of financial education for the growing generations of consumers of financial services. They should include personal financial management/planning as a core course into their general/social studies curriculum.

Insurance

The Czech Republic has taken steps to harmonize its legislation with the related Directives of the European Union. However even with full compliance with the EU Directives, consumer protection in the Czech insurance sector lags behind best practice in well-developed financial markets. The major areas that would benefit from improvement relate to customer disclosure before and at the point of sale, claims dispute resolution mechanisms, appropriate licensing and training of intermediaries and other insurance professionals, and consumer education.

Consumer Protection Laws and Institutions

The basic insurance law does not deal with consumer protection in detail, although the insurance law states that insurance supervision is exercised “in the interest of consumer protection”. The basic law is supplemented by a law on intermediaries and an insurance contracts law, which cover the basic requirements of an effective insurance market. In addition, there is the overriding legal recourse of all citizens under the Civil Code.

Existing Practice

There appears to be no institution specifically mandated to ensure consumer protection in the pensions and insurance sectors, although the CNB as the supervisor of the market has some general responsibilities in the area.

Recommendations

For the sake of providing a specialized focus on the problems of consumer protection in the insurance sector, either the CNB should handle consumer protection enforcement in insurance or a new, separate institution should be established. In the terms of primary legislation, the MOF took over responsibility for consumer protection in financial market in April 2006 and should thus prepare relevant legal changes.

Sales Practices & Disclosure

Existing Rules and Practice

Insurance products can be viewed in two different categories. Non-life insurance products, or insurance products without a savings component, have historically been seen as commercial products. By contrast sophisticated, long-term insurance products (such as life insurance and pensions which have contractual savings components) are viewed as financial investment products and should be subject to consumer protection regulations similar to those that govern collective investment funds and securities. However in the Czech system, sophisticated and non-sophisticated products are treated alike. While collective investments are subject to strict rules, similarly sophisticated insurance products are not governed by analogous regulations. This does not imply a return to an old fashioned supervisory model involving product approvals. It simply means that certain minimum levels of information gathering, information storage and disclosure, including the use of Key facts statements, should be required for more sophisticated products.

Multi-level selling structures are also an important aspect of the insurance system in the Czech Republic. This is characteristic of earlier development stages in insurance and pension markets. As products become more sophisticated consumers require more professional financial advice and multi-level sellers should be replaced by certified financial advisors or industry professionals. While products have become more sophisticated in the Czech Republic, multi-level selling

remains as the dominant medium through which consumers are approached and advised on different insurance and pension products.

The issue of cooling off periods under insurance contracts is regulated by Article 23 of Act No. 37/2004 Coll., on Insurance Contracts. The policyholder's right to withdraw from an insurance contract is general, subject to certain conditions. The policyholder has the right to withdraw from any insurance contract if the insurer or an agent authorized by the insurer provided untrue or incomplete answers to the policyholder's questions in writing concerning the private insurance to be concluded. Policyholders may exercise this right within two months after the day they become aware of such a fact. Article 23 (4) of the same Act further regulates the option of withdrawal from the contract in the case of an insurance contract concluded in the form of a remote transaction. Insurers are required to provide adequate notice of cancellation and renewal.

Article 21 of the Intermediaries Law lays out the requirements of intermediaries at the point of sale. This includes carrying out the activity with "professional care and to protect the consumers" interests. The client may request information as to the intermediary's qualifications and remuneration, and the intermediary may not offer kick backs. The intermediary is obliged to provide certain information including the register on which he is registered and the availability and nature of insurance complaint procedures. The intermediary is also required to carry out a proper analysis of needs but no specificity on this matter is provided. The information the intermediary is required to provide has to be in writing, but no format is specified in the law or other regulations. While insurance companies can prepare the formats for such documents, the supervisor should be responsible for specifying minimum requirements in the case of sophisticated insurance products and provide examples of best practice.

The Insurance Contracts law requires substantial disclosure regarding the nature of the contract and the insurer (Articles 4 and 66). In addition reasonable protections are built in if premiums are not paid under regular premium contracts. However the law does not specify what information should be provided to—and collected from—the consumer at the point of sale of the contract.

Insurance intermediaries are now required to be licensed and this entails an examination process appropriate to the "nature of the products he mediates" (Insurance Intermediaries Law Article 18) The Czech National Bank (from April 2006) overviews examinations for independent intermediaries: these are carried out through an "examination commission". Tied and subordinate agents are theoretically required to obtain qualifications through specified training institutions or authorized insurers. However evidence of qualification does not have to be submitted if the insurer provides a "written declaration" that the agent meets specified competency requirements and the company takes full responsibility for the agent's insurance related activities (Insurance Intermediaries Law Article 13).

There are three levels of intermediary qualification²³ according to the products sold and the nature of the advice being provided. In addition there is a continuous professional development requirement with five yearly testing following the taking of an "updating training course." Agents found to be operating above their formal qualification level and otherwise in conflict with the information in the register are subjected to severe sanctions, up to CZK 10 million (about \$450,000).

²³ The three levels are basic (needs to have basic training and to be able to explain products); medium (needs general knowledge, 2 years of professional experience, product knowledge, the ability to analyze competing products they are authorized to sell and to offer the appropriate product); high (as for medium but with 4 years of professional experience, and a knowledge of product markets as a whole and having the ability to explain the basis of recommendations).

CNB maintains a website which lists insurance companies and provides the main insurance laws and regulations. It also provides access to the annual reports of the insurance division, although these do not have to be produced until nine months after the end of the financial year.

General comparative and misleading²⁴ advertising is forbidden under the Commercial Code but the detailed wording would indicate that this is not aimed at financial services.

Recommendations

Officially specified point of sale “fact find” documentation and “key facts” consumer awareness literature (as per the model used by the Financial Services Authority in the United Kingdom,) should be introduced for savings style life insurance and pensions contracts, as is becoming a standard EU practice. These should be available to a court of law for at least 10 years after an insurance contract is sold. Key facts disclosure documents of a standard format should be provided to all policyholders at the time of sale. This should include information on consumer recourse and cooling off periods. In addition, for sophisticated insurance products such as pensions and savings style life insurance, all promotional and illustrative material provided to a client by an insurer or an agent (of any kind) should be deemed to be part of the insurance contract. Furthermore, for these sophisticated products, the intermediary should be required to disclose commission if such disclosure is requested by the consumer unless the product is a single premium product, in which case the securities law should apply.

While the law requires that the information the intermediary provides be in writing, it does not specify a format. Insurance companies should be able use their own formats for simpler insurance products, provided they are audited by the supervisor. However with respect to the sophisticated insurance products, the supervisor should require minimum criteria.

Cooling off periods²⁵ for life insurance and pensions-related contracts should be specified in the law. Although the Insurance Law in Article 23 provides for the right to withdraw a contract, this is only for fraud and misrepresentation. A cooling off provision should have no conditions attached to it and simply provide for the parties to reflect on the contract after the intensity of the sales pitch. This is provided for in Article 23(4) in relation to distance selling and should be applied to all retail insurance contracts with a savings component. Cooling off periods should be for at least one week and preferably two weeks. Non-conditional cooling off periods should be available to the consumer regardless of the insurer’s level of disclosure.

The intermediaries should be required to obtain an appropriate level of qualification depending on the sophistication level of the insurance product. EU Directive 2002/92/EC on Insurance Mediation requires that insurance intermediaries possess appropriate knowledge and ability as determined by the home member state of the intermediary. However insurance products vary in their complexity.²⁶ The level of professional expertise required to advise a client on basic household insurance products differs significantly from that required to recommend the most suitable life insurance product. Agents selling pensions and life insurance products, which include significant savings elements, should be required to have knowledge and ability commensurate

²⁴ The ban of misleading advertising is also a subject to the Consumer Protection Act, as well as to the Radio and television Act of the Czech Republic.

²⁵ A cooling off period is a period in which the consumer may unilaterally cancel the contract from inception without penalty.

²⁶ Article 12, para 3 of the EU Mediation Directive states that advice must be based on the information provided by the consumer and ...”shall be modulated according to the complexity of the insurance product being proposed.” By implication, the intermediary must have the necessary skills to give such advice. Para 4.1 provides the authority to require qualifications according to the product being distributed.

with the complexity of the product they are selling. Thus the qualifications for agents selling pensions and life insurance products should be high (i.e. at the third level) and thus more stringent than those selling basic insurance products. The current widespread multi-selling practice in the Czech Republic does not ensure that sophisticated products are sold by only qualified agents.

The comparative and misleading advertising sections of the Commercial Code should be revised to include financial services.

Account Handling

Existing Procedures and Practices

The Commercial Code provides circumstances in which the principal may evade liability if an intermediary, without consent “diverges from the principal’s instructions” in a manner which is not in the interest’s of the principal (Section 578). As noted above tied and subsidiary agents are deemed to be acting on behalf of the insurer under the Intermediaries Law. Section 585 specifies that any consideration received must be “turned over” to the principal without delay.

Recommendations

Regulations should be promulgated specifying the rules for the handling premiums and premium adjustment related cash by intermediaries. These should require that moneys should be remitted to the insurer within a specified period (typically up to 90 days in the case of brokers).

Dispute Resolution Mechanisms

Existing Procedures and Practice

A Financial Arbiter has been established, but with a very limited jurisdiction. He can only hear matters related to payments, so most insurance matters are outside his jurisdiction. The Czech National Bank is effectively the only recourse available to policyholders with grievances at present.

Article 24 of the Insurance Contracts Law provides an insurer with an avenue to deny claims if the insured event appeared to be caused by a material non-disclosed fact.

Recommendations

The mandate of the Czech Financial Arbiter should be expanded to include insurance and pensions products and services. Since the ability to deny a claim based on non-disclosure can easily be abused, an effective and widely known claims complaints procedure through the Financial Arbiter should be instituted and the clients should be informed about complaint rules and procedures when signing the insurance contract.

Compensation & Guarantee Schemes

Existing Procedures and Practice

Aside from the usual motor insurance provisions protecting uninsured motorists under third party insurance arrangements, there is no guarantee facility in the Czech Republic. However the issue of broad guarantee schemes in the EU insurance industry is currently an issue under debate.

Recommendations

The Czech Republic should follow EU developments on compensation and guarantee schemes. However it may be helpful to require that insurance companies provide as much financial information as possible to consumers. Where debt and claims-paying ratings are available from approved internationally accepted rating agencies, the companies should be obliged to publish the ratings.

Consumer Education & Financial Literacy

The Consumers Association has an appropriate mission – “to protect consumer's interests in domains where the power of an individual consumer is not sufficient” – and claims in its web site to represent consumers of financial services. However it appears to be largely concerned with the activities of small businesses, and there has to be some question as to its capacity to deal with complex financial matters, including insurance.

Recommendations

The educational and referral capacity of the consumers associations, particularly with regards to sophisticated financial instruments, should be strengthened. In addition, the insurance sector should be encouraged to produce educational materials and to actually engage with the education system.

Annex III: Financial Ombudsmen in the United Kingdom & Germany

A financial ombudsman is an important institution of a modern financial system. It provides a mechanism of an out-of court resolution of disputes arising from consumer complaints about services of financial firms. Such mechanism ensures that (i) the courts are not overburdened with small complaints unresolved between consumers and financial firms, thus preserving the efficiency of the court system, and (ii) consumers get a fast and fair resolution of their complaints by impartial and knowledgeable professionals of the ombudsman's office.

To properly serve the financial system by settling financial disputes, a financial ombudsman is expected to be independent, impartial, fair and reasonable – an informal judge of financial complaints. Integrity and professionalism of the ombudsman are its key features required for holding confidence of the firms and consumers alike. The ombudsman should have a compulsory jurisdiction over formally regulated financial firms, and be available to offer the same services to unregulated firms which join voluntarily. Finally, it should have an independent assessor overseeing the ombudsman's quality of service.

The financial ombudsman is a fixture in the financial systems of, for example, the British Commonwealth countries--UK, Ireland, Australia, New Zealand, and South Africa, among others. The UK Ombudsman is particularly well set up and handles a large variety of complaints, covering all segments of the financial system. Its operational experience demonstrates that the amount of consumer complaints increases as the financial products become increasingly complex, spanning various segments of the financial market. For instance, currently, the majority of complaints handled by the UK financial ombudsman are related to mortgage endowments--a product with banking, insurance and pension savings characteristics.

Office of Financial Arbiter of the Czech Republic should be an important ingredient in the Czech financial system which is moving towards the best international standards of performance. However, the powers of the Czech Financial Arbiter are few, limited to dispute settlement in the area of payments and cards. Furthermore, it is financed by public funds (CNB is the funding agency specified in the Act on Financial arbiter). Public funding of the Financial Arbiter's office may turn out to be a limiting factor on the way to expanding the mandate of the Arbiter. Private financial firms have an inherent stake in strong mandate and good performance of the Financial Arbiter, and they should contribute to funding the Arbiter's office, up to the full amount required.

The Office of Financial Arbiter of the Czech Republic should have its mandate legally expanded to cover all banking activities, as well as insurance, securities market, and other financial sector activities (e.g., pension funds and lending products). Its financing structure should be moved to that of being funded by the covered financial firms. Integrity and professionalism of the ombudsman's office should be carefully guarded, the operation of the Arbiter should be monitored and evaluated by a board and there should be proper accountability rules.

United Kingdom

The Financial Ombudsman Service of the UK (FOS) was established in 2000 by merging six ombudsman services for separate financial sector sectors (banking, insurance, investments, etc.) under one roof and giving the new service a mandate pretty much over the entire financial system.²⁷ The creation of the integrated FOS was mandated by the Financial Services and Markets Act of 2000 which also established the Financial Services Authority (FSA) – the integrated regulator and supervisor of the British financial system.

FOS is not a regulator. It is an out-of-court alternative dispute settlement service, which is charged to resolve disputes which arise between financial firms and their customers and which cannot be resolved between these two parties amicably.

Most of the firms over which FOS mandate extends are in the so-called compulsory jurisdiction. They are FSA-regulated firms which by law have FOS as the dispute settlement authority where their customers can send their complaints about firm services and products. In addition to the compulsory jurisdiction firms, there are voluntary jurisdiction members of the ombudsman scheme which, by definition, chose to participate in the scheme voluntarily. All firms from both jurisdictions pay levies to support FOS operations – a base general levy, and case fees. Notably for institution building, it was crucially important at the outset of operations of FOS for the new service to be open and transparent with their constituents – banks, insurance and investment companies – about the budget of FOS and the fee structure. The involvement of these constituents/stakeholders in budgetary discussions, among other, proceeded smoothly, resulting in a quick establishment of trust in FOS by the financial industry.

Sample fees FOS charges its constituents are as follows:

- £0.0059 per deposit account for depository institutions, mortgage lenders, subject to a minimum levy of £100,
- £0.055 per £1,000 of annual gross premium income for general (non-life) insurers, subject to a minimum levy of £100,
- £0.0007 per £1,000 of funds under management for fund managers, subject to a minimum levy of £100,
- Flat fee of £50-75 for credit unions, corporate finance advisers, operators/trustees/depositories of collective investment schemes, etc.
- Case fees of £360-475 for the third and subsequent standard/special cases, respectively

What makes FOS likely the best established financial ombudsman in the world – in one of the largest and most sophisticated financial markets? The FOS has a well structured and clear legal foundation, objectives, values, and principles of operation – and implements them in a superb fashion. In a summary, FOS was set up by law as an independent public body, with a mandate to resolve individual disputes between consumers and financial services firms--fairly, reasonably, quickly and informally. FOS is neither a consumer champion nor an industry trade-body. It is completely independent and deals with disputes fairly and impartially. It focuses on the facts of each complaint--not at how well people present their case, so no one should need any special expertise or professional help in order to bring their complaint to FOS.

FOS aims to give clear, jargon-free reasons for its decisions--so that any fair-minded person can understand why FOS reached a particular conclusion. It helps consumers and firms settle disputes

²⁷ More information on FOS can be found at <http://www.financial-ombudsman.org.uk/default.htm>

without the need for FOS involvement – and to try to help prevent the need for complaints in the first place. FOS service is an informal alternative to the courts, aimed to be free of rigid procedures and be as flexible as possible in its approach.

Germany

Based on the principle that conciliation is better than litigation, Germany's private commercial banks voluntarily introduced an out-of-court conciliation procedure. The Ombudsman Scheme was established in 1992 under the auspices of the German Banks Association (GBA) to settle disputes between banks and their customers as quickly and smoothly as possible. The Ombudsman Scheme is the centerpiece of the private commercial banks' consumer policy concept, which rests on three pillars: prior information, transparent contract arrangements and out-of-court dispute-resolution facilities. The impartiality of the scheme is reflected in a large number of consumer complaints resolved in banks' favor.

The Ombudsman's scheme has been a successful alternative (out-of-court) dispute resolution scheme from the start, with the number of cases growing each year. The Ombudsmen are five respected former judges and judicial system officials, selected by the GBA, with a no-objection input from consumer protection organizations. The Ombudsman scheme's activity is delineated in the Rules of Procedure, which were approved by the German Federal Ministry of Justice.

The benefits of this modern dispute-resolution scheme, in the words of the GBA, are obvious. The scheme is free of charge to bank customers, and presents no risks for them. If they do not accept the Ombudsman's decision, they are still free to go to a court of law. The banks are obligated to accept Ombudsman decisions in disputes involving amounts up to €5,000. Experience has shown that banks also usually accept Ombudsman decisions against them even where disputes involve amounts exceeding €5,000. The complaint resolution procedures are widely accepted, effective, quick, and non-bureaucratic.

One valuable consequence of the introduction of the Ombudsmen Scheme is that most private commercial banks have set up schemes of their own to handle customer complaints. These in-house complaint-settlement schemes have been a success. A large number of complaints are handled and resolved by the banks and do not need to be settled by an ombudsman. In many cases, easy-to-understand information on banking procedures or complex, abstract banking transactions takes care of any supposed disputes in advance. For more information, see www.bankenverband.de.

Annex IV: EU Framework for Consumer Protection in Financial Services

Articles 153 and 95 of the Treaty establishing the European Community has set out the requirement for a high degree of consumer protection as a necessary feature of a genuine EU-wide internal market. Food safety, public health and consumer protection issues are covered by a single Directorate-General within the European Commission. On 7 May 2002, the European Commission adopted a new Consumer Policy Strategy specifying its overall political approach for the five year period, 2002-2006.

Many of these focus on providing consumer protection through regulating the competence and financial strength of the providers. Others, such as the Consumer Credit Directive, aim at making it easier for consumers to make well-informed choices.

The European Consumer Consultative Group was established by the Commission in 2003 in order to constitute a forum of general discussions on problems relating to consumer interests and consumer protection, to advise and to guide the Commission when it outlines policies and activities having an effect on consumers, to act as a source of information and sounding board on Community action for the other national organizations.

Sales Practices and Disclosure

The legal base for future implementing measures are (a) Article 7 of Prospectus Directive 2003/71/EC, in conjunction with Article 35 (5) of Commission Regulation (EC) No 809/2004 implementing this provision in respect of disclosure of information prior to the admission of securities to a regulated market/prior to a public offer of securities, as well as (b) Article 19 (3a) of the Transparency Directive. Both the Prospectus and the Transparency Directive follow the four-level approach:

- essential principles,
- implementing measures,
- co-operation and
- enforcement.

Financial Market Abuse Directive 2004/72/EC obliges the issuers to carry out any disclosure/notification of transactions in accordance with the rules on transfer of personal data laid down in Directive 95/46/EC on the protection of individuals with regard to the processing of personal data on the movement of such data. The Directive also requires that the competent authorities in the Member States publicly disclose their decisions regarding the acceptability of the market practice concerned, and also transmit their decisions as soon as possible to the CESR which makes them immediately available online. All the transactions related to shares admitted to trading on a regulated market or to derivatives or other financial instruments linked to them have to be notified to the competent authority in the Member State.

UCITS Directive 1985/611/EEC, as amended provides the framework for the establishment and operation of collective investment undertakings in tradable securities. It requires the use of a custodian for each undertaking as the primary investor/ consumer protection vehicle. The custodian holds the customer assets and monitors the activity of the asset manager for the undertaking, or investment company for self-managed undertakings, to verify that actions taken are in compliance with the undertaking rules and in the best interests of investor/consumers. The

EU has issued a Green Paper on the Enhancement of the EU Framework for Investment Funds to improve the EU regulatory structure in the industry. COM(2005) 314, 12-7-2005

The Transparency Directive 2004/109/EC establishes requirements in relation to the disclosure of periodic and ongoing information about issuers whose securities are already admitted to trading on a regulated market situated or operated within a Member State²⁸. Greater disclosure in the financial accounts is a part of the Financial Services Action Plan. The issuer has to make public its annual financial report at the latest four months after the end of each financial year and has to ensure that it remains publicly available for at least five years /together with the audit report/. The issuer has to disclose the total number of voting rights and capital at the end of each calendar month during which an increase or decrease has occurred. Moreover, the issuer must make public without delay any changes in the rights attaching to the various classes of shares and derivatives.

Directive on Distance Marketing for Consumers of Financial Services 2002/65/EC. This Directive adopted in 2002 lays down common rules for selling contracts for credit cards, investment funds, pension plans, etc. to consumers by phone, fax or internet. The Directive fills the "legal gap" in existing consumer protection legislation, left by the exclusion of financial services from the 1997 Directive on distance selling. Its main features are:

- the prohibition of abusive marketing practices seeking to oblige consumers to buy a service they have not solicited ("inertia selling");
- rules to restrict other practices such as unsolicited phone calls and e-mails ("cold calling" and "spamming");
- an obligation to provide consumers with comprehensive information before a contract is concluded; and
- a consumer right to withdraw from the contract during a cool-off period--except in cases where there is a risk of price fluctuations in the financial market.

"Distance marketing" means selling by telephone, fax, proprietary computer networks and the internet. A Directive regulating the distance selling of (all other) goods and services was adopted in 1997 and entered into force in 2000 (Directive 97/7/EC). Financial services were excluded from its scope since they were considered to require a separate set of rules.

Based on the Directive, sellers of financial services and products are obliged to provide consumers with a comprehensive package of information before a contract is concluded. This package should include the identity, contact details etc. of the supplier, the price and payment arrangements, contractual rights and obligations as well as information about the performance of the service offered. Information on the technical quality and nature of the financial service must be also provided in accordance with the rules of the "vertical" directives on credit, insurance and investment services or with relevant national rules for services not currently subject to EU legislation.

Comparative Advertising Directive. The EU has adopted Directive 97/55/EC of October 6, 1997, amending Directive 84/450/EEC of September 10, 1984 concerning misleading advertising, to include provisions regarding the conditions under which comparative advertising is permitted. The Directive defines "Comparative Advertising" as any advertising which explicitly or by implication identifies a competitor or goods or services offered by a competitor. Comparative advertising is permitted only when:

- 1) it is not misleading;
- 2) it compares goods or services meeting the same needs or intended for the same purpose;

²⁸ Does not apply to units issued by collective investment undertakings other than the closed-end type.

- 3) it objectively compares one or more relevant features of those goods and services;
- 4) it does not create confusion in the marketplace between the advertiser and a competitor's trademark, trade name or products;
- 5) it does not discredit or denigrate a competitor's trademark, trade name or products;
- 6) it does not take unfair advantage of the reputation of a competitor's trademark or trade name; and
- 7) it does not present goods or services as imitations or replicas of goods or services bearing a protected trademark or trade name.

Any comparison referring to a special offer must clearly indicate the date on which the offer begins and ends or, where appropriate, that the special offer is subject to the availability of the goods or services.

Although the Directive does not preclude Member States from providing more extensive protection with regard to misleading advertising, they may not enact more stringent requirements with regard to mere comparison of products²⁹.

Consumer Credit Directive. The Consumer Credit Directive, adopted in 1987 aims to create an environment where consumers are sufficiently protected throughout the EU, so that they can carry out cross-border transactions with confidence. This Directive was amended in 1990 and 1998. It is based on minimum harmonization, which means that Member States are obliged to implement at least the provisions contained in the Directive. However, they may also maintain or introduce stricter rules in favor of consumers³⁰.

Directive on Unfair Business-to-Consumer Commercial Practices. Directive 2005/29/EC on Unfair Commercial Practices was signed by the European Parliament and the Council on 11 May 2005. The Directive, which was proposed by the Commission in June 2003, aims to clarify consumers' rights and boost cross-border trading by harmonizing EU rules on business-to-consumer commercial practices. The new legislation outlines "sharp practices" which will be prohibited throughout the EU, such as pressure selling, misleading marketing and unfair advertising. Certain rules on advertising to children are also set out. Through this legislation, EU consumers will be given the same protection against aggressive or misleading marketing whether they buy locally or from other Member States' markets. Businesses will benefit from having a clear set of common EU rules to follow, rather than a myriad of divergent national laws and court case rulings, as is currently the case.

The Directive was published in the Official Journal on 11 June 2005 and its provisions must be applicable in the Member States within two and a half years of its publication. The Commission works with the Member States and all the relevant stakeholders to make sure that the Directive is transposed into national law in a timely and accurate manner.³¹

²⁹ For more information, see http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=EN&numdoc=31997L0055&model=guichett

³⁰ For more information, see http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=EN&numdoc=31987L0102&model=guichett

³¹ For more information, see http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/oj/2005/l_149/l_14920050611en00220039.pdf

Account Handling

Directive on Personal Data and Privacy. The Directive on Personal Data and Privacy (95/46/EC) regulates the processing of personal data, regardless if the processing is automated or not. The Directive defines Personal data as "any information relating to an identified or identifiable natural person ("data subject"); an identifiable person is one who can be identified, directly or indirectly, in particular by reference to an identification number or to one or more factors specific to his physical, physiological, mental, economic, cultural or social identity;" (art. 2 a). Processing is defined as "any operation or set of operations which is performed upon personal data, whether or not by automatic means, such as collection, recording, organization, storage, adaptation or alteration, retrieval, consultation, use, disclosure by transmission, dissemination or otherwise making available, alignment or combination, blocking, erasure or destruction;" (art. 2 b). The Directive leaves the responsibility for compliance with the "controller", which is defined as the natural or artificial person, public authority, agency or any other body which alone or jointly with others determines the purposes and means of the processing of personal data. The rules that are outlined in the Directive are applicable both to controllers established within the EU as well as outside controllers that use equipment situated within the EU in order to process data³².

Directive on Markets in Financial Instruments 2004/39/EC (MiFID). This Directive is a central component of the Financial Services Action Plan, and confines itself to setting out the general high-level obligations which Member State authorities should enforce. It aims to allow investment firms, banks and exchanges to provide their services across borders on the basis of their home country authorization, and seeks to bring closer into line national rules on the provision of investment services and the operation of exchanges, with the ultimate aim of creating a single European "securities rule book". The Directive is designed to enhance investor protection, including by setting minimum standards for the mandate and the powers national competent authorities must have at their disposal and establishing effective mechanisms for real-time cooperation in investigating and pursuing breaches of the Directive. The Directive maintains the principle of a pre-trade transparency obligation whereby "internalisers" (i.e. firms trading outside regulated markets) would be obliged to disclose the prices at which they will be willing to buy from and/or to sell to their clients. However, it limits this disclosure obligation to transactions up to "standard market size", defined as the "average size" for the orders executed in the market. The Directive also includes a set of protective measures for "internalisers" when they are obliged to quote, so that they can provide this essential service to their customers without incurring undesirable risks. More detailed implementing measures will be set down by the Commission, following consultations with market participants and Member States, and taking into account advice from the Committee of European Securities Regulators (CESR)³³.

Dispute Resolution Mechanisms

FIN-NET. The European Commission launched on 1 February 2001 an out-of-court complaints network for financial services to help businesses and consumers resolve disputes in the Internal Market rapidly and efficiently by avoiding, where possible, lengthy and expensive legal action. This network, called **FIN-NET**³⁴ has been designed particularly to facilitate the out-of-court

³² For more information please visit <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31995L0046:EN:HTML>

³³ For more information please visit http://europa.eu.int/eur-ex/pri/en/oj/dat/2004/l_145/l_14520040430en00010044.pdf

³⁴ For more information please visit http://ec.europa.eu/internal_market/finservices-retail/finnet/index_en.htm

resolution of consumer disputes when the service provider is established in an EU Member State other than that where the consumer lives. The network brings together more than *35 different national schemes* that either cover financial services in particular (e.g. banking and insurance ombudsmen schemes) or handle consumer disputes in general (e.g. consumer complaint boards). Both on- and off-line services are covered. This work is based on the Commission Recommendation 98/257 of 1998 on the principles applicable to the bodies responsible for settlement of consumer disputes. Out-of-court dispute settlement schemes for financial services take various forms in different Member States. Sometimes there exists a central scheme at the national level--sometimes schemes are regional or even local. Some of the schemes are public and some are private. Also the status of the decisions varies from mere recommendations for both parties (for examples the National Consumer Complaint Board in Sweden and the reclamation service at the Bank of Spain) to decisions which bind the service provider (for example in most private banking ombudsman and insurance ombudsman schemes). FIN-NET is the first *fully functioning* cross-border ADR network in the EU. In September 2002, the European Commission has published a new consumers' guide to FIN-NET, which is available in all eleven official languages.

ECC-NET. FIN-NET complements the **ECC-NET** (European Extra-Judicial Network, more at www.eejnet.org) which establishes a more general network of ADRs notified to the Commission by Member States as applying core principles (contained in Commission Recommendation 98/257/EC) to guarantee their fairness and effectiveness. The EEJ-Net, launched by the Commission in May 2000 provides a communication and support structure made up of national contact points (or "Clearing Houses") established by each Member State³⁵.

To help consumers and businesses (also in financial services) deal with problems that may arise in exercising their Single Market rights, the Commission has also published a useful guide "Enforcing your rights in the Single European Market". The guide and the relevant national Fact sheets give comprehensive information on how to seek redress, including details of national out-of-court settlement systems. This guide is available though the "Dialogue with Citizens" website at europa.eu.int/citizens.

Compensation & Guarantee Schemes

Directive on Deposit Guarantee Schemes 94/19/EC. The Deposit Guarantee Schemes Directive (94/19/EC) obliges all Member States to set up compensation schemes for depositors. It establishes a minimum guarantee level of €20,000 whereby should a bank fail, depositors throughout the EU would be guaranteed to receive their money back up to that amount. However some Member States have introduced higher guarantee thresholds, and the manner in which the schemes function in practice has also not been converged. The Commission has recognized that differences in deposit guarantee schemes may prove problematic in the case of pan-European banking structures, but also more generally in the face on an increasing tendency towards EU integration of the banking market, these differences may inhibit the development of a sound framework for cross-border groups from competition and financial stability perspectives.³⁶

Directive on Investor Compensation Schemes 97/9/EC. Directive 97/9/EC, known as the Investment Compensation Scheme Directive (the ICD), and the national measures implementing it in the EU Member States are important regulatory mechanisms. They aim to protect investors

³⁵ The network deals with any disputes between a consumer and a business over goods and services, such as problems over delivery, defective products. However, is complemented by FIN-NET which is a dedicated network dealing exclusively with consumer complaints about financial services.

³⁶ For more information please visit http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&numdoc=31994L0019&model=guichett&lg=en

against the risk of losses in the event of an investment firm's inability to repay money or return assets held on their behalf. The Directive establishes some basic principles, provisions and definitions and gives member States leeway to implement it in the way they find most suitable for their own situation. The directive lays down certain basic requirements for national investor compensation schemes in order to provide a harmonized minimum level of investor protection across the EU. It is left to each Member State to implement an appropriate scheme and to determine the most suitable way of organizing and financing such schemes. Thus, while all EU Member States have implemented the ICD, the manner in which the directive has been interpreted and applied varies quite considerably.³⁷

Consumer Education & Financial Literacy

Article 153 of the Treaty establishing the EU acknowledges the consumer's right to education and information in all the fields. Education is an area for which Member States are primarily responsible, at national, regional or local level. This applies equally to consumer education and, to some extent, to consumer information.

The European Commission's role is to complement Member States' activities in these areas and facilitate co-operation between Member States. The aim is to empower consumers by reinforcing their knowledge, skills and confidence.

Inter-active Consumer Education Project

In general, the European Commission has developed, in co-operation with the higher education world, a web-based consumer education platform called *Dolceta* (this includes financial services). This is targeted at trainers and other multipliers in consumer education as well as the "informed" consumer. The learning tools that are developed in this context go beyond the simple provision of general information, to include learning exercises and other interactive material.

The first phase of this long-term education project is aimed at adult education. EUCEN (the European Universities Continuing Education network) has developed two interactive on-line consumer education modules on the following topics, to be used in adult education:

- basic consumer rights, the advantages of the internal market and redress possibilities in case of problems; and
- financial services (comparing prices, asset allocation, understanding products and services, etc.).

These modules focus as far as possible on the cross-border aspects of each of the topics and the approach is the pragmatic "problem solving" method recommended by adult education practitioners. They will have to take into account and complement possible existing national/international consumer education projects. Subject to a positive evaluation of the web tools, it could be decided to expand the operation to more traditional areas of education, i.e. school and university education.

European Consumer Centers

The European Consumer Centers Network (ECC-network) is an important interface between the Commission and European consumers. The role of the network is to help European consumers understand better how to make the Internal Market work for them and to provide advice if they

³⁷ For more information please visit http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=EN&numdoc=31997L0009&model=guichett

encounter a problem. An additional important task of the network is to provide the European Commission with important "grassroots" information on consumer concerns.

The Commission's aim is to have at least one ECC in every Member State. Today, Decks operate in 26 European countries. The ECC in the Czech Republic operates under the Ministry of Industry and Trade. Besides the tasks to inform consumers about the opportunities offered by the Internal Market and to assist them in pursuing cross-border complaints, the ECCs co-operate with each other and with other European networks such as FIN-Net (see below), and also conducts cross-border comparisons of such things as prices, legislation and other issues of consumer concern.

Training Courses for Staff of Consumer Organizations

The Commission has launched a training project to strengthen the capacity of consumer organizations. Training courses for staff members from all consumer organizations are organized by BEUC (Bureau Européen des Unions de Consommateurs, or the European Consumer's Organization, at www.beuc.org) in 3 areas: management, public relations and lobbying, as well as EU consumer law.

New Initiatives in Mortgage and Consumer Lending

Mortgage Credit Green Paper COM(2005)327. In 2005, the Commission issued the Green Paper³⁸ launching a debate on harmonizing the rules on mortgage credit in the EU. The consultations, drawing a large number of responses from a variety of stakeholders in all member countries ended in late 2005 with a public hearing which gave pointers for the future work of the Commission in the mortgage credit area.

The underlying idea of more integration and harmonization in the EU mortgage market is that more cross-border activity and competition in the EU mortgage market could increase consumer choice and reduce costs. The consultation was launched to assess whether Commission action can help to bring about these improvements in choice and value in the EU mortgage market.

The Green Paper looks at whether and how Commission action to develop the Internal Market in mortgages could provide concrete benefits for EU consumers. It touches on a variety of topics, including but not limited to: (i) consumer advice by mortgage lenders on the appropriateness of mortgage products, (ii) harmonization of EU standards for information about mortgages, and the APR in particular, (iii) for rules on calculating interest and for fees for switching mortgage loans, (iv) cross-border lenders' access to information in other countries on potential borrowers' credit histories, property valuations and land registers be improved, to encourage them to do more cross-border business, and (v) expansion of non-bank mortgage lenders which would increase competition in the market.

Proposed Consumer Credit Directive (CCD) 87/102/EEC. The European Commission adopted in September 2002 a proposal for a new directive on consumer credit. The existing EU-wide rules from 1987 have not kept pace with the important evolution in this sector and, at the same time, only set minimum standards. They have largely been overtaken by national regulation. The absence of common rules reduced cross-border transactions and led to differences in consumer protection in Member States.

³⁸ For more information please visit <http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52005DC0327:EN:NOT>

New EU-wide rules for consumer credit, as proposed, would be expanded to modern forms of consumer credit today. Borrowers would gain improved transparency on products (costs, terms and conditions) and can more easily compare offers on a cross-border basis. Lenders would gain improved opportunity to assess borrower risk, but in return they will be subject to "know thy client" obligations before granting any credit. Consumers would also have the right of withdrawal within 14 days, free of charge and without justification (a contentious issue--the Directive on Distance Selling talks about 7 days; the industry wants 3 days). Harmonized consumer credit rules throughout the Union would not only increase the protection of consumers across borders but also their confidence and thus strengthen the functioning and the stability of the consumer credit market in the European Union.

Implementation of the new CCD remains a contentious matter. The original proposal of the Commission for the new CCD was made in 2002 and, considered as too prescriptive and too rigid by the financial industry, drew a lot of suggestions for amendments from the European Parliament, European Council, and the stakeholders. After lengthy consultations and the first modified proposal in 2004, the EC issued the second modified proposal in late 2005 which is yet to be adopted by the European Parliament and the Council³⁹.

³⁹ For more information please visit http://ec.europa.eu/consumers/cons_int/fina_serv/cons_directive/index_en.htm



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