The Future of Banking Supervision and Regulation in Selected Transitional Economies in Relation to European Monetary Union

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Executive Summary

1. This study’s central aim is to research the essential features of regulatory and supervisory systems for banking which will enable the associated countries of Central and Eastern Europe to promote financial stability and create an efficient financial infrastructure. It is highly policy relevant.

2. The successful development of stable, efficient, properly supervised and regulated financial systems is an essential aspect of both the transitional economic reforms and the preparations for accession to the European Union by the associated countries of Central and Eastern Europe.

3. The regulatory and supervisory systems chosen must be compatible with the aims of alignment to the internal market and eventual accession to the Union which will involve acceptance of the acquis communautaire.

4. To tackle the research and policy issues a sound knowledge of the banking systems in the associated countries and the European Union as well as their regulatory and supervisory system is required. This project builds on the significant work which has been supported through the ACE programme and elsewhere on the restructuring of the financial systems of the economies in transition. It identifies the critical features of the regulation and supervision of banking which will facilitate integration into the single market and eventual accession.
Banking Restructuring in Hungary

Ferenc Karwalits from the Hungarian Central Bank, gave an overview of some of the issues involved in the restructuring of Hungarian financial services firms covering banking, securities and insurance. Several issues were discussed in depth.

Market History

Government guarantees for banks creates moral hazard. In Hungary, the government had to bail out failing banks, inducing fears for the stability of the financial sector. Therefore the government decided to introduce strict supervision and announced full privatisation of the sector. The clean-up of the sector was undertaken before institutions were sold into private ownership. Bad loans issued by the formerly state owned firms were exchanged for Government bonds. In most cases, these firms eventually failed and less than 4% of the face value of their outstanding debts was repaid. Commercial banks were recapitalised. Some bad loans were kept on the books of the banks when provisions were deemed sufficient. Many banks were then taken over by foreign interests. Privatisation followed the clean-up operations immediately.
Institutional Reform and Government

Banking supervision was separated from the Central Bank, and entrusted to an independent body. The implementation of BIS standards is difficult in Hungary as the risks are different from those envisaged by the BIS due to the role played by government.

Government involvement as the major owner of banks, the largest depositor and the primary issuer of debt instruments is dominant in several Central European States. One outcome of this is that bonds issued in exchange for firms’ losses are not investment grade. Therefore efforts to stimulate a genuine capital market are necessary.

The state of regulation in Hungary at present was compared to EU requirements:

- licensing: management requirements - to be reinforced
- minimum capital: 10 m ECU, 2 times EU requirement
- tier-two capital: allowed at 100%
- branches: will be allowed in 1998
- regulations: technical translation often difficult
- derivatives: covered by securities act
- off-balance sheet items: to be controlled more tightly
- market risks: no regulation, not sufficiently taken into account
- deposit insurance fund: half EU Standard, relating to smaller deposits; includes corporate depositors

Banking Supervision in Hungary.
**Erika Marsi**, Head of the Department of Supervision, gave an overview of recent experiences in Hungarian banking.

Banking and securities supervision merged on the 1 January 1997. Licensing procedures have been streamlined, and both sectors are subject to similar requirements. However their activity does not overlap, as banks are not entitled to trade on the stock exchange. Orders have to be transmitted through an affiliated brokerage firm.

Much attention is paid to effective supervision including on site inspections. The Agency disposes of wide powers to this effect. However, its staff is limited with only 37 persons at present. Therefore on site visits take place at most once every two years. Inspection teams are supported by external auditors. Consolidated supervision and the supervision of activity in the derivatives markets have not yet been taken on by the supervisors.

EU banks have taken over several Hungarian banks. About 60% of the banking industry is foreign owned. Branches are not yet allowed, but the rule will be relaxed as of 1 January 1998. The question of "unknown deposits", i.e. deposits the owner of which is not known to the bank, but appears from the mere inscription on a bearer document, owned by the depositor, was discussed. This practice will have to be discontinued due to fears of money laundering.
EMU Issues

David Green gave a presentation outlining the major issues of banking supervision which will arise post Monetary Union in the European Community.

The major issues discussed included the need for maintaining separate banking supervision in each of the member states and the possible reasons for a reassignment of some supervisory tasks to the EU level. The impact of new competition in the banking industry especially from the securities side and also arising from new entrants in retail banking including manufacturers and supermarkets, is driving down the value of the banking licence and contributing to a changing distribution of risks within the banking system. As risks are pan-European and are easily transmitted from one state to the other, the following questions arise: Who will bear the ultimate risk of paying for a banking collapse or significant financial fragility and who will have responsibility for exercising lender of last resort responsibilities?

On the general issue of banking supervision it was noted that although the Treaty on European Union contains an allusion to reassigning banking supervision at the level of the European Central Bank it seems unlikely and inappropriate to have supervision centralised at the EU level. A combination of the application of the principle of subsidiarity, the need to take account of structural differences in the banking systems and the wish to maintain supervision according to present national standards all point in this direction. The ECB has but a weak statutory basis for expanding its supervisory functions; also its relatively slender democratic basis may lead to problems of accountability.
Therefore an intermediate proposal could be considered. This would involve reassigning part of the supervisory competencies to the EU, especially those relating to the larger cross border entities, and to cross border mergers: The rule would be an indirect one, involving standard setting and strategy, not actual implementation. In the longer term the case of a European wide banking commission might arise for consideration. Also there is the risk of imposing too many charges on the ECB. Its policies should be limited to monetary policy and not to make it account for all policy matters, many of which have on purpose been left outside the scope of its action.

**Securities Markets**

**Eddy Wymeersch** gave an overview of some of the issues involving securities markets which might impact on banking regulation and supervision. These issues are likely to grow in importance in the near future.

Three factors are likely to lead to traditional banking business increasingly shifting to the securities sector. These are disintermediation, securitization and changes in regulatory requirements including the burden of the prudential ratios. Furthermore, banking regulation has inspired securities regulation, especially the ISD which is in many respects a duplicate of the 2nd Banking Directive. The implementation of the ISD has lead to a major reregulation drive in the EU Member States.

Prudential supervision has been largely integrated in most member states so that prudential supervision of both banks and securities houses is exercised by the same body. In an increasing number of cases, central banks do not exercise prudential supervision as this may cause reputational damage, interfere with the Bank's prime responsibility as lender of the last resort and create potential conflicts with its role
of guarantor of the payment systems. These difficulties generate problems of moral hazard.

Most of the time securities markets supervision is placed in the hands of one or several separate bodies, as securities markets supervision has been reformed to follow the lines of a more functional nature. The issue of whether or not the three main fields of supervision - banking, securities, insurance - should be centralised will be a hotly debated topic in the light of the recently announced reshuffle of supervisory competencies in the UK.

Separate attention was paid to the consequences of the introduction of the Euro on the banking and securities markets. It is undeniable that these effects will be numerous, complex and often unpredictable. As previously stressed by David Green, concentration in the banking sector is likely to occur, and in fact is already under way.

The smaller securities markets will probably suffer, as domestic government bonds will all be denominated in the Euro; local differences may persist in terms of risk premia - putting Governments under pressure, but convergence is likely in this arena. Derivative markets in instruments linked to local currencies are due to disappear. The concentration of derivatives markets in one or two major market centres will result. In the equity markets, comparability of prices will increase competition between markets, and between securities in identical sectors.

The pressure of integration on securities markets will further increase as many market centres will have difficulty surviving in the increasingly competitive environment. The interlinkage of securities markets is already under way within the Benelux countries, and with Paris and Frankfurt for new securities striving to
create competitive trading platforms for smaller shares ("Nouveau marché"). The former schemes for stimulating the integration markets by making their securities mutually available are likely to happen, but only in a gradual way. Projects similar to Eurolist, which has already been abandoned, are likely to be unsuccessful (under the present competitive pressures).

In the meantime the function of the stock exchange is changing rapidly: from government run, regulatory agencies, they are increasingly becoming private companies, offering services to the public against payment of fees. Their regulatory function will in all likelihood disappear, except for their policing powers on the trading system, for which, as the systems’ organisers, they will continue to be responsible.

**The Current Situation in Central Europe**

The discussion turned to the specific circumstances prevailing in some of the Central European states represented around the table.

The ownership situation of the bank is quite different: while Hungary has 60% foreign ownership, it is only 20% in Slovenia (4 minor foreign banks), and 7% in the Czech Republic. Domestic banks continue to be dominated by the State, especially in Slovenia, but also in the Czech Republic. The relationship with business firms remains difficult, as these are also largely state owned. The question whether or not to have universal banking also relates to the high volatility of the securities markets, and the reportedly still limited skills in securities trading. Therefore it was considered more prudent to keep both functions separate. Universal banking and its relationship to business firms is an issue that needs further research.
**Lazslo Szakadat** dealt with issues of information about the development in the banking sector in each of the Central European States. Data from central banks in the region has been collected. Additional information on the privatisation procedures on the ownership structures and foreign influence is required. The extent to which the IMF and EBRD may be of assistance needs further investigation.

**Roman Matousek** dealt with the banking reforms in the Czech Republic for the period 1990 to 1997. Several stages of development have occurred. In the first stage, the entry to the banking sector was made very easy, leading to many small players, although concentration of business remained high. Many banks belonged to commercial and or industrial groups for which they acted as the in-house bank. In 1995, eleven banks got into difficulty, leading to reorganisation involving mergers, capital injections and liquidation. A deposit insurance scheme was introduced, guaranteeing a relatively low sum, lower than that specified by the EU directive but adapted to the then existing situation in the Czech Republic.

The main issues confronting the banking sector in the Czech Republic were seen as follows: the shortage of skilled labour; the need for clear specification of targets and the adaptation of supervision to international standards. Useful lessons for supervisors may be derived from an investigation of how the banking sector reacted to mistakes and what caused the failures.

**Concluding Discussion.**

The concluding discussion mainly related to ideas for future research work. The main areas identified were:
1. Bibliography on financial structures, reform and supervision in transitional economies (including statistical data)

2. Quality of supervision of banks
   - checklist of items documenting "good quality of supervision"
   - criteria for measurement of quality of banking supervision

3. Anatomy of Institutional Framework
   - Central bank
   - Capital market- institutional v. functional supervision.
   - capital markets as disciplining mechanism
   - corporate governance schemes in the banking sector
   - banking supervision- separation of functions from central bank
   - investor protection schemes.
Summary of Working Papers Presented

Recent Developments in the Banking Industries in the Selected Transitional Economies and a Survey of Statistical and Other Information Sources in the Potential Member Countries (by István Ábel and László Szakadát)

Important issues in the recent development of the banking industries in the selected transitional economics include.

1. Distortions in market structure

In Central and Eastern European economies (CEECs) the restructuring of the banking industry started in the late 1980s. The monobank system was transformed into a two-tier banking system in each country by decrees. This artificial intervention made the newly established state-owned commercial banks (SOCBs) vulnerable to systemic risks, because these SOCBs inherited non-diversified portfolios and clientele from the national banks when they were set up. The collapse of COMECON, floods and droughts show that systemic risk was not simply a theoretical issue but a real danger. Another characteristic of the new banking systems in CEECs is that relatively large banks were created, one of which was usually a retail bank with a dominant position in the household deposit market. This distorted market structure has had several long-lasting consequences. It is interesting and worthwhile to conduct a comparative market structure analysis which shows how market forces evolved in the banking industry in the selected CEECs. As part of the analysis we pay special attention to the entry barriers in various market segments. This relates to licensing problems, the regulations governing the establishment of new financial institutions and those pertaining to mergers, and acquisitions. In practice, a kind
of infant industry argument provided the basis for the protection of the domestic banking industry.

2. The Independence of the Central Bank

The separation of central banking from commercial banking activity meant that the independence of the central bank became a political issue. There is some evidence that a strong and independent central bank can provide a sound basis for stable monetary policy, and central bank independence is positively correlated with lower inflation rates. Within this project we could compare the formal and informal independence of central banks in various countries covered by the research. Various measurements can be used simultaneously: the nomination of presidents and their deputies of the bank of issues, changes in these positions, the length of time these chief executives are in office legally and in practice, to whom the presidents are responsible, the structure of the boards, decision-making mechanisms in monetary policy, the implementation of monetary policy, deficit financing, etc. We cannot ignore the costs of an independent central bank. There is a rich literature on the negative consequences of a discretionary policy of independent central banking.

3. Banking supervision

As the most important issue for the project, the emphasis will obviously be on banking supervision. In some countries banking supervision is implemented by the central bank, in other countries there is a separate body for this task. There is some analytical argument for independent banking supervision but it has its own costs. We have to compare the practices of the countries in question. However, regardless of the independence of banking supervision, the key issue seems to be
the changes in regulation. To what extent the various CEECs have adjusted their rules to the BIS standards. The researches in this field usually show minor differences but in certain respects we can find significant gaps between the Basle accords and the supervisory policy of selected transitional economies. It is worthwhile keeping in mind that not only the banking law and its implementation rules must be analysed but some related rules must also be taken into account - in particular accounting rules and bankruptcy regulation.

4. **Bad loans**

Our research should include the problem of bank restructuring policies. The banking sector in each country went through some sort of consolidation process. The key issue here was how the flow and stock problems of bad debts have been treated in various economies. The stock problem requires some sort of state intervention. In each country, the financial authorities implemented a kind of bail- or carve-outs. This aspect of bank restructuring is well documented and there is a rich literature about this topic. The flow problem can be handled by some legislative changes. However, changes to the rules of the game must be supplemented with the privatization of SOCBs.

5. **German vs Anglo-Saxon banking system**

A related topic at this point is the feature of the banking sector, namely whether a German-type universal banking or an Anglo-Saxon-type system was adopted by policy-makers and how this choice was influenced by the privatization strategy of the countries in question. For example, the Czech voucher privatization scheme strongly implied universal banking. In contrast, the strong analytical and empirical resistance against cross-ownership implicitly led to a formal separation
of investment and commercial banking activities. Here again there exist different kinds of arguments and the pros and cons are almost in balance. Human resource policy aspects must be as much taken into account as the problems of monitoring and cross-ownership.

6. Privatisation of State Owned Central Bank

This is politically very sensitive. Everywhere in the world policymakers must confront various elements of economic nationalism. This makes privatisation a hard task even if economically this measure seems quite plausible and efficient. Moreover, there are various ways to privatise those financial institutions in the state’s portfolio. Economic reasoning probably favours the involvement of strategic investors but there can be strong domestic resistance to such an outcome. Needless to say, the technique of privatisation can also have some impact. External and internal macroeconomic imbalances and other factors can heavily influence governmental decisions in this way.

7. Crisis management

The regulations governing the banking industry must, explicitly or implicitly, be prepared to handle the failure of banks and other financial institutions. The Czech, Hungarian, and Bulgarian experiences show that it is an important issue in practice. Policy concerning bank mergers and acquisitions is also an important factor. The state can play an active role in this field. A highly correlated issue is obviously deposit insurance. In each CEEC the government had to set up a deposit insurance scheme. What sort of policy is optimal in both the short and the long run? This is an important question all over the world but especially for economies in transition.
**Primary Sources**

- **Annual Reports of National Banking Supervision**

  In Hungary SBS issues its annual reports. It is a good source of all relevant information on banking supervision and the prudential operation of financial institutions operating in Hungary.

  In other countries banking supervision is not separated organisationally from the central bank, but the national bank has its own unit charged with supervision. In this case the various reports of central banks usually contain a few paragraphs on banking supervision.

- **Occasional Papers of National Banking Supervision**

  In Hungary SBS occasionally, but rather rarely, issues Working Papers on various issues relevant to banking supervision.

- **Annual Reports of National Banks**

  In each country the central bank issues its annual reports. They are rich sources of information.

- **Monthly Reports of National Banks**

  - **Hungary:** The NBH issues its MR each month. This is a good source of information on monetary processes.

  - **Slovenia:** The BS issues its MR each month. Similar to the reports of NBH.

  - **Czech Rep.:** The CNB also issues its MR but it is hardly available. CNB also issues a leaflet on economic events relating to monetary policy and events in CR. It is available.

  - **Slovakia:** NBS issues its MR each month. The situation is similar to the Czech case.
- Poland: The BS issues its MR each month. Similar to the reports of NBH, but it contains less information.
- English translation of Banking Act, Act on Deposit Insurance, etc.
  - Hungarian and Slovak ones have already been available
  - I assume that it must be available in other countries as well since foreign banks operate in these countries.
- Annual reports of commercial banks
  - These reports are usually also available in English, but it is time consuming to collect them due to the high number of financial institutions. It seems reasonable to focus on large banks playing a dominant role in the various economies.

**Secondary Sources**

- IBRD country reports
- IBRD Discussion Papers
  
  e.g. A study by Borish, Ding and Noel (Borish, Michael - Ding, Wei - Noel, Michel [1996] On the Road to EU Accession. World Bank Discussion Paper No. 345) is a good review of financial sector development in Visegrad countries.
- BIS materials
- Papers and book produced by the academic community
Hungarian references


Borish, Michael - Ding, Wei - Noel, Michel [1996] On the Road to EU Accession. World Bank Discussion Paper No. 345


An Overview of Basic Concepts, Issues, Problems and Open questions of Banking Supervision and Regulation Drawing from the Experience of Slovenia: Major Points (by Neven Borak and Vladimir Lavrac)

The banking sector in the former socialist countries is undergoing massive restructuring caused by bank rehabilitation programs which we term the *restructuring effect* and by the introduction of a regulatory framework in line with banking directives and BIS guidelines which we term the *modernisation effect*.

Characteristic outcomes of these effects are: 1. A high level of state involvement. 2. An overbanked system due to the introduction of liberal licensing and low entry requirements. 3. Bad debts and independent central banks.

The regulatory frameworks introduced included risk weighting schemes, minimum and risk weighted capital limits, exposure limits, loan classification and loan loss provisions, limits on ownership and limits on lending to shareholders and to the supervisory authorities. There has also been a tendency to replace implicit deposit guarantees with explicit deposit insurance schemes. The capitalisation effect in solving the problems of bad debt and the recapitalization of banks has been achieved primarily through the exchange of government bonds for bad debts. Generally, there have been no significant links between the recapitalization of banks and enterprise sector restructuring or privatisation.

Both effects introduced into the former eastern socialist countries a kind of universal banking system which raised familiar questions including the relationship between banking and commerce, the activities of a universal bank,
the organisational model of universality and the regulation and supervision of a universal bank. The World Bank expectation that banks would have a significant role in corporate governance based on their creditor position did not occur in the case of Slovenia. Instead, government credit guarantee schemes for bank loans to enterprises were extended.

Government involvement in the banking sector has several important dimensions; the government is simultaneously the most significant owner of banks, the most significant debtor, the most significant guarantor and also a very important provider of liquidity to banks. In other words, the banking sector has shifted towards an extremely high degree of exposure to the government. In these circumstances something like eastern universality emerges instead of true universality in the western sense.

A review of banking sector balance sheets in Slovenia reveals that the banking system is in the position of degenerating towards a kind of Tobin’s defence banking. Such developments raise the question of a possible further transformation of accepted universal banking principles to Litan’s narrow bank concept or Bryan’s core bank proposal which were developed from the Chicago School proposal on 100 per cent reserve requirements.

Different concepts have a further impact on differences in regulatory developments. After their inclusion in legislation these concepts have had a dominant influence on the shaping of the whole financial system and not only on the banking sector. The shape of the financial system influences the sources of external finance for enterprises as there is either more centralised dependence on banks or more decentralised dependence on capital markets.
Universality, as it seems, is preferred by the state: it is easier to obtain additional sources from the oligopolistic banking sector alone than from the decentralised capital market. Eastern universality cannot be genuine universality. The banking system is the backbone of the financial system and enables a process of centralisation of finance. Unusually, the centralisation of finance is connected with government involvement in economic decisions.

**TWO UNIVERSALITIES**

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Convergence of Prudential Banking Supervision and Regulation in the Czech Republic (The Second Banking Directive - Harmonisation Process) (by Ramon Matousek)

1. Introduction

Since the early 1970’s we can trace attempts by EU countries to harmonise banking regulation. Substantial progress in the harmonisation process occurred in 1977 when the so-called “First Directive” came into force.¹ This Directive was an essential contribution leading to the harmonisation of banking regulation. However, a key step towards creating a single EU banking market was introduced by the Second Banking Directive. This “Directive” enables the movement of banking services and the establishment of branches within the EU countries. A further important directive is the so-called “Consolidated Supervision Directive” whose task is to regulate banking groups on a consolidated basis, rather than to only undertake solo supervision.²

The Second Directive has enabled banking services and the financial markets of EC countries to integrate. Its contribution might be described as follows:

• The Second Directive and further directives already mentioned which harmonise the element of prudential supervision are desirable for the stability of banks.

¹ First directive on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions, 12 December 1977, Directive 77/780, O.J.L. 32/30 of 17 December 1977.

² The list of the directives which substantially influence the banking industry are as follows: the second Banking co-ordination Directive, the Own Funds Directive, the Solvency Ratio Directive, the Money Laundering Directive, the Large Exposures Directive, the Investment Services Directive, the capital Adequacy Directive.
• The essential element of the Second Directive is then the principle of “Home Country Control”, under which each “credit institution” is supervised by the supervisory bodies of its "Home Member State"\(^3\). This enables credit institutions to perform the authorised activities in a “Host” state without needing to re-authorise the banking licence.

As for the principle of “Home Country Control” or the Home state’s responsibility, these require that every bank uses the standard accounting principle and adequate internal control. The role of a “Host” state lies in the control of the liquidity of branches and implementation of “Host” state monetary policy. This power of “Host” state (i.e. to control the liquidity of foreign branches) must be seen in the light of ensuring the credibility of a banking system.

Banking regulation and supervision in Central and East European countries (CEECs) is undergoing the deep process of deregulation of financial markets, although the time period in which it is carried out is significantly shorter compared, for example, to OECD countries. The situation in CEECs has been exceptional in the requirement to simultaneously establish the institutional, legal and operational conditions for a market system.

The rapid growth and expansion of the financial market in the Czech Republic and other CEECs, and, in particular, the growth in the number of commercial banks and their activities, brings into question how and by how much these activities should be controlled (supervised) and regulated by authorities. Needless to say, the manner in which regulation is performed has a direct impact on the efficiency, stability and credibility of the banking system as a whole.

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\(^3\) Member State - state where a credit institution has been licensed.
Not only in the Czech Republic but also in other Central and Eastern European countries, there is the problem of finding the appropriate way of controlling these activities, i.e., prudential regulation and supervision. The basic theme of this discussion is to ask what sort of policy and targets should be adopted and applied? A further question might be, what makes the situation different in performing banking supervision and regulation in the Czech Republic with respect to the Second Banking Directive? Therefore the main target of this study will aim at identifying the crucial shortcomings of conducting banking supervision in the Czech Republic compared to the harmonisation process enabling the integration of the Czech banking into the EU.
Legal aspects of banking supervision in the EU and the possibilities of legal transplant to the transitional economies in Central and Eastern Europe
(by Michel Tison)

When assessing the legal framework of EU banking regulation and supervision and the possibilities of transplanting this framework to the transitional economies, account should be taken of several specific features of the EU regulatory framework. In particular attention must be paid to the proper objectives of EU supervisory regulation, and to the paradigm of minimum harmonization and mutual recognition of prudential standards.

A. Prudential regulation in the European Union

1. Harmonization of prudential standards
The extent and level of harmonization of banking supervisory standards is determined primarily by its objective of realizing a common and, more recently, a single internal market for banking services. Since the Commission endorsed its ‘new approach’ to harmonization as part of its 1992 Internal Market Programme, this limited objective has also been reflected in the pattern of regulation. The initial objective of ‘full’ harmonization of banking supervisory standards which prevailed in the ‘60s and ‘70s as a precondition for achieving market integration, was substituted by the concept of ‘minimum’ harmonization and mutual recognition. In line with the principle of subsidiarity, regulation at EU level was to be limited to the extent necessary to effect mutual recognition by member states of each others’ prudential standards. In other words, the prudential standards enacted at EU level do not aim at creating an exhaustive regulatory system, but are confined to the minimum standards which in the view of the
community legislature is required to create a climate of mutual confidence between Member States.

The ‘minimum’ character of EU harmonization of banking laws as a precondition for mutual recognition appears *inter alia* from:

- **The material scope of harmonization** EU rules only concern market access (authorization requirements) and some prudential rules (own funds requirements). Member states however retain large autonomy in the practical implementation of these standards (for example, what are sound administrative and accounting procedures), and in devising the instruments of supervision (for example the existence and frequency of on site examinations). Moreover, the EU directives abstain from interfering with the institutional framework for prudential banking supervision (supervision by central bank or by separate authority).

- **The possibility for Member States to formulate additional prudential requirements.** However, the principle of mutual recognition does not enable Member States to impose these additional requirements upon credit institutions authorized in another Member State who make use of their ‘European passport’. The mutual recognition principle may thus lead to regulatory competition between Member States in setting prudential standards above the European ‘minimum’ level, which is to be attained by all Member States.

The fear expressed by several scholars that the mutual recognition principle would cause excessive competitive deregulation between Member States, does not seem to hold true with respect to prudential standards in banking. First, the prudential standards set at EU level are quite high: the implementation of the EU directives generally led to an upgrading of prudential standards in most Member
States. In fact, the adoption of the relevant EU directives cannot be isolated from the regulatory developments at international level, and within the Basle Committee in particular. Second, in those Member States which imposed high prudential standards prior to the directives, for instance with respect to initial own funds of credit institutions, the implementation of the EU banking directives has not automatically affected the existing standards. Maintaining more stringent prudential standards in national law could be perceived in the market as an element of stability and relative strength of the domestic banking sector. This might in turn lead to regulatory competition for higher prudential standards which we term *competition for excellence*.

2. **Mutual recognition**

The mutual recognition principle with respect to prudential regulation and supervision is based on the assumption that all Member States possess an equivalent supervisory system which conforms to the minimum harmonization of prudential standards. This is reflected in the legal presumption of home country rule, unless otherwise specifically provided in the directives (for example host country competence for liquidity supervision of branches). The host country cannot exercise any prudential competence towards credit institutions licensed in another Member State and using its European passport. Neither is the host state supervisor entitled to intervene unilaterally in case of alleged improper prudential supervision by the competent home country supervisor. The host state could only file a complaint before the Court of Justice for breach of the relevant directives by the home state, and ask the Court to revoke the credit institutions’ European passport by way of an interim measure.

In practice, the effectiveness of prudential supervision of international banks and banking groups will be largely dependent upon the success of informal
mechanisms of co-operation between supervisory authorities. Thus, the legal framework of administrative co-operation provided for in the directives has in many cases been complemented by the conclusion of bilateral Memoranda of Understanding between supervisory authorities.

3. Deposit protection and investor compensation schemes

Although not forming part of prudential regulation as such, the 1994 Deposit Protection Directive and the 1997 Investor Compensation Directive may be seen as a necessary complement to the prudential standards. The directives illustrate that the prudential regulation cannot completely prevent the failure of credit institutions.

Both directives are consistent with the paradigm of minimum harmonization and mutual recognition: Credit institutions and investment firms remain subject to their home country scheme for activities undertaken in other Member States by virtue of their ‘European passport’. This harmonization is however limited. The minimum level of coverage for any protection or compensation schemes is established, and a list of mandatory or optional exclusions of coverage by the protection scheme in case of default by the credit institution or investment firm is enumerated. The organisation of the protection schemes and their funding arrangements are left to the Member states. This situation may be deplored: the credibility in the market of protection schemes depends on the level of protection, and from the possibility of the scheme covering ‘normal’ banking failures. This situation calls for the adoption at EU level of some basic rules with regard to the funding of protection schemes, particularly since the EU directives confer upon depositors and investors legally enforceable rights against the protection scheme.
B. Legal transplantation of EU prudential standards to the transitional economies

Although ‘minimal’, the prudential rules adopted at EU-level may be considered as basic principles applicable to banking supervision in all industrial economies. The European rules are fully in line with the *Core Principles for Effective Banking Supervision* published by the Basle Committee on Banking Supervision in April 1997, although the latter principles are more general in nature and only constitute recommendations. It may therefore be argued that the legal transplantation of EU prudential regulation to the transitional economies does not give rise to conceptual difficulties as these rules only implement internationally agreed prudential standards.

The transplantation of specific standards should not, however, be limited to a literal transcription of the European rules. Some specific standards could and should be tailored to the particularities of the markets in the transitional economies, and may sometimes reflect specific economic choices. For instance, by imposing an initial capital for financial institutions at a level of 10 million ecu, instead of 5 million in the EU, the Hungarian banking law illustrates the policy choice of not allowing smaller banks to enter the domestic market.

As important as the setting of prudential standards is the enforcement and supervision of the standards by the prudential authorities. While most EU Member States have a longstanding tradition of exercising prudential supervision over banks, this is not, on the whole, the case in the transitional economies. The objectives of market confidence and stability pursued by prudential regulation must in any case be supported by high quality supervision, in terms of both organization, expertise and instruments for supervision. It will therefore be of
primary importance to define the parameters in assessing the quality of supervision.

The supervisory systems in the transitional economies are still to a large extent based on territoriality: branching by EU credit institutions is often highly restricted, for obvious reasons of protection of the domestic banking sector in transition. Other transitional countries adopt a more open attitude, but still retain substantial supervisory competencies over branches of EU institutions. By contrast, the home country control principle applies to inner EU branching by credit institutions.

The legal transplantation of the coverage ceilings imposed by the EU directives on deposit protection and investor compensation schemes to the transitional economies should also take into account the specificity’s of the (retail) market in these countries. For instance, the coverage ceilings could be fixed at a lower level than imposed by the EU directives, provided this is justified by a lower relative importance of household savings in total deposits with credit institutions. However, special attention should be paid to the funding of the protection schemes: the contributions by banks to the protection fund should be sufficient to cover ‘normal’ bank failures, which, however, should be assumed to be more probable in the transitional economies than in many EU Member States.

The main conclusion from above is that the legal transplantation of EU rules should not be an aim in itself. The EU prudential standards are only a minimum devised to achieve market integration, and should in any case be adapted to the specificity’s of the markets in transition. The transplantation of standards should be accompanied by measures to ensure the high quality of the supervisory action by prudential authorities.