

CHALLENGES TO FINANCIAL REGULATORS IN THE ACCESSION COUNTRIES

European Shadow Financial Regulatory Committee

Statement No. 18

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May 1, 2004 marked the entry to the EU of ten new members, of which eight are Central and Eastern European (CEE) countries. Since 1989, these countries have made remarkable progress in the transition to market economies and the development of their financial sectors. Furthermore, they have nearly completed the implementation of all EU laws and regulations into their national legal frameworks.

The banking sectors in the CEE countries are predominantly in private hands. Banks also appear to be profitable with healthy capital ratios in most of the countries. A striking result of the transition process is that the banking systems have become dominated by foreign-controlled banks. The share of total bank assets held by foreign-controlled banks exceeds 70 percent in most of these new member states, with one notable exception being Slovenia, where the foreign share in the state dominated banking system is less than 20 percent. The foreign control of the CEE banks, which typically are operated as subsidiaries, as well as the typically high degree of market concentration among them, create challenges for regulators with respect to the supervision of the foreign owned banks, and the development of securities markets.

The need for coordination of home and host country banking supervision

As is standard in international supervisory practice, the responsibility for supervision of a subsidiary is placed on both the home and the host country supervisor. The joint responsibility is asymmetric in that the home country supervisor has the responsibility to view the subsidiary in the context of the entire institution, while the host supervisor focuses solely on the subsidiary itself. Whereas there are generally frequent contacts between the supervisors, the degree to which the home country supervisor is *obliged* to share information about the bank is rather unclear.

In a Basel Committee document from October 1996 on “The Supervision of Cross-Border Banking”, paragraph 30 refers to the information flows from home to host supervisor. This paragraph states that keeping host supervisors apprised of “material adverse changes in the global condition of the banking groups operating in their jurisdictions”....“will typically be a highly sensitive issue for home supervisors (both with respect to substance and timing) and that decisions on information-sharing necessarily will have to be made on a *case-by-case basis*” (our italics). The EU

consolidated banking directive of 2000¹ refers in article 56 to measures to facilitate consolidated supervision. Accordingly, the competent authorities of each member state shall communicate to each other “all relevant information which may allow or aid the exercise of supervision on a consolidated basis.” In our view, however, it does not materially strengthen the requirement for provision of information by the home to the host supervisor.

Potential for deficiencies in the sharing of information create scope and incentives for increasing the risk of host country subsidiaries. Specifically, if a multinational bank as a whole is facing distress, it might shift risk to the subsidiary where it expects the greatest government support. If the subsidiary goes bankrupt, it is the deposit insurance system in the host country which is responsible for providing support. This implies losses, which are borne by the local taxpayers. High banking concentration in a host country adds to the likelihood of a bail-out, because the government may not be willing to accept the failure of a subsidiary which constitutes a substantial part of the country’s financial system. Under these circumstances, the subsidiary is likely to take increased risks in the host country. Such behavior would become even more serious for the host country if the home supervisor can avoid responsibility for the bank’s distress by forbearance regarding potential insolvency, which may lead it to indulge the bank’s transfer of risk to the subsidiary.

We note that some of the new member states have quite strict provisioning requirements, and we surmise that this may result from concerns about the lack of information provided by home country supervisors about the parent institutions. To the extent that these requirements go beyond what would be strictly necessary to maintain financial stability with full information available to host supervisors, they constitute a cost in terms of inefficiency for the domestic economy.

In order to counterbalance the perverse incentives described above, the European Shadow Financial Regulatory Committee (ESFRC) recommends that the scope of provision of information from the home country supervisor to the host country supervisor should be broadened substantially in respect of the health of the institution as a whole. The increased flow of information to host country supervisors would be of particular benefit to the new EU entrants given the scope of foreign bank activity. Besides the benefit in terms of financial stability, it could reduce the need for the strict current provisioning requirements and their related costs identified above.

An information sharing requirement would also be helpful in terms of the implementation of Basel 2, where the internal ratings systems of the subsidiaries need to be validated by both home country and host country supervisors. It would benefit in particular the host supervisors in the new member states having important foreign subsidiaries, who are already facing problems with such validation given shortage of resources and statistical data problems.

¹ Directive 2000/12/EC of the European Parliament and of the Council of March 20, 2000 relating to the taking up and pursuit of the business of credit institutions, OJ L 126 26/05/2000.

The role of securities markets

The dominant role of a few foreign banks in many of the new member states accompanies a financial structure where financing options are limited. Firms remain restricted in their choices of funding sources, and households have a limited number of investment alternatives. Securities markets can provide an alternative source of external financing for firms, as well as a placement for households, but these markets remain unimportant in CEE countries, in spite of encouragement by governments. Notably, they have so far failed to provide consistent liquidity, except for a limited number of stocks.

To some extent, it is natural for securities markets to develop gradually during the process of financial development. Nevertheless, for the sake of sustained economic growth it is desirable that conditions be provided for securities markets to expand. This does not imply that we favor government-sponsored or subsidized stock markets in each country. In our view, it is not even necessary that each country has its own stock market, particularly in the perspective of future entry to the eurozone. Rather, securities markets should be allowed to emerge freely and to compete for firms and investors. What is important is that:

1. Firms are able to find the cheapest source of funding by means of issuing equity and other securities where they think it is to their advantage. These considerations should exclusively determine the decision whether and where to list.
2. Domestic investors must be able to trade as safely and readily in foreign as in domestic securities markets.

Even though many firms are currently not in the position where issuing equity or bonds would be attractive, the emergence of liquid markets would encourage the use of private equity and debt financing. This is also important for early-stage financing, because the venture capitalist usually has the exit route of placement in equity markets as the final objective. Venture capital financing is often superior to bank financing of early-stage projects, because banks are not willing to take the risks involved in such projects, where collateral is limited. Furthermore, venture capital firms supply advice and capabilities at critical growth phases. Another benefit of securities markets is that they provide the opportunity for more established firms to issue listed and unlisted debt securities. Medium-term bonds, commercial paper and other forms of structured finance can replace bank loans and improve firms access to funding.

The EU provides a regulatory framework for securities markets through many directives which are being implemented by the new member states. This legislative process has the intention both to allow domestic markets to emerge and to enable cross border transactions by investors and exchanges. The new member states need to take full advantage of the opportunities that this process provides.

For securities markets to function effectively liquidity is essential. It requires a sufficient number of participants with access to reliable information. In this context, we note that pension funds are growing rapidly in many of the CEE countries, following early reform

of unsustainable pay-as-you-go systems. Pension fund growth will spur development of securities markets in the CEE, and entry to the EU should facilitate this for pension funds falling under the Institutions for Occupational Retirement Provision Directive of 2003. Article 18 generally mandates governments to require such institutions to invest in accordance with the “prudent person rule”, and not to prevent pension funds from investing up to 70% of assets in equities and corporate bonds (or 100% where members bear the risk). They must also permit currency mismatch for up to 30% of portfolios. This will entail a marked easing of the relatively strict portfolio restrictions imposed hitherto in some CEE countries, and hence permit wider equity investment. We recommend that CEE countries should not take unjustified advantage of the Clause 6 of Article 18 permitting more stringent investment rules on an individual basis “provided they are prudentially justified”.