

Financial sector development in SEE: the roles of EU accession and Basel II

1. Introduction

Although recent research (Levine et al 2000, Wachtel 2001, Berger, Hasan and Klapper 2003) has stressed the importance and robustness of the link between financial sector development and economic growth in most countries, the connection seems empirically weak in transition countries (Berglof and Bolton 2002). In particular, in the countries of Southeast Europe (SEE),¹ indicators of banking system development such as credit to the private sector/GDP have deteriorated as economic growth improved (Mehl and Winkler 2002).

Most likely, this paradox is more apparent than real. Transition countries necessarily had to "clean up" portfolios of bad assets accumulated under communism and the first years of transition in order to stabilize their financial systems and even their macroeconomies. Thus this paper will start from the presumption that further economic development in SEE requires further financial development. In particular, I will focus on two external influences: the EU accession process, and the Basel II accord. The discussion of SEE countries' approach to these two sets of issues will be framed in the broader context of how SEE countries can achieved the desired goals of financial development and economic growth in general.

The basic themes of this paper are two-fold. First, there are major opportunities associated with the EU accession process, including greater access to resources through FDI, improved access to capital markets and official assistance. These flows can make great contributions to stabilizing and deepening SEE financial systems. But there are important challenges as well, as greater presence of foreign banks will pose important regulatory issues, and heightened capital inflows may produce increased volatility and raise risks of "sudden stops" and macroeconomic instability.

Second, banking supervisors in the SEE countries will face major challenges. The decision of whether, when, and how to adopt Basel II is only one of these. More

fundamentally, supervisors are faced with the challenge of adapting supervisory practices to their own local circumstances, including the level of financial development, strength of administration, and relations between supervisors and political authorities.

It is important to note at the start that the SEE countries are quite heterogeneous in economic and political terms. For this reason, there certainly is no “one size fits all” approach to the issues raised here.

The remainder of this paper is organized as follows. In the second section, I discuss what kind of financial sector SEE countries can aim for, and how public policy and in particular banking supervision can contribute to the development of such a financial sector. In the third section, I examine the EU accession process in light of financial sector development needs. In the fourth section, I focus on the issues raised by Basel II for SEE. The fifth section concludes.

2. What kind of financial sector for SEE and how to achieve it?

As Paul Hare indicates in his paper for the first session of this conference, financial systems in the SEE countries are relatively undeveloped. M2/GDP, credit to private sector/GDP and stock market capitalization/GDP, the standard indicators of financial development used in growth models, are relatively low for SEE countries. Furthermore, the EBRD’s overall assessment of banking sector development suggests that all the SEE countries, with the exception of Croatia, are far from desired levels.

Crucially, the institutional framework for the financial sector is also weak in the SEE countries. While in some cases the letter of the law may provide adequate protection for creditors, processes for collection of debt, foreclosure of collateral and bankruptcy remain difficult to use in practice. This often limits the range of financial instruments that may be profitably employed.

These observations lead me to suggest the following:

1. *The strategic issue in financial sector development is improved protection of creditors' rights.* At present, the courts often cannot be relied upon to enforce claims, and

¹ In this paper, I will define Southeast Europe to include Albania, Bosnia-Herzegovina, Bulgaria, Croatia, Kosovo, Macedonia, Serbia and Montenegro, and Romania.

political influence often makes debt collection slow or impossible. Laws on foreclosure and bankruptcy may be reexamined, but often the problem is not the letter of the law, but enforcement. This means that the issues involved are administrative and political.

The demand for creditor protection exists, but may not be strongly articulated in the political arena. But the key issue is probably the supply of creditor protection. Here, what is needed is political actors who see that a strong system of creditor protection and rule of law is actually superior to a system of arbitrariness and political influence. In the next section, I will return to this issue in the context of European integration.

2. *One should never lose sight of the macroeconomic prerequisites for financial development.* These include low inflation, moderate fiscal deficits, reasonable real interest rates, and a manageable balance of payments position and foreign debt. As Berglof and Bolton (2002) point out, macroeconomic stability is complementary to creditor protection. Governments that cannot enforce bankruptcy and continue to subsidize loss-makers have great difficulty maintaining macroeconomic stability.

3. *Given weak creditor protection and weak financial infrastructure, financial systems in SEE are likely to remain bank dominated, and reform energies should be put above all on banking.* In particular, it would be unrealistic to expect too much from stock markets.² Mechanisms to transfer equity stakes are important, to facilitate exit and create a market for ownership. But formal stock markets require high levels of transparency and strong enforcement of rules and procedures. Furthermore, some of the best SEE companies have already listed on western stock exchanges,³ and some top companies have delisted when bought by foreign strategic investors.

Other financial institutions are, of course, currently present. Insurance has great potential. Pension reforms that create mandatory individual pension funds can also stimulate development, by spreading experience with financial investment among broader sections of the population, and by creating demand for securities. But experience in Croatia, for example, shows that the pension funds are likely to mainly invest in government paper. This is not only due to legal limits, but also to the lack of alternative

² Berglof and Bolton (2002) argue that "bank-led finance may be inevitable at certain stages of development and that efforts to develop stock exchanges in some countries may have been premature."

³ In some cases, however, these listings are mainly for prestige purposes, and the main trading in the company's shares continues on the home stock exchange. I owe this point to Arnaud Mehl.

low-risk securities. Thus pension reform, while having a positive effect on financial market development, cannot be expected to produce major steps forward overnight.

Other capital market players, such as investment funds and venture capital, also cannot be expected to develop rapidly. Investment funds created via the privatization process have not had a major impact in the region, and venture capital has mainly been foreign and small scale.

4. *Banking supervision can play an important role by limiting risk taking, facilitating the exit of unsound institutions, and establishing discipline and respect for law.* Banking supervision exists for two broad reasons: to insure the stability of the system, and to protect the interests of uninformed depositors. Bank failures do not necessarily indicate supervisory failures. In fact, prompt recognition and resolution of failed institutions helps minimize costs, and is crucial to maintaining discipline and ensuring stability.

Bank supervisors in transition countries in general have faced difficult challenges in establishing credibility. An important initial hurdle was to show that failed institutions could and would be closed. Furthermore, supervisors have to show that they will not tolerate late and inaccurate reporting. Finally, supervisors must show that they are able to identify excessive risk taking and to take measures to either bring such banks into compliance or shut them down.

5. *Attention must be paid to providing adequate protection and incentives for bank supervisors.* In many cases, bank supervisors can be sued for their actions. As long as supervisors act in good faith and within the standards of their profession, they should be exempt from personal liability. This must be written into banking laws. Of course, banks must have legal recourse against supervisory action; but this recourse must be against the supervisory institution, and not against the individual supervisor.

In addition, bank supervisors are often poorly paid and punished, rather than rewarded, for taking action against a bank. For banking supervision to perform its role properly, adequate resources must be allocated to banking supervision.

6. *Institutional arrangements must be devised to maximize the political independence of bank supervisors.* In practice, this is likely to mean that bank supervision should remain within the central bank, since it usually has the highest level of legal and financial autonomy. Of course, as recent struggles in accession countries such as Hungary, Poland

and the Czech Republic, and SEE member Serbia and Montenegro show, legislating central bank independence is one thing, and enforcing it is quite another.

Although many European countries have now integrated financial supervision outside of the central bank, the reasons for such moves are not present in SEE. Institutions such as the UK's FSA and Germany's BaFin were created to deal with the fact that banks were becoming less and less banks and more and more diversified financial conglomerates. Such trends are not present in SEE yet, and the examples of advanced countries should not be artificially transplanted.

7. The importance of prohibiting pyramid schemes and other non-bank financial institutions from creating havoc must not be forgotten. Regulatory frameworks must give clear authority to deal with all financial institutions, including both the normal range of non-bank financial institutions and the more exotic institutional or informal manifestations of pyramid schemes. It does not matter so much which regulatory institution has authority over pyramid schemes, but it is crucial that someone be in charge.

3. EU Accession and financial sector development

Broadly speaking, the main potential benefit of the EU accession process is increased political stability and stronger democratic institutions. If these are achieved, economic development in general, and financial development in particular, will doubtless be strengthened. (Kaminski and de la Rocha 2003)

The road to be traveled, of course, varies dramatically from EU candidates Bulgaria and Romania, to recently restructured Serbia and Montenegro, and finally to Kosovo, whose status remains undetermined. However, further discussion of the political challenges facing each country or territory are outside the scope of this paper.

Regarding financial sector development in particular, moves towards EU accession send favorable signals to potential investors. The prospect that the *acquis communautaire* will be implemented over time should strengthen investor confidence. This would hold out the prospect of greatly improved access to resources on the international capital markets, and to special facilities of the EU and its member states. In addition,

growing political stability and strengthening of the legal framework, which would in part be the result of the EU accession process, should help attract increasing FDI.

There can be little doubt that easier access to resources and increased FDI are favorable to SEE countries. In particular, FDI in the form of entry of banks from EU countries has already played a major role in stabilizing the financial systems of both the current accession countries and several of the SEE countries (notably Croatia, Bosnia-Herzegovina, and Bulgaria). Foreign banks have superior capital strength, risk management and marketing skills, diversified portfolios and banking experience. Their entry into SEE markets should be welcomed.

But although the overall picture is positive, it is important to note that SEE policymakers face dilemmas and challenges regarding foreign banks:

1. *Can foreign banks be expected to stand by their “children” in SEE when they get into trouble?* If the answer is no, or may be no in some cases, then SEE regulators cannot be complacent about failure of foreign banks. Indeed, the case of Rijecka Banka in Croatia, in which a rogue trader incurred losses just less than the capital of the bank, should be a warning. The foreign majority owner, Bayerische Landesbank, walked away from the bank, returning its stake to the Croatian government for \$1. BLB had failed to detect the fraud during the due diligence process, and in fact failed to detect the fraud for the two years thereafter, when it was majority owner of the bank. It is not coincidental that the largest cases of operational risk have occurred at foreign subsidiaries of large banks (Barings, Allied Irish)

The point is simply this: regulators must continually strengthen their procedures for resolving bank failures, whether or not foreign banks are present or even predominate in the banking system. And they must do what they can to keep the banking system attractive to potential entrants, so that in case of failure, investors can easily be found.

2. *Are foreign banks especially biased towards retail lending in SEE?* Retail is an area in which foreign banks’ superior marketing knowledge and standardized products give them strong advantages. In several countries in the region, including Croatia, Bosnia and Romania, retail lending has grown fast since the entry of foreign banks. However, it is not only foreign banks that have favored such loans; domestic banks have attempted to

keep up, seeing the advantages of such lending (high demand, relatively low default rates, risk dispersion among large numbers of clients).

In Croatia, the Croatian National Bank has imposed a sort of reserve requirement on loan growth above 4% per quarter, without any distinction between types of loans. This has led to a more rapid decrease in lending to enterprises, a result that is not considered desirable, but is accepted as a price of the need to slow down credit growth. The policy issue here is quite important and, as yet, far from settled.

3. *Will foreign banks service SME's?* A considerable literature has sprung up on the issue of whether large banks are relatively uninterested in SME's in the US (Berger etc). In Latin America, where many large banks were sold to foreigners, the behavior of the foreign banks became the issue. The argument is that large banks and foreign banks have competitive advantage in dealing with standardized loans for consumers or larger firms whose books are relatively transparent. The soft, localized knowledge crucial for SME loans is likely to be unavailable or too expensive to acquire for large and foreign banks. At the same time, research by Clarke et al (2001) suggests that foreign bank entry, by raising competition and increasing the supply of funds, lowers interest rates and improves lending conditions, thus indirectly stimulating the supply of SME loans. For this reason, even if the first argument is correct, the global effect of foreign bank entry on SME loans may not be negative.

In SEE, there may be room for a little bit of cautious optimism in this area. First, there are very few large firms with transparent balance sheets to lend to. Competition to lend to such firms is extremely strong, and many banks are simply forced to look for other clients. Second, some of the foreign banks arriving in SEE have strong SME orientations in their home countries. And third, at least in Croatia, foreign banks have tended to employ local managers who do have the needed personal relationships and soft knowledge.

4. *Foreign bank entry may make it more difficult for the authorities to control and stabilize capital inflows, complicating exchange rate management and increasing the foreign debt.* Foreign banks have much higher credit ratings than domestic ones, and in any case often can borrow from their "mother" banks. In addition, a decision by a large foreign bank to allocate an extra 1% of its portfolio to one of the smaller SEE countries

may be overwhelming, since the larger foreign banks already involved in SEE have total assets well above 200 billion Euro, and the banking systems of most SEE countries have total assets less than 20 billion Euro.

The situation is further complicated for those countries with SAA agreements with the EU, since these countries are committed to fully liberalizing capital flows over a four-year transition period.

5. *There may be tradeoffs between the rate of increase of financial deepening and financial system soundness.* In recent years, there have been many examples of credit booms leading to banking and currency crises (Caprio and Klingebiel 1996, Gavin and Hausman 1996, Eichengreen and Arteta 2000). Credit booms often lead to deterioration of credit quality, and often stimulate aggregate demand and in particular imports. If both negative impacts are strong enough, a twin crisis may emerge.

However, as Gourinchas et al (2001) show, booms do not always lead to crises. And financial deepening requires that credit grow faster than GDP; otherwise the credit/GDP ratio would not grow.

This raises the question of how to manage credit booms. Authorities may adopt a wait and see attitude. This may be easier to do from the macro side, since balance of payments problems may be seen developing fairly clearly. Credit quality, however, is very difficult to monitor in real time. And it is even more difficult to accurately predict in a forward-looking way.

Two regulatory instruments have been proposed to handle such problems. One is the idea of speed limits, whereby banks are simply forbidden to grow beyond a certain rate. Another is dynamic provisioning, currently in force in Spain, whereby banks are required to add a “statistical provision” during years when the credit portfolio improves in quality. In the same spirit, banks are able to draw on these provisions in years when credit quality deteriorates. The statistical provision flattens the level of provisioning over the cycle, dampening fluctuations in profitability and credit growth.

At present, Croatia has used a variant of the speed limit idea, but only on a temporary basis (during 2003). Other SEE countries may want to consider these proposals.

To summarize, while foreign bank entry is certainly on the whole very positive for SEE, there are important challenges to be faced. In addition to this, the EU accession process raises important questions about the speed of adoption of the Maastricht criteria, EU banking directives, the EU deposit insurance directives, and the liberalization of capital account transactions.

1. *Maastricht criteria.* Since macroeconomic stability is a key to financial sector development, it is clear that SEE countries want to fulfill the Maastricht criteria. The only question is how quickly. Several accession countries, including Hungary, Poland and Slovenia, had inflation rates substantially above the Maastricht thresholds right up to the past year. Since membership in ERM and adoption of the Euro are not required on entry to the Union, even accession itself does not imply meeting the criteria. Further discussion of these issues goes beyond the scope of this paper, but it should be sufficient to say that the path towards meeting the criteria will be determined by the SEE countries themselves in the light of their overall macroeconomic policies and strategies.
2. *Banking directives.* Most of the EU banking directives codify aspects of the Basel I accords and the Core Principles on banking supervision. Banking supervisors in SEE are already working to align their practices with these standards. While there will be specific changes needed, such as consolidated supervision, further steps in EU accession will not generally require major changes in this area over and above the ongoing efforts to improve supervision and implement the core principles.

As countries come closer to accession, it will be necessary to amend or rewrite banking laws to allow information sharing with the EU and its organs, and to grant automatic right of establishment to EU banks. These changes can be safely postponed by those countries that do not expect to accede in the near future.

Another very important issue regarding implementation of EU banking directives is the introduction of the Basel II agreement. I postpone this discussion to the next section.

3. *Deposit insurance directives.* Here the situation is rather different than with banking directives. For one thing, the minimum level of deposit insurance coverage of

€20,000 mandated in EU Directive 94/19/EC is certainly too high for SEE countries. Comparative studies by the IMF suggest that deposit coverage averages about 3 times GDP per capita. (Garcia 1999) Immediate adoption of EU norms, of course, would result in much higher levels, drastically decreasing the number of uninsured depositors and thereby decreasing the potential market discipline that such large depositors could exert. Not to mention the potential fiscal liabilities involved.

For another thing, there is now a certain amount of research suggesting that introduction of deposit insurance when the institutional framework is extremely weak can actually increase financial sector instability (Demirguc-Kunt and Detragiache 2000). While this research is still somewhat tentative, it does stand to reason that deposit insurance schemes that are incompletely funded and untested will not have the same stabilizing effect on depositors as well funded and well established systems. For these reasons SEE countries that do not yet have deposit insurance schemes would be well-advised to seriously discuss the timing of introduction, design and maximum coverage without feeling obliged to comply with EU directives immediately.

4. Basel II in SEE

The Basel II accord proposes important changes in supervisory practice. It rests on three pillars: minimum capital requirements, supervisory review and market discipline. The accord provides a menu of choices for how countries can implement the three pillars. Most importantly, supervisory authorities decide whether to implement the standard approach or one of the two forms of the internal ratings based approach.

In the standard approach, capital requirements are set by pre-determined risk categories similar to the current accord. The new accord, however, provides more risk buckets, and gives a role to external credit ratings agencies (ECA's) in determining capital requirements for lending to sovereigns and foreign banks and companies.

In the internal ratings approaches, banks model their capital requirements based on parameters such as the probability of default, loss given default, exposure at default and (in some cases) maturity of claims. Banks' models are subject to supervisory review and authorization.

The EU has decided to implement the framework by the end of 2006. However, the SEE countries are not obliged to do so, and even the two accession countries could conceivably argue for a derogation if they felt the need.

There are strong reasons for SEE countries *not* to implement the internal ratings aspects of the accord any time soon. These methods require at least a whole business cycle of data on large numbers of individual borrowers. Such data are not available in SEE. And even if they were, the overall instability make it difficult to believe that such data would lead to adequate predictions about default rates and losses in the future.

Furthermore, for banks to use such methods, they must have highly skilled statisticians and financial economists. Even if foreign banks active in SEE have such people, their work must be monitored by equally skilled supervisors. It is very doubtful whether SEE supervisory authorities can train such personnel by 2006.

However, this does not mean that SEE countries could not implement the standard approach by 2006. The standard approach augments Basel I in several ways that are quite relevant, especially the new emphasis on operational risk. Also, the standard approach only uses external credit agencies for ratings of sovereigns, and since most countries in the region are rated, this does not represent a problem either.

The decision about whether to implement Basel II in its most minimal form rests mainly on an assessment of how well supervisors currently implement Basel I and the core principles, and on an assessment of the supervisors' ability to master the new requirements in the coming 3-4 years. The answers to these questions may well vary country by country. It is certainly reasonable to think that some SEE countries will be able to implement the standard approach to Basel II by end 2006 or shortly thereafter.

The presence of foreign banks in SEE raises some additional issues. It can be expected that foreign banks will pressure supervisors to allow them to use their internal rating models. Foreign banks are spending large sums on creating such models in their home countries, and they may see the marginal costs of extending these models to SEE countries as low. Furthermore, they may believe that use of the models in SEE may allow them to obtain lower minimum capital requirements.

Fortunately, as long as the foreign banks are operating through subsidiaries in SEE, supervisors can simply refuse to authorize the use of the models. They should do

this if there is any doubt about the quality of the data, the appropriateness of the model to local conditions, or the ability of the supervisory authority to evaluate the models. In other words, the bias should be to refuse.

Foreign banks may attempt to convince supervisors that they are required to use the models by their home country supervisory authorities. This, however, is simply not true. The accord allows banks to exempt certain geographical areas from the models if data are unavailable or inadequate. SEE supervisors should avoid being pressured into approving the models.

Where problems could conceivably occur would be in cases where foreign banks set up branches in SEE. Thus far, branches have been infrequent and small scale. But branches would be subject to home country supervision, since they are directly included in the home bank's balance sheet. In this case, conceivably, home country supervisors could approve use of internal models in SEE jurisdictions against the wishes of SEE supervisors. However, the lack of such branches makes such a problem relatively unlikely for the moment. If it should become a problem, SEE regulators could consider restricting the activities of foreign branches, just as the US does not allow foreign branches to perform retail banking.

The use of internal ratings by some banks could in theory provide them with a competitive advantage if it led to lower capital requirements. Thus it is very important that host and home country supervisors work together in dealing with foreign bank branches and even subsidiaries to avoid special treatment.

There has been some concern that SME lending will be negatively affected by the new accord. The reason is that exposures to firms with good credit ratings (mainly large firms) will carry lower capital requirements than exposures to unrated firms. However, in SEE, almost all firms will be unrated, so that this effect will not occur. Also, it may be possible for banks to put some SME loans into their retail portfolio, as specified by the accord. The retail portfolio, if it consists of exposures of less than 1 million euro and meets some additional criteria, has a 75% capital weight instead of the standard 100%.

Finally, there has been some concern that Basel II will impede cross-border lending. Under Basel I, sovereigns were classified as OECD members, with 0% risk weights, or non-OECD members, with 100% risk weight. The absurdity of this

distinction was underlined when two OECD members, Mexico and South Korea, defaulted in the 1990's. Basel II proposes to use external credit rating agencies' assessments, and creates a set of risk buckets based on this. Lending to foreign banks and corporates is based on this classification, with risk weights higher than the sovereign's.

Many criticisms have been raised on this score. Ratings agencies are rightly accused of lagging actual changes in borrower creditworthiness. And the 150% risk weight on sovereigns with ratings below investment grade creates an incentive to be unrated rather than badly rated.

However, it is difficult to see a better alternative here. From a supervisory perspective, it is better to acknowledge the risks in lending to sovereigns with poor creditworthiness. 150% risk weights make lending more expensive. However, the new accord will give sovereigns with below investment grade credit ratings a further incentive to improve their rating (or avoid being rated at all!)

Ward (2002) worries that emerging market economies will be pressured into adopting Basel II by the International Financial Institutions and perceptions of the need to "join the club" in order to receive the most favorable lending terms in international capital markets. It is important that both the EU and the SEE countries themselves clearly understand that rushing to adopt the most sophisticated supervisory practices is not advisable at this point for SEE. Political pressures regarding this issue should be resisted.

Furthermore, SEE countries should carefully consider non-conformity in their minimum capital requirements as well. Albania, Bosnia-Herzegovina, Bulgaria, Croatia and Moldova already require minimum capital adequacy ratios of 10-12%. Other SEE countries could consider this as well.

In summary, so long as supervisors stick to the standard approach, and phase in implementation of Basel II at a pace compatible with their own capabilities and conditions, Basel II should not have disruptive effects in SEE. On the contrary, steps towards better monitoring of operational risk, improved transparency and disclosure, and better adaptation of risk weights to economic risk should provide a modest improvement in the quality of supervision and overall stability in the banking system.

5. Concluding remarks

I have tried to point out the risks and opportunities in EU accession and Basel II for financial development in SEE. In the end, I would like to suggest that SEE countries can take advantage of these opportunities by carefully tailoring their responses to their own financial development goals and economic and political environments. There is no reason to adopt the most sophisticated regulatory or risk management approaches if the necessary preconditions are not met. And SEE countries should carefully consider by what path they can reach their goals, for it may well be that what appears to be the straightest and shortest way is not that at all.

APPENDIX 1: THE PRESENT STATE OF SEE BANKING SYSTEMS

The current level of financial development in SEE varies quite a bit from country to country. Table 1 shows five of the basic indicators of financial sector development that have been found to be significant in growth regressions. SEE and CEE countries are compared.

Table 1: Indicators of financial sector development

	Total bank assets/GDP		Credit to private sector/GDP		Commercial bank deposits/GDP		m2/GDP		Stock market capitalization	
	1996	2001	1996	2001	1996	2001	1996	2001	1996	2001
Albania	73,0	55,0	3,9	4,0	38,0	46,5	38,4	62,1	na	na
Bosnia*	81,3	54,5	na	7,0	16,0	28,6	18,8	47,0	na	na
Bulgaria	158,2	38,5	35,3	14,6	63,6	27,1	71,0	40,9	0,2	3,7
Croatia**	62,6	87,5	21,4	34,2	29,8	59,7	34,0	65,1	15,3	16,8
Macedonia	36,2	42,4	26,5	12,5	7,7	21,3	10,5	29,3	2,3	0,4
Moldova	19,4	25,3	6,8	14,8	7,9	14,7	14,6	16,8	2,3	2,4
Romania	39,0	26,1	11,5	8,0	23,5	21,0	27,9	24,0	0,2	6
AVERAGE	67,1	47,0	17,6	13,6	26,6	31,3	30,7	40,7	4,1	5,9
AVERAGE w/o Croatia	66,8	37,4	16,0	11,4	23,7	22,5	28,6	31,6	1,0	2,5
CEE										
Czech Republic	100,4	96,7	47,2	24,5	62,6	66,1	71,5	76,9	31,4	15,4
Hungary	56,5	59,5	21,9	30,6	40,7	44,4	48,1	45,6	5,8	16,7
Poland	47,4	52,9	15,9	18,4	31,1	40,3	36,7	44,3	6,6	14,0
Slovakia	81,4	93,0	30,4	27,6	60,4	61,3	68,7	68,4	11,5	3,3
Slovenia	64,1	87,1	26,4	40,4	36,6	54,1	44,4	60,3	3,6	15,3
AVERAGE	70,0	77,8	28,4	28,3	46,3	53,2	53,9	59,1	11,8	12,9
Euro zone		243,2		108,4		81,1		84,8		

*total bank assets/GDP and commercial bank deposits/GDP for 1997 rather than 1996

**m4/GDP instead of m2/GDP

Sources: IFS and EBRD

Beginning with total bank assets to GDP, we see that SEE countries lag far behind the Euro zone. Not only that, as of 2001, they also lag quite far behind CEE, especially when Croatia is excluded. At first glance, the sharp fall in this indicator in SEE from 1996 to 2001 may seem strange. The main cause is the drastic drop in Bulgaria. This drop is partly the result of the hyperinflation and banking crisis of 1996 and 1997. But part of this drop, and probably much of the drops in Romania and Albania as well, reflects recognition of the fact that many of the assets on banks' books in 1996 were actually worthless. To the extent that decreases in bank assets simply reflect recognition of past losses, they are not worrisome economic phenomena but actually represent attempts to come to grips with the actual state of affairs.

The figures on credit to the private sector/GDP reinforce these observations. The decrease in credit in Bulgaria is the most striking. By 2001, all of the SEE countries except Croatia have credit less than 15%, while Croatia is actually above the CEE average at 34%.

The low levels of deposits to GDP indicate the limitations facing the banking sectors in SEE. In 2001, all the SEE countries except for Albania and Croatia had deposit/GDP ratios under 30%. The gap between SEE and CEE, which had an average of 53.2%, is enormous. Clearly, these differences are shaped both by differences in aggregate savings ratios and differences in depositor confidence in the banking system. Sophistication of payments systems and the extent of the unofficial economy also would be important determinants of deposits. M2/GDP ratios tell basically the same story.

Finally, stock market capitalization/GDP remains in the low single digits in SEE, again with the exception of Croatia. Only Slovakia of the CEE countries has such a low level of stock market development. With small numbers of high-quality companies, limited disclosure and transparency, questionable rule of law and inexperienced regulation, the short-run prospects for stock market development in SEE are far from rosy.

The data in Table 1 present a picture of the quantity of financial development, so to speak, in SEE. Table 2 tries to address the quality of financial development.

Table 2: Foreign bank presence, bad loans and EBRD ratings

2001 data	Foreign bank share	Bad loans	EBRD banking reform	EBRD Financial Regulations		Transparency International Corruption Perceptions Index 2002
				Extensiveness	Effectiveness	
Albania	86,1	6,9	2,3	2	1,7	2,5
Bosnia	63,1	7,0	2,3	1,3	1	na
Bulgaria	66,7	7,9	3	3	3	4,0
Croatia	74,8	15,0	3,3	3	3	3,8
Macedonia	43,5	24,7	3	3,3	2	na
Moldova	60,9	9,9	2,3	4	3	2,1
Romania	60,6	3,4	2,7	4	3	2,6
Serbia and Montenegro		24,4	1	3,3	2	na
AVERAGE	65,1	12,4	2,5	3,0	2,3	3,0
CEE						
Czech Republic	70	13,7	3,7	3,3	3	3,7
Hungary	62,2	3,1	4	3,7	3,7	4,9
Poland	61,3	20,1	3,3	4	3	4,0
Slovakia	60,6	24,3	3,3	3	3	3,7
Slovenia	16,0	8,2	3,3	4	3,7	6,0
AVERAGE	54,0	13,9	3,5	3,6	3,3	4,5
no Slovenia	63,5					

Foreign Bank share: foreign bank share in total capital, Banking Supervisors of Central and Eastern Europe Review 2002. Transparency International Data from www.transparency.org. All other data from EBRD *Transition Report 2002*.

Interestingly, the share of foreign banks in SEE and CEE is similar, especially if we exclude Slovenia, which has been rather closed to banking FDI. While the SEE's may be more attractive due to the lack of strong local competition and government's weaker bargaining position, the CEE's provide a more stable and predictable environment. It seems that both groups of countries are quite attractive for foreign banks.

Also, there is virtually no difference in bad loan ratios in the two groups of countries. However, this aggregate situation hides important differences in individual countries. Furthermore, the meaning of the numbers may be quite different in different countries. That is, Hungary's 3.1% bad loans have been achieved in a situation of relatively stable economic growth and firm banking supervision, while Romania's 3.4% bad loans have come in a situation of unsteady economic growth and less developed

banking supervision. The fact that the two countries have similar bad loan ratios cannot be taken to imply that the banks in both countries do equally good jobs of risk management, nor can it be taken to imply that bank supervisors apply equally strict loan classification criteria with equal consistency.

If we now move to the EBRD ratings provided in the next columns, we see that overall banking sector progress is on average one rating better in CEE than SEE. Since a score of 4+ means that a country has reached EU standards, this means that the CEE countries are one big step closer to meeting EU standards than SEE countries. This is a big gap; in recent years countries have usually taken several years to advance by a full point on the EBRD's scale. For example Hungary, considered a leader in banking reform, stayed at a rating of 3 from 1993 to 1996, despite major bank recapitalizations and privatizations. It achieved a rating of 4 in 1997. Slovenia remained at 3 from 1993 to 1998, despite the rehabilitation of 3 of its largest banks and significant regulatory improvements. In 1999, Slovenia moved up, but only to 3+.

Importantly, when we look at the question of regulatory effectiveness, the gap between SEE and CEE is less in extensiveness (0,6) than in effectiveness (1,0).⁴ This is characteristic of SEE's problems: laws and regulations may be on the books, but they are not well-enforced. To be fair, we should note that effectiveness ratings are lower than extensiveness ratings in CEE as well. But the larger gap between CEE and SEE in effectiveness underlines SEE's weaknesses in that area.

Finally, the last column provides the Transparency International Corruptions Perception Index for 2002. While there is a big difference between the SEE and CEE average, it is interesting to note that Bulgaria and Croatia actually did slightly better than the Czech Republic and Slovakia. Less encouraging, however, are the scores for Moldova and Albania and, importantly, EU candidate Romania.

APPENDIX 2: THE MAIN EU DIRECTIVES RELATING TO BANKING AND FINANCIAL SERVICES

⁴ Extensiveness measures the degree to which laws concerning banking and securities regulation generally conform to international standards. Effectiveness measures whether the laws are comprehensively enforced. This includes whether laws are supported by appropriate regulations and whether the laws are enforced by bodies possessing adequate powers and independence. (See EBRD *Transition Report 2002* p. 41.)

1. Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC defines licensing procedures, minimum capital levels and supervision of credit institutions.
2. Council Directive 89/647/EEC on a solvency ratio for credit institutions aims to harmonize supervision and to strengthen solvency standards among credit establishments in the Community.
3. Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions defines standard formats and contents of these reports.
4. Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes defines guarantees provided to depositors and defines a minimum coverage level.
5. Council Directive 92/121/EEC of 21 December 1992 on the monitoring and control of large exposures of credit institutions limits the exposures banks may have to a single client.
6. Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate defines standards and procedures for the supervision of financial conglomerates.
7. Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganization and winding up of credit institutions

Most of the EU's directives on banking actually codify the recommendations of the Basel Committee on Banking Supervision. For example, the Second Banking Directive (89/646/EEC) required member states to follow the 1988 capital accord. Since SEE countries have generally been attempting to harmonize bank regulations with BCBS standards, these aspects of European regulation do not represent an additional burden. Furthermore, as I discuss in more detail in regard to Basel II, these directives do not have legal force until SEE countries become EU members. And it may be possible to negotiate

derogations in cases where the implementation of elements of the directives seems inappropriate at the moment of accession.

Some other EU directives set particular parameters that will affect SEE countries if and when they become members. Most notably, the deposit insurance directive (94/19/EC) sets the minimum level of deposit insurance that EU member states must provide. This level, 20,000 €, is well above the levels provided by SEE countries. Unless a derogation is sought, new entrants to the EU will have to raise their coverage levels substantially.

However, raising coverage levels would decrease the number of uninsured depositors who are believed to most actively monitor bank performance. This could increase moral hazard. In addition, increased coverage raises the contingent liabilities of the government to the extent that deposit insurance schemes are ultimately financed by the government and not by banks. It should be noted that even if banks fund the deposit insurance scheme through contributions, in more severe banking crises, these funds are often exhausted and government funds are called upon (for example, in the Savings and Loan Crisis in the United States in the late 1980's and early 1990's).

Finally, EU banking directives also stipulate the division of authority between host and home country supervisors regarding member states banks with branches in other member states. For example, Directive 2001/24/EC stipulates that the authorities of the home state of a bank with branches in one or more host member states have the legal right to initiate reorganization or winding up of the institution as a whole. The home member authorities are only obliged to inform the host member authorities; they are not obliged to consult them.

There are a number of important issues of this sort, including the question of who will provide lender of last resort facilities to a branch or a subsidiary of a bank. While the answer in principle is clear, the practicalities are not, mainly because no such cases have yet arisen. However, these issues, although important, will probably be low on SEE states agenda, since they refer to the situation obtaining after EU membership.

A final, very important observation about EU banking directives is that, unlike the voluntary Basel agreements, EU directives have the force of law for EU members. This decreases EU members' flexibility in implementing the Basel requirements relative to

non-EU countries. For example, the United States plans to only require its largest banks to implement Basel II provisions. Such an approach would not be possible in the EU.

APPENDIX 3: THE INSTITUTIONAL ORGANIZATION OF BANKING SUPERVISION

Banking supervision must be organized to minimize political interference. Matters such as determination of whether bank owners and managers are fit and proper, whether banks are solvent, and the most appropriate remedial measures or resolution procedures in particular cases should be left to the judgment of experts, and should not be the subject of political lobbying. Political involvement is appropriate in establishing broad policies, such as setting criteria for licensing, for example, or determining the manner of resolution when public funds are involved. Furthermore, supervisory authorities can and should be held accountable for their work. However, political involvement in individual cases is certainly not desirable.

Achieving the proper balance between the unhindered functioning of supervisory expertise in particular cases and political accountability over broad policies and cases of supervisory misconduct or error is a major challenge in all countries. The challenge is all the greater in transition countries, where political involvement was highly pervasive during the communist period, and often still remains high.

A glance at the organization of banking supervision around the world immediately reveals that these matters are resolved in different ways in different countries. In some cases, central banks are responsible for bank supervision; in other, separate government agencies are responsible; and in a third group, the Ministry of Finance itself is responsible. Generally speaking, supervision by the Ministry of Finance is the most politicized and least effective, while there is little systematic evidence to distinguish between central bank or separate agency supervision. (Barth, Caprio and Levine 2001)

In the SEE countries studied here, central banks are responsible for bank supervision, except for Bosnia and Herzegovina. The case of Bosnia and Herzegovina is special, however, because specific political circumstances surrounding the Dayton Agreement led to the establishment of entity-level banking supervision authorities. The only way to devolve supervision to the entities was to keep it outside of the central bank.

Keeping banking supervision in the central bank was probably a logical solution for SEE countries at the beginning of transition. Central banks have a relatively high degree of independence from political interference compared to other institutions. Also, central banks are usually responsible for managing the payments system, a key to systemic stability. Further, central banks are not directly dependent on the budgetary process, since they usually have substantial income from their management of the country's foreign exchange reserves. While there may be pressure to turn over profits to the budget, the Central bank does not have to go to the Treasury for funds. Quite the opposite; the Treasury has to attempt to squeeze the Central bank to extract its profits.

In addition, the strong reputation of the Deutsche Bundesbank and the growing consensus in the 1990's that central bank independence tends to result in low inflation led to the adoption of central bank laws that, at least on paper, granted high degrees of independence to SEE central banks. (Cukierman, Miller and Neyapti 2000) Naturally, the de facto degree of independence was not always as high as it was de jure. Nonetheless, it seems reasonable to believe that central banks were more independent of political influence than separate government agencies would have been.

What has changed in the meantime? Starting with the establishment of the Kredittilsynet (a unified financial services regulator) in Norway in 1986, there has been a growing trend to unite the various agencies supervising financial institutions into a single, all-encompassing financial regulator. Single regulators exist in 13 countries: Austria, Denmark, Germany, Iceland, Ireland, Japan, Korea, Norway, Sweden, the UK, Hungary, Latvia and Estonia. (Briault 2002). In addition, at least two other countries, Australia and the Netherlands, have collapsed their regulatory agencies into two bodies, one for prudential supervision and one for conduct of business supervision (Jonk, Kremers and Schoenmaker 2001). And Finland has a Financial Services Authority linked to its central bank along with a separate agency to supervise mandatory pension funds. (Taylor and Fleming 1999)

The main driving force behind these organizational changes in financial supervision is the ever-increasing integration of financial services markets. Demarcations between banking and insurance, and between banking institutions and capital market

institutions, are breaking down as financial conglomerates become more and more important in the advanced countries.

Regulators had to reappraise their organizational schemes and their practice in light of these developments. In many cases, it was found that there were overlaps between the authorities of different regulatory agencies. At the same time, there were also gaps, types of financial firms or products that were not regulated by anyone.

The movement toward unification of regulatory bodies has been a response to these challenges. The benefits of unification include comprehensive supervision, avoiding gaps in coverage or overlaps; economies of scale in data gathering and support services; greater influence of the single regulator as opposed to several smaller regulators; and more consistent approaches across financial instruments. At the same time, costs of unification include high transition costs in transforming separate agencies into one, cultural clashes between prudential regulators and business compliance regulators, and possible diseconomies of scale due to excessive size of the new agency.

Furthermore, as the Dutch and Australian cases show, it is not entirely self-evident whether unification, even if desirable, should result in the formation of a single agency or perhaps two agencies. Both the Dutch and Australian authorities argued that prudential supervisors could be grouped together profitably and could be given the task of overseeing the stability of the financial system. Business compliance supervisors, they argued, should be grouped into a different agency. Business compliance supervisors (for example securities supervisors) are more concerned with cases of fraud, misleading advertisement and insider trading, which have little to do with the assessments of balance sheets and risks that prudential supervisors focus on.⁵

What, if anything, are the implications of these debates for SEE countries? It should be noted that several accession countries (Hungary, Estonia and Latvia) have unified their financial services supervisory authorities. These are countries with strong foreign bank presence. The home countries of the foreign banks active in these countries—mainly Germany, Austria and the Scandinavian countries—have single

⁵ The Dutch model keeps the central bank involved in prudential supervision, while the Australian model rests on an independent prudential agency. In addition, the Dutch model has two closely cooperating but distinct prudential supervisors, the central bank and the Pension Supervision Agency, while Australia has a single prudential supervisor (the Australian Prudential Regulation Agency).

financial supervisors. Thus it may be easier for these transition country supervisory agencies to communicate and cooperate with their EU counterparts if they are organized in the same way, as single agencies. In addition, the foreign banks in Hungary, Estonia and Latvia have to some extent started to function as financial conglomerates.

Despite this, one can question whether adoption of this model makes sense in SEE. Financial conglomerates do not yet exist in SEE. In fact, capital markets are very poorly developed and pose little threat to systemic stability.

Goodhart (2000) argues against separating central banking from banking supervision in developing and transition countries for three reasons:

1. The financial structure tends to be less complex in developing and transition economies, with financial conglomerates themselves less complex and less important.
2. Developing and transition economies have been more prone to systemic instability. Effective reaction to systemic instability requires that the central bank maintain the best possible information about banks--by keeping supervision in-house.
3. The status and quality of the personnel in central banks in developing and transition countries tends to be substantially higher than in other regulatory institutions. This is due to the relatively high degree of independence of central banks, and the high status enjoyed by those central banks that have succeeded in achieving low inflation and acceptable levels of macroeconomic stability. Central banks' advantage is also partly because central banks are not directly funded from the budget, and therefore can pay better salaries and offer better chances of education, training and career advancement (although central banks are also vulnerable to competition from commercial banks for the best cadre).

I believe that these arguments continue to apply to SEE countries. Thus, for the foreseeable future, it would make sense to leave banking supervision in central banks. However, this does not preclude something along the lines of the Finnish or Dutch solution. That is, SEE countries could consider bringing other supervisory agencies that deal with prudential issues into an enlarged supervision agency tied to the central bank.

Most likely, insurance and pension funds would be the prime candidates for such a merger. Such a merger would increase the status and clout of the non-bank regulators, and could enhance the central bank's ability to monitor and defend the stability of the financial system as a whole.

There are, however, good arguments for the status quo. It will take time for SEE regulatory agencies to master the skills necessary to supervise such institutions as stock markets, insurance funds, pension funds and investment funds. Radical organizational change through merger may prove to be disruptive and may destroy fragile progress made.

As SEE financial markets deepen and the competencies of regulatory agencies improve, it may be advisable to revisit these organizational questions. However, even EU membership does not require a change in the organizational structure of financial supervision. For example, the Banca d'Italia continues to supervise Italy's banks, even though the country is a member of the EU and the Eurozone. While the formation of a European banking supervisory authority has been proposed (Vives 2001), it is far from clear whether it will happen, and whether such an authority would be a banking supervisory authority only or a financial services authority. Absent a clear model, SEE countries have no reason to make major changes at this point.

APPENDIX 4: THE PROBLEM OF SUPERVISORS' INCENTIVES

Oftentimes, bank supervisors are expected to behave with perfect impartiality, using their expertise to make the most accurate judgment possible about the soundness of regulated institutions. However, as Boot and Thakor (1993) pointed out in their aptly titled article "Self-Interested Bank Regulation", it is naive to expect that supervisors would not have their own interests.

I will discuss two aspects of "self-interested" regulation: problems created by political influence and corruption, and problems created by the career interests of supervisors. I begin with the first aspect. Clearly, if corruption is a general problem, it cannot be expected that bank supervisors will be immune. It would be helpful to pay supervisors well, but supervisors will generally be lower paid than private sector bank

employees. This creates personnel retention problems for the supervisory agency, and temptations to accept bribes.

In a related vein, supervisory incentives can be distorted if supervisors fear political or legal reprisal for undertaking corrective actions against banks. The Core Principles on Banking Supervision (BCBS 1997) advocate granting supervisors legal immunity for actions undertaken in good faith and in accordance with professional standards: supervisors should have "protection (normally in law) from personal and institutional liability for supervisory actions taken in good faith in the course of performing supervisory duties" (BCBS 1997 p.14).

Tison (2003) disputes this, arguing that European case law "allows to duly take into account the complexity of prudential supervision and the discretion left to supervisory authorities in performing their functions." But it is hard to be enthusiastic about a large degree of reliance on courts to arbitrate banking supervision cases. Arguably, even in the EU, such an approach could have a chilling effect on supervisors, and could lead to large numbers of very complex and expensive suits.

When we translate these arguments to SEE, where courts are far more subject to political and interest group influence, the case for leaving these matters to the courts seems even weaker. In SEE, where the independence and professionalism of public servants has hardly been adequately established, it seems extremely unwise to make supervisors individually legally responsible.

Even the idea of making supervisory institutions legally responsible in SEE countries should be dealt with very carefully. Given the strong pressures likely to be exerted by interested parties and by politics, it should be required that complainants show that the regulator has not acted in good faith and/or has committed gross negligence. That is, the requirements for overturning a regulatory decision should be very high.

The second aspect of problems relating to supervisory incentives is that supervisors may allow their own reputational and career considerations to distort their action. Supervisors may practice forbearance, avoiding taking harsh measures against a bank, in the hopes that the situation will improve of its own accord and the supervisor will not be blamed for allowing the bank to fail. However, experience shows that

problems almost invariably get worse, not better, and that the eventual cost of resolution rises if action is delayed.

Forbearance became a major theme in the debate surrounding the U.S. Savings and Loan debacle in the 1980's. Forbearance was seen not only in the practice of individual supervisors, but in Congressional rulings that lowered capital adequacy standards in the face of widespread insolvencies in the S&L industry in the early 1980's. (US GAO 1985, Lindgren, Garcia and Saul 1996)

The main remedy for the tendency to forbearance was the introduction of prompt corrective action obligations in the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. FDICIA actually required supervisors to take specified actions against banks whose capital was impaired, including withdrawing the bank's license if capital adequacy falls below 2%. The key point here is that supervisory discretion is limited, since the law specifies mandatory steps in specified situations.

In addition, FDICIA introduced the principle of least cost resolution. This protects the interests of taxpayers, and prevents supervisors from attempting to cater to particular interests by compensating depositors or investors beyond the minimum required by law and by the need to resolve the problem institution.

FDICIA-style limitations of supervisory discretion tend to be opposed by supervisors and banks alike. Supervisors argue that discretion is useful and will allow them to handle problem situations with appropriate flexibility, avoiding shutting down viable but troubled banks. Bank owners similarly argue that shutting a solvent but poorly capitalized bank infringes on shareholders' property rights. They similarly oppose legislation allowing supervisory authorities to limit banks' actions or to remove managers and owners at undercapitalized banks.

At present, to the authors' knowledge no SEE country has strong FDICIA-like legislation. In Croatia, for example, prompt corrective action powers have been substantially strengthened by the new Banking Law, passed in 2002, but supervisory discretion remains relatively wide. The principle of least cost resolution is not clearly stated in law.

APPENDIX 5: THE MAIN FEATURES OF THE BASEL II AGREEMENT

The Basel capital accord of 1988 represented a major step towards the goal of creating a level playing field for international competition among banks. In addition, it succeeded in creating awareness of the importance of bank capital as a buffer against losses. The Accord was intended to increase the stability of financial systems. However, some economists have pointed out that regulations forcing banks to hold more than their desired level of capital may lead banks to actually increase the riskiness of their portfolio. This happens because the capital regulations restrict the risk-return frontier, and the banks may choose to obtain this lower, constrained level of utility by increasing risk or by decreasing return. (Koehn and Santomero 1980, Kim and Santomero 1988 and Rochet 1992). In addition, numerous authors have suggested that rigid minimum capital adequacy requirements could lead to "credit crunches" during recessions (Bernanke and Lown 1991, Peek and Rosengren 1997 and 2000, Hancock and Wilcox 1997 and 1998).

Empirical evaluation of these claims is a rather complex task. Jackson et al 1999 find indications that introduction of the accords did induce weakly capitalized banks to rebuild their capital ratios more rapidly than otherwise. The same authors regard evidence on the accord's effects on banks' overall portfolio risk inconclusive. Despite this, Berger, Herring and Szego (1995) conclude the empirical evidence rather strongly suggests that overall bank risk is lower with higher equity. For example, Avery and Berger (1991), using U.S. bank data from 1983 to 1989, find that the risk weights implemented under the first accord lead to capital requirements that are better predictors of write-offs and bank failure than unweighted assets.

Thus, there is some evidence that the capital accord had an impact on bank capital ratios and that it provided a better approximation to bank risk. At least three issues remain, however. The first is whether the first Accord tended to produce credit crunches. Hancock and Wilcox (1997, 1998) and Peek and Rosengren (1997, 2000) find evidence of effects on particular sectors such as real estate or small business due to pressure on capital at banks in the United States during the early 1990's. But they do not find any major effects at the national level, nor do they see such evidence for other countries.

The second issue is whether the exact risk weights prescribed by the first Accords accurately reflect asset risk. The answer is clearly no. Jones and King (1995), for example, show that the correlation between risk-weighted assets and the probability of

failure can be substantially improved if the risk weights are increased on assets that are classified as substandard, doubtful or loss by bank examiners.

The third issue is whether the first Accord creates substantial incentives for regulatory arbitrage. Again, the answer must be yes. For example, since all non-collateralized loans to firms get a 100% risk weight, such loans to low risk firms are actually charged a capital requirement above the true economic requirement, while such loans to high risk firms may actually be charged a capital requirement below the true economic requirement. Since banks are required to allocate the same amount of capital for each euro of loan to the high-risk firm and the low-risk firm, it is actually cheaper to favor high risk loans within the capital requirement category.

Recognizing these two problems, the Basel Committee on Banking Supervision sought to amend the first accords in order to make regulatory capital requirements come as close as possible to “true” economic capital requirements. In addition, developments in risk modeling made it possible to use much more sophisticated techniques to measure risk and therefore economic capital. The Basel II accord allows banks to use these techniques not only for their own internal risk management purposes but also to determine regulatory capital.

The Basel II accord includes three "pillars": capital requirements, supervisory review, and market discipline. Each of the three pillars is intended to reinforce the others. Capital requirements, although determined in a greater variety of ways, continue the basic thrust of the first Accord. Supervisory review is strengthened and made more explicit, in part because of the greater responsibility devolved onto banks. In particular, supervisory review is crucial in testing and certifying banks' credit risk models. Finally, the element of market discipline is explicitly introduced, relying heavily on public disclosure as a way to inform market participants about banks' behavior, and thus to enable market participants to exert pressure on banks' behavior.

This whole approach leads to several very tricky issues. First, the fact that banks themselves are to be allowed to calculate their own regulatory capital requirements creates severe incentive problems. The Basel II process attempts to build in safeguards to avoid abuses. But, at the same time, if banks are to have incentives to spend the

substantial resources needed to build sophisticated risk models, there must be some benefit to doing so. And the logical benefit is decreased regulatory capital requirements.

A second tricky issue involves the development of risk models themselves. Such models are still relatively new, and their robustness to structural changes in the economy in general and the financial markets in particular has yet to be fully tested. Historical data can be used to backtest the models, and to simulate the performance of the models in hypothetical scenarios, but more experience will be needed to see how well the models perform when used widely.

A third tricky issue is the possible procyclicality of the Basel II capital requirements. Under Basel I, capital requirements were based on broad classifications of the types of assets held in a bank's portfolio. Capital per se was not directly affected by cyclical forces, but provisioning of course was. Under Basel II, to the extent that banks downgrade their assessment of a borrower's creditworthiness during a recession, banks would have to increase their capital to reflect this. This would be on top of increased provisions reflecting increased expected losses on exposures to the clients.

Since raising capital would be especially difficult in such times, banks could be forced to reduce their holdings of risky assets, creating an extra element of credit crunch. Catarineu-Rabell, Jackson and Tsomocos (2003) point out that the degree of procyclicality depends crucially on banks' modeling procedures. If banks use models that consider over-the-cycle creditworthiness, as some of the ratings agencies now do, the problem would be minimal. But if banks use models that revise creditworthiness estimates frequently on the basis on the most recent information, the procyclicality issue could be quite significant.⁶

These issues are of major importance for the functioning of Basel II in general. However, our focus in this article on what Basel II might mean for SEE. I will examine this by providing an overview of the changes in capital requirements contained in the accord, including an overview of the options most likely to be used by SSEE countries. In this context, it is very important to note that the Basel II accords actually provide a

⁶ Carpenter, Whitesell and Zakrajšek (2001) use historical ratings agency data to simulate the cyclical effects of the Standard approach when most firms have ratings. They find no significant evidence of procyclicality.

menu of options to banks. Furthermore, bank supervisors may limit banks' choices by declaring some of the more complex menu options unacceptable.

Arguably, the most important menu choices in the whole accord are between the Standard, Foundation Internal Ratings Based and Advanced Internal Ratings Based Systems for determining capital. The Standard approach most closely resembles the Basel I system. Assets are classified into a somewhat larger number of risk buckets, each of which has its own capital weighting. The IRB approaches use banks own risk models, in the Foundation variant with many parameters set by supervisors, and in the Advanced version with relatively few parameters set by supervisors.

In what follows, I will focus on the Standard approach. I do this because I strongly believe that the requirements of the IRB approaches are unattainable for SEE banks and supervisors. IRB requires at least 5 years of historical data, but in fact ideally data should be available for a whole business cycle. IRB is to be phased in from 2006 to 2009, so theoretically SEE banks could start collecting data now and have enough data by 2009. But that is extremely unrealistic, since full testing of such models would require more data.

In addition, IRB models are based on the supposition of reasonably stable macroeconomic conditions. The major changes currently underway in SEE, including continued privatization, legal and regulatory reform, adoption of EU-friendly legislation and so on, raise grave doubts about the usefulness of even current data for predicting borrower creditworthiness in, say, 2010.

Finally, IRB places enormous demands on both banks and supervisors. Banks must create and test the models, and show that the models are an integral part of their credit underwriting and risk assessment practice. Supervisors must verify that the models provide meaningful assessment of borrower and transactions risks as well as accurate and consistent risk estimates.

Both bank capabilities and supervisory capabilities to implement these very technically challenging tasks by 2006 are very questionable in SEE. While it would certainly be welcome for both parties to begin their preparations as soon as possible, it would be very unrealistic and in fact completely unnecessary to attempt to implement IRB in 2006.

Another argument against rushing to use IRB is that the Standard approach already contains important improvements on Basel I. The main innovations in the Standard approach compared to Basel I are:

- use of external credit ratings agencies' ratings to grade exposures to sovereigns and rated corporates
- correspondingly, removal of the OECD vs non-OECD distinction for sovereigns
- Introduction of a 150% category for below-investment grade sovereigns and corporates, and for unprovisioned past due claims
- Introduction of a 75% risk weight for retail claims
- Lower risk weight for retail and residential mortgages
- 20% weight for some short-term commitments.

Since the Standard Approach is certainly the most relevant one for SEE countries, I will briefly discuss some of its most interesting features in some more detail. The use of ratings agencies has been an extremely controversial proposal. However, for sovereigns, the use of ratings agencies will be a major advantage for non-OECD countries with investment-grade ratings. If such countries have S&P ratings above BB+, exposures to them will get lower capital requirements.⁷

No one disputes that ratings agencies may make mistakes, nor indeed that ratings changes usually lag events. Despite this, the advantage of the new proposal is a much more nuanced set of capital requirements.

The countries that will be at disadvantage are not the unrated, but ones with a below investment-grade rating. Unrated sovereigns get a 100% weight; below investment grade sovereigns get a 150% weight. This creates a perverse incentive for a sovereign that does not expect to get an investment grade rating to avoid getting a rating at all. (Svoronos 2003) And, after a crisis or other event that leads to a downgrade below investment grade, this feature of the Accord would additionally complicate a country's ability to return to international capital markets, since the country would not be able to become unrated but would have to live with the 150% weighting. Of course, a country in

such a situation would have difficulties accessing capital markets anyway, and the increased capital charges might only be a minor component of the overall increase in borrowing costs.

The use of ratings agencies' assessments for corporates is likely to be largely irrelevant in SEE. Very few domestic companies are currently rated, and the prospects for substantial increases between now and 2006 or 2007 are small. If corporates are not rated, they get the same standards 100% risk weight on unsecured exposures as in Basel I.

The Basel II accord also offers more favorable treatment for exposures to domestic banks and securities firms in local currency. Such exposures with original maturities of less than 3 months have a risk grade one notch above the domestic sovereign. In most cases, the domestic sovereign will be given a 0% risk weight, so that exposures to banks and securities firms will carry only a 20% risk weight.

The 75% risk weight for retail claims recognizes the substantially lower default rates usually seen on retail exposures. This retail portfolio, however, must be less than 0.2% of the bank's overall portfolio, and must not contain exposures to single borrowers of more than 1 million Euros. Small businesses may be included in this "regulatory retail" portfolio. This offers some compensation for the fact that unrated small businesses will automatically get 100% risk weights, while rated (but not top-rated) corporates will get 50% risk weights (S&P A- to A+).

Finally, the treatment of residential mortgages is more favorable, with risk weights of 35% a possibility if loan to value ratios are low enough and loss histories are favorable.

Two other major types of risk are covered in the Basel II requirements, and would be necessary to implement even for countries only using the simplest version of the Standard approach. First, banks must provide capital for market risk. This covers risk in the trading book, currency risk and interest rate risk. In fact, this requirement is not new, having been included in the enhancements of the original accord made in the second half of the 1990's. Thus market risk issues should not provide major new problems to most supervisors and banks.

⁷ The credit ratings received by sovereigns from export credit agencies may also be used. Many commentators from non-G10 countries believe that these ratings give a fairer picture of creditworthiness than those of commercial external credit ratings agencies.

Second, the Basel II accord requires banks to set aside capital to cover operational risk. However, there are three choices as to how to calculate the capital requirement. The Basic Indicator Approach is extremely simple: operational risk capital requirements are set at 15% of gross income. A slightly more complicated method is the Alternative Standardized Approach, which varies the multiplying factor between three settings (12, 15 and 18%) for different lines of business. The third approach, the Advanced Measurement Approach, requires that the bank have in place its own systems of monitoring and measuring operational risk. It is doubtful whether any SEE banks would be able to do this.

Furthermore, implementation of Pillar 3's disclosure requirements can also be done relatively simply, and can reinforce Pillar 1 and Pillar 2. Basel II disclosure requirements push banks to disclose major financial information (such as abridged balance sheets and income statements) more frequently, perhaps on a semi-annual or quarterly basis. They also push banks to disclose risk management methods. While the investing public that would be able to make use of such information is certainly small in SEE, their influence could potentially be large. And the requirements of disclosure may well increase the quality, as well as the transparency, of banks' work.

To summarize, Basel II introduces a number of potentially useful refinements that can be adopted in SEE. While there is no obligation to adopt Basel II at the same moment as EU member states, SEE countries can opt for the simplest menu options. Successful implementation of Basel II would be likely to strengthen investor confidence, both within and outside of the country. As long as SEE authorities do not approach this matter in an overambitious fashion, but choose realistic options, Basel II may prove to be a benefit for them.

Admittedly, there may be pressures on supervisory authorities to implement Basel II in a more ambitious manner than I have suggested. Ward (2002) worries that the International Financial Institutions will push Basel II compliance through its regular policy consultations or through the Financial Sector Assessment Program (FSAP) program. However, this need not be harmful, if the specific conditions in each country are taken into account and appropriate timetables and menu choices are made.

Furthermore, foreign banks operating in SEE may be eager to use internal models, in part because the marginal costs of extending the models they are using in EU countries to SEE may seem small. While banking supervisors certainly should encourage banks to improve their risk management techniques, they should be cautious about such transplantation. Most reputable banks keep substantially higher capital levels than the statutory minimum in SEE, so it should be pointed out to banks that the issue of whether or not models are used to set minimum capital levels is not really something to fight about.

APPENDIX 5: LENDING BOOMS AND CONSUMER CREDIT GROWTH: HOW BIG A PROBLEM?

Cross-country experience suggests that rapid lending growth is often connected to asset quality deterioration and balance of payments problems. Asset quality deterioration may be a result of lower underwriting standards as banks expand their client base to include new, less creditworthy borrowers (Gavin and Hausman 1996). Or it may occur because banks' internal processes are strained by greater numbers of loan applications. Finally, deterioration may occur because the share of new borrowers increases, decreasing average bank relationships and thus decreasing the bank's ability to be sure of the quality of its client (Niinimäki 2001)

The connection between rapid lending growth and macroeconomic problems is even clearer. In open economies, overheating created by rapid lending growth draws in capital inflows. Income and price effects combine to create current account problems, and, in more extreme cases, currency crises.

Gourinchas et al (2001) pose the important question of whether lending booms are indeed problematic. They show that the frequency of banking or currency problems following lending booms has been much higher in Latin America than elsewhere. They also point out that lending booms necessarily have a good side—they result in financial deepening. And financial deepening is believed to cause higher rates of GDP growth.

Thus a serious policy dilemma exists between the desire to avoid lending booms turning into banking or currency crisis, and the desire to encourage financial deepening. Several approaches are possible. One approach is to prevent lending booms ex ante by

imposing "speed limits" that prevent banks from growing more rapidly than a certain amount.

At the other extreme, one can adopt a pure wait and see attitude, acting only ex post when problems emerge.

One of the problems with the ex post approach is that banking problems are very hard to assess in real time. Asset quality indicators reflect the state of portfolios with a lag. Furthermore, despite improvements in credit risk modeling, it is doubtful whether developing or transition countries possess the data necessary for accurate modeling, due to extensive structural changes and (for transition countries) very short data series. (Kraft and Jankov 2003)

With this in mind, it seems logical to look for policy measures that do not ex post prevent all lending booms but either moderate the boom or increase bank safety during the boom. Along the first line, dynamic provisioning requires banks to smooth their provisioning over the cycle. This system, now in force in Spain, requires the banks to hold a certain level of general "dynamic" provisions based on historic provisioning averages (Fernandez de Lis 1999, Mann and Michael 2002). If, in a given year, specific provisions and other general provisions exceed the prescribed level, the bank may decrease this general "dynamic" provision. Since years with higher than normal provisions are recession years, the system works to reduce provisions and thus create income precisely when banks need it most.

Conversely, when times are good and banks are growing rapidly, the dynamic provision would be positive, forcing banks to invest income in building up the dynamic provision. This would tend to smooth out income over the cycle, and to smooth out lending.

The dynamic provisioning idea is relatively untested, and also requires a good estimate of historical provisioning averages. An alternative would simply be to require banks to hold higher capital levels if they grow above certain thresholds. A version of this idea will be implemented in Croatia starting in 2004.

How relevant is all this for SEE? Caprio and Klingebiel (1997), based on a large cross-country example, find that the probability of banking problems grows significantly if real credit growth exceeds two times real GDP growth for three consecutive years.

Although further research has not always upheld this rule of thumb, I will use it here as a way of raising the question of rapid loan growth in SEE.

Table 3: Excess of real credit growth over twice real GDP growth

	Albania	Bulgaria	Croatia	Macedonia	Romania
2000	1,2	-5,7	-4,8	-12,4	-24,4
2001	4,0	17,8	14,1	21,3	14,5
2002	21,0	29,1	18,5	4,0	32,5

Source: national central banks

Table 3 shows the results of simple application of the Caprio and Klingebiel rule of thumb to recent SEE data. Where the result is positive, lending has grown "too fast." Strikingly, lending grew substantially "too fast" in Albania, Bulgaria, Croatia and Romania in 2002, and appears set to do so in 2003 as well.

What explains such rapid credit growth? Relatively strong economic growth certainly contributes. Substantial capital inflows have strengthened loan supply. Here the fact that foreign banks now hold majority shares in most of SEE's banking systems means that the supply of funds has greatly improved. And low interest rates in developed countries, along with low levels of profitability in home markets such as Italy, Germany and Austria, have contributed a strong push factor. Strong capital inflows are thus both a sign of reform success and a potential source of new problems.

How should SEE central banks and governments react? Clearly, loan growth must be seen in the context of banking system soundness and the overall macroeconomic picture. Given the weaknesses of banking systems in all the SEE countries, generally poor current account performance, and in some cases problematic external debt ratios, there seems to be a case for concern. Certainly, with credit/GDP indicators low, policymakers want credit to grow more rapidly than GDP. But the substantial violations of the rule of thumb seen here should raise warning flags.

There may, however, be a partial mitigating factor here. In some countries, the recent lending boom has been much more a boom in lending to households than lending to enterprises. Insofar as households tend to have better repayment records, this would decrease the probability of asset quality problems. At the same time, household lending is often tied up with purchases of imports such as cars and appliances, and a household lending boom can exacerbate current account problems.

Table 4: share of household loans in total loans, %

	Albania	Bosnia	Bulgaria	Croatia	Macedonia	Romania
1997		5,2	10,3	28,9	6,5	4,4
1998	5,1	8,8	20,1	32,5	7,3	4,9
1999	48,1	9,8	18,2	37,9	9,9	4,5
2000	36,2	12,9	17,6	42,3	7,6	4,7
2001	14,3	20,6	19,4	43,8	7,4	5,6
2002	18,3	34,5	19,4	47,5	10,7	8,5
2003*	20,7	38,1	21,2	50,6		

*first half

Source: national central banks

Table 4 shows that lending to households has increased its share substantially in Bosnia, Croatia and Romania. Increases in Bulgaria have been milder after a big jump in 1998. Albania experienced a consumer lending boom in 1999 that ended in major loan write-offs, and it appears that consumer lending only began to rebound again after 2001. Macedonia experienced a noticeable increase in 2002. The overall picture is one of increased consumer lending in SEE.

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