

Cross-Border Banking in Central and Eastern Europe

Issues and Implications for Supervisory and Regulatory Organization on the European Level

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Executive Summary (German)

In den vergangenen zwei Jahrzehnten kam es in der Bankenwelt zu einem massiven Trend in Richtung Internationalisierung durch welchen neue Anforderungen an das Regulierungs- und Aufsichts-Rahmenwerk entstanden sind. Zentral- und Osteuropa (CEE) ist im speziellen eine Region mit einem extrem hohen Anteil ausländischer Finanzinstitutionen. Westeuropäische Banken, und hier vor allem Institutionen aus dem nahen Österreich, haben die Chance in den späten 90er Jahren und am Anfang dieses Jahrhunderts genutzt und haben durch Involvierung in den Privatisierungsprozess von Staatsbanken in den vergangenen Jahren ihren Heimatmarkt deutlich nach Osteuropa erweitert. Wegen diesen massiven Privatisierungen, welche durch das vom Kommunismus geerbtem Problem von massenhaft faulen Krediten und ineffizienten Bankenmärkten erforderlich wurden, rangieren im internationalen Vergleich über ausländische Beteiligung am Bankenmarkt sechs der hier besprochenen neun CEE Ländern unter den Top-10. Diese Eigenschaft ist verbunden mit einer extremen Eigentümer-Konzentration auf EU-15 und vor allem österreichische Banken. Österreich ist zurzeit, gemessen an Bilanzsummen, der größte ausländische Investor im Bankensektor in Kroatien, Rumänien, Tschechien, der Slowakei und Ungarn. Fragen mit Bezug auf Regulierung und Aufsicht von grenzüberschreitenden Banken sind daher vor allem in CEE und Österreich von außerordentlicher Wichtigkeit für das Wirtschaftssystem. Durch einen Trend in Richtung grenzüberschreitende Fusion von Finanzinstituten wird dieses Thema jedoch auch innerhalb der gesamten EU immer dringlicher.

Mit dem Anstieg von grenzüberschreitenden Eigentümern von Finanzinstitutionen entsteht auch die Situation, dass sich die rechtliche Organisation von Bankengruppen (und damit der öffentlichen Aufsichts-Struktur) zunehmend von der operativen Organisation und dem Risikomanagement der Institutionen entfernt. Wichtige Fragen wie undiversifizierte lokale Einheiten, eine Divergenz zwischen den Meinungen von Herkunfts- und Gast-Aufsichtsbehörden sowie externe Effekte auf Gastländer durch die Entscheidungen von Aufsichtsbehörden im Herkunftsland werden dadurch immer wieder aufgeworfen. Ähnliche Probleme existieren nicht nur in Bezug auf die Aufsicht von grenzüberschreitenden Banken, sondern auch in Bezug auf das Auffangnetz für Banken, welches durch einzelne Länder zur Sicherung ihrer wirtschaftlichen Stabilität bereitgestellt wird. Bei Einlagensicherungen entsteht zum Beispiel das Problem, welches Land für die Sicherung von Einlagen zuständig ist. Eine Falschausrichtung von Aufsichtsverantwortung über Insolvenzverfahren/Krisenbeilegung und Verantwortung über die Finanzierung eben dieser Entscheidungen ist ebenfalls das Resultat.

Als Antwort auf diese Probleme verfolgt das ‚Basel Committee on Banking Supervision‘ (BCBS) die Einführung von supranationalen Regulierungs- und Aufsichtsübereinkommen und -Standards. Gleichzeitig hat die Europäische Union (EU) eine Reihe von Richtlinien erlassen um die Bankengesetzgebung in den Mitgliedsstaaten zu harmonisieren. Diese Richtlinien basieren auf drei Säulen: (1) minimale Harmonisierung von Bankengesetzen, (2) das Herkunftslandprinzip für nicht harmonisierte Gesetzesbereiche und (3) Herkunftsland-Aufsicht über Filialen. Weiters

zielt die EU-Gesetzgebung auf eine möglichst einheitliche Implementierung und Interpretation von BCBS Richtlinien ab. Ein Bereich der in der EU-Gesetzgebung jedoch klar zu kurz kommt ist das Auffangnetz für Banken.

Wie diese Arbeit zeigt können CEE Länder mit der heutigen Lösung für Probleme durch grenzüberschreitende Banken, welche durch internationale und EU Richtlinien bereitgestellt wird, nicht zufrieden sein. Erstens verbleibt das Problem der adäquaten Übersicht über Bankengruppen durch Aufsichtsbehörden. Des Weiteren verbleiben Mängel in der Regulierung von Finanzinstitutionen, vor allem im Bezug auf das Sicherheitsnetz und Krisenbeilegung. In Verbindung mit der Wirkung von einer Verbreitung der rechtlichen Form der Societas Europaea und damit einhergehender Filial- statt Tochtergesellschaftstruktur sind diese Probleme imminent und müssen in der nahen Zukunft gelöst werden. Diese Arbeit analysiert daher drei mögliche Lösungen, eine auf Basis der Reorganisation von Finanzinstitutionen (Societas Europaea Modell) und zwei anhand Änderungen in Regulierungs- und Aufsichtsstruktur in Richtung einer zentraleren Verantwortung (Lead Supervisor und EU Behörde Modelle). Jedes Modell hat Vorteile gegenüber dem heutigen System, vor allem in Bezug auf eine Neuausrichtung von Schlüsselverantwortungen von Aufsichtsbehörden parallel zu der Realität der Bankstrukturen, verbesserte Kommunikation zwischen nationalen Behörden und einer Berücksichtigung von externen Effekten. Trotzdem bleiben zentrale Probleme, vor allem in Bezug auf das Sicherheitsnetz und Krisenmanagement. Während diese Modelle daher gute Lösungen für ‚normale Zeiten‘ sind zeigen sich entscheidende Schwachpunkte in Krisenzeiten.

Wie diese Arbeit zeigt muss die EU daher zwei wesentliche Punkte auf ihre Tagesordnung setzen: 1) die Harmonisierung der Sicherheitsnetze für Banken in Krisenzeiten und 2) eine Reform der Bankenaufsicht während normalen Zeiten, idealerweise durch die Gründungen einer EU Aufsichtsbehörde. Nur nachdem eine Lösung für den ersten kritischen Teil gefunden wurde können neue Modelle für die Bankenaufsicht auf EU-Ebene realistisch diskutiert werden. Wie so oft wäre es nötig, dass eine Kerngruppe von EU Mitgliedstaaten vorprescht und einen Weg für diesen Zentralisierungs-Prozess vorgibt. Eine Aufsichtsbehörde und Sicherheitsnetz der Europäischen Währungsunion wäre vielleicht der nötige Anreiz um nationalen Behörden und Regierungen zu demonstrieren, dass im Bereich der Bankenaufsicht und – Regulierung das Beste für Europa auch das Beste für die einzelnen Mitgliedstaaten ist.

Executive Summary (English)

Over the past two decades, the world of banking has experienced an unprecedented trend towards internationalization, which has led to new demands on the regulatory and supervisory framework designed to ensure safety and stability in the banking sector. Central and Eastern Europe (CEE) is a region that has seen a particularly stunning increase in international banking presence. Banks from nearby Austria and the rest of Western Europe expanded their 'home markets' to the formerly communist countries during the large scale privatization programs of state-owned banks. Due to these massive privatizations to foreign financial institutions in the late 1990s and early 2000s, necessitated by the burden of bad debt problems inherited from communist times and inefficient banking markets, six of the discussed CEE countries rank among the top-10 in the ranking of foreign ownership of banking assets. This characteristic of high foreign ownership of the banking market in CEE is coupled with a large presence and concentration of ownership with EU-15 and especially Austrian banks. Austria is currently the largest foreign investor in terms of control of banking assets in the Czech Republic, Slovakia, Hungary, Romania, and Croatia. Thus, regulatory and supervisory concerns about cross-border banking are an especially important topic in CEE and Austria as the stability of the entire financial system of the region depends on a smooth function on the financial sector.

With an increase of cross-border ownership of financial institutions, a major challenge for supervisory structure has been the recent development that the legal organization of banking groups and thus the supervisory structure overseeing them has become increasingly unreflective of their operational organization and risk management procedures. Several important issues, such as undiversified local operations, a divergence in supervisory opinions between home and host countries, and large externalities on host countries resulting from home supervisors' decisions thus result. These problems are not only concerned with the supervision of banks but also with the safety net provided by countries to support financial stability in their economies. With respect to deposit insurance for instance, the issue concerning responsibility for the foreign activities of a bank and the externalities of decisions made by supervisory authorities of countries other than that providing the deposit guarantee arise. Furthermore, a misalignment of supervisory authority over insolvency and crisis resolution procedures and the country that has to carry the financial burden may arise.

In response, the Basel Committee on Banking Supervision (BCBS) has pursued the adoption of supra-national arrangements on regulatory and supervisory standards. At the same time, in order to promote the objective to "foster a market where financial services and capital can circulate freely at the lowest possible cost throughout the EU - with adequate and effective levels of prudential control, financial stability and a high level of consumer protection," the European Union (EU) has adopted a multitude of directives to harmonize the banking laws of its member states. These directives are based on three pillars: (1) minimal harmonization of banking rules, (2) mutual recognition of non-harmonized banking rules, and (3) home country control in supervision. Furthermore, legislation has focused on integrating the common market in financial

services through a common approach to the application of recommendations issued by the BCBS. However, an issue that is only marginally touched by EU legislation is the safety net for banks provided by each member state.

As this paper shows, CEE countries cannot be fully satisfied by the current solution to the issues that arise due to foreign ownership of banking assets as proposed in the form of international and EU regulations. First of all, while regulation is already well aligned, supervisory oversight is still a significant issue. Furthermore, deficiencies in the regulatory approach, especially with regards to the safety net and crisis resolution still exist. Coupled with the impact of potential wide-spread adoption of the legal form of *Societas Europaea* and a resulting increase in branch rather than subsidiary structure, these concerns need to be addressed in the near future. This paper thus analyzes three possible solutions to these issues on an EU basis, one based on the reorganization of financial institutions themselves (*Societas Europaea* model) and two on a change in regulatory and supervisory responsibility towards a more centralized authority (lead supervisor or EU authority). Each approach has a lot of merit especially with respect to concerns about information exchange, a re-alignment of key functions of a bank and supervisory structure, and adequate consideration of pan-European externalities. However critical problems concerning the safety net and crisis management and -resolution due to the misalignment of supervisory decision making and responsibility for the ultimate provision of deposit insurance and lender-of-last-resort facilities remain. Thus, while they are acceptable approaches for ‘normal times’, it is in times of crisis that the weak spots appear, which is exactly when an effective supervisory and regulatory environment and actions are most crucial.

As this paper concludes, the EU must therefore put two critical issues on its agenda: 1) a harmonization of safety net and resolution procedures for times of crisis and 2) the reformation of the supervision of banks during normal times and a re-alignment of supervisory and bank’s organization, ideally through the establishment of an EU supervisory authority. Only after a solution has been reached for the first critical stepping stone, essential new approaches to the cross-border supervision of EU-bank can be realistically discussed and effectively implemented. As in other spheres of policy, it may be time for a core group of EU member countries to forge ahead and plough a path for this centralization process. As such, an EMU supervisory authority and safety net may just be the push necessary to demonstrate to national legislators that in the case of banking regulation and supervision, what is best for Europe as a whole may just be what’s most beneficial for each country involved.

Abbreviations

AMA....	Advanced Measurement Approaches for Operational Risk (Basel II)
BAC....	Banking Advisory Committee (EU)
BCBS...	Basel Committee on Banking Supervision
BIS.....	Bank for International Settlements
CAD....	Capital-Adequacy Directive
CADII ..	Capital-Adequacy Directive II (also CRD)
CEBS...	Committee of European Banking Supervisors
CEPS....	Center for European Policy Studies
CEE....	Central and Eastern Europe
CGFS...	Committee on the Global Financial System (at the BIS)
CRD.....	Capital Requirements Directive (also CAD II)
DGD....	Deposit Guarantee Directive
EBRD...	European Bank for Reconstruction and Development
EC.....	European Community
ECB.....	European Central Bank
Ecofin...	Council of EU Economics and Finance Ministers
EEA....	European Economic Area (the EU-25 plus Iceland, Liechtenstein, Norway, and Switzerland)
EEC.....	European Economic Community
EFR.....	European Financial Roundtable
EMU....	European Monetary Union
EP... ..	European Parliament
ESCB...	European System of Central Banks
EU.....	European Union
EU-8.....	new member states of the EU after 2004 enlargement in CEE (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia)
EU-10...	new member states of the EU after 2004 enlargement (EU-8 plus Cyprus and Malta)
EU-12...	Current EMU (Euro) members (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain)
EU-15...	EU member states before 2004 enlargement (EU-12 plus Denmark, Sweden, and the United Kingdom)
EU-25...	current EU member states (EU-15 plus EU-10)
FBD.....	First Banking Co-ordination Directive
FIFDI...	Financial Institution Foreign Direct Investment
FMA.....	Finanzmarktaufsicht (Austrian Financial Market Authority)
FSAP....	Financial Services Action Plan
FSC.....	Financial Services Committee (of the European Parliament)
FSSA....	Financial System Stability Assessment (of the IMF)
G-10....	Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States
IASB....	International Accounting Standards Board

IFRS..... International Financial Reporting Standards
IRB..... Internal Ratings-Based (Basel II)
LOLR... Lender-of-last-resort
MOU.... Memorandum of Understanding
OeNB... Oesterreichische Nationalbank (Austrian National Bank)
SBD..... Second Banking Co-ordination Directive
SE..... Societas Europaea (European Corporation)
SOB..... State-Owned Bank
SOE..... State-Owned Enterprise

I. Introduction

Over the past two decades, the world of banking has experienced unprecedented change. Following the trend of globalization in other economic sectors, the financial industry began to internationalize after decades of protectionism and the promotion of national champions had reduced cross-border banking activity to a minimum. With more cross-border provision of financial services and the advent of cross-border mergers in the financial sector, the trend towards internationalization recently gripped the retail banking business as well. Apart from creating challenges for individual banks, this development also led to new demands on the regulatory and supervisory framework designed to ensure safety and stability in the banking sector, and thus on the economy as a whole.

Central and Eastern Europe (CEE)¹ is a region that has seen a particularly stunning increase in international banking presence. This follows a trend in Europe where cross-border banking groups typically exist in regions with strong cultural or language ties (such as the Benelux and Nordic region). Central and Eastern Europe, having been largely united under the Austro-Hungarian Habsburg Empire until 1918 is thus a natural region for the expansion of cross-border banking due to remaining cultural ties between Bavaria, Austria and the eastern countries of the former Empire. Following the fall of communism and several severe banking crises, CEE countries thus opened up their banking market to foreign entry and privatized state-owned financial institutions to foreign investors. Banks from nearby Austria were natural acquirers, and with the rise of

¹ For the purpose of this paper, Central and Eastern Europe is defined as the 8 continental countries who joined the European Union on May 1st, 2004 (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovenia, and Slovakia) as well as the three countries expected to join the European Union next (Bulgaria, Croatia, and Romania). Focus will be laid on the non-Baltic states in CEE since that is where the business of Austrian banks is concentrated.

international financial institution FDI in CEE thus came the rise of Austrian banks as regional players.

Due to this development, countries in CEE have become a region where the financial environment can be considered ahead of the trend with an abundance of cross-border provisioning of banking services and cross-border ownership of financial institutions. As Mucci et al. (2004, p. 158) state, “New Europe is now one of the few regional markets in the world where foreign ownership is predominant, and where cross-border strategic players can compete directly in a fairly liberalized framework while exploiting and supporting what has already become their ‘second home’ market.” CEE thus serves as an excellent example to investigate issues that arise due to cross-country banking activity and ownership, and Austria, due to the extension of its banks’ ‘home market’ to the east, can be used to examine the issues raised for home countries of cross-border banking groups. Furthermore, due to a recent trend towards increased foreign ownership in the ‘old’ EU-15 countries², the analysis of the experience in CEE is especially relevant today as it may find application in the rest of the EU.

Central issues arising from cross-border banking are differences in regulation as well as the distribution of supervisory authority and responsibility between home and host countries of multinational banks. A variety of regulatory backgrounds creates an un-level playing field where banks could gain an unfair advantage based on where they are incorporated, leading to ‘regulatory arbitrage’ and possibly a resulting decline in regulatory standards. Supervision is an equally important issue as experience has shown (see Banco Ambrosiano or BCCI). Thus, dealing effectively with cross-border banking

² EU-15 refers to the countries that were members of the EU prior to the enlargement round in 2004, namely Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the United Kingdom, Luxembourg, the Netherlands, Portugal, Spain, and Sweden.

operations is of specific concern for supervisory and regulatory authorities in CEE countries and an issue that is of great importance for the EU as a whole. As the globalization of financial institutions progresses, the topic similarly arises in the global context and a discussion on the adequacy of existing regulatory and supervisory structures is thus essential.

In analyzing this topic, this paper first gives an overview of fundamental definitions and concepts of financial regulation and supervision. It then provides a summary of CEE banking markets by describing the current market structure and its historic roots. Austrian participation in these markets is specifically stressed to provide the perspective of a home country. Following this summary is a theoretical section based on current literature outlining major issues caused by cross-border banking activities such as stability of the banking sector, contagion effects on the economy, and a loss of market signals. This theoretical discourse is followed by a chapter dedicated to the Basel Committee of Banking Supervisors' work in addressing the raised issues on a global level and an outline and critical analysis of the major banking legislation currently in force in the European Union. Based on this analysis of foreign banks in CEE, potential issues of cross-border banking, and the current inter- and transnational legislation, this paper then progresses to examine three currently discussed solutions to the outlined problems on the European level.

II. Focus and Essential Definitions

While the term ‘financial institutions’ refers to firms active in a diverse field of activity such as banking, insurance, investment management, etc, this paper focuses exclusively on banking due to the fact that the integration of financial markets in CEE has progressed the farthest in this field. Furthermore, the emphasis is specifically on retail banking, which according to the *Dictionary of Finance and Banking*, is the “mass-market banking in which the customers are private individuals and small business customers ... typically offer[ing] a wide range of such services as personal loans, mortgages, pensions, and insurance as well as providing current accounts and savings accounts.” The paper is generally not concerned with other banking activities such as the interbank and wholesale markets or investment banking services.

Cross-border retail banking activity in the EU can take several forms. As outlined by the European Commission (2004a, p. 11), these are mainly (1) a purchase of services provided by foreign banks by physically crossing the border to another country, (2) a provision of services from a bank offering services in a country other than it’s country of incorporation without establishing a separate business operation there, (3) an establishment of subsidiaries/branches in the local market, and (4) the provision of services on a pan-European level that are delivered locally. This paper focuses mainly on option (3) due to it’s relevance in CEE and the specific regulatory and supervisory issues it raises.³

³ Option (2) is becoming an increasing issue though with the increased usage of cross-border e-banking services, but it will not be discussed here.

Under this option, financial services can be offered either through a branch or a subsidiary of the foreign bank. A branch is an operating entity that does not have a separate legal status from its parent bank and whose powers are thus defined in the parent's charter whereas a subsidiary is a legally independent institution owned by a bank incorporated in a country different from the subsidiary (Basel Committee on Banking Supervision 1983, p. 2 & Committee on the Global Financial System 2004, p. 11). In discussing foreign ownership of banks, an important question is what exactly makes a bank a domestic versus foreign bank. Several criteria have been put forward, including location of headquarters, the nationality of the bank's owners, the country where a bank derives most of its business from, etc. (Mihaljek 2004, p. 25). In this paper, a subsidiary is considered foreign if fifty percent or more of its equity is held by one or more foreign financial institutions incorporated in a foreign country, or special clauses grant them operational control with a lower equity share.⁴ Branches of foreign banks are by definition foreign-owned.

Financial services, especially banking, are one of the few areas in the economy where “even the most radical free-marketeters have never advocated ‘market-only regulation’” but rather “debates center around the appropriate extent of state intervention rather than whether state intervention is necessary” (Grossman 2005, p. 131). In this context, banking *regulation* refers to the laws and rules applicable to banking. These legal conditions are usually set by the legislative branch. *Supervision* refers to the enforcing of banking regulations and the monitoring of banking activities by the relevant authorities and is thus the executive branch of financial market control. The supervisory

⁴ Financial investors are not considered foreign ownership here since, usually, the issues pertaining to regulation and supervision do not apply to non-bank owners of local banks (except for holding companies).

authority, which is usually either part of the central bank or an independent agency,⁵ is therefore bound by the established legal environment. With respect to cross-border supervision, the terms ‘consolidating’ or ‘home’ and ‘host’ supervisor are used. The terminology in this paper refers to the supervisor responsible for the ultimate mother-bank or holding company as ‘home’ and ‘consolidating’ supervisor and to the supervisor in the country where a foreign bank’s branch or subsidiary operates as the ‘host’ supervisor. This terminology is similar to that used by the Committee of European Banking Supervisors (CEBS); however is not completely conforming to the language used in EU Directives (Committee of European Banking Supervisors 2006, p. 5).

The regulation and supervision of banks has two main reasons: consumer protection and fear of the existence of systemic risk. Regulation and supervision are key tools in addressing the ‘moral hazard’ that is caused by the governments’ safety nets, which include deposit insurances and lender-of-last-resort responsibilities (see Section IV.b.4.i for a summary of the functioning of the safety net). Safety nets tend to reduce the incentive for creditors to discipline bank risk-taking and may tempt banks to take excessive risks. Thus, “banking regulation and supervision must replace the market discipline removed by safety net” (Stevens 2000, p. 2). In effect, the aim of effective and efficient regulation is to enforce a reasonable “tradeoff between the opportunity cost of current government supervisory and disciplinary activities and deferred costs associated with the residual probability and severity of possible future crisis” (Kane 2001, p. 13).

⁵ While an important and current topic, this paper does not explore the different structures of national regulatory agencies and its merits, but it should be noted that currently, no clear favorite for the distribution of authority and responsibility for financial institutions supervision has been established and a variety of systems are in use across the EU-15 states and CEE countries (see footnote 17).

There are two different kinds of supervision, namely prudential and conduct of business supervision. Prudential supervision targets the solvency and safety and soundness of financial institutions whereas conduct of business supervision focuses on the interaction of financial institutions with their customers (Schüler 2003, p. 2). This paper will focus on prudential supervision, as it is the main concern in cross-border banking.

III. The CEE Banking Market

III.a. The History of CEE Banking

III.a.1. From Communism to a Market Society

A key factor contributing to the unusually high percentage of foreign ownership in CEE banking markets (see Section III.b.1 below) is the history of the region. All countries share a communist past and experienced major economic difficulties following the fall of these regimes. In the communist economic model, the banking sector was limited to a large extent to the operation of so-called ‘monobanks’ that were responsible for collecting deposits, compensating the depositors at rates fixed by the government, and providing loans to businesses. In some countries, there were two large banks, each with a monopoly in the two separate monetary circles (the productive sector and the household sector). Few also fostered specialized financial institutions in place of the single bank for the productive sector, each serving separate economic sectors such as an agricultural, industrial, construction and foreign trade bank (Green 2002b, p. 3).

Independent of the exact structure of the different banking markets, all credit institutions in centrally-planned CEE functioned as the central tool of control and credit allocation as well as for monetary policy, acting simultaneously as “the financial advisor, the treasurer, the cashier and the auditor of every enterprise” (Dembinski as quoted in Green 2002b, p. 2). They served as mere conduits to finance the production plans and targets set by ministries for individual firms. Once targets were centrally determined, the state budget was allocated and the money necessary for investments and working capital was transmitted through these state-owned banks (SOBs). Decisions concerning credit

allocation were thus entirely based on production needs rather than capital efficiency and little consideration was paid to the ability to repay loans. Communist banks were thus essentially “passive administrative units rather than active processors of credit information and risk-takers operating on commercial principles.” (Sherif 2003, p. 18) Due to this structure of credit allocation and the fact that the idea of bankruptcy was practically unknown, much of the loan portfolio of communist banks was unrecoverable. Since state-owned enterprises (SOEs) held a dominant position as borrowers, the SOEs had an especially difficult time forcing loan repayments.⁶

III.a.2. The Inheritance from Communism – Banking Restructuring in CEE

After the fall of communism and embrace of capitalism in CEE, the need to restructure the banking system in the formerly centrally-planned economies was apparent. Thus, monobanks were broken up to form a two-tiered system similar to the common practice in western countries with a central bank responsible for monetary policy and commercial banks⁷ servicing households and firms. The break-up of these banks was either administered along regional or sector lines. In order to stimulate competition, most CEE countries adopted very lax licensing and regulatory regimes, leading to a large increase in number of banks. In Poland, for instance, nine state-owned regional banks were established and a very liberal licensing policy with low initial equity requirements was implemented (Raczko 2001, p. 321). The Czech Republic carved five commercial banks out of the former Czechoslovakian State Bank and pursued an equally liberal licensing policy (Matoušek 2001, p. 355). However, these loose policies allowed

⁶ For more background on the communist banking sector see for instance Mihaljek, p. 6

⁷ The terms ‘commercial bank’ and ‘retail bank’ are used interchangeably in this context.

the establishments of very unstable banks and bad loans at the SOBs ballooned as debtor firms were forced to (often unsuccessfully) compete on the open market and banks began to adopt a more risk-based approach to valuing their exposures. The bad debt problem inherited from communist times was exacerbated by further extension of loans to the same, bankrupt SOEs due to political pressures to support these failing companies as well as a system of 'ever-greening' these exposures to delay the recognition of losses. Furthermore, the lack of complex interest rate and risk management in communist times due to the central allocation of credit left banking staff with little experience regarding the capitalist financing mechanism and banking decision process, leading to further bad loans.

Coupled with severe recessions in the early 90s, which increased the massive bad debt problem in the corporate sector and led to numerous defaults, this inefficient situation resulted in several rounds of banking crisis in CEE. In Bulgaria, for instance, the economic crisis in 1996 and 1997 was largely caused by non-performing loans resulting from debt overhang, a weakness in governance and unsound credit policies leading to nine out of ten state-owned banks (80% total market share) having negative equity (Thimann 2002, p. 31). Since banking efficiency is critically for the development of an economy, CEE countries quickly recognized that something had to be done as "individual state-owned institutions have relatively low efficiency and high nonperforming loans, and large market shares for SOBs are associated with reduced access to credit, diminished financial system development, and slow economic growth." (Berger 2005, p. 2184)

The situation required restructuring and recapitalization of many SOBs. Emergency bail-outs, considered necessary to avoid a collapse of the entire economic system, were thus organized by

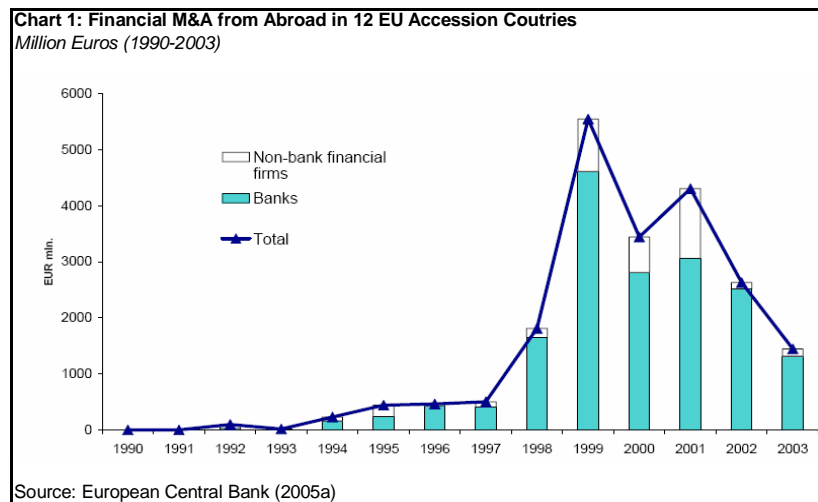
Table 1: Estimated Cost of Bank Restructuring and Deposit Compensation
Cumulative costs 1991-1998 in % of GDP

	Cost for Government	Costs for Central Bank	Total Cost
Bulgaria	26.0%	11.8%	37.8%
Croatia	n/a	n/a	29.0%
Czech Republic	20.9%	4.8%	25.7%
Hungary	12.9%	0.0%	12.9%
Poland	2.4%	0.5%	2.9%
Baltic States	2.3%	0.4%	2.7%

Source: Mihaljek (2003)

governments and central banks across the region. A staggering cumulative cost of between 2.7% (Baltic States) and 37.8% (Bulgaria) of average GDP was incurred

between 1991 and 1998 due to bank restructurings and compensation provided (see Table 1). Other CEE countries such as Croatia, Romania,



Slovakia and Slovenia also undertook at least one major re-capitalization program (Sherif 2003, p. 30). These extreme costs, coupled with increasing empirical evidence that bank privatization resulted in efficiency gains and positive effect for the economy as a whole led most governments to proceed with full or partial privatizations of their SOBs. As can be seen in Chart 1, flows to financial institutions in the 12 EU accession countries⁸ contributed a large majority of total FDI and accelerated after 1998, when bank restructuring programs had been completed and privatization efforts intensified. Privatization was the cheaper way out for the governments since, as Clarke et al. (2000,

⁸ The EU-10 plus Bulgaria and Romania

p. 3) state, “the present value of future re-capitalization [costs for SOBs] far exceeds the costs associated with privatization.” The costs of maintaining SOBs was even significantly larger despite the fact that every CEE country, with the exception of Poland, offered guarantees to protect foreign banking investors from a deterioration of existing assets in privatized banks.

III.a.3. Developments in Banking Regulation and Supervision in CEE

One of the main issues during the banking crisis faced by CEE countries in the early 1990s was the low quality of banking regulation and supervision, resulting from a complete neglect of this function during communist rule. However, as CEE countries began membership talks with the EU, they implemented the so-called *acquis communautaire*, which encompasses the entire EU legislation by which all member states are bound. Thus, the countries that have joined or are about to join the EU are now “the most advanced in terms of legal and institutional reforms in the region.” (Raiffeisenbank Research Unit 2005, p. 5) This paper will analyze EU banking regulation later on (see Section V.c.), however, another very important aspect of the EU accession talks should not be ignored, namely the Phare program. This program focused on institution building in applicant countries, including the establishment and development of competent and effective banking supervisory authorities. Within the Phare program, the twinning program was of special importance with regards to CEE supervisory capacity. This framework to provide access to the various expertise of EU member states enabled the long-term transfers of CEE banking supervisors to member state’s supervisory authorities as well as the deployment of expert missions to applicant countries’ agencies (Piroska

2004, p. 6). The EU thus played a central role in training bank supervisors and central bankers, influencing not only the regulatory environment through the *acquis communautaire*, but also the supervisory culture of the new member countries.

One of the main criticisms of CEE banking is the persistence of deficiencies in the court systems of the countries, leading to difficulties in contract enforcement and access to collateral. For instance, as Barisitz points out in a recent publication of the Austrian National Bank (OeNB), Bulgaria continues to have an “environment of weak corporate governance, limited contract enforcement capacities and insufficient rule of law,” (Barisitz 2005, p. 69) Croatia faces a “tenuous rule of law and slow working, overburdened courts,” (Barisitz 2005, p. 77) in the Czech Republic the “breakthrough in lending will only materialize once the rule of law improves and courts work more efficiently,” (Barisitz 2005, p. 63) Poland faces “lingering deficiencies of the court system,” (Barisitz 2005, p. 62) and in Slovakia the “judicial infrastructure would need an overhaul.” (Barisitz 2005, p. 66) These issues, which are not directly related to banking regulation but have very important implications for the working of banks, are currently being addressed in CEE countries and they will hopefully achieve an EU-15 level very soon.

III.b. Foreign Ownership in CEE Banking

III.b.1. Foreign Ownership of Banking Assets in EU-15 and CEE Countries

With 99% of bank assets in foreign-owned banks, New Zealand and Botswana rank number one in the world in terms of foreign ownership of the banking system (Kaufmann 2004, p. 66). However, due to the massive privatization of SOBs to foreign

financial institutions in the late 1990s and early 2000s for reasons described above, six CEE countries rank among the top-10, and all but Slovenia rank in the top-20 on the ranking of foreign ownership of banking assets.

This characteristic is in sharp contrast to EU-15 countries. Among the EU-15, an integrated wholesale market exists and cross-border activity in big volume markets is large, especially since the adoption of the Euro. However, there has been very limited direct cross-border retail banking activity (European Commission 2004a, p. 5). For example, cross-

Austria	19.6%
Belgium	22.9%
Denmark	16.0%
Finland	7.4%
France	11.1%
Germany	6.0%
Greece	22.0%
Ireland	44.0%
Italy	5.8%
Luxembourg	93.9%
Netherlands	11.8%
Portugal	26.5%
Spain	11.0%
Sweden	7.6%
UK	49.8%
EU-15 (weighted average)	22.3%

Source: Dermine (2005)

border loans from banks to the private non-financial sector within the Euro area is below 5% of total loans granted (Trichet 2005). Cross-border ownership is also low, accounting for only 22.3% of EU-15 banking assets in 2004. According to Dermine, apart from Luxembourg, no EU-15 country has more than 50 percent foreign ownership of banking assets (see Table 2).

The level of integration that does exist among the EU-15 is the result of cross-border M&A activity and branching of foreign institutions, though M&A transactions involving banks are mainly due to national rather than pan-European consolidation. From 1997 to 2004, a total of 1,024 M&A transactions involving one or more credit institutions were recorded within the EU-15. 46.9% of these deals were within-borders, 23.8% were within the European Economic Area (EEA)⁹ and 29.3% involved countries outside the EEA. Considering transaction values, the percentage of domestic deals is even larger, accounting for 76.2% of M&A transactions involving at least one credit institution (see Table 3).

Table 3: Banking M&A Activity in EU-15
Transactions incl. 1+ credit institution (1997-2004)

In number of transactions

	Domestic	Intra-EEA	Outside EEA
Austria	18	4	27
Belgium	10	14	26
Denmark	6	11	3
Finland	2	5	5
France	80	31	39
Germany	91	29	51
Greece	21	9	10
Ireland	1	3	3
Italy	154	27	22
Luxembourg	0	21	3
Netherlands	9	17	17
Portugal	14	14	6
Spain	47	36	42
Sweden	5	12	13
UK	22	11	33
Total	480	244	300
%	46.9%	23.8%	29.3%

In billion Euros

Total	539.3	99.6	69
%	76.2%	14.1%	9.7%

Source: Dermine (2005)

Massive consolidations have thus taken place domestically, but the European level is lagging behind. While some cross-border mergers and acquisitions have taken place, judging from the share

Table 4: Cross-Border Banking Among the EU-15
Relative to total banking assets (2004)

	Banking assets	Percent
Total assets of credit institutions	29,010	100.0%
Total assets of domestic institutions	21,873	75.4%
Total assets of foreign institutions	7,138	24.6%
Total assets from EU* countries	4,953	17.1%
Branches	2,352	8.1%
Subsidiaries	2,601	9.0%
Total assets from non-EU* countries	2,185	7.5%
Branches	1,304	4.5%
Subsidiaries	881	3.0%

Note: *EU countries include EEA countries under EU banking law
Source: Schoenmaker (2006b)

of total value, these transactions have mainly involved the acquisition of smaller banks.

⁹ The EEA includes all EU countries as well as Iceland, Liechtenstein, Norway, and Switzerland. All of these countries with the exception of Switzerland are subject to EU banking law.

The data by Schoenmaker, who calculates a slightly higher 24.6% market share of foreign institutions among EU-15 countries (see Table 4) compared to Dermine's 22.3%, shows that the market share of foreign institutions in EU-15 countries is roughly split equally between subsidiaries and branches. Thus, branching also seems to be an important mode of access to foreign EU-15 countries, especially for non EEA countries.

Recently, large cross-border mergers have been announced that will increase the percent of foreign ownership in the banking sector of EU-15 countries. The largest such deals were the acquisition of Abbey National (UK) by Banco Santander (Spain) in the second half of 2004 and UniCredit's (Italy) merger with Germany's Hypovereinsbank as well as Dutch ABN-Amro's purchase of Banca Antonveneta (Italy), both in 2005. Despite increasing volumes of these mergers, there is still a lot of resistance on the national level to such deals, as has been recently shown by Banca d'Italia's interference in the ABN-Amro-Banca Antonveneta deal and in the BBVA (Spain) bid for Banca Nazionale del Lavoro, which ultimately was abandoned by the Spaniards.

In contrast to this situation in the 'old' EU member states, CEE countries have embraced foreign ownership. Cardenas notes that "foreign bank entry in [emerging market economies] has been the result of dealing with financial crises, while in mature economies foreign entry comes from competitive pressures." (Cardenas 2003, p. 3) As outlined above, this is true in CEE to a large extent as well. As can be seen in Table 5, the market share of foreign banks is well above the average for the EU-15 in all analyzed markets. In the Czech Republic, where foreign banks account for 83.1% of banks' capital and 96.1% of assets, the foreign strategic investors "contributed to overcoming the lingering financial crisis that had plagued the country since the mid-1990s." (Barisitz

2005, p. 62) In Hungary, which was the first country to open the banking sector to foreign strategic owners in 1997, foreign ownership of banking capital and assets amounted to 80.4% in 2004. Romania, which commenced fairly late with its banking sector reforms, also boast a foreign participation of 69.3% in banking capital and 62.1% of assets in 2004.¹⁰

The other CEE economies show similarly high foreign involvement in the banking industry. One exception is Slovenia, where foreign banks account for merely 36.2% of banking assets in 2004. It is also the only country apart from Poland that still boasts a significant share of state SOBs (19.1% in 2004), though the government has recently made moves

Table 5: Market Share of Foreign Banks in CEE
As % of banking assets/capital

	2000	2001	2002	2003	2004
Bulgaria					
% Capital	-	-	-	-	-
% Assets	67.0%	70.0%	72.0%	82.3%	82.5%
Croatia					
% Capital	-	-	-	-	-
% Assets	84.1%	89.3%	90.2%	91.5%	91.3%
Czech Republic					
% Capital	54.5%	69.9%	81.9%	84.9%	83.1%
% Assets	75.4%	94.2%	93.3%	95.9%	96.1%
Hungary					
% Capital	66.7%	63.0%	78.3%	81.9%	80.4%
% Assets	68.1%	63.0%	78.3%	81.9%	80.4%
Poland					
% Capital	77.6%	80.2%	77.8%	76.7%	73.7%
% Assets	69.5%	68.7%	67.4%	67.8%	67.6%
Romania*					
% Capital	53.8%	60.6%	64.9%	66.3%	69.3%
% Assets	50.9%	55.2%	56.4%	58.2%	62.1%
Slovakia					
% Capital	28.1%	60.5%	85.3%	88.9%	89.6%
% Assets	40.6%	90.5%	95.6%	96.3%	96.7%
Slovenia					
% Capital	12.0%	16.0%	32.5%	33.1%	-
% Assets	15.3%	15.6%	34.7%	36.0%	36.2%

Note: *BCR not included as foreign in figures
Sources: Bank-Austria Creditanstalt (2004/2005/2006),
Raiffeisenbank Research Unit (2005)

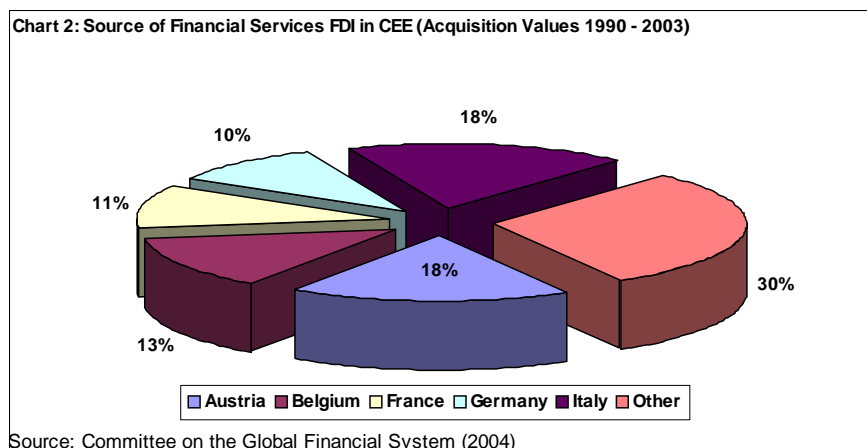
to at least sell minority holdings in its largest banks to foreign investors (Raiffeisenbank Research Unit 2005, p. 26). Furthermore, small, foreign-owned banks have recently been very successful in household lending and are aggressively penetrating the retail market, which is not reflected in ratios based on assets (Raiffeisenbank Research Unit 2005, p. 26). Thus, foreign involvement is significant in each considered CEE market. These

¹⁰ This number has since increased significantly as 61.8% of the largest Romanian bank, BCR with a 2004 market share of 25.9%, was sold to Austria's Erste Bank at the end of 2005. In mid-2006, 90.1% of the former savings bank CEC with a 2004 market share of 6.9% will also be sold to a strategic foreign investor (BA-CA 2005, p. 47).

numbers are even larger if direct cross-border lending by EU-15 banks is taken into account, which is substantial in corporate lending as it represents a large percentage of loan financing of subsidiaries of foreign corporations in CEE. The importance of foreign involvement in the banking industry is further amplified by the fact that CEE economies are generally similar to the continental bank-based system rather than the Anglo-Saxon market-based finance system, leading to an increased importance of banks for the economy.

The characteristic of high foreign ownership of the banking market in CEE is coupled with a large presence and concentration of ownership with EU-15 banks. The presence of non-EU banks in CEE is rather limited (mainly to Citibank and GE Capital), underlining the importance of EU banking law for this region. There exist very few large, domestically-owned banks in CEE, and only OTP of Hungary has been able to also become a regional player. OTP, which is mainly owned by a number of domestic investors and funds, has actually become a strategic foreign investor in the banking markets of

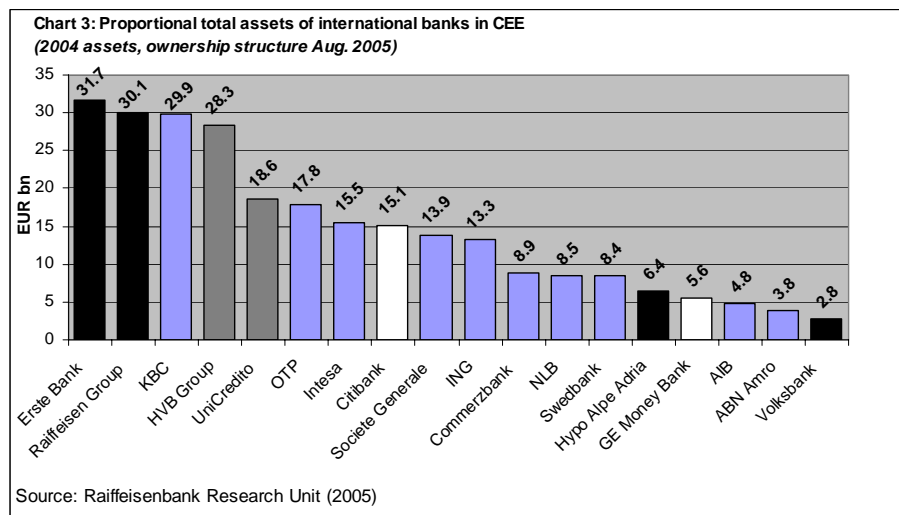
Slovakia,
Bulgaria,
Romania and
Croatia (countries
with significant
Hungarian



minorities). Apart from OTP and a few large domestically-owned national players such as state-owned Polish PKO BP, banking markets are dominated by EU-15 institutions.

Entry of these banks into CEE began with the expansion of industrial firms to the east, when foreign firms ‘followed their customers’ and provided service to home-country clients establishing themselves in the new markets. As the eastern countries began to prosper and EU membership negotiations began, more western banks discovered the region as a potentially highly profitable market. Taking advantage of large-scale privatizations of the banking sectors (see Section II.a.2), EU-15 banks began to enter the markets in a significant number. It is interesting to note that in the CEE economies, the largest acquirers are banks from small countries (especially Austria and Belgium). From 1990 to 2003, Austria accounted for 18% of M&A deals in terms of value, with Italy also contributing 18% and Belgium investing 13% of the total volume (see Chart 2).

In terms of presence in CEE, Erste Bank and the Raiffeisen Group of Austria took the lead in 2004 in terms of proportional total assets in the region¹¹ with €31.7bn and €30.1bn, respectively (see

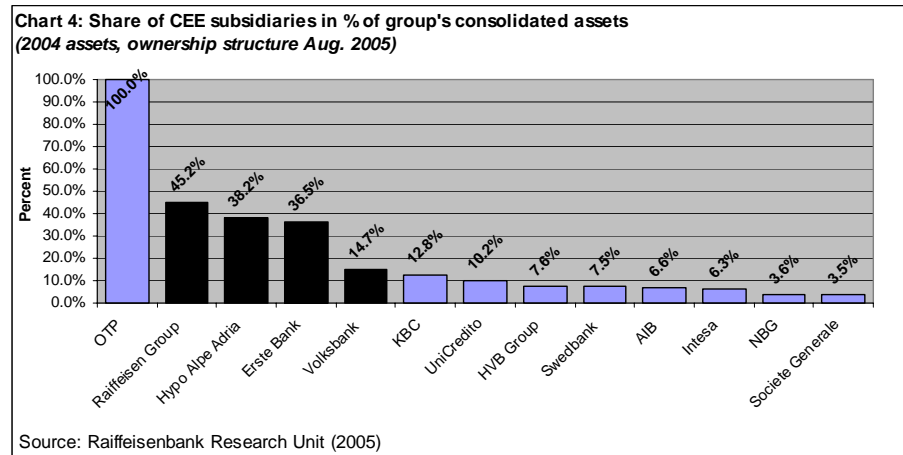


¹¹ The publication by Raiffeisenbank Research Unit includes the same countries under the label ‘CEE’ as this paper with the exception of the Baltic States. Furthermore, Serbia, Bosnia and Herzegovina, Albania, Kosovo, Russia, Ukraine, and Belarus are added.

Chart 3). However, adding the assets of HVB Group (including the CEE subsidiary Bank-Austria Creditanstalt) and UniCredit, which merged in 2005, the new UniCredit Group would take a clear lead with €46.9bn.¹²

Concerning the exposure of international banking groups to the CEE market, OTP is clearly number one with 100% of assets in the region (see Chart 4). The Hungarian

bank is followed by four Austrian banks, namely Raiffeisen Group (45.2% of assets in



CEE), Hypo Alpe Adria (38.2%), Erste Bank (36.5%) and Volksbank (14.6%).¹³ The importance of EU and especially Austrian banks in CEE becomes clear in these two tables, where Austrian banks¹⁴ are marked black¹⁵ and banks from other EU countries are marked light blue.

¹² This simple addition assumes that all subsidiaries of the two banks will remain in the newly formed group, which seems unlikely given regulatory resistance in Poland and Croatia.

¹³ For purposes of this comparison, Bank-Austria Creditanstalt is considered part of HVB Group since HVB was the ultimate consolidating entity. On a stand-alone basis, the Austrian subsidiary of HVB Group responsible for all CEE banking subsidiaries (now the holding company for CEE activities of the entire UniCredit Group) would have had more than 30% of assets in the CEE countries.

¹⁴ The term 'Austrian banks' refers to banks that are under Austrian home country supervision in this paper.

¹⁵ Unicredito and Bank-Austria Creditanstalt are marked grey.

As can be seen in Table 6, Austrian banks command a significant market share in most of the countries analyzed. The importance is further increased when UniCredit, where the Austrian subsidiary Bank-Austria Creditanstalt is to become the sub-holding company for all CEE assets with the exception of Poland, is included in the figures. Without UniCredit, Austria is already the largest foreign investor in terms of

	Austrian Banks	UniCredit	Under Austrian Supervision	Banks Under AUT Supervision #1 Investor?
Bulgaria	8.0%	24.8%	32.8%	Yes
Croatia*	33.4%	25.1%	58.5%	Yes
Czech Republic	24.4%	6.9%	31.3%	Yes
Hungary	13.1%	5.4%	18.5%	Yes
Poland**	1.9%	20.2%	1.9%	No
Romania***	34.8%	4.6%	39.4%	Yes
Slovakia	40.0%	9.6%	49.6%	Yes
Slovenia****	5.2%	5.3%	10.5%	No

Notes: *Splitska Banka (9.4%) the former HVB subsidiary will be sold by Unicredito due to competition issues (not included in Unicredito), **Uncertainty over Unicredito/HVB-BACA merger and resulting supervisory control (likely will fall under Banca d'Italia consolidated review), ***BCR (25.9%) counted towards Erste Bank, ****2003 data

Sources: own calculations based on data from Bank-Austria Creditanstalt (2004/2005/2006), Raiffeisenbank Research Unit (2005)

control of banking assets in the Czech Republic, Slovakia, Hungary, Romania, and Croatia. Adding the results of the assumed solution to the HVB/UniCredit merger, Austrian banks have a 2004 market share in terms of banking assets above 50% in Croatia, more than 30% in the Czech Republic, Slovakia, Romania, and Bulgaria, as well as over 10% in Hungary and Slovenia. The Austrian banking sector is thus the largest investor in all countries discussed with the exception of Poland, Slovenia, and the Baltic States. In the Baltic States, Sweden takes an even more dominant position, with Swedfund and SEB controlling over 60% of the total Baltic market (BA-CA 2004, p. 15).¹⁶

¹⁶ Due to the low involvement of Austrian banks in the Baltic States, this paper focused on CEE countries other than those three countries.

III.b.2. Foreign Involvement in CEE Banking - Branches vs. Subsidiaries

As described above, there is a legal distinction between foreign banks' branches and subsidiaries in a host country. As can be seen in Table 7, foreign banks prefer to enter other EU-15 markets using branches, with 563 foreign banks having established branches in host EU-15 countries and only 397 having established subsidiaries. As can be seen in Table 4, roughly 12.6% of total EU banking assets is held by branches of banks from outside the country, with 12.0%

	Branches	Subsidiaries
Austria	18	14
Belgium	38	20
Denmark	15	7
Germany	65	20
Greece	14	3
Spain	50	44
France	52	123
Ireland	31	20
Italy	76	7
Luxembourg	43	83.0
Netherlands	20	13
Portugal	22	11
Finland	18	3
Sweden	17	14
UK	84	15
EU-15	563	397

Source: Dermine (2005)

held by subsidiaries of banks from a country other than the country of operation.

Similar to the total level of foreign ownership of banking assets, this choice of market entry provides another distinction between the 'old' EU countries and the CEE economies. Table 8

outlines the number of foreign banks having established branches or subsidiaries in CEE countries at the end of 2003 and also shows

	Numbers		% of Assets	
	Branches	Subsidiaries	Branches	Subsidiaries
Czech Republic	9	18	10%	79%
Hungary	0	28	0%	62%
Poland	1	45	1%	67%
Slovenia	1	5	1%	18%
Slovakia	3	16	13%	84%
Romania	7	30	n/a	n/a
Sum/average	21	142	5%	62%

Note: % share of branches and subsidiaries may not add up to total foreign-owned banks assets since later also include indirect/minority foreign ownership

Sources: European Central Bank (2005a), Barisitz (2005)

the percentage of banking assets held by a subsidiary or branches of foreign financial institutions. In contrast to the EU-15 area, subsidiaries far outstrip the establishment of a

branch system both in total numbers (142 to 21) as well as in percentage of banking assets controlled in each country (a non-weighted average of 5% versus 62%). This bias can be observed among all CEE countries, with more than 85% of banking assets held by foreign establishments concentrated in subsidiaries rather than branches of foreign banks in all countries.

One of the main differences between the two regions leading to this dissimilarity has been the legal environment allowing banks to enter markets. As will be discussed below (Section V.c.2), the Second Banking Co-ordination Directive of the EU permits banks that have a license in any EU country to open branches in another member state without further bureaucratic impediments. As the EU-15 countries have been operating under this rule for several years, the abundance of branches as compared to subsidiaries can at least partially be explained.

Dermine (2005, p. 20) furthermore outlines eight reasons for the abundance of subsidiary structure in CEE; (1) an effort to keep 'business as usual' after a merger, (2) an effort to reassure local management, (3) a reassurance of shareholders in order to obtain their approval for the merger, (4) a reassurance for government and public that an acquired bank will remain committed to the country, (5) a tax reason due to differing tax structures in markets of operations and corporate tax liabilities in the event of a conversion from subsidiary to branch, (6) difficulties with changing deposit insurance regimes, (7) an effort to 'ring-fence' operations in individual countries and thus avoid risk-shifting, and (8) the ease of selling subsidiaries rather than branches. Baudino (2004, p. 2) expands the reasoning to the fact that foreign banks generally aim to take over inefficient banks and turn them around. In essence, these arguments boil down to the fact

that the subsidiary structure in CEE is mainly due to the fact that many banks entered the CEE markets via acquisition of privatized local banks, which were already incorporated under domestic rules and cross-border banking is thus the result of large scale M&A activity rather than organic growth, as is more the case in EU-15 countries. Furthermore, CEE governments often actively discouraged the opening of branches due to supervisory issues (as will be further discussed in Section IV below). Poland for instance required banks that wanted to open branches to negotiate an additional agreements with the National Bank specifying the amount of credit line that would be granted to the Polish branch by the mother bank, which would act as own funds. The Polish authorities would then calculate prudential norms such as loan concentration ratio based on this amount. Furthermore, special reporting requirements were imposed on branches of foreign financial institutions (Raczko 2001, p. 313).

With regards to Austrian participation in the region, it should be noted that apart from a few branches opened recently in the vicinity of the Austrian border by small savings and cooperative banks, the six large Austrian banks represented in the CEE region (Bank-Austria Creditanstalt, Erste Bank, Raiffeisen, BAWAG/PSK, Hypo Alpe Adria and Volksbank) all operate via subsidiaries in each country. This is true for all large EU-15 players in the market with the exception of ING, which has established branches in several countries (Gardó 2006).

III.b.3. Advantages of Foreign Ownership in the Banking Sector

Foreign ownership of banks can have substantial positive effects on the banks' as well as the entire economy's performance. Just the inclusion of foreign banks in the privatization process already creates a significantly more competitive environment and can thus lead to significant improvements in the banking sector. Foreign owners usually also inject fresh capital and transfer significant know-how, technology and improved corporate governance to the acquired CEE institution, boosting competitiveness, stimulating competition and strengthening public confidence in the sector. Foreign bank entry was thus crucial in the restructuring efforts of CEE banking markets, as they were "instrumental in the privatization of banking institutions and pacemakers for the transformation process [due to the fact that they] emphasized standardized credit evaluation over lending based on 'soft' information and long-term customer relationships." (Committee on the Global Financial System 2005, p. 1)

Non-domestic owners of privatized banks have thus been shown to significantly improve performance. Clarke et al. demonstrate that economic efficiency and capital adequacy were significantly higher for banks that were privatized to foreigners rather than domestic investors in a sample of South American and CEE countries (Clarke 2005, p. 1918). Similarly, a study by Bonin et al. concludes that "attracting a strategic foreign owner in the privatization process improves both profit and costs efficiency." (Bonin 2005, p. 2168) Through an increase in competition, foreign ownership can also serve to mitigate the negative effects of high market concentrations in banking sectors in CEE countries, where the top five banks hold an average of 72% of total banking assets (European Central Bank 2005a, p. 5).

Furthermore, foreign ownership can help to absorb the impact of domestic economic shocks because subsidiaries and branches of foreign banks have access to liquidity from abroad. In some instances, parent banks from abroad have already acted as *de facto* lender-of-last-resort and financiers of recapitalizations for their CEE subsidiaries. In Hungary, for instance, ABN-Amro and KBC guaranteed clients against losses due to an alleged fraud at K&H, the two banks' Hungarian subsidiary (Cardenas 2003, p. 9). Holding companies often provide their foreign subsidiaries with 'comfort letters' that assure support in the time of distress. While such arrangements are not legally enforceable, the rating agency Fitch-IBCA for instance has created a bank rating that assesses the likelihood of support provided to banks, including from foreign parent companies. In general, branches have easier access to the parent bank's capital since they are part of the same legal entity.

However, experience has shown that such support cannot be taken for granted. If costs are too high compared to benefits derived from continuing operation in the country and reputation risks for the parent bank, foreign banking groups might opt not to support failing subsidiaries. In CEE markets, Bayrische Landesbank's decision not to support its failing Croatian subsidiary Rijecka banka but rather to turn over its ownership stake for a symbolic dollar to the Croatian government is an example of this (Barisitz 2005, p. 78). Similarly, during the Argentinean financial crisis in 2002, both the Canadian Bank of Nova Scotia and Credit Agricole from France decided not to bail out their subsidiaries (Dermine 2005, p. 19). Such behavior has, however, been the exception rather than the norm in CEE.

IV. Theoretical Regulatory and Supervisory Issues of Cross-Border Banking

IV.a. Introduction

Sovereignty is a central concept of international political theory. It is “the capability of a state to project and maintain power both domestically and internationally” (Makler 2002, p. 828) and sovereignty over financial institutions by a country is administered through regulation and supervision. The relaxation of restrictions placed on foreign ownership of financial institutions thus “poses one of the strongest challenges to sovereignty in emerging markets because it can eclipse domestic control of a financial system.” (Makler 2002, p. 838) This is the central issue of cross-border banking, as now-Fed-Chairman Bernanke points out that the “combination of global banking and sovereign states has, for some time, produced what we may delicately call ‘tensions’.” (Bernanke 2004) Following is thus a theoretical discussion of issues caused by the globalization of financial services, for the sovereign (the states) as well as for the banks themselves.

IV.b. Problems for the Sovereign

IV.b.1. Supervision and Financial Stability

As pointed out, the regulation and supervision of banking activities is a central cornerstone of a country’s sovereignty to control and protect its entire economy. However, due to complexities associated with cross-border banking institutions, regulatory and supervisory structures are undermined and governments thus fear for their effective influence over their countries’ economies.

A major challenge for supervisory structure¹⁷ has been the recent development that the legal organization of banking groups has become increasingly unreflective of their operational organization and risk management procedures. The European Commission has dubbed this the ‘re-organization of the value-chain’ in which the centralization of upstream business functions has led to the development of banking institutions where back-office and strategic decision-making are removed from local management and organized on a pan-European group level. This development includes centralize liquidity management, pan-European assets/liability management, and consolidated risk management (European Commission 2004a, p. 9). As a result, subsidiaries of foreign banks often tend to behave like branches even though they are legally incorporated as subsidiaries. As pointed out in a ECB publication, in Poland, “in practice part of the subsidiaries have already been operating like branches, focusing above all on sales, with decision-making power being locally limited and part of risk management being located abroad.” (Thimann 2002, p. 185) This situation is similar to Hungary where “a number of these [foreign] banks are already operating like branches, which is perceptible in many areas ranging form decision-making mechanisms to risk management activities.” (Thimann 2002, p. 114)

As a consequence, pan-European financial groups are managed with “minimal regard for legal entities, national borders, or functional regulatory authorities and with

¹⁷ The term ‘supervisory structure’ here refers to the distribution of responsibilities and authorities between countries. This paper is not concerned with the internal organization of supervisory agencies within countries, which differ vastly. For instance, among the EU-15, seven countries (Austria, Belgium, Germany, Ireland, Luxembourg, the Netherlands, and the United Kingdom) have integrated supervision of the entire financial sector while the other eight countries organize supervision on a sectoral basis. Among CEE countries, the Czech Republic, Lithuania, Poland, Slovakia and Slovenia also organize their supervision on a sectoral basis. Further differences exist as to the involvement of central banks in banking supervision, ranging from complete responsibility of the central bank for this task to an independent, separate supervisory authority.

substantial and complex intra-group financial transactions.” (Herring 2003, p. 4) The nation-based supervisory structure may therefore no longer be aligned with the risk management structure and exposures of the supervised institution. While host supervisors have *de jure* control over banks in their jurisdiction, this development results in a very limited *de facto* control over domestically operating banks as important decisions are made centrally and the financial state of the subsidiary is largely dependent on the parent company. This can cause problems with regard to the question of appropriate supervision of banks by the host supervisor and with respect to stability issues.

A centralization of risk management means that financial institutions increasingly measure their risk exposures on a regional or even global scale. By consolidating all exposures from different countries, individual subsidiaries or branches may remain subject to significant risks even if the whole group’s risk is judged to be adequate. Thus, a large bank with operations in different national markets could be satisfied with its diversification of risk while individual local operations could end up “specialized in local credit risk,” (Dermine 2005, p. 28) thus becoming more vulnerable to country-specific shocks. While it is expected that losses at one location will be offset by gains in another subsidiary and thus overall risk decreases as the diversification of a banking group increases, such a set-up could lead to significant profit volatility on the level of individual subsidiaries. Furthermore, there can be no guarantee that losses in one subsidiary will be covered by the parent bank using offsetting gains somewhere else. Examples have been quoted above (see Section III.b.3). In many cases, the creditors and investors vary for different subsidiaries (due to minority shareholding and a listing of the subsidiaries, for instance) and a transfer of assets may therefore be illegal. It is of no importance to host

supervisors that the consolidated bank has adequate capital to cover its risks if this capital is not available to the subsidiary in the host country during a crisis.

Due to the described issue, it is essential that a host regulator, who is responsible for local operations of a larger financial institution, is able to rely on the home supervisor to fulfill his duties. In that respect, McCarthy outlines four issues the host supervisor is concerned with: the legal powers of the home supervisor, his willingness to fulfill the responsibilities with regard to the foreign subsidiary/branch, his competency, and the ability of involved agencies to react quickly and adequately in a crisis (McCarthy 2005, p. 295). The first issue is caused by the fact that the powers or structures of different national regulatory regimes are not homogeneous. In the banking industry, an additional problem is that while it is supervised in every country, there are differences as to which specific activities banks are allowed to engage in.

Concerning the subject of the willingness of the host supervisor, it is important to note that there could exist a divergent evaluation of systemic importance of a specific bank between host and host country authorities. A foreign subsidiary judged to be significant in the host country may not represent a significant share of a large banking group while a subsidiary that is significant for a banking group (and thus its consolidated supervisor) from a relatively small home market may not be considered significant in a large host market. The home supervisor might therefore not devote the attention to this banking group deemed appropriate by the concerned host supervisor and visa versa. With respect to crisis situations, decisions to bail-out large financial groups and other responsibilities largely lie with the home supervisor or other home country agencies. In the case of branches of foreign banks, with the exception of liquidity supervision, all

decisions are made by home supervisors and host supervisors thus only have marginal responsibilities and authority. Home agencies are not accountable to the host country and not responsible for its stability. Thus, they may not consider ‘spillover effects’ or negative externalities of their decisions for host countries when making decisions as “it may be reasonably assumed that regulators of all types operate primarily in the best interest of the citizens of their own country and not necessarily in the best interests of the host countries, particularly during bad economic times when insolvencies threaten.” (Eisenbais 2005, p. 10) This can cause significant concern for host supervisors, especially in markets like CEE where foreign banks dominate.

It is also important to note that not only supervisory responsibilities and incentives may be misaligned. Shareholders of the parent company may also not necessarily aim to maximize the value of each individual subsidiary but rather the value of the bank as a whole, which may not be aligned with the best interest of every single subsidiary. New Zealand, which as stated has the world’s highest foreign ownership share of banking assets, has been struggling with this issue for some time and requires banks to explicitly state in their constitution that directors are prohibited from damaging the subsidiary to the advantage of foreign holding companies (Cardenas 2003, p. 18).

As home and host supervisors collect complementary information, it is essential that the two communicate relevant knowledge and ensure that the other is aware of risks that may arise. This is especially true with respect to the host country’s supervisors’ advantage in collecting information pertaining to local market conditions, specific borrowers, etc. Thus, in 2001, the IMF stated in its Financial System Stability Assessment (FSSA) of the Czech Republic that “the predominant foreign control of the

Czech banking system highlights the urgent need for strengthening supervision of foreign banks' establishments. Most importantly, it will require an efficient system of information sharing and formal Memoranda of Understanding (MoUs) with supervisory counterparts." (Schoenmaker 2006a, p. 9) Similar statements were made in IMF's assessment of other CEE countries. While increased communication is essential, the increased foreign ownership in the banking sector and resulting improvement in product offerings and organizational complexities also necessitate an improvement of supervisory capability in the host countries to deal with such sophisticated institutions.

Barth thus concludes that "foreign ownership can be a two-edged sword" since foreign banks can create "additional challenges [for host supervisors] in terms of developing a comprehensive understanding of foreign banks' operations, and jurisdictional tensions may arise" but they also lead to an improvement of supervision by being supervised by a sophisticated home supervisor who might "compete up" the supervision level (Barth 2004b, p 20).

IV.b.2. Contagion of Financial Crisis

IV.b.2.i. Introduction to Contagion

Another issue that is closely aligned with foreign ownership of the banking sector is that of crisis contagion. With mostly between 60% and 97% foreign ownership of banking assets (see Section III.b.1), and direct cross-border lending by EU-15 banks accounting for 42% of GDP in the EU-10 in 2003 (European Central Bank 2005a, p. 20), CEE host countries may increasingly become exposed to events taking place in other countries. As the ECB points out, the financial links between EU-15 and CEE countries

may result in a “risk transmission channel within the EU.” (European Central Bank 2005a, p. 6) Following is thus an analysis of contagion between ‘old’ and ‘new’ member states, considering both home-to-host and host-to-home contagion.

IV.b.2.ii. Contagion from Home to Host Countries

Due to one-sided nature of investments, the described risk transmission channel would most likely adversely affect CEE economies due to the systemic risk of a transmission of EU-15 crisis to CEE. This issue is even more pronounced when the ownership of a host country’s banking sector is highly concentrated in one or a few home countries. As discussed above, Austrian banks command a significant market share in most of the CEE economies (see Table 6), thus making a transmission of shocks from Austria to the region an important threat. This relationship between CEE and Austria is similar to issues in Latin America with respect to exposure to Spanish crisis and New Zealand’s exposure to Australian banks. The fact that foreign investment in CEE banking is not very diversified among countries (see Chart 1) and banks (see Charts 2 and 3) might create additional problems for the region due to contagion not only from the EU-15 to the east, but also between individual CEE host countries. This is due to the fact that banks active in the region who are experiencing losses due to a crisis in, let’s say Hungary, might have to reduce exposure in the Czech Republic and thus transfer the crisis. Also, several CEE economies may be hit by the same contagion from one country (for instance Austria) due to the high market share of banks from a few countries in the entire region. The issue of credit stability and pro-cyclical lending behavior by foreign banks is thus a very important concern for CEE. As Padoa-Schioppa, member of the ECB

executive board points out, the “advent of the euro [further] increases the likelihood of the propagation of financial stability problems across national borders.” (Padoa-Schioppa 1999) As several CEE economies are expected to join the common currency as early as in 2007, the risk of contagion is thus further increased.

A study by the Dutch National Bank investigates the effect of foreign banks on credit stability in CEE. It uses a large dataset from the region and concludes that there is no “evidence of such destabilizing behavior” but that on the contrary, “during crisis periods, domestic banks contracted their credit and deposits, whereas foreign banks did not show a reduction.” (de Haas 2003, p. 18) Thus, the pro-cyclical nature of lending by domestically owned banks is somewhat stabilized by foreign banks’ lending in times of duress, contributing to overall stability. This is due to the fact that “the operation of internal capital markets may make foreign bank subsidiaries less dependent on local monetary conditions and more dependent on capital and liquidity provision of the foreign-based holding company.” (de Haas 2003, p. 18) Concerning home-to-host contagion, the authors conclude that a negative relationship between economic growth in the home country of foreign banks and the credit supplied by subsidiaries of foreign banks in host countries exists. Thus, the belief that host countries are constricted by difficulties of the parent banks seems uncertain as the regional banking groups are “stimulated to increase their credit in order to make up for the lack of profitable investment opportunities in the home country.”¹⁸ The authors conclude that “in terms of stability – foreign banks in CEE behave as friends rather than foes.” (de Haas 2003, p. 18)

¹⁸ However, this conclusion should be viewed with caution as there is only a limited amount of data available due to the lack of EU-15 (home) country crisis in the past decade. As the contraction of lending by Japanese banks in the United States during the Japanese recession showed, contagion is still a concern.

IV.b.2.iii. Contagion from Host to Home Countries

Contagion can also go to other way, from host to home countries of large cross-border banks. While the ECB concludes that “impact [of the risk transmission channel] on EU-15 banks rather limited [and it is] more likely to have impact on systemic risk in the new member states,” (European Central Bank 2005a, p. 27) a few EU-15 markets could be significantly affected due to high exposures in this region. The ECB bases its quoted conclusion on the fact that loan exposure of EU-15 banks to CEE countries was limited to 2.6% of total foreign claims and 4.5% of claims on EU-25 countries in 2003. However, in four countries (Austria, Greece, Italy, and Sweden), the exposure to CEE totaled more than 10% of EU-25 claims (European Central Bank 2005a, p. 21). This could be a problem as non-performing loans in new member states are still relatively high compared to the EU-15 average with 10.4% compared to 3.1% (European Central Bank 2005a, p. 25). Austria is especially affected by this as the Financial System Stability Assessment of the IMF identified “growing exposure to transition economies in central and eastern European countries, while important for boosting profitability, [] as a potential source of risk” (Kato 2005) that would “require continued monitoring and vigilance.” (International Monetary Fund 2004, p. 4)

Austrian banks are not only significant for individual CEE countries as described above, but conversely these markets are of essential importance for the Austrian banks themselves. Analyzing the largest Austrian banks displays a large exposure to CEE. As can be seen from Charts 1 and 2 (see Section III.b.1), 45.2% of Raiffeisen Group’s consolidated assets are located in CEE, a figure that is 35.6% for Erste Bank and above

30% for Bank-Austria Creditanstalt. The Czech Republic accounts for the most significant share of Austria's exposure in the region with approximately 40%, followed by Slovakia, Croatia, Poland and Hungary (International Monetary Fund 2004, p. 10).¹⁹ Furthermore, Bank-Austria Creditanstalt derives 61.0% of its profits from CEE subsidiaries, while Erste Bank's CEE customers contribute 61.4% and Raiffeisen's CEE holding company supplies 48.4% of post-tax profits.²⁰ Since economic downturns in the region could result in an increase in non-performing loans and a reduced growth in credit, the growing exposure of Austrian banks to local clients and thus to the macroeconomic environment in CEE is an important issue for Austrian stability. Furthermore, since foreign investment by Austrian bank's is largely concentrated in this region (as opposed to other, larger European banking groups that are important players in CEE but have also expanded to other markets and are thus better diversified), adverse macroeconomic developments in the entire region could have very serious effects on the health of Austria's financial system. As the IMF points out in the aforementioned report, the fact that Austrian banks are largely invested via subsidiaries may reduce the threat as parent companies would be somewhat insulated from developments in CEE (Hrdlicka 2006). Nonetheless, profitability of the local banking sector would be significantly hurt despite the organizational structure if CEE subsidiaries fail to contribute their earnings to overall group performance.

In interviews at the Austrian National Bank (OeNB) conducted in January 2006, however, Karin Hrdlicka, Head of Unit in the Financial Markets Analysis and

¹⁹ Based on 2003 data that does not including HVB-UniCredit merger and several additional acquisitions by Austrian banks in CEE.

²⁰ Calculations based on information available on company websites. Bank-Austria Creditanstalt and Erste Bank figures are for 2005, Raiffeisen figures for 2004.

Surveillance Division and Michael Würz, Head of the same division downplayed this risk for Austria stating that the “risk is controllable.” (Würz 2006) Since the Russian crisis in 1998, there have thus not been any large losses for Austrian banks in the CEE region (Hrdlicka 2006). This is also reflected in a stringent stress test that was performed on the Austrian banking system by the OeNB in 2004.²¹ Apart from stress tests for credit risk, market risk (interest rate risk, foreign exchange risk and equity risk), liquidity risk and contagion risk within the Austrian banking sector, a separate stress for CEE exposures analyzed the effect of exogenous shocks from that region. A deterioration of loan loss provision ratios was used as indicator of stress and both direct cross-border lending and indirect lending through subsidiaries was considered. The test calculates that no banks fall below the 8% capital adequacy ratio set as evaluation criteria and that “it can be concluded that the Austrian banking system performs well under a CEE shock scenario.” (Boss 2004, p. 847)

Despite these observations and the previously mentioned studies negating a negative effect of foreign banking on CEE stability, it is nonetheless the consensus in the European Union, supported by the ECB, that “financial stability concerns are no longer exclusively a national concern but have also become an issue of European interest.” (European Commission 2004a, p. 18) Nonetheless, this paper will leave the issue of financial contagion aside when discussing regulatory and supervisory developments since, apart from supervisory communication, these are less relevant for contagion.

IV.b.3. Market Discipline and the Third Pillar

²¹ The test was conducted for the entire Austrian banking sector, the individual sectors of the banking industry (savings banks, cooperative banks, etc) and finally for a subset of six banks most active in CEE (covering 44.3% of total Austrian banking assets and 98% of all CEE assets of Austrian banks).

Another issue caused by the increased takeover of banks by foreign institutions is the loss of valuable information due to the de-listing of the acquired bank's equity from the local stock exchange. Market signals are included in the so-called "third pillar" under the international agreement on capital adequacy (discussed further down in Section V.b.3). A de-listing not only ends the flow of market signals through the pricing of a firm's equity and thus the market's evaluation of the bank's risk but has further subtle consequences. For one, a de-listing also results in a reduction of financial reports and information that must be made available to the public as private firms only have limited reporting requirements. Thus, quarterly reports may be ceased and regular investor and analyst meetings are discontinued. Even annual reports of a privately held subsidiary may not have to be made public. Secondly, a delisting of the local bank also leads to the discontinuation of independent analyst reports tracking and evaluating the stock and thus the bank. Such analysts provide important work by deciphering complicated financial information and performing peer comparisons.

The information published by the acquiring institutions cannot fully make up for this loss of information as consolidated information doesn't have the detail that would be obtained from individual reporting of the subsidiary. Even if the parent is listed and has a secondary listing on the stock exchange of the host market, such as Erste Bank's listing in Prague, the information communicated through the stock price of the consolidating entity is often not applicable to evaluate the financial position of a subsidiary. This would only be the case if the subsidiary constitutes a large share of the listed bank's business.

In dealing with this issue, several solutions have been proposed. One would be the mandatory publication of information by de-listed subsidiaries equivalent to the

requirements listed companies have to fulfill. However, the Committee on the Global Financial System (CGFS), a subcommittee of the Bank for International Settlements points out that “regulatory disclosure requirements cannot fully substitute for financial market signals.” (Committee on the Global Financial System 2005, p. 20) Host authorities may also require the subsidiary to issue subordinated debt on the local exchange. This could be a gauge of the health of the unlisted subsidiary. Another alternative is to require the public listing of a minority stake in the subsidiary on local exchanges. The Polish government used to commit large foreign-owned banks in Poland to be listed on the Warsaw stock exchange, thereby subjecting them to market scrutiny and strict reporting requirements. The free float of these banks’ equity generally doesn’t exceed 25% though, and with accession to the EU, the rule has been dropped (Thimann 2002, p. 176). In general, such requirements cannot be imposed within the European Union, and thus there is no way for replicating the market signals obtained through the listing of major banks.

IV.b.4. Considerations Regarding the Safety Net

IV.b.4.i. Introduction to the Safety Net

Apart from the misalignment of supervisory and organizational structures of banks, the problems associated with financial stability and a loss of public information, large foreign ownership in the banking market also causes issues with respect to the safety nets set up for banks. As already discussed, it is a common view that foreign parent banks will support their subsidiaries in host countries in time of financial distress and thus these banks are safer for local depositors. However, as examples show (see Section

III.b.3), such action is not always the case. Host supervisors also need to consider that due to legal constraints, it might not always be feasible to transfer capital between different parts of a banking group, especially across national borders. The issue of private internal support to banking operations of large groups in foreign lands thus does not have a clear-cut solution. This is also true for the official support system.

Banks have three central roles in the economy: they facilitate the payment and clearing system, function as an intermediary to match claims issued by borrowers with the investments needs of depositors and creditors, and are fundamental in distributing, pricing and monitoring credit allocation (Megginson 2005, p. 1932). These functions are not comparable to the roles any other sector of the economy and thus banks have always been of special concern to national authorities. The prospects of industry-wide ramifications of banking failures are especially concerning given the key role of the banking sector in funding a nation's economic development. Dudzinski thus argues convincingly that

“the poor performance of one individual firm (despite its size) cannot harm the economic outcome of the economy as a whole. However, a bank's default or bankruptcy may strike all of the financial system through the disruption of the monetary circuit and the payments network, and eventually it may affect other banks' viability. Bank failure incurs a systemic risk.” (Dudzinski 2003, p. 227)

This systemic risk is what makes banks so peculiar, as the failure of one bank can have disproportionately large effects on the economy as a whole. The maturity mismatch of assets and liabilities leads to issues such as insufficient liquidity despite solvency, credit crunches in the event of a run on a bank, a fall in asset prices due to emergency sales, etc. that can have significant impacts on other parts of the economy. As pointed out, ‘market-only regulation’ is therefore never considered for banks but rather “debates center around the appropriate extent of state intervention rather than whether state intervention is

necessary.” (Grossman 2005, p. 131) Countries have thus devised safety nets to protect their banking industries. These are centered on deposit insurance schemes and a lender-of-last-resort (LOLR) function in order to prevent liquidity crisis of solvent banks. Systems to bail out insolvent banks in order to minimize impact on the economy also exist, though these are usually not publicized due to the moral hazard they create.

An important concept to consider in this discussion is the difference between illiquidity and insolvency. Due to a mismatch of the maturities of short-term liabilities, such as current accounts, with long-term assets, such as SME loans or mortgages, a bank that is solvent, i.e. technically able to pay off all its debts if allowed sufficient time, may not be liquid enough to do so immediately. When a large amount of liabilities mature at the same time (for instance during a bank run where maturation of accounts is forced by depositors) but assets are still locked up, a bank may thus become illiquid but not insolvent. Insolvency, on the other hand, occurs when the equity buffer between liabilities and assets is wiped out and a bank no longer has the ability to pay off all its debts. In the case of the withdrawal of large funds at the same time, an illiquid but insolvent bank may be forced into insolvency by having to pursue the emergency sale of illiquid assets at a discount to market value.

Deposit insurance schemes try to prevent bank runs by giving depositors security that they will be able to withdraw their deposits, eradicating the incentive for depositors who do not need their money to withdraw out of fear that a bank's assets will be depleted. Similarly, the lender-of-last-resort (LOLR), usually the central bank, will step in to provide loans to an illiquid but solvent bank in order to prevent the emergency sale of assets and possibly a resulting insolvency. The LOLR will only lend to solvent banks that

are not able to borrow funds on the market and will only do so for a limited amount of time. In contrast, bail out and recapitalization measures provide funds to insolvent banks (or banks where the equity has fallen below a regulatory level) in order to prevent a widespread financial crisis.

As discussed in Section II, regulation and supervision of financial institutions serves to replace the market discipline removed by the safety net since depositors have less incentive to monitor their banks if their deposits are guaranteed or they expect to benefit from LOLR support. Since banks were historically set up on a national basis, so were the safety net and hence regulation and supervision. With a change to a more international orientation of the banks, issues for the safety net and hence regulation and supervision thus naturally arise. The disparate organization and characteristic of these national safety nets therefore create further issues for international banking.

IV.b.4.ii. Deposit Insurance and Lender-of-Last-Resort

With respect to deposit insurance, the question arises which country's system is responsible for the foreign activities of a bank. While subsidiaries are always subject to the host country scheme, some countries have chosen to further include all branches of foreign financial institutions in their own (host) deposit insurance scheme. This is especially true in countries where foreign ownership is high and the coverage of branches is important to reassure the public and thus achieve the public-policy objective of financial stability. When this is the case, however, the problem arises that the host-country deposit insurance scheme is dependent on adequate supervision of the branches by the home supervisor since host supervisors only play a marginal role in monitoring

branches. Thus, the supervisory authority does not lie with the same country that would ultimately have to bear the costs in case of a failure of the bank. This is clearly a misalignment of incentives. In the case of BCCI, for instance, Luxembourg was responsible for consolidated supervision but lacked incentive since the bank pursued no banking business in the country and Luxembourg was not responsible for deposit insurance or lender-of-last-resort provisions since the banking subsidiaries of the holding company operated under the jurisdictions of other countries (Herring 2005a, p. 7). Host countries in such a situation may therefore require collateral in the form of pledged assets, “notional capital” etc. which act as own funds.

Generally, due to this problem, host countries often prefer to accept the coverage of deposit in branches of foreign banks provided by the home country. However, several countries have depositor preference legislations that give deposits at domestic branches of the parent bank priority over deposits at foreign branches in the case of the failure of a bank. This is, for instance, the situation in the United States as well as in Australia. In this case, coverage of deposits placed in branches of foreign banks by the host authority is absolutely essential to reassure depositors, but may expose a country to the externalities of decisions made by other regulators and supervisory authorities. New Zealand’s banking market is dominated by subsidiaries of large Australian bank but one of the five largest banks is still a branching operation by an Australian bank (Bollard 2004, p. 38). As a solution, New Zealand is matching domestic deposits with collateral provided by domestic assets as a replacement of equity (Kaufman 2004, p. 72).

The lender-of-last-resort faces similar issues, especially when troubles occur at foreign branches of a large bank. In this case, the central bank of the home country is the

lender-of-last-resort that would provide emergency liquidity assistance to the branch. However, it may be politically unfeasible to transfer national assets (such as funds of the national bank) across borders to support a foreign branch that is in distress. At the same time, host provision of the LOLR function is controversial as well. The issue arises that LOLR support should only be granted to solvent institutions but host authorities, due to a lack of supervisory authority, often are not in a position to judge the solvency of a foreign bank with domestic branches. Similarly, it would be difficult for the host country national bank to justify the support for a branch of a foreign bank, which in effect would amount to a subsidy to a foreign firm.

With respect to branches and the issue of LOLR and deposit insurance, the central concern is thus a misalignment of decision and supervisory power with respect to liquidity and solvency of financial institutions and responsibility for the provision of crisis funds. The home supervisor of a bank thus could cause significant externalities for foreign (host) deposit insurance schemes and lender-of-last-resort facilities. Illiquidity doesn't necessarily have to lead to insolvency, which could be averted by an effective safety net. However, if authorities responsible for solvency (host), deposit insurance (host or home), liquidity (home), and liquidity support (home or host) are of different nationalities, they may have divergent interests and the safety net might not work properly. Such uncertainty is not providing assurance to the public and hence may not be effective at preventing a bank run. A smooth and dependable functioning of deposit insurance and LOLR facilities, which may possibly be hampered by cross-border banking, is therefore essential for the proper functioning of the banking industry.

IV.b.4.iii. Insolvency and Liquidation

In cross-border banking, not only the avoidance of insolvency through a safety net but also actual insolvency and crisis resolution procedures are an issue. In the case of subsidiaries, it is relatively easy to define the applicable jurisdiction due to a separate incorporation in the host country. A subsidiary may therefore be liquidated independently and under the laws of the host country. Subsidiaries that are solvent also do not have to follow mother banks into insolvency procedure. However, this could reduce the effectiveness of consolidated supervision as legal restrictions often prevent the consolidation of banks during insolvency procedures even though solvency for a banking group is determined on a consolidated basis (Eisenbais 2005, p. 11). Also, with regard to subsidiaries, the collusion of home country supervisors with the parent bank to transfer assets from host to the home market is a real fear by host supervisors, especially in CEE (Dermine 2005, p. 28).

Furthermore, the increasing centralization of operations in multinational banking groups could lead to the fact that ‘functionality’ could pose a problem. This is due to the fact that management expertise, records, communication technology, etc that are vital to the operation of a bank are under a different jurisdiction. Critical services, know-how and decision-making power are thus effectively outsourced. For instance, in the case of Drexel Burnham Lambert’s failure, despite an isolation of the regulated subsidiaries from the rest of the group, Herring points out that the continuation of operation of these subsidiaries was unfeasible without the infrastructure of other parts of the bank (Herring 2003, p. 13). This is another reason host supervisors may be skeptical about foreign ownership and home supervision as the decision by home supervisors whether to declare

a bank insolvent or pursue other crisis resolution measurements can lead to significant externalities on foreign subsidiaries. The Reserve Bank of New Zealand has recently publicized its ‘Outsourcing Policy’ to address this issue. Through this, banks with liabilities exceeding NZ\$10bn are obliged to have

“legal and practical ability to control and execute any business, and any functions relating to any business, of the banks that are carried on by a person other than the bank, sufficient to achieve, under normal business conditions and in the event of stress or failure of the bank or of a service provider to the bank, [a smooth provisioning of ‘core’ bank functions].” (Reserve Bank of New Zealand 2006, p. 2)

With this arrangement, the Reserve Bank hopes to mitigate the risk that “operation and management of the bank might be interrupted for a material length of time,” (Reserve Bank of New Zealand 2006, p. 4) by ensuring functionality even in the case of a banking crisis in Australia and insolvency of the mother banks.

Even more complex situations could arise if branches in foreign countries are concerned as they and their assets are an integral part of and inseparable from the parent bank. This could pose problems during insolvency. The interests of home and host country authorities may well be contrary when deciding whether to declare a bank insolvent (rather than bailing it out) and during insolvency resolution. Home country regulators will be most concerned with the relative importance of the bank in the home country and disregard the relative importance of the bank’s branches in host countries. They may thus let a bank go into bankruptcy that would be considered ‘too big to fail’ by the host country. As Alan Bollard, Governor of the Reserve Bank of New Zealand points out,

“home and host countries can have very different views on the choice of technique for responding to bank distress... [and] these choices have to be made on the basis of an assessment of the costs and benefits of alternative approaches within each market, and there can be no assurance that different countries will – or should – necessarily come to the same conclusion.” (Bollard 2005, p. 37)

As such, the risk of a systemic crisis may be judged very differently in different countries. For example, in deciding to shut down Bank Herstatt in 1974, the German authorities took great care to minimize the effect of the closure on the German markets but failed to take the international effects into account. As Herring points out, the “closure of an internationally active bank is likely to have international consequences” (Herring 2003, p. 8) that need to be considered in the decisions about how to resolve an insolvent bank, but may not be adequately reflected in home authorities decisions due to their limited accountability to foreign constituencies. Different liquidators may also have different objectives, ranging from depositor protection, minimizing losses to domestic or international creditors, financial stability concerns, or even the protection of employees or sale of the concerned institution (Herring 2003, p. 21).

In the resolution of such cross-border branching insolvency, two different doctrines exist, the ‘single entity’ and ‘separate entity’ doctrines. Under the ‘single entity’ approach, banks are liquidated as a whole and all creditors, independent of which branch they used, have *pari passu* claims on the assets. The ‘separate entity’ doctrine, similar to the depositor preference legislation discussed in Section IV.b.4.ii, advocates a separate liquidation of branches located in different countries and gives priority to creditors in the home country before compensating those in other countries. Through the process of ‘ring fencing’, home and host country authorities can place limits on the resources or obligations that can be transferred abroad to foreign branches or the parent company of a financial institution (Cardenas 2003, p. 13). The United States have such an approach to the liquidation of branches of foreign banks, where proceeds from a separate liquidation are used to compensate domestic creditors (Holthausen 2003, p. 5). Australia similarly

does not allow the transfer of assets from a bank incorporated domestically to be used to compensate creditors of foreign branches until all Australian claims have been satisfied. Such regulations would of course be harmful for host countries where a large share of the banking market is in foreign hands, such as the case in the CEE region, as well as for home countries of large banking groups since domestic creditors could be at a disadvantage to foreign subsidiaries.

Observing the issues raised in times of crisis, it is apparent that the complexities increase with branches of foreign banks compared to subsidiaries. As described above, foreign banks in CEE primarily operate via subsidiaries. However, since accession to the European Union and adoption of community legislation (specifically the single passport provision described further below), all banks chartered in any EU country are allowed to establish branches in the CEE countries.²² Furthermore, through the statute for a *Societas Europaea* (discussed in more detail in Section VI.b. below), subsidiaries within the EU and EEA may be transformed into branches through a relatively simple procedure. Several CEE countries already report that some local subsidiaries of foreign banks will transform into branches and that there is significant interest in the establishment of new branches under the single passport rule. Thus, supervisory control could decrease further and the issues described above could become increasingly important.

IV.c. Problems for Cross-Border Banking Groups

Foreign ownership of the banking industry and resulting complexities in the regulation and supervision of financial firms are not only an issue for national authorities but for the financial institutions as well. Venturing into a new country does not only

²² Romania, Bulgaria and Croatia are an exception until their actual accession into the Union.

entail general risks related to the entry into new markets and cause bureaucratic hassles while setting up. Rather, the operation in different countries leads to continual complexities in the bank's reporting, accounting, and treasury systems. For example, even before the enlargement of the European Union to CEE, there were 39 different authorities at least partially responsible for prudential supervision in the EU-15 countries. Institutions such as Deutsche Bank or ABN Amro, active across all EU-15 countries, were reporting to more than 20 supervisory authorities in 2002. Similarly, a single Austrian financial institution active in CEE may have had to report to up to 18 national supervisory authorities in 2004 (Austrian Financial Market Authority 2005b). Not only reporting requirements, but regulatory requirements such as minimum capital requirements and calculation methods can differ significantly as well.

Increased complexities for banks can also have effects on host banking markets as largely divergent systems of regulation and accounting between various countries leads to a reduction in competition and liquidity. This is due to the fact that subsidiaries in host markets have to comply with home and host rules since the strictest rule always prevails. Banks are thus faced with expensive multiple reporting and compliance requirements, reducing the benefits reaped from economies of scale of cross-border consolidation. Furthermore, the issues outlined above could lead to stricter standards imposed by host countries and thus higher costs of doing business across border. Instead of such a system, multinational banks would much rather have 'one face to the customer' approaches to cross-border regulation and supervision, allowing them to deal with only one regulatory system and supervisor. It is thus important to address the issue of cross-border banking regulation and supervision due to issues for national authorities and negative effects on

stability but also in order to create an environment agreeable for international banks and conducive to an efficient working of the banking system. As Schoenmaker points out, “supervisory structures should... adapt to market developments and not the other way round,” (Schoenmaker 2006a, p. 21) and an efficient regulatory and supervisory environment is necessary to reach goal of a common European market for financial services and foster the ability of EU banks to compete on a global market.

V. International Regulation

V.a. Introduction

As pointed out earlier, banking regulation and supervision are forms of exercising a country's sovereignty and the increase of cross-border banking "poses one of the strongest challenges to sovereignty in emerging markets because it can eclipse domestic control of a financial system." (Makler 2002, p. 838) However, the sovereign state is not the only category of authority in the global financial system and national sovereignty can be replaced by other mechanisms. Baker et al. (2005, p. 10) pinpoint four distinct categories of authority beyond states that govern the global financial industry, namely 1) international multilateral institutions, 2) transgovernmental regulatory networks, 3) regional regulatory cooperation, and 4) private authority (including the market). In the context of this paper, the transgovernmental regulatory network, which is defined as consisting of national regulatory authorities that cooperate on a specialized area of financial governance, is the Basel Committee on Banking Supervision (BCBS). Indeed, the BCBS was the first transgovernmental network when it was established in 1974 to aid cooperation of the G10 countries in the regulation of international banking. In the context of CEE, the international multilateral institution, which by definition consists of member states, is the European Union which eight of the discussed CEE countries have already joined, and three expected to join soon. The European Union, with its numerous directives on banking regulation, can also be considered a regional regulatory cooperation, though the integration goes beyond that. Problems with private authority in countries with a large foreign ownership share of the banking market have already been

discussed (see Section IV.b.3). Following is thus an outline and evaluation of the BCBS' and EU's influences on international banking regulation and supervision in general, and on CEE countries and Austria specifically.

V.b. The Basel Committee of Banking Supervisors

V.b.1. Introduction to the Basel Committee

As Kern states, “the first step to achieving effective international supervision is for an international authority to facilitate effective coordination of national regulatory responsibilities and to promote minimum standards and norms of good practice for the supervision of international banking activities.” (Kern 2000, p. 3-4) This is what the BCBS set out to do in 1974 when it was founded by the central banks of the G-10.²³ The Committee does not have any formal supranational authority or possibility to give legal force to its policies and does not aim to create uniform national banking regulations and standards. Rather, it focuses on creating common principles in the supervision of banks that are followed by participating countries and thereby link the variety of different systems currently used around the globe.

V.b.2. The Basel Concordat

In 1975, the BCBS issued its first guidelines, termed the ‘Basel Concordat’, for banks operating outside their home countries. In it, five basic principles on the separation of responsibility between home and host authorities were established, giving the host supervisor responsibility over liquidity of the foreign bank's local operation and the home

²³ Representation on the committee includes the G-10 countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) as well as Luxembourg and Spain.

supervisor responsibility for solvency of the entire bank. The Concordat furthermore adamantly recommended that all legal obstacles to the exchange of supervisory information be removed.

In 1983, the original Concordat was replaced by the ‘Principles for the Supervision of Banks’ Foreign Establishments’. Here, the concept of ‘consolidated supervision’, meaning the monitoring of a banking group’s risk based on the entire business portfolio, to be conducted by the home supervisory authority was introduced. Thus,

“host authorities are responsible for the foreign bank establishments operating in their territories as individual institutions while parent authorities are responsible for them as parts of larger banking groups, where a general supervisory responsibility exists in respect of their worldwide consolidated activities. These responsibilities of host and parent authorities are both complementary and overlapping.” (Basel Committee on Banking Supervision 1983, p. 4)

As in the original Concordat, depending on the aspect of supervision considered (solvency, liquidity, foreign exchange operations...), the distribution of responsibility varies. With respect to solvency, the home authority is primarily responsible for branches of foreign banks. For subsidiaries, solvency supervision is a joint responsibility, with host authorities taking the approach that subsidiaries are separate entities, while home authorities need to assess the effect of foreign subsidiaries on the consolidated solvency of a banking group. With respect to liquidity, primary responsibility for branches and subsidiaries lie with the host authority since liquidity is closely related to local customs and money markets. As stated by the BCBS, consolidated supervision of liquidity “may not always be practicable as a technique for supervising liquidity, because of differences of local regulations and market situations and the complications of banks operating in different time zones and different currencies.” (Basel Committee on Banking Supervision 1983, p. 7) Home supervisors, however, should be concerned with standby or other

facilities/commitments granted by the parent banks to foreign subsidiaries (Basel Committee on Banking Supervision 1983, p. 6).

The 1983 guidelines furthermore introduced the concept of ‘dual key supervision’, where the authorities in both home and host country concurrently assess each other’s ability to carry out the responsibilities assigned to them (Kern 2000, p. 8). In the case of a detected inadequacy, several possible solutions, such as extended supervision by the host authority (in case of home deficiencies) or a discouragement of continuing of operations in certain host countries (in case of host deficiencies), are proposed. The issue of supervisory gaps due to the organization of international banking groups (such as through holding companies) is also addressed, and responsibilities are assigned to home and host supervisors, respectively (Basel Committee on Banking Supervision 1983, p. 3).

The ‘Report on the Supervision of Cross-Border Banking’ (issued in 1996) together with the ‘Minimum Standards for Supervision of International Banking Groups and Their Cross-Border Establishments’ (1992) further detail the responsibilities and rights of home/host supervisors. Home supervisors are thereby granted the right to carry out on-site inspections in the jurisdictions of other supervisory authorities “for the purposes of carrying out effective comprehensive consolidated supervision.” (Basel Committee on Banking Supervision 1996, p. 4) Also, it is stated that “any home supervisor that licenses a banking entity has a responsibility to monitor its operations on a worldwide basis.” (Basel Committee on Banking Supervision 1996, p. 7)

While these guidelines mainly concerned the supervision of internationally operating banks, the 1988 ‘Basel Accord on Capital Adequacy’ was aimed to influence banking regulation through the development of uniform minimum risk-based capital

requirements. The goal was to establish a level-playing field for internationally active banks so that banks from one country would not suffer a competitive disadvantage through the imposition of higher capital adequacy requirements and thus higher costs than banks from another country. Thereby, competition by countries on regulatory grounds and a resulting ‘race to the bottom’ was aimed to be prevented. The Accord has recently been followed up the more fine-tuned ‘New Accord’, commonly referred to as ‘Basel II’.

V.b.3. The New Accord - Basel II

The New Accord, currently in the final round of review and due to be implemented starting in 2007 goes much further in the harmonization of capital adequacy rules than the

original Accord by incorporating not only credit and market risk,

Chart 5: Basle II		
Financial Stability		
Pillar 1	Pillar 2	Pillar 3
Minimum Capital Requirements	Supervisory Review Process	Market Discipline
Credit Risk Standardized Approach FIRB Approach AIRB Approach	Banks Internal Capital Adequacy Assessment Process Risk Management	Disclosure Requirements
Market Risk Standardized Approach Internal VaR Approach	Supervisors Evaluation of Internal System Assessment of Risk Profile Review of Compliance Supervisory Action	
Operational Risk Basic Indicator Approach Standardized Approach AMA Approach		

Source: Austrian Financial Market Authority (2005)

but also operational risk as a factor. It furthermore allows for more institution-specific rules, where the specific risks incurred by each individual credit institution are reflected more accurately in their capital requirement. This is achieved through the option allowing banks to use specific internal statistics in the internal ratings-based (IRB) model to determine the appropriate level of risk-adjusted capital for credit risk. Apart from

minimum capital requirements (Pillar 1), the New Accord explicitly identifies two further pillars in controlling risks: a supervisory review process (Pillar 2) and market discipline (Pillar 3) (see Chart 5).

In its ‘High-Level Principles for the Cross-Border Implementation of the New Accord’ the BCBS addresses the issues arising with banking groups that have cross-border activity. It recognizes that the New Accord will require considerably more cooperation among home and host supervisors since “the new rules will be applied at each level of the banking group, so that there is a technical requirement on the part of both home country and host country supervisors to provide a Pillar 1 and Pillar 2 assessment.” (Basel Committee on Banking Supervision 2003, p. 4) Furthermore, banking groups active in more than one market may need to gather approval for certain individual approaches to calculating capital requirements or for allocating capital to less significant subsidiaries (instead of calculating capital adequacy on a stand-alone basis) from home as well as host supervisors (Basel Committee on Banking Supervision 2005, p. 1). Home country supervisors still retain the right to impose additional capital requirements under Pillar 2 if they deem necessary.

With regards to diversification benefits, the BCBS recognizes an issue described above by stating that “experience has shown that capital is generally not freely transferable within a banking group, especially during times of stress, [and thus] each banking subsidiary within the group must be adequately capitalized on a stand-alone basis.” (Basel Committee on Banking Supervision 2005, p. 3) Therefore, the benefits of diversification of the entire group, which can be recognized for the consolidated capital adequacy requirement may not be included for significant banking subsidiaries and can

be limited for non-significant subsidiaries by the host supervisor. The BCBS further stresses the host supervisor's important position due to "knowledge of local market conditions and their ability to take supervisory actions and communicate directly with the entities... [and to] monitor, assess and deal with the local risks" and acknowledges host country concerns about their ability to "safeguard the stability of their financial systems." (Basel Committee on Banking Supervision 2005, p. 3)

As stated by Herring, the "tensions between the home and host country [that] are present under the Basel I regime, [] are likely to be greatly exacerbated by several features of Basel II ... [since] multinational banks are likely to be subject to different capital standards in different countries." (Herring 2005c, p. 16) This is due to the issues of multiple reporting and calculation requirements described above, as well as due to the fact that the New Accord allows for several different options in the rules and the implementation for the rules for supervisors. This is the result of the aim of the BCBS to be sensitive to the broad variety of financial institutions concerned. Thus, for computing capital charges under Pillar I, a bank active in several jurisdictions may have to apply a "complex array of approaches in computing its regulatory capital charges." (Herring 2005b, p. 2-3) Herring further points out that probability of default and loss given default, two key parameters used in calculating credit risk under the IRB approach of the New Accord vary significantly with differences in bankruptcy laws and enforcement, and small variations in these statistics could lead to substantial variations in capital requirements (Herring 2005c, p. 20). Thus, while the home supervisors are clearly in the best position to evaluate the use of the IRB and AMA approach across a group, it is the host supervisors that are most qualified to deal with local provisions (Committee on the

Global Financial System 2005, p. 9). The BCBS also echoes the concern of the banking industry that

“requiring calculation of [market risk] requirements at each legal entity would be unduly burdensome from the standpoint of having to make numerous separate calculations and may not be feasible given data constraints in the case of small- and medium-sized subsidiaries... [and] it would be costly and burdensome to maintain the systems infrastructure for separate loss databases in multiple jurisdictions.” (Basel Committee on Banking Supervision 2005, p. 3)

With regard to the implications for CEE banking groups and Austria, the Basel II guidelines themselves are not directly relevant. Instead, the EU has transformed the guidelines into a binding Directive (see Section V.c.4).

V.c. Regulation on the EU Level

V.c.1. Introduction to EU Legislation

As can be seen with the BCBS, supra-national arrangements on regulatory and supervisory standards have taken the form of recommendations only. These recommendations have no legal enforceability and are merely suggestions to national regulators/supervisors. In contrast, with progression of European integration much more formal arrangements are being established. Since the inception of the Single Market Program at the end of the 1980s the ‘Single Market for Financial Services’ has been a goal of the European Union. In 2000, the European Council endorsed the Financial Services Action Plan (FSAP) which was intended to remove remaining barriers to an integrated EU financial market.²⁴ Some FSAP measures have taken the form of EC regulations, which are direct legislation effective immediately in all member states. However, most measures have been implemented via EC directives, which work indirectly by forcing member states to transpose the essence of the directive into their

²⁴ EEA countries, with the exception of Switzerland, also accept the entire European banking legislation and thus these countries are covered in the discussion referring to EU banking law.

individual legal system (Financial Services Authority 2003, p. 7). The EU General Director for Common Market and Services, Alexander Schaub thus rightfully states that technically, “a majority of legislation is not produced in Brussels, but by the national legislative authorities.” (“Es geht ja nicht um Luxuregulierung,” Der Standard 2005) Among the EU-25, Austria has so far been exemplary, with close to 100% of guidelines and directives adopted into law whereas other countries still stand at 70%.

The objective to “foster a market where financial services and capital can circulate freely at the lowest possible cost throughout the EU - with adequate and effective levels of prudential control, financial stability and a high level of consumer protection” has been reiterated in the European Commission’s ‘Green Paper on Financial Services Policy (2005 – 2010)’ in 2004 (European Commission 2004b, p. 3). The following section thus analyze the EU banking legislation and its shortcomings with respect to this goal and the issue of cross-border banking outlined above relevant to Central and Eastern Europe and Austria.

V.c.2. The Foundation of EU Banking Legislation - the Two Banking Directives

The ‘First Banking Co-ordination Directive’ (FBD - European Economic Community 1977) was issued in December 1977 and aimed at simplifying the opening of branches in member states for banks of the European Community (EC). It also established the Banking Advisory Committee (BAC), which was the first EC-level committee made up of representatives of national regulatory authorities and finance ministries. It further establishes that in the European Community, banking regulation covers “all undertakings whose business is to receive deposits and other repayable funds

from the public and to grant credits for their own account,” a definition that was later extended to all “electronic money institutions” (European Community 2000). This was an important step considering the disparate banking systems in the member states which had resulted in a wide variety of activities banks could and could not undertake and thus established freedoms for a wide range of banking activities. However, it also creates the problem that while a common definition of banking activities between home and host country is achieved, this definition is simply the acceptance of the home definition. Host banking supervisors may therefore be unfamiliar with certain activities of branches of foreign institution since in their jurisdiction, banks do not conduct such business. A solution to the divergent definition of banking activities is thus not reached; however, long-term harmonization may be the result of applying host interpretations. Furthermore, the FBD establishes common standards for granting banking licenses and basic principles of bilateral cooperation between supervisory authorities.

The ‘Second Banking Co-ordination Directive’ (European Economic Community 1989b – referred to as SBD) issued in December 1989 created the concept of a ‘single passport’, which henceforth enabled banks with a license in any one member state to open branches and operate in all other member states without having to seek additional approval from host authorities. Furthermore, the principles of ‘mutual recognition’ and ‘home country control’ were established, ensuring that member states recognize and accept basic regulations in other countries and recognize the responsibility of home-country authorities and application of home-country laws for prudential regulation, deposit insurance, and insolvency resolution procedures for banking branches. Host authorities only retained the regulatory power for issues deemed necessary to protect

‘public interest’, such as marketing, advertising, customer protection, and conduct-of-business legislation. Further important areas expressly reserved for the home state are liquidity supervision and monetary policy (which has changed for EMU members after the introduction of the Euro in 1999, when responsibility for monetary policy was transferred to the ECB). In the case of emergency, host-country supervisors may furthermore take any measures deemed necessary to protect depositors, investors and other stakeholders. If insufficient home-country supervision is alleged, host states can even ask the European Court of Justice for an interim revoking of the single license provision.

V.c.3. The Single Market Program and Other Directives

The endorsement of the Single Market Program in 1992 engulfed the two Directives and confirmed the three pillars for a single market in banking: (1) minimal harmonization of banking rules, (2) mutual recognition of non-harmonized banking rules, and (3) home country control in supervision, reinforced through home-host cooperation (European Union 2006). While international agreements on banking regulation mainly resort to the ‘national treatment principle’ under which foreign firms are treated equal to domestic firms in a domestic market, the EU thus went a step further in integrating the banking market by giving home countries wide responsibilities in supervision and regulation and through the encouragement of at least some form of adjustment of national laws towards a common ground via minimum harmonization (Dermine 2005, p. 3). However, financial institutions complain that such an approach leaves too much discretion for individual member states and additional requirements resulting in divergent

regulatory regimes that are an obstacle to cross-border banking. The European Commission has therefore provided more detailed legislation and even some maximum harmonization (see following sections). However, the EU is restricted in its ability to force harmonization due to the principle of ‘subsidiarity’ under Article 3(b) of the 1992 ‘Maastricht Treaty’, (European Union 1992) which allows the adoption of directives by the European Council and European Parliament and resulting centralization of legislation only when such action is absolutely necessary to ensure the fundamental freedoms of provision of services and establishment for economic actors. As a matter of fact, ‘minimum harmonization’ provisions were often *de facto* complete harmonization since minimum standards were set higher than standards existing in member states. This is especially the experience in CEE, where the requirements of minimum harmonization have led to an ‘upping’ in many regulatory standards.

The 1992 Maastricht Treaty also established the European Monetary Union (EMU) and European System of Central Banks (ESCB). Although the main objective of the ESCB is price stability, the treaty explicitly mentions the field of regulation and supervision of financial institutions, leaving the possibility of the ECB assuming regulatory and supervisory functions open.²⁵ So far, this article has not been used. Thus, as ECB Executive Board member Padoa-Schioppa points out, a novelty has been created through the “abandonment of the coincidence between the area of jurisdiction of

²⁵ **Article 105 (5)** states that “The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.” **Article 105 (6)** further states that “The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.” (European Union 1992)

monetary policy and the area of jurisdiction of banking supervision” (Padoa-Schioppa 1999) with the establishment of the EMU.

The principle of minimum harmonization has led to several important directives on the subject of the establishment and pursuit of the business of financial institutions in the past years, most of which were consolidated in the ‘Consolidated Banking Directive’ (European Community 2000) in 2000. This directive has repealed most banking-related directives and consolidated the respective rules relevant to banks concerning (European Union 2006)

- the abolition of restrictions on freedom of establishment and freedom to provide services; (European Economic Community 1973)
- the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of business; (European Economic Community 1977, 1989b)
- own funds, solvency ratios, consolidated supervision, and large exposures. (European Economic Community 1989a, 1989c, 1992a, 1992b, respectively).

The essential minimum harmonization in EU banking legislation adopted up until the year 2000 thus encompasses the minimum level of capital (own funds) required for the authorization and pursuit of business, rules on risk-weighted capital adequacy, consolidated supervision, concentrations of lending, supervisory control of major shareholders in banks and of control cross-shareholding between the banking and non-banking sector, deposit guarantee systems, as well as specific disclosure requirements.

In 1994, the ‘Directive on Depositor Protection’ (European Community 1994), which set up minimum standards for national deposit guarantee schemes, was adopted in an effort to create a level-playing field for cross-border banks. The 2001 ‘Directive on the

Reorganization and Winding-Up of Credit Institutions’ (European Community 2001) was passed in order to ensure an orderly winding up and reorganization of failed financial institutions at a European level with *pari passu* standing of creditors irrespective of their home country within the European Union. The ‘Financial Conglomerates Directive’ (European Community 2002) furthermore set up rules concerning the lead supervision of nationally and cross-border operating financial conglomerates in 2002. Issues with respect to the safety net and crisis management and thus these directives are discussed in more detail further down (see Section V.c.6).

V.c.4. The Implementation of Basel Guidelines on the EU Level

European Union legislation in the field of banking law has largely focused on integrating the common market in financial services through a common approach to the application of recommendations issued by the BCBS (see Section V.b.). As a result, all 25 ‘Core Principles for Effective Banking Supervision’ published by the committee in 2004 are incorporated into various EU directives on the banking sector (Clarotti 2000, p. 87). However, the EU has not only followed the path of the Basel Committee with regard to supervision but also concerning regulation, especially capital adequacy. In 1993 the first ‘Capital Adequacy Directive’ (CAD) was implemented which is to be replaced by the ‘Capital Requirements Directive’ (CRD) coming into force in 2007. The CRD writes the Basel II framework into a new directive that applies to all banks and investment firms within the EU. Therefore, the EU has decided to treat Basel II as “internationally acceptable standards that should apply to all banks” (Herring 2005c, p. 14) rather than the

US approach of viewing it as “standards that should apply to all internationally active banks.” (Herring 2005c, p. 13)

Similar to the BCBS proposal, the CRD outlines three pillars. The current rules on capital adequacy, set forth in the CAD, are due to be updated to the more flexible Basel II approach. Similarly, operational risk will be incorporated into the minimum capital requirements under Pillar 1. With regard to Pillar 2, the supervisory review process, the CRD also establishes a framework for a further enhancement of supervisory cooperation and information exchange on banking groups active across borders. This is ensured through guidelines on consultation on supervisory action (Article 132 of the CRD), on written arrangements through MoUs covering the coordination and cooperation between home and host supervisors (Article 131), and on a process of joint validation of internal risk models (Article 129) (Committee of European Banking Supervisors 2006, p. 3).

Article 129 specifically states that banking groups may submit a single application covering the consolidated and stand-alone capital requirements of each subsidiary and supervisors must collectively determine the adequacy of using the internal rating based (IRB) approach for credit risk and AMA for operational risk measurements. In cases where no agreement is reached after six months of deliberation, however, the consolidating supervisor can decide on the model alone (this should be the exception rather the norm) (Committee of European Banking Supervisors 2006, p. 30). As Marianne Kager, Chief Economist of Bank-Austria Creditanstalt states (2006, p. 23), this is a

“step in the right direction; realistically, however, it should not be expected to resolve the problem of multiple calculations to comply with supervisory regulations. In this respect, the CRD, with its roughly 100 national options that are partly in core provisions of supervisory regulations, has not brought any improvement on the current status.”

The issue addressed by Kager concerns the number of choices that still exist with respect to the implementation of Basel II granted by the BCBS and the European Union.

As pointed out (see Section V.b.3), the New Accord itself provides multiple options and thus the rules can be implemented with significant differences across countries. This leads to a situation where EU supervisors are faced with 143 different options for implementation and for banks to choose between (Herring 2005c, p. 15). Of these 143 choices, around 100 are at the discretions of member states while the remaining 43 are options for the individual banks. Several of the national options were added by the European Parliament in order to provide leeway and accommodate national differences concerning provisions such as recognition of capital, capital requirements for specific risk categories, etc. (Würz 2006). The CRD also allows financial institutions to choose different approaches for different business lines. As the Austrian Financial Market Authority (2005b, p. 38) points out, “it was of special significance to create different approaches and concepts to take the heterogeneity of the banking system into consideration [and thereby] to find both cost-effective solutions for small institutions and models for globally active banking groups enabling them to employ complex, highly risk sensitive, internally developed systems.”

Supervisors may thus be faced with the problem of ‘regulatory cherry-picking’ by financial institutions and a possible pressure to qualify domestic banks for the advanced approaches prematurely in order to ensure their competitiveness (Herring 2005c, p. 15). The Basel II implementation will be as much of a challenge for supervisors as for the financial institutions. Banks will become increasingly difficult for consolidated supervisors to comprehend due to the number of options used in sub-consolidated entities

(Karas 2006). Pan-European banks may, furthermore, continue to suffer from regulatory and supervisory differences within the EU due to the implementation options, leading to further barriers to the true Europeanization of the financial service sector. Furthermore, a consolidation of exposures and hedges in various countries and thus recognition of the diversification of risks would also be ignored through a renewed fragmentation of regulation and supervision (Herring 2005c, p. 17).

According to Stephan Karas, Head of International Affairs and European Integration at the FMA, however, the industry (with the exception of truly international banks in the EU) are generally happy with the awarded options and resulting flexibility to take account of local needs. Würz (2006) also points out that banks could actually profit from these choices, but that the Austrian National Bank (OeNB) would generally agree that “the ultimate goal would be to offer as uniform as possible implementation.”

As an amendment to the CRD, the EU implemented a regulation concerning the application of international accounting standards per January 1, 2005. Consolidated accounts of any firm listed on a stock exchange must thereby be presented according to International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). Capital requirements can therefore be calculated on common rules starting in 2007. According to the Austrian Financial Market Authority (2005b, p. 28), most EU countries will immediately begin calculating own funds of credit institutions according to IFRS-based rules in the same year.

V.c.5. Supervisory Cooperation and the Lamfalussy Process

The cooperation between supervisors in the EU is based on three cornerstones, bilateral cooperation (established via MoUs), multilateral coordination (via EU institutions such as the CEBS, which is concerned with individual banks, the ECB, which is concerned with overall stability, and the BCS, which is the forum for banking regulation legislators), and the increasing convergence of supervision through EU legislation (Hrdlicka 2006).

Austria, due to its important position as a home country for many large CEE banks, has championed close cooperation with CEE regulators and supervisors well before the entry of those countries into the EU in 2004. The EU enlargement and resulting common banking legislative framework, however, has led to a significant improvement in “mutual understanding and confidence in the equality of the respective supervisory standards.” (Austrian Financial Market Authority 2005a) Regular bilateral meetings between supervisory authorities take place with the Czech Republic, Slovakia, Hungary, Slovenia, Croatia, and Poland. Meetings have also been held with representatives from Bulgaria, Serbia, and Bosnia-Herzegovina (Austrian Financial Market Authority 2005b, p. 15). Furthermore, the FMA have set up ‘cooperation meetings’ for each relevant Austrian bank where the responsible supervisors for the bank’s operations in host countries are invited to Vienna for specialized meetings on the implementation of Basel II. In this system, the experts on the bank from each country where the bank is a player convene and thus the consolidated knowledge on its operations and exposures is present (Karas 2006). With respect to Basel II implementation, all of these banks will most likely use the IRB approach and will thus require substantial supervisory cooperation. These meetings are currently, however, not considered for continuous supervisory cooperation.

FMA-Chairman Andreas Grünbichler has emphasized the importance of “intensive and flexible cooperation between national supervisory authorities.” (Austrian Financial Market Authority 2004) With respect to the EU enlargement and growing exposure of Austria’s banking industry to CEE the FMA has thus pursued the negotiation of MoUs with supervisory

authorities. As of end-2005 the FMA was close to concluding negotiations on banking sector MoUs with Romania and Poland and had concluded negotiations with most other major markets for Austrian banks (see Table 9). The

CEE	Bulgaria	2005
	Croatia	2005
	Czech Republic	2001
	Hungary	2001
	Poland	under negotiation
	Romania	under negotiation
	Slovakia	2003
	Slovenia	2001
Other EU	Cyprus	under negotiation
	France	1995
	Germany	2000
	Great Britain	1994
	Italy	1998
	The Netherlands	1997

concept of ‘supervisory colleges’

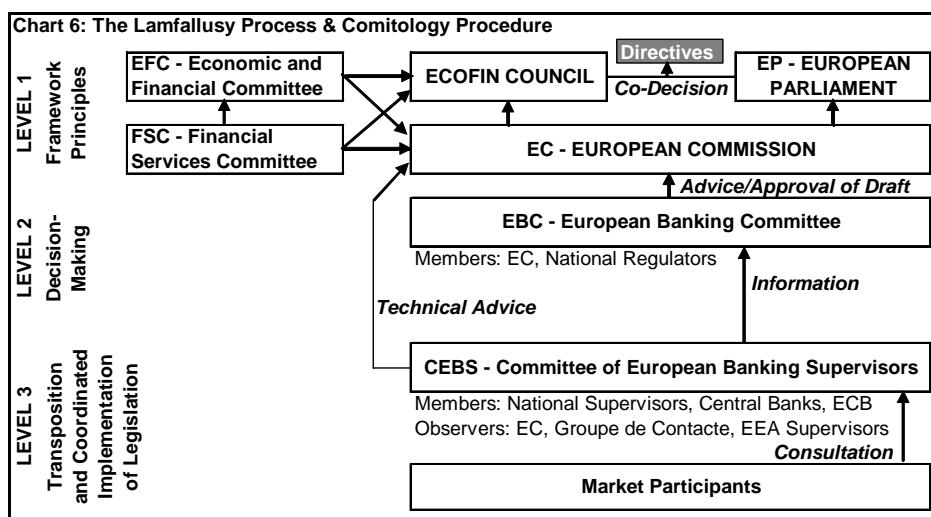
Sources: Austrian Financial Market Authority (2005), www.fma.gv.at, www.bnb.bg, www.imf.org

for specific banks is one that has been gaining popularity across the EU recently, hopefully contributing to the exchange of information and at least partially addressing concerns regarding differences in systemic risks of a banking group in various countries (outlined in Section IV.b.) by fostering communication on this topic. However, problems persist for large banks where it is unclear which supervisory institutions should participate and which countries should attend the meetings.

In 2003, a new legislative structure for banking regulation has been adopted on the EU-level, namely the Lamfalussy Process. Legislation is split into the issuance of framework principles, decision-making and implementing measures and the transposition and coordinated implementation of legislation and hence increased cooperation (see

Chart 6). On Level 1, EU legislation is formally proposed by the European Commission in the form of directives or regulations. These proposals are then decided on by the European Council of Ministers (Ecofin) and the European Parliament (EP) in the so-called ‘co-decision’ process. This legislation should be in the form of framework principles

with implementation powers given to the Commission. On Level 2, legislation on



Source: Austrian Financial Market Authority (2005)

the technical details and on the implementation of the framework principles is adopted by the Commission under the ‘comitology’ procedure with the European Banking Committee (EBC), which consists of legislative members of national governments and regulatory authorities. On Level 3, the Committee of European Banking Supervisors (CEBS), which includes the executive branches for banking supervision of member states, aims at facilitating the consistent implementation of EU legislation through the issuance of non-binding guidelines and standards (Financial Services Authority 2003, p. 13 & 2005b, p. 14). From April 16, 2003 until accession to the EU in May 2004, the new member states have participated in committees on all levels as ‘active observers’ and have thus influenced EU banking legislation before actual entry into the EU.

The Lamfalussy Process concentrates mainly on the legislative process and aims at speeding up decision making on and implementation of EU regulation in order to ensure a regulatory regime that is adaptable to market developments. As such, politically sensitive principles are adopted via the ‘co-decision’ procedure, while technical implementation measures can quickly be agreed on through the ‘comitology’ procedure. The process is also neutral with respect to the organization of national regulatory and supervisory structures since each member state is free to choose its representation at the various levels. The Center for European Policy Studies (CEPS) praises the Lamfalussy Process not only because of efficiency gains in regulation, but also due to its contribution to the convergence of supervisory practices and cultures by establishing regular meetings of supervisors at an unprecedented level (Levin 2004, p. 2).

The CEBS consists of banking supervisory authorities and central banks of all member states, the ECB, as well as observers from EEA countries. It serves to promote effective daily cooperation and information exchange by providing a forum for national supervisory authorities as well as to promote convergence of supervisory practices and a consistent implementation and day-to-day application of EU banking regulation. In 2004, the CEBS participated in the drafting of the CRD and was especially active in reducing national discretions and advocating common rules for disclosure, accounting and reporting. Currently, guidelines for situations of crisis management are also under discussion. According to the Committee of European Banking Supervisors (2006, p. 1), its guidelines are intended to serve as “the starting point for substantial developments in the supervision of cross-border groups, through the creation of operational network mechanisms.” The CEBS forum is further thought to aid the prevention of externalities

caused by decisions made by individual authorities (as outlined in Section IV.b.) due to an increased communication on the EU-level and peer pressure to consider such externalities in the decision process. Würz (2006) points out that the trust between supervisory authorities within the EU and with the new member states has significantly improved due to the regular exchange of ideas and information in EU committees and the peer-reviews facilitated through the committees. Especially with regards to CEE authorities, he remarks that they were “underestimated and clearly play in the same league.”

However, the Lamfalussy Process also has shortcomings. For one, the Level 3 Committee is intergovernmental organization with no means or powers of its own. The European Financial Roundtable (EFR), an association of thirty large European financial institutions²⁶ that aims to “contribute to the European public policy debate on issues relating to financial services and in particular the completion of the single market in financial services,” (www.efr.be) recently issued a critique of this process. It criticizes that “other than the beneficial side effect of more frequent contacts between supervisors, the Lamfalussy process did not change the structure of financial supervision in the EU.” (European Financial Services Round Table 2005, p. 20) As such, the process of supervisory convergence, relying on peer pressure and non-committal benchmarking is due to take a long time and its outcome is uncertain. However, as Hrdlicka (2006) points out, since these legally non-binding guidelines can only be adopted unanimously and thus with the consent of every member state, implementation is implicitly guaranteed. Nonetheless, criticism remains that supervisory cooperation has not been formalized on

²⁶ Aviva, Generali, Barclays, Munich Re, Deutsche Bank AG, AXA, Nordea AB, Allianz AG, BBVA, ABN-Amro Bank, Crédit Suisse Group, Crédit Agricole, Royal Bank of Scotland, UBS AG, BNP Paribas, UniCredit Italiano SpA, Zurich Financial Services, AEGON NV, ING Group, and Fortis

an EU level but rather only bilateral agreements have been encouraged. Furthermore, the establishment of the CEBS itself has not affected the distribution of responsibilities between home and host supervisors and done little to re-align supervisory overview and operational structure of financial institutions.

V.c.6. Safety Net & Crisis Resolution within the EU

One issue that is only marginally touched by EU legislation is the safety net for banks provided by each member state. As discussed, the centralization of power in the EU is restricted by the principle of ‘subsidiarity’ according to which the EU can only take over aspects of the legislative or executive power if “objectives of the proposed action cannot be sufficiently achieved by member states and can, therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.” (European Union 1992) The safety net has remained a national domain with only minimal harmonization across the EU and will be analyzed in the following pages.

V.c.6.i. National Deposit Insurance Schemes

Minimum harmonization has been pursued with respect to deposit insurances with the 1994 ‘Directive on Depositor Protection’ (European Community 1994 - commonly referred to as Deposit Guarantee Directive or DGD) which aimed at creating a level-playing field for cross-border banks. In congruence with the concept of minimum harmonization as opposed to centralization it doesn’t establish uniform pan-European deposit insurance. A minimum coverage of €20,000 per account and the mandatory publication of participation in depositor protection schemes are implemented, however,

several important differences between member states still exist. For one, the level of coverage still varies, with several countries imposing higher thresholds.²⁷ The number of schemes per country also varies, with separate systems being established for the savings, cooperative and other banking sectors in several member states. Lastly, and most importantly, the directive does not deal with the funding of the insurance schemes. Countries are thus free to implement ‘ex ante’ (where every year a certain percentage of assets of a bank is charged into a fund, whose assets can be tapped in the case of a crisis) or ‘ex post’ (where banks commit to finance arising deposit claims in the case of an actual crisis) financing schemes. There are also no common rules on the level of insurance premiums (in the case of ‘ex ante’ funding) or the distribution of the financial burden (for ‘ex post’ schemes) as well as whether these funds are to be administered publicly or privately. As will be discussed later (see Section VI.b.2), this poses significant problems for the transformation of cross-border subsidiaries into a branch system as envisioned by the *Societas Europaea Statute*.

The DGD also establishes the concept that host country deposit insurance schemes cover deposits at local subsidiaries of foreign (EU) banks while branches in foreign countries are covered by the parent bank’s home country scheme. As discussed (see Section IV.b.4.ii), with regards to subsidiaries, this arrangement can lead to problems as a disparity in responsibilities exists due to the fact that the host supervisory authority has no right for consolidated supervision. The home country supervisory authority is not accountable to taxpayers in host countries who may ultimately end up paying for the deposit insurance should a crisis occur (via their banks or in the case the

²⁷ Only the Baltic States currently have coverage levels below €20,000 as the EU granted them a transitory period until 2007/8 due to low income levels.

funds are not sufficient, via government expenditures). On the other hand, an arrangement where home country deposit insurance covers depositors in host countries could as well be politically sensitive. Branches of foreign banks which are covered by home country schemes in the EU may also opt to join the host country scheme and enjoy better conditions by ‘topping up’. These branches could thus be insured by a country whose agencies have no authority to influence its risk-taking behavior due to the EU principle of host supervision for branches (European Financial Services Round Table 2005, p. 22). As described, in the international arena, countries opt to ‘ring-fence’ assets of local branches. While this practice is not allowed for branches of EU banks in other EU countries, some member states, such as Germany choose to ring-fence assets of non-EU banks (Garcia, p. 10).

The fact that the DGD was designed specifically with the concern of a level playing field in mind and as a means of consumer protection also explains the lack of appropriate consideration the current system has for the preservation of financial stability across the EU. The remaining issues suggest that an explicit agreement concerning the sharing of costs among member states in the case of banking failures that concern more than one jurisdiction is necessary. While an EU-wide fund would probably be the simplest and best solution, Garcia points out that due to the funding constraints imposed on the EU budget, this is unlikely (Garcia, p. 18).

The European Commission is currently reviewing the Deposit Guarantee Directive; however, as José Roldán, then CEBS-Chair pointed out in a presentation in October 2005 (Roldán 2005), the official position is that there is “no immediate case for major reform.” His personal opinion, however, is that “greater harmonization is needed”

since a “fully-functioning single market requires more harmonized arrangements.” Peter Nyberg, deputy chairman of the Financial Services Committee (FSC) of the European Parliament similarly addresses the need for a swift addressing of the deposit guarantee problem (European Commission 2005, p. 3). As discussed in this section and the following review of European supervisory models, a harmonization of the deposit insurance schemes does seem important, however, it should be noted that from a political perspective, such efforts are currently relatively unrealistic as, so far, the “deposit insurance reform has been largely neglected by policymaking debate.” (Garcia, p. 18)

V.c.6.ii. Domestic Lender-of-Last-Resort

With regard to the issue of liquidity crisis in the EU, a distinction needs to be made between ‘general liquidity crises’ and ‘institution-specific crises’ (Schoenmaker 2003, p. 28). In a general crisis, a central bank usually steps in to provide liquidity. In the case of actions such as open market or direct lending operations that benefit all banks equally, no specific supervisory information is necessary and national jurisdiction is hence no problem. However, in the case of institution-specific crisis where only one or more specific banks are experiencing a liquidity crisis, the decision of liquidity (lender-of-last-resort) support requires detailed solvency information and thus an involvement of the relevant supervisory authority. The ECB thus probably does not have a mandate as lender-of-last-resort, either within the EU-25 or within the Euro-area, despite the fact that the EC Treaty is ambiguous about this topic.

Instead, the ECB has continually stressed the policy of “constructive ambiguity,” as former ECB-president Duisenberg refers to it (Schüler 2003, p. 17). Under the current

approach, the lender-of-last-resort responsibility for both branches and subsidiaries falls to the respective national central bank.²⁸ The EU has therefore decided in favor of a ‘domicile approach’ for the purpose of lender-of-last-resort operations. In the case of a liquidity shortage, the country where the bank is physically operating, whether it is a bank’s headquarter, a branch or a subsidiary, is thus responsible (European Financial Services Round Table 2005, p. 20). As ECB-President Trichet points out, the “existing arrangements ... regarding the central bank function of granting emergency liquidity assistance... do not warrant consideration at the EU level.” (European Commission 2005, p. 2)

Such a ‘domicile’ arrangement can lead to the issue that host countries are responsible for fiscal costs arising from a liquidity shortage in a branch supervised by a foreign home supervisory authority which possesses the relevant information about solvency. This misalignment of information can be a significant issue when a central bank has to act fast in the case of an institution-specific liquidity crisis. It is also worrisome for CEE countries that branches established by foreign banks might require substantial support in the case of liquidity crisis without the CEE authorities having any control over whether the banking group will be declared insolvent (see discussion below).

The European Commission recently proposed a review of liquidity supervision in order to respond to the centralization of liquidity management (European Commission 2005, p. 2). The European Financial Services Round Table (2005, p. 20) points out that host responsibility for liquidity supervision and hence LOLR provision is the “logical

²⁸ The ESCB has made arrangements for coordinating crisis liquidity support. This is based on two basic principles: (1) lender-of-last-resort operations are a national responsibility (though national central banks may in any case only lend against collateral), (2) potential liquidity impacts due to such operations need to be managed in consistency with “the maintenance of the unified monetary policy stance”. (IMF 2005, p. 12)

corollary of the existence of different national currencies.” Due to the implementation of the EMU, it is questionable whether within the Euro-area this should be the case as banks manage liquidity on a pan-European level for Euro exposures. However, this review has not started yet.

V.c.6.iii. Home Insolvency Procedures

With regard to insolvency procedures, the second aspect discussed above concerning crisis management (see Section IV.b.4), the EU has adopted the ‘Directive on the Reorganization and Winding-Up of Credit Institutions’, which went into effect in 2004. This directive lays out the ‘single entity’ approach under which problems at a distressed bank and its branches are approached and all involved countries recognize the home country’s reorganization measures and winding up proceedings with *pari passu* treatment for all EU creditors.²⁹ Home country authorities have the sole responsibility to reorganize or wind-up a bank (including foreign branches) according to its own laws. Failing subsidiaries, however, are the responsibility of host country authorities and governed by local laws. This could lead to the issue discussed above (see Section IV.b.4.iii) with regard to consolidation during insolvency. Whether branches or subsidiaries, the underlying principle in the EU is that the costs are born by one country (host for subsidiaries, home for branches) and are not shared.

As pointed out above, the assumption that home countries will take full account of cross-border externalities caused by their decisions regarding the solvency of a bank active across borders is probably flawed. Even within the EU, this problem is not

²⁹ Several exceptions to this principle of mutual recognition exist as host-country laws with regards to employment contracts, immovable property, ships and aircraft, netting and repos apply.

eradicated. Branches of a foreign EU bank in a member state may thus be considered ‘too big to fail’ by host supervisors but not home supervisors, who are, however, responsible for the decision of insolvency and may not consider the bank important enough to bail out. Furthermore, even if systemic risk is large in both home country of a bank and host country of branches, but the cost of rescuing a bank would be relatively large compared to home country resources, the issue of ‘too large to rescue’ may arise under the regime of home country control over solvency (Wolgast 2001). When banks with multiple countries of operation are concerned, the issue becomes even more complicated as the ability of a large number of national supervisors to quickly agree on a coordinated action is questionable.

With regard to subsidiaries, the issue of ‘functionality’ has also been discussed, which applies equally in the context of the EU and remains unsolved by current legislation. In fact, this problem may even be exasperated by the limitations imposed on national supervisors and regulators in restricting the centralizing of functions within the EU. An approach similar to New Zealand’s Outsourcing Policy would be illegal between EU countries due to the rules on the free provision of services across the member states. Thus, especially for CEE countries where foreign banks predominantly operate via subsidiaries (see Section III.b.2) but centralize key function, an issue may arise. For instance, Austrian authorities may decide that Raiffeisen might be too expensive to bail out. However, Raiffeisen’s various subsidiaries in CEE depend on the central provision of functions like risk management, marketing, product development and IT and might not be viable operations on their own. The decision in Austria thus carries externalities that are not included in the decision.

Concerning general co-operation in crisis management situations, the ECB signed a MoU with the national central banks, banking supervisory authorities, as well as the national ministries of finance that went into effect in 2005. While the memorandum is not a public document, according to the ECB press release, “the principles and procedures contained in the MoU deal specifically with the sharing of information, views and assessments among the authorities potentially involved in a crisis situation, the appropriate procedures for such sharing of information and the conditions for cooperation and information flow at the national and cross-border level ... [as well as arrangements for] stress-testing and simulation exercises.” (European Central Bank 2005b) The ECB itself emphasizes that the MoU is a non-legally binding instrument that aims at preserving national responsibilities. Previous MoUs on the topic exist, however, the 2005 memorandum is the first to also include the EU finance ministers, which is essential to ensure financial support for decisions made according to the MoU procedures.

While efforts have thus been made to coordinate crisis management and harmonize the safety net, these arrangements have to be viewed with some scepticism due to issues pointed out above. Even the governor of the National Bank of Slovakia showed concern in a recent presentation that several issues remain and crisis management “has only been solved theoretically.” (Šramko 2006) He further points out that “in the case of a bankruptcy, we’ll see that there is still need for discussion between home/host supervisors, especially because of the issue of non-harmonized deposit insurance schemes and the related major question with regards to who will ultimately pay.” (Šramko 2006) In a recent ‘war game’ exercise, EU regulators simulated a pan-European financial crisis with the aim to “test the ability of national regulators to share information

with other national bodies in a crisis and to overcome ‘differences in culture’ and other practical obstacles.” (“Europe simulates financial meltdown,” Financial Times) Sadly, this exercise concluded that “progress has been insufficient in most of the member states.” (ECB report as quoted in “Europe simulates financial meltdown”)

VI. Solutions for CEE in the context of a search for a European Solution

VI.a. Introduction

As determined above, CEE countries cannot be fully satisfied by the current solution to the issues that arise due to foreign ownership of banking assets in the form of international and EU regulations. First of all, while regulation is already well aligned, supervision oversight is still a significant issue. Furthermore, deficiencies in the regulatory approach, especially with regards to the safety net and crisis resolution still exist. Financial institutions themselves are also not satisfied yet either. Coupled with the impact of potential wide-spread adoption of the legal form of Societas Europaea and a resulting increase in branch rather than subsidiary structure, these concerns need to be addressed in the near future.

This section thus aims at discussing possible solutions to the outlined problems. First, the possibility for banks to establish as a Societas Europaea (SE) to avoid regulatory burdens in connection with cross-border business is discussed. Furthermore, solutions to the issues caused by separate home/host supervision are discussed by analyzing the concepts of lead supervisor as well as a single European supervisory authority. Lastly, the main regulatory issues that remain with current legislation with respect to all of these solutions are analyzed.

VI.b. Societas Europaeas

The establishment of a pan-European Societas Europaea (SE) was made possible by the ‘Regulation on the European Company’, which entered into force in 2004.

Societas Europaeas are trans-national firms that are allowed to operate in a market consisting of 28 members (the EU-25 plus Iceland, Liechtenstein, and Norway). Supervisory authorities, when faced with criticism on the disparate supervisory regimes and non-harmonized aspects of banking regulation thus often refer to the transformation into a SE and resulting conversion of all foreign subsidiaries into branches as an easy solution to the multinational bank's woes. Following is an analysis of this approach.

VI.b.1. The Possibility of Transformation of Banking Groups into Societas Europaeas

As is argued, the path of becoming a Societas Europaea is the simplest way for financial institutions to rid themselves of inconsistencies in supervisory and regulatory frameworks since due to the principle of home-country supervision of branches and mutual recognition of regulation, all operations within these 28 countries would come under one jurisdiction. Adoption of such a legal structure would also be a more accurate reflection of organizational and operational structures of the banking groups due to aforementioned centralization of certain tasks. It would thus realign organizational and supervisory structure to a level more reflective of the current set-up. Furthermore, such an organization could be advantageous with respect to Basel II implementation since branches do not necessarily require separate capital and thus tedious confirmation of multiple credit and operational risk models and different implementation options of the CRD could be avoided. The organization as a SE also has certain tax benefits. Centralization of certain function within functionally integrated organizations in so-called 'shared services centers' that sell their services across borders to various subsidiaries of a

banking group triggers VAT charges. However, if organized as a SE, shared services are no longer sold between legally independent companies and thus no VAT is due (Schoenmaker 2006a, p. 19 & Dermine 2005, p. 22).

Among all EU banks, the Nordic giant Nordea has so far been the only one to attempt such a move. It decided to establish as a Societas Europaea in order to benefit from economies of scale in providing services and integrating its organization as well as in order to realize tax savings. A new parent company was established in Sweden (Nordea SE) with which the three remaining subsidiaries in Norway, Denmark and Finland were consequently merged and thus transformed into branches. Therefore, prudential supervision over all operations of the bank in the Nordic countries covering capital adequacy, solvency, etc. fall under the responsibility of the Swedish authority. The Swedish deposit insurance system also covers all deposits as prescribed in the EU directive, though branches outside of Sweden have the option of topping up their coverage. Furthermore, the Swedish central bank carries responsibilities as lender-of-last-resort for Swedish operations, while Norwegian, Danish and Finnish authorities cover their respective territory due to the 'domicile' approach of the EU. In the case of insolvency, which is decided by Swedish courts, Swedish law would apply to the winding up or restructuring of all branches. In principal, political accountability would thus be matched for supervisors, deposit insurance and resolution authorities (Garcia, p. 17).

VI.b.2. Problems under Current Regulation Environment

Despite the fact that the SE statute is still in its implementation phase, discussions have already started concerning the appropriate supervisory structures (Christl 2005, p.

71). As the European Financial Roundtable (EFR) points out, the transformation into a SE is not as optimal as it may seem given the benefits outlined above. Rather, several discrepancies continue to obstruct a smooth functioning of the bank. Foremost, the political problems pertaining to home country deposit insurance and host country lender-of-last-resort responsibilities for a foreign-supervised bank described in the discussion above (Section IV.b.4.ii) remain.

With respect to deposit insurance, the first issue arising is the political feasibility of one country covering the deposits of clients in all EU markets a bank operates in and thus a transfer of money in the case of crisis. Furthermore, since funding and administration of deposit guarantee schemes are not harmonized in the EU an issue arises when changing from host to home country system as would be necessary during a transformation into a SE. Since the DGD also contains no provision for exiting one scheme and entering another, no clear rules on the transfer of arising liabilities and assets exist (Dermine 2005, p. 23). This is a specific problem Nordea has run into, as the schemes of the four Nordic countries differ with respect to ‘ex ante’ and ‘ex post’ funding as well as with regard to the size of the premium. Nordea could thus lose the money its former subsidiaries had already contributed to the ‘ex ante’ Norwegian and Finish schemes, while at the same time fellow banks protected by the ‘ex post’ Swedish system could rightfully complain about their exposure to Nordea’s former subsidiaries when these were not liable for Swedish deposit insurance in the past.

As a result, Mr. Schütze, member of Nordea Group executive Management, announced in June 2004 that Nordea will “apply to Internal Market Commissioner Frits Bolkenstein for a ‘grandfather clause’ for the 1994 Directive to exempt SEs formed by

the merger of existing banks in different countries from the home country requirement for deposit guarantees and thereby simply continue in local schemes.” (Nordea 2004)

Thus, a central principle of EU banking regulation (home country control over branch deposit insurance) would be disturbed by this arrangement. The issue of disparate deposit insurance regimes and host insurance for branches of foreign institutions where host authorities have no supervisory control over would arise and a misalignment of supervisory decision power and responsibility for funding of crisis resolution would result. This issue becomes increasingly important as the establishment of SEs will mean that a company’s home country will become a diffused concept, especially when a directive under discussion would facilitate the transfer of any company’s (including but not limited to SEs) legal seat (Karas 2006).

Furthermore, the EFR remarks correctly that “supervisory arrangements should not dictate the organizational set-up of a firm, which should be the prerogative of a bank’s management.” (European Financial Services Round Table 2005, p. 22) Many arguments for a subsidiary structure and against branches still exist (see also Section III.b.2). With regards to CEE countries and Austrian banks’ subsidiaries there are several main issues. Firstly, many CEE subsidiaries still have minority shareholders that would have to be bought out in order to convert local operations into branches. These shareholdings are often widely dispersed among institutional investors (like the EBRD or local investment funds), employees, governments, and local private investors and a 100% takeover could thus be tedious and costly. This is especially true if such transactions would have to be executed in multiple countries with multiple subsidiaries as would be the case for most banking groups. Secondly, several CEE subsidiaries have maintained

their local brand or incorporated the local name into the corporate identity. Branching would leave less flexibility to exploit brand value. Thirdly, incorporation in the host country is often very important to pacify local politicians, management and customers. Thus, the proposal for banks to transform foreign operations into branches is not an option that should be considered the solution to the current supervisory problems.

Another point of criticism with regard to the SE solution is that despite a lack of legal authority, host supervisors often get involved in foreign banks' branches, especially when these branches have a systemic importance. As Hrdlicka (2006) points out, this issue could be especially problematic in Poland where local supervisory authorities insist on a strong host component going as far as to try and review the parent bank in the home country. This issue is critical all over CEE. EU regulation generally grants little authority to host country supervisors over the activities by a branch and all reports are consolidated and addresses to the home supervisor. The transformation of large banking subsidiaries into branches would thus leave host authorities with little information about the bank's risks but leave them responsible for LOLR facilities and possibly deposit insurance if Nordea sets the precedent, increasing the externalities of home authorities' decisions. Thus, increased and more binding cooperation beyond that envisioned by the guidelines and directives discussed above is necessary.

Specific to the Nordea case, there is no issue with regard to different systemic importance of the bank in its markets of operations (at least among the four Nordic countries) as the bank is a result of a merger of four roughly equally important and large banks from each country. Also, ownership of the company is rather evenly spread out amongst the four countries, thus the issue of possibly abandoning one of the markets

when it is in trouble is very unrealistic and externalities of the owners' decision on each country are considered since ownership is not concentrated in one country (Goldberg 2005, p. 13).

Such a benevolent structure would be very unusual in most other examples, especially in CEE where M&A activities usually involve the taking over of relatively smaller banks by larger institutions from the EU-15. While the absolute sizes may be smaller, the systemic importance of the acquired CEE banks can be much larger than that of the parent bank in its home country. This is due to the fact that many privatized banks in CEE were former monopolists and despite breaking up these monopolies, markets are highly concentrated. EU-15 banking markets show a much lower concentration. In several cases, relatively less important Austrian banks thus control systemic important banks in CEE. For instance, Erste Bank acquired the former monopoly savings banks with market shares beyond 30% in the Czech Republic and Slovakia, as well as recently in Romania while the parent bank doesn't have such a large market share in the Austrian market.³⁰ Furthermore, the ownership structure of the resulting entity is usually not equally dispersed between home and host country. Austrian banks are, for instance, closely held by mostly Austrian investors (and few EU-15 and US funds). Almost no equity is held by residents or funds from CEE countries where the banks are active. This creates a skewed incentive for owners and supervisors even if the organization of a SE was chosen. The ECB thus concludes that "widespread use of the institutional form of *Societas Europaea* may have implications on systemic risk." (European Central Bank

³⁰ This is not taking into account cross-guarantee system with Austria's numerous local savings banks which Erste Bank does not own. A striking example outside the countries analyzed in this paper is Albania, where Austria's Raiffeisen Bank controls close to 50% of the banking market.

2005a, p. 29) There is thus room for additional concern in CEE with regard to the structure of a Societas Europaea.

VI.c. Lead Supervisor

While incorporation as a SE might solve some problems for cross-border banking operations (though, as shown, not as many as commonly claimed), the issue of effectively supervising subsidiaries and consolidated banking groups remains. Especially in CEE, where this form of organization is prevalent (see Section III.b.2), and the trend might not change significantly in the near future (see Section VI.b.2), different solutions are thus under discussion. One of them is the concept of lead supervision.

VII.c.1. The Lead Supervisor as Solution to Fragmented Supervision

The current debate on supervisory structures within the EU and globally is increasingly tending towards the approach of a lead supervisor. For instance, Article 129 of the CRD includes the option of establishing a lead supervisor with respect to model validation for banking groups (see Section V.c.4). An exact interpretation of this approach would entail a surrender of all regulatory and supervisory authority by host countries to the home country lead supervisor (Andrews 2005, p. 9). This would be appealing for banking groups as multiple regulatory relationships would be replaced with a ‘one face to the customer’ relationship. Several members of the ECON Committee of the European Parliament have favored the lead supervisor concept as “the most efficient step forward.” (European Commission 2005, p. 4) In 2002, the European Financial

Roundtable (EFR) also embraced this approach as the ideal solution to European supervision from the industry's perspective.

In their proposal, the EFR advocates a lead supervisor that would act “in exactly the same manner for a subsidiary (wholly owned or fully controlled) as he or she acts for a branch in the present home country control model (with an extension to liquidity supervision).” (European Financial Services Round Table 2004, p. 14) As such, a common internal model for the CRD would be validated and authorized by the home authority for both group and local level, allowing for a centralized risk management approach. Furthermore, diversification benefits would be recognized for every sub-entity and capital allocation would be turned from a “bottom-up approach [to a] top-down approach [where] capital adequacy [is] assessed at the group level first.” Liquidity and Pillar 2 rules would similarly be common on consolidated and sub-consolidated levels. Lastly, the lead supervisor would be able to approve the centralization of functions such as risk management, single booking entity, IT platforms, payment systems, custody, clearing and settlement functions, etc..., recognizing that “these cross-border set-ups within a financial group are different from the traditional outsourcing practice.” (European Financial Services Round Table 2004, p. 17) According to this proposal, the role of the host supervisor would thus be confined to occasional on-site inspections by instruction from the lead supervisor, as well as a valuable source of information of local market conditions, practices, and customers. In order to enhance home/host cooperation, the systematic establishment of colleges of supervisors involved with a specific bank, which would advise the lead supervisor though without legal power, is furthermore recommended (European Financial Services Round Table 2004, p. 15).

According to the European Financial Services Round Table (2004, p. 16), the implementation of these concepts would be possible immediately due to the option provided to host supervisors to delegate all responsibilities and powers on solvency to the consolidating supervisor. The view that the 2000 Consolidated Banking Directive in combination with the CRD provides for the possibility of a complete delegation of supervisory responsibility over a subsidiary from host supervisor to a consolidating supervisor is also shared by the Committee of European Banking Supervisors (2006, p. 7). Level 1 and 2 of the described Lamfalussy Process would also be left undisturbed by the proposed lead supervisor concept since those are concerned with banking legislation rather than supervision. Thus, legally, the concept is at least a possibility (with the exception of the transfer of liquidity supervision).

In a series of papers, Schoenmaker similarly explores the concept of a lead supervisory. He advocated a model similar to the one by the EFT described above, but adds a European mandate to it, arguing that a purely national mandate does not provide enough incentives for the lead supervisor to incorporate cross-border externalities of his decision that arise in the case of a failure of a financial institution (Schoenmaker 2006a, p. 16+). By transferring the mandate to a central European level, this problem can be defused. Schoenmaker's proposal thus includes the creation of some form of European System of Financial Supervisors (working like the ESCB³¹) which would take key supervisory and policy decisions and thus fully involve and be accountable to host

³¹ In the ESCB, decisions on interest rates movement are taken by the entire Governing Council which includes the Governors of all EMU national banks. However, the members of the Council are obliged to decide on interest rates with consideration to the euro area's condition rather than national preferences. (See Schoenmaker 2006a, footnote 12)

authorities. Daily supervisory tasks on the other hand would be conducted by the lead (consolidating) supervisor, thus reducing regulatory burden on individual banks.

It should be noted that, due to the form of Societas Europaea banks operating via cross-border branching, a similar regime to both models is already implied in the EU banking legislation since all responsibilities (except liquidity) lie with home supervisors (Vesala 2005, p. 101).

VI.c.2. Problems under Current Regulation Environment

One of the foremost problems with the approach of a lead supervisor is that it would enable banks from different home countries to compete in a host market under different rules, thus negatively affecting the original goal of a level playing field for financial institutions. While this may facilitate regulatory convergence in the long run, in the short run this could lead to significant competitive distortions. Furthermore, the willingness of host-state authorities to relinquishing all influence of the regulation of financial institutions headquartered outside their legal jurisdiction is more than questionable. As Kager, Chief Economist of Bank-Austria Creditanstalt points out, especially with regards to the CEE region, “politically speaking, it is not realistic to believe that a country will leave 80% or more of the responsibility for its financial stability to foreign supervisory authorities.” (Kager 2006, p. 23) She thus argues that an increase in the degree of pan-Europeanization (cross-border ownership and activity) in the financial sector would reduce the chances that an agreement on such a structure would be reached. In a subsidiary system, a risk that home country authorities collude with the parent banks to protect national interest exists has already been an important

concern in CEE (Dermine 2005, p. 28). Furthermore, if diversification benefits for the banking group are fully recognized for subsidiaries, significant issues could arise for them if the offsetting exposures and capital are held elsewhere in the group and cannot be transferred at the critical moment due to limitations on capital transfers among subsidiaries and between the group and subsidiaries (see Section IV.b.1).

Once again, the issues of deposit insurance and liquidity support remains unsolved through such a structure because the nationality of supervisory decision makers differs from those who would have to cover the ultimate costs in case of a liquidity/solvency crisis under the current systems based on the 'domestic' approach. Externalities of the home (lead) supervisor would actually increase due to the transfer of all regulatory and supervisory authority from home to host country. Such externalities would at least slow down the crisis management and could, in the worst case, also lead to complete inaction where national authorities disagree on the approach to the crisis (European Financial Services Round Table 2005, p. 34). While the European Financial Services Round Table (2005, p. 37) argues correctly that such issues exist independently of an implementation of the lead supervisor concept in the European legislation, specifically in the case of an establishment as a *Societas Europaea* (see Section VI.b.2 above), such an approach would exacerbate the problems and furthermore extend them to subsidiaries (assuming current banking legislation remains otherwise unchanged) and thus create even more concern in CEE.

Kager further criticizes Schoenmaker's proposal of a European System of Financial Supervisors and the concept of a delegation of responsibility to lead supervisors due to the lack of efficiency. Without far-reaching changes to EU banking law, banking

groups would still have to produce multiple reports and capital calculations for each subsidiary since those would still be subject to national banking laws. Those laws are still applicable even in the case of a complete delegation of responsibilities (Kager 2006, p. 22). In this context, it is important to point out again that EU directives have an indirect effect on national legislation by establishing binding frameworks but leaving it to national legislative bodies to transpose the essence of the directive into the individual national law system. Banking legislation has exclusively taken the form of directives and is thus only harmonized to a certain extent, even with regard to issues determined by the directives. Only EU regulations have a direct effect on all member states and firms operating in these countries (Financial Services Authority 2003, p. 7). While possible for prudential supervision, a direct application of home country banking laws and regulations would thus require a radically new European legal basis. With respect to branches, while the issues described persist, at least such a legal base is given through the Statute of the European Company.

Due to such an abundance of concerns, it must therefore be concluded that the lead supervisory concept is not necessarily a solution to the issues of pan-European banking in the short or medium term. In the long run, such a system would theoretically be possible. However, such an approach would require substantial changes to EU legislation and an invasion of national sovereignty through the application of home country laws for host subsidiaries, as well as a pan-European approach to the safety net and crisis management.

VI.d. EU Supervisor

The lead supervisor concept is just one approach aimed at ensuring the effective supervision of subsidiaries and consolidated banking groups. Another approach that has been advocated within the EU is a centralized supervisor at the European level that replaces national and even lead supervisors.

VII.d.1. Centralized EU Supervision of Banks to Eradicate Home/Host Issues

In contrast to regulation, which is aligned between EU member countries to a certain extent, prudential supervision of banking institutions is clearly a national task within the EU. Article 105 of the Maastricht Treaty designates financial supervision as a national responsibility. However paragraph 6 establishes a procedure by which supervisory tasks may be transferred to the ECB without the need for additional legislation (see Section V.c.3). The question of a transnational supervisor has thus been raised, though the specific form of such an authority remains open. If a central European financial supervisory authority were to be established, the aforementioned principle of subsidiarity recognized by Article 3 of the Maastricht Treaty will need to be considered. It would be legally possible if it can be demonstrated that the cross-border externalities triggered by the current regime are important enough to be taken into consideration. Given the discussion of issues above, a European jurisdiction can thus probably be provided.

As Schoenmaker argues, the EU faces a trilemma similar to the trilemma of monetary sovereignty, floating exchange rates, and free capital flows (one is always mutually exclusive if the other two are chosen). With respect to banking supervision, a

single financial market, systemic stability, and national supervision may constitute such a situation (Schoenmaker 2006a, p. 1). Thus, if a common market for financial services is desired, national sovereignty over supervision might have to be abandoned. As Würz (2006) from the OeNB confirms, there will inevitably be a call for a European banking supervisor if the coordination on the basis of interaction via the CEBS proves unsuccessful or unsatisfying over the next few years. Thierry Francq, chairman of the European Parliament's Financial Services Committee (FSC) subgroup on supervision also argues that the centralization of business functions by banks calls for a more centralized supervisory structure (European Commission 2005, p. 5). However, such a discussion has had no reflection in the current literature apart from the described paragraph in the Maastricht Treaty.

Sándor Gardó (2006), member of Bank-Austria Creditanstalt's Economic Research Unit advocates a system similar to the organization of the ESCB where one central authority is responsible for supervision and relevant legislation, but execution would occur through the local units (national supervisory authorities). Thus, one central agency would have the final authority in the case of disputed between national authorities and could ensure a common interpretation of EU regulations. Contrary to the Schoenmaker model for lead supervision (see Section VI.c.1 above), the ultimate authority and responsibility would lie with this agency, not with national agencies. Furthermore, local authorities, acting under the auspice of a European supervisor, would have no authority on the imposition of additional requirements on local banks. While European legislation would have to be adopted, the system would be neutral with regard to national supervisory organization. The problem of differing systemic importance of

several national operations of a banking group would also be avoided as all countries would have a shared responsibility via the centralized authority and cross-European effects of a decision would have to be considered.

In such a proposal, it is important to remember that of approximately 8370 credit institutions within the EU (Schoenmaker 2006b, p. 7), only a very small percentage actually operate on a cross-border basis. However, these few banks account for a disproportionate large share of total banking assets, especially within Austria. Thus, it would be possible to have the European agency solely responsible for banks that are active across borders and leave supervision of purely domestic players to national authorities. An alternative would be the imposition of thresholds to determine whether a bank falls under EU or national supervision. Similar to delineation of national vs. EU authority in the field of competition law, where the EU agency is only activated in cases above thresholds for turnover, market share and number of member states involved, certain limits could be set to determine EU supervisory responsibility. Due to systemic concerns, however, parameters for decision should take systemic importance of home/host operations into consideration. For determining the impact on host markets, market share, role of the entity in the host market (market maker, provider of liquidity, etc.), and integration into the financial infrastructure would have to be considered. Concerning importance for the group, contribution to group performance, risk-taking behavior and diversification effects as well as the extent of centralized functions need to be taken into account (Committee of European Banking Supervisors 2006, p. 12). In the case of Austria, all banks active in CEE would probably have to be supervised on a European level due to the importance of CEE subsidiaries for performance (see Section

IV.b.2.iii above), the immense systemic importance of several subsidiaries in CEE countries (see Section IV.b.2.ii above), as well as the integration of these banks into host market financial systems.

An alternative approach to splitting supervision between national and EU-level based on the activities of individual banks would be a division based on product category. With similar intent, the Green Paper on Financial Services by the Internal Market Commissioner mentions the possibility of introducing a '26th regime'. Such an approach would mean that a few financial products, such as mortgages or life insurance, would receive a special European status and be authorized and supervised on a pan-EU level. They would thus avoid the heterogeneous legislation of the 25 member states, giving the concept its name (Dermine 2005, p. 8). While such an approach has its merits, it would not be feasible for the entire banking industry as supervision based on products instead of entity would not take into account all the total risks individual banks are exposed to. Furthermore, even with a '26th' regime, such products sold by banks would still be subject to consolidated banking supervision.

As Schoenmaker (2003, p. 32) points out, the real policy question is not whether to raise supervision to a European level, but rather about when such a transformation should take place. The answer ultimately rests on the developments in the financial markets and the degree of cross-border externalities. While among the EU-15 countries, risks associated with cross-border banking outlined above may still be bearable due to low exposure to cross-border banking, CEE countries might be less reluctant to accept the current situation due to their high exposure. Furthermore, certain EU-15 countries whose banking markets are closely linked to other national markets, such as Austria, Nordic

countries and the Benelux, may advocate a move in that direction as well once nationalistic tendencies get overshadowed by potential costs of banking crisis.

VI.d.2. Problems under Current Regulation Environment

It is often argued that a major obstacle to the approach of one central European supervisory authority is the importance of local know-how and knowledge as well as facilities and resources for on-site inspections. Also, the variety in structures of national supervisory authorities, ranging from integrated independent financial market agencies to sectoral supervision and integration into national central banks is often quoted as an obstacle to such a solution (Karas 2006). However, the proposed system of ‘25+1’ similar to the ESCB would address such concerns and would be neutral with respect to national organization of supervision. The issue of differences in legal powers of individual regulatory and supervisory authorities nonetheless remains important in such a system.

Another issue would be the inclusion of EEA countries under the regime. Furthermore, the problems outlined with national provision of emergency liquidity assistance and the national fiscal burden of bailing out domestic banks would not be addressed by a European supervisor, but rather the misalignment of supervisory information and burden would increase. Deposit insurance schemes, which would still be provided on a national level similarly would be administered on a level different from the supervisory authority. Indeed, if members of a central European supervisory authority would have to act similarly to ESCB members, considering only the European perspective and disregarding national concerns, the misalignment of decision making and the burden of cost could increase even if care was taken to implement variables to

consider systemic importance as outlined in the previous section. This is due to the fact that externalities to countries could not be considered on an individual basis, but would only be considered as one item in a large pan-European cost-benefit-analysis. Systemic importance of a subsidiary may therefore not always be reflected in the decision. As Herring (2005c, p. 18/19) thus points out, “national supervisory authorities are unlikely to cede responsibility for safety and soundness to an EU supervisory authority in the absence of a corresponding budget to clean up problems that might result from cross-border banking crisis.”

The proposed ‘dual approach’ to supervision with an EU regulator responsible for certain banks might also violate level playing-field principles since banks in the same market could be subject to different supervisory regimes (European Financial Services Round Table 2005, p. 41). In Austria, for instance, only about six banks (accounting for more than half the banking market) would fall under European supervision while the remaining credit institutions would probably be subject to Austrian supervision. At the time the SBD was passed, there was already a heated discussion on establishing a two-tiered system of regulation and supervision with a different set of rules for banks that were active on a cross-EU basis. However, the idea was dismissed because it was thought that such a system would be inconsistent with the fundamental freedom to supplying services on a level playing-field (Clarotti 2000, p. 72). However, the alternative of delegating authority to central EU supervision for all banks would be impractical given the large number of financial institutions and the number of banks that operate on a purely local level. Thus, common regulation and supervisory laws (and ergo maximum harmonization through EC regulations rather than directives) where cross-border banks

and local banks are subject to exactly the same rules but applied by a European and national authorities, respectively, would be the only possible solution. This, however, seems like an unlikely option due to the resistance of member states to transfer more sovereignty and decision- and rule-making authority to the EU level. As with the lead supervisor concept, the critical issue of national laws applying despite an EU supervisory authority would have to be addressed through a series of regulations from the EU.

While this approach seems effective in addressing many issues outlined above, Josef Christl, member of the Directorate of the OeNB, points out that the political process of integration is not advanced enough for the establishment of a system of European banking supervision (Christl 2005, p. 72). While Karas (2006) of the FMA believes that “theoretically the idea has merit, [he] is rather skeptical.” This is due to the problems that would be encountered in trying to implement such an approach. Thus, in his conclusion, Christl (2005, p. 71) quotes Goethe (“One must leave something for the future”) in expressing his belief that a European supervisory authority is only realistic in the very long term.

VI.e. The Eternal Problem of Crisis Management

As can be seen from the analysis above, every model presented on European supervision, whether based on the reorganization of financial institutions themselves (Societas Europaea model) or a change in regulatory and supervisory responsibility towards a more centralized authority (lead supervisor or EU authority), raises significant issues about safety net, crisis management and resolution that make them impractical

alternatives to the current system. Under current legislation pertaining to these issues, the three models are thus unfeasible.

The misalignment of supervisory decision making and responsibility for the ultimate provision of deposit insurance and lender-of-last-resort facilities are crucial weak points of each solution. A safety net is only effective in avoiding crisis when it is perceived as reliable, which, due to cross-border transfers of money and externalities of decisions made by national agencies can currently not be guaranteed. As Freixas shows in his model, 'ex post' negotiations on burden sharing related to a banking crisis (whether systemic or of an individual bank) are ineffective as countries try to minimize their own costs, leaving the home country faced with the prospect of enormous costs relative to the bank's local importance or a closing of the institution. In this analysis, Freixas refers to the current European regime as 'improvised co-operation', which is not able to ensure a smooth resolution to looming or actual crisis (as quoted in Goodhart 2006, p. 6). As Kane (p. 3) argues, the EU's finance ministers are "fooling themselves... about the reliability of the essentially improvisational crisis-prevention and crisis-resolution responsibilities that currently constitute the EU's financial safety net."

Thus, a European solution to deposit insurance, lender-of-last-resort and banking recapitalization is essential. One option would be a solution that effectively forces national supervisors to adequately take into account externalities of their decisions on other EU countries. Kane (p.22) argues for the introduction of incentives for safety-net officials that are "strong enough to make country-based regulators (and the national taxpayers that back them up) accountable 'ex post' for the opportunity costs that their activities impose on poorly informed loss-bearers in partner countries."

Alternatively, EU-wide systems of the safety net are under discussion. With regard to deposit insurance, Goodhart advocates an EU fund that is financed through the seigniorage of ECB and of national banks of non-participating EU and EEA countries. Such a funding mechanism would ensure a spreading of the financial costs of a crisis over countries and time. An ‘ex ante’ option would be spreading the costs among all countries based on a fixed key (such as the ECB capital key for euro countries³²). This could be politically difficult as cross-border transfers are a sensitive issue at the EU level and could violate the Maastricht Treaty’s clauses on EU financing. Furthermore, such a regime could potentially create moral hazard problems since countries do not shoulder the relative costs of the banking failure in their jurisdiction but a fixed amount, thus possibly leading to negligence or preferential treatment when large domestic banks are concerned.

As an alternative, an ‘ex post’ scheme is possible where only countries affected by a specific banking failure bear the costs of failure. The distribution of costs could be related to pre-determined variables such as the (pre-crisis) assets or liabilities of the failed bank in each country. Such an approach would limit intra-national transfers to a minimum and would not violate funding limitations imposed on the EU (Goodhart 2006, p. 3-13).

Lastly, private insurance is sometimes advocated for banks that are ‘too big to fail’, requiring them to pay insurance premiums in addition to regular contributions to national deposit insurance schemes to a privately administered EU insurance fund (Goodhart 2006, p. 7). While a good idea in theory, the reliability, even with reinsurance,

³² The ECB capital key is a function of a country’s GDP and population share of ESCB countries.

is questionable and ultimately the national governments could again be faced with the issue of shouldering the costs of deposit insurance.

With regards to the lender-of-last-resort function, it is important that the decision on granting emergency liquidity is made on the same level as a bank is supervised due to the importance of solvency information for this decision. A movement towards an EU supervisory authority would thus have to be complemented by an EU system for liquidity assistance that goes beyond the agreement of the ESCB, which only involves the twelve EMU members. In the case of a lead supervisor, due to a practical information monopoly on the solvency of a bank, liquidity assistance needs to be closely coordinated between national authorities. Although politically unfeasible, responsibility for the lender-of-last-resort function may even have to be transferred to the authorities of the same nationality as the lead supervisor. In the context of the EMU, where currency considerations are no longer a concern, the shift of responsibility for liquidity from host to home supervisors is already long overdue.

With regards to insolvency, the globalization of financial services has led to the paradox that “international banks may become ‘too big to save’, while large domestic banks tend to be ‘too big to fail’.” (Goldberg 2005, p. 10) Insolvency and failure resolution procedures for EU banks, while somewhat harmonized through the 2001 directive on winding-up and reorganization procedures for banks thus also require a more common approach. As pointed out above (see Section V.c.6.iii) insolvency and resolution costs are still borne by one country and not shared, which would be problematic in the case of an EU supervisory authority. On the other hand, countries not involved in a bank-specific crisis may rightfully find it unfair if they were asked to pay for the costs through

an EU fund. Similarly to the 'ex post' scheme proposed for deposit insurance, an 'ex post' resolution and recapitalization procedure could be established that includes only affected countries based on relative local involvement of the affected bank.

The European Shadow Financial Regulatory Committee in 2005 also proposed the introduction of structured early intervention procedures (with the possibility for early closure) for problem banks in the EU, a practice that has been engrained in the US system for years and could lessen the financial burden in the event of a bank failure due early intervention when certain critical equity levels are reached and a cap on maximum equity losses before shut-down (Goodhart 2006, p. 5). Through this, an incentive system to avoid closure through the recapitalization of the solvent bank through its shareholders is aimed to be constructed. If owners refuse to inject further capital, authorities would intervene and limit the risk-taking ability of the bank. This would mimic the actions of an efficient market (without the safety net) and thus possibly prevent insolvency or the necessity for early closure. However, an early intervention and closure procedure would probably have to be administered on an EU-level due to the huge externalities such a decision could carry for other member states.

These issues, though not emphasized enough, are being discussed at the EU level as well, including the current discussion on amending the DGD and concerning liquidity supervision. As pointed out above, however, it seems likely that due to incompatible national interests and a current trend against European centralization, significant changes to the system are unlikely though essential for the progression of European banking integration (see Section V.c.6.i above).

VII. Conclusion

Dickinson argues that if there is one lesson from the Asian financial crisis for CEE countries, it is that they should not draw the conclusion that opening up financial markets is wrong, but rather the need to ensure that the regulatory and supervisory system keeps pace with developments in the private financial sector (Dickinson 2001, p. 16). As countries with a very large exposure to EU-15 banks due to cross-border ownership links and direct provision of financial services, the issues raised by the BCBS and the current EU three pillar approach of mutual recognition, home supervision, and minimum harmonization are especially relevant for this region. On the other side, the importance of CEE business for Austrian banks has led to a heightened awareness of stability and crisis issues in Austria as well. While the current EU system would be an “immense progress in comparison to the present situation” (Wolgast 2001) on a global scale, the developments in Europe with regard to increased integration of financial markets (and results such as the EMU, the SBD and implementation of *Societas Europaeas*) now require further evolution of the regulatory and supervisory framework. This development should mirror the increasing pan-Europeanization of banks in order to keep pace with the private sector.

The current system results in many unresolved issues outlined in this paper, leading the Centre for European Policy Studies (CEPS) in Brussels to conclude in a recent study that “European financial regulation is a chaotic building site rather than the advertised level playing field [where] co-ordination between regulators is not developed enough to handle a Europe-wide financial crisis.” (“A blurred Euro-vision.” The

Economist) Progress has been made in the field of financial regulation due to faster rule-making and stronger involvement of expert committees enabled by the Lamfalussy process, but important issues remain. An area not even touched upon in this paper are the complementary policy areas such as corporate governance, company law, accounting and auditing standards, and court system that are essential to the development of financial markets and are currently still fragmented in the EU (European Commission 2004b, p. 7).

As Grossman (2005, p. 145) concludes, “the hierarchy between jurisdictions is leading, and will continue to do so, to a replacement of ‘lower’ national and subnational jurisdictions where they exist by European-level agencies and institutions.” In conclusion, an effective handling of banking crisis in the European Union and an efficient common banking market (also through the realization of banks as *Societas Europaeas*) ultimately requires a more harmonized EU approach to banking regulation and an EU authority for supervision. As has been shown, such a true common market for financial services with level playing-ground and ensured financial stability in turn can only be realized if a more centralized approach to crisis management and resolution as well as harmonization of the safety net are pursued. Such developments would be key in reducing some of the most prominent externalities existing under the current regimes and thus opposition to change. As outlined, numerous members of the executive branch and the legislative branch on the EU-level (members of the EFC, the CEBS, the ECB, the FMA, the OeNB, etc. have been quoted above) are aware of the need for more central supervision and provision of the safety-net. It is the national legislators that continue to resist this transformation.

Three solutions, the transformation of banks into Societas Europaeas as well as a new supervisory approach through a lead supervisor and an EU regulator, respectively, have been discussed in this paper. Each approach has a lot of merit especially with respect to concerns about information exchange, a re-alignment of key functions of a bank and supervisory structure, and adequate consideration of pan-European externalities. Thus, issues with respect to normal times can be solved through these approaches. However, with each potential solution critical issues, especially with respect to the safety net and crisis management and resolution, remain unsolved. It is in times of crisis that the weak spots of these approaches appear, but it is exactly in these times that effective supervisory and regulatory environments and actions are most crucial.

As this paper discovers, the reorganization of European supervision is insoluble under the current legislative framework and can thus only be secondary to a change in the EU's approach to the safety net and crisis management and resolution. As Goodhart elegantly puts it, “[a]bsent [] a shift of the fiscal competence for crisis resolution to the EU level, calls for transfers of supervisory functions to a central, European body are, in my view, nugatory and little more than whistling in the wind. That brings us back to the question of how to share the burden of rescues when the relevant public authorities are national but the financial system is international.” (as quoted in Schoenmaker 2006a, p. 20) Thus, before thinking about the structure of EU regulation and supervision, a revision of the safety net to reflect the realities of a changed market is most important. Crisis management and fiscal responsibility need to be made fit for a more pan-European supervision. The advent of banking groups transforming into Societas Europaeas and a more wide-spread use of the ‘single passport’, resulting in an increase in branching

activity, as well as an increase in cross-border M&A activities makes the issue of safety net reform an immediate and critical need. CEE countries are especially affected by the currently weak supervisory system, heterogeneous regulations, and impeding changes in banks' organizations due to very high foreign ownership of their banking sectors.

The EU must therefore put two critical issues on its agenda: 1) a harmonization of safety net and resolution procedures for times of crisis and 2) the reformation of the supervision of banks during normal times and a re-alignment of supervisory and bank's organization, ideally through the establishment of an EU supervisory authority. Only after a solution has been reached on this first critical stage can discussion and implementation of new approaches to the cross-border supervision of EU-banks usefully proceed.

A first step towards the long-term option of an EU supervisory agency and the harmonization of safety net and crisis management and resolution facilities could be the adaptation of such a structure by the 12 EMU member states (EU-12). A central (EMU) supervisory authority operating like the ESCB and thus judging the effect of its action on an EMU-wide basis would limit externalities caused by its decision. Liquidity supervision can be centralized with this authority due to the existence of a common currency. Thus, the LOLR function can be administered by the ESCB. Furthermore, one deposit insurance scheme can be devised for the entire EMU area. In the short run, a feasible solution would be an 'ex ante' financing mechanisms that distributes costs of the deposit insurance to affected members states (through a pre-determined allocation mechanism based on, for instance, location where deposits were originally made). These costs can then be paid by the individual member states' own currently existing deposit

insurance scheme. Thus, such a solution would be neutral with regards to the structure ('ex ante' or 'ex post') and specifications (premiums, distribution of burden between banks) of national schemes and would therefore avoid the outlined problem occurring when banks are forced to switch between EU member states' schemes. Through this structure, the issue of the distribution of financial burdens in the case of a crisis is averted. Similarly, such an allocative structure could be used in the case of a recapitalization of a bank. Through the seigniorage of the ECB, the ESCB would also have a system to guarantee payments and LOLR provision.

Legally, such a structure would be possible through the invoking of Article 105 paragraph 6 of the Maastricht Treaty stating that states that

“the Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.” (European Union 1992)

A stumbling block for this solution might be the full harmonization of national laws concerning banking regulation and supervision, but it is certainly more realistic for 12 countries than for 25. While CEE countries currently would not be affected by this approach, Slovenia is expected to join the EMU in January 2007 and other CEE member states are soon to follow. Membership in the EMU and thus an EMU supervisory authority could thus solve many of the issues outlined above with a quick and relatively simple solution. It would effectively re-organize the safety net to re-align it with the reality of the financial industry, and simultaneously bring supervision and regulation to a trans-national level.

In the long run, a centralization of regulatory and supervisory power within the EU seems inevitable given the market structure of the financial industry and changes

likely to happen in the near future. Through the creation of the ‘single passport’ and the Societas Europaea, the EU has set the groundwork for the pan-Europeanization of its financial institutions. Now, it is time to follow suit with public policy to ensure financial stability and an efficient and competitive banking sector. As often, it may be time for a core group of EU member countries to forge ahead and plough a path for this centralization process. An EMU supervisory authority and safety net may just be the push necessary to demonstrate to national legislators that in the case of banking regulation and supervision, what is best for Europe as a whole may just be what’s most beneficial for each country involved.

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