EKONOMIA ECONOMICS 2(14) • 2011
ISSN 2080-5977

Ewa Miklaszewska
Jagiellonian University

THE CONSEQUENCES OF THE POST-CRISIS REGULATORY ARCHITECTURE FOR THE BANKS IN CENTRAL EASTERN EUROPE

Summary: Responding to the financial crisis 2007-2008, the global banking industry has been recently undergoing fundamental regulatory changes, imposed by the Basel III Agreement, the 2010 US Dodd-Frank Act, and the introduction of a new European supervisory architecture. The paper analyses the possible long-term impact of this new financial architecture on the banking sectors of CEE-5 countries. Poland and other CEE countries have not been directly affected by the crisis and had no need to fundamentally modify the supervisory structures as was the case in highly developed countries. Therefore, the aim of this article is to contribute to the discussions about the anticipated long-term impact of the new regulatory arrangements for bank stability and efficiency in CEE Countries.

Keywords: financial architecture, financial crisis, bank regulation.

1. Introduction

Although the 2007-2008 financial crisis affected the whole world, for the first time the leading industrialized nations were most affected, in this respect making the crisis unique [IMF 2010]. For many East European countries, the crisis was largely secondary in nature and banks in those countries turned out to be initially less affected. The term "Eastern Europe" is a very broad one and in many cases misleading, since it encompasses a number of groups, with a different degree of economic and financial developments:

– Central Eastern Europe (CEE): Poland, Hungary, the Czech Republic, Slovakia, and Slovenia, which have been EU members since 2004, including Slovenia (since 2007) and Slovakia (since 2009) in the Eurozone;
– Baltic Countries: Lithuania, Latvia, Estonia, in the EU since 2004, and Estonia, in the Eurozone since 2011
– South Eastern Europe: Romania and Bulgaria (EU members since 2007), and Croatia, Serbia, Bosnia and Herzegovina, Albania, and Kosovo;
– Commonwealth of Independent States (CIS): Russia, Ukraine and Belarus.

This paper concentrates on the relatively homogeneous group of Central East European Countries CEE-5 and pays particular attention to the possible impact of the post-crisis global financial regulations on the long term prospect within the CEE-5 banking sectors. Most CEE banks entered the crisis in sound shape, after successful restructuring in the 1990s and thus required less restructuring than their international owners. Moreover, most CEE banks had some experience in crisis management in the recent past: early 1990s or 1997-98, and the traditional intermediation bank business model, which dominates in CEE, in the end turned out to be the safest.

2. The banking sector in CEE-5

CEE-5 countries are at the similar stage of institutional development, financial and macroeconomic reform, and banking sector depth (see Figure 1). They share a number of common characteristics: large domestic markets, well-established legal and business rules and standards, young and educated workforce, and relatively fast economic growth, particularly in the pre-crisis period. They are open economies, with exports making up 60-80% of GDP, with the exception of Poland (less than 40%), which has the largest domestic market. The process of fundamental bank reforms, restructuring and privatization has now largely been completed in these countries. Consequently, CEE countries are also among the top most attractive regions for foreign investment [Ernst &Young 2007]. The share of foreign investors in the banking sectors exceeds 80% on average, with the exception of Slovenia (see Figure 2).

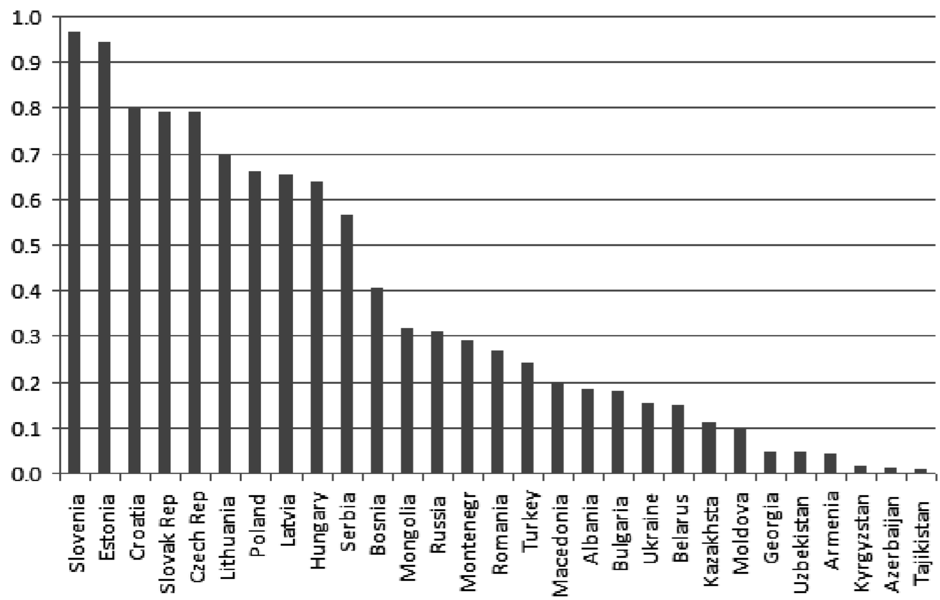

Fig. 1. Households with a bank account

Source: [Beck, Brown 2010].

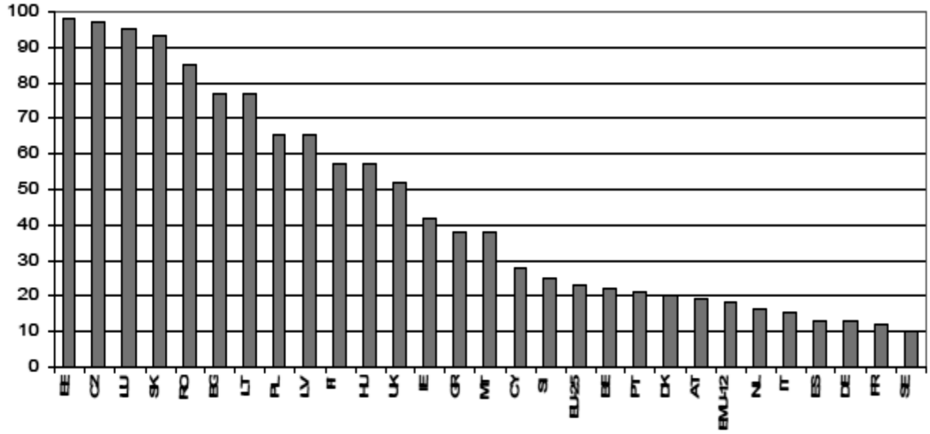

Fig. 2. Market share of foreign-owned banks (percent of assets)

Source: [Kudma 2009].

Despite numerous gloomy projections, the macroeconomic figures for CEE-5 countries remained good throughout the crisis and the banking sectors overall were less affected than in the EU and made an earlier return to profitability (see Table 1).

Table 1. CEE-5: Bank performance, selected indicators (%)

	ROA			ROE			NPL			C/I		
	06	08	09	06	08	09	06	08	09	06	08	09
Czech Republic	1.2	1.2	1.5	23.4	21.7	26.0	3.7	3.3	5.3	53	54	42
Hungary	1.5	0.8	1.1	23.8	11.6	14.8	2.6	3.0	5.9	54	59	42
Poland	1.7	1.6	1.2	22.5	21.2	11.8	7.4	4.4	7.0	63	57	56
Slovakia	1.3	1.0	0.7	16.6	14.1	8.4	3.2	3.2	4.3	57	60	57
Slovenia	1.3	0.7	0.5	15.1	8.1	6.3	2.5	1.8	2.3	56	55	59

Source: [ECB 2005-2009].

A relatively liberal financial sector combined with large foreign ownership is a distinguishing feature of new EU Member States. Poland has the largest and relatively low concentrated banking sector (see Table 2) and a sound financial system, with low dependence on sophisticated financial instruments and high leverage. Czech and Slovak banks were characterized by a very conservative funding structure, based on domestic deposits and focused on traditional banking activities. Hungarian banks displayed the highest degree of risk, stemming not only from high non-depository financing, but also from high dependence on foreign currency loans: 70% of the banking sector loans to the private sector in Hungary are denominated in foreign currencies [EBRD 2010].

Table 2. CEE: macroeconomic and banking key figures (2008)

	Banking Assets, bn Eur	Number of banks	C5	Loans as % of GDP	Total Loans as % of Total Deposits	NPL as % of Total Loans	% Share of Foreign Banks in Total Assets
Poland	262	70	44	46	118	4.5	67
Hungary	126	38	54	59	136	2.9	83
Czech Rep.	154	37	62	56	81	2.8	88
Slovakia	63	26	71	47	77	2.9	96
Slovenia	47	19	59	90	88	1.6	29

Source: [Raiffeisen Research 2009].

Foreign banks invested heavily in the CEE region right from the beginning of the transition period. At present, approximately 70% of the CEE banking market is controlled by foreign banking groups. Among large banks, only in Poland and Slovenia are there state or domestic privately controlled banks (see Table 3).

Table 3. Top 5 banks by assets in CEE-5 (major shareholder)

CEE-5:	1	2	3	4	5
Poland	PKO BP **(state)**	PeKaO SA (UCG)	BRE (Commerzbank)	ING BSK (ING)	BZ WBK (Santander)
Hungary	OTP (foreign diverse)	K&H (KBC)	CIB (Intesa SP)	MKB Bank (Bayern LB)	Raiffeisen (RZB)
Czech Rep.	Ceska Sporitelna (Erste)	Ceskoslovenska Obchodni Bk.(UCG)	Komercni Bk (SocGen)	UniCredit (UCG)	Raiffeisen (RZB)
Slovakia	Slov Sporitelna (Erste)	VUB (Intesa SP)	Tatra (RZB)	CSOB (KBC)	UniCredit (UCG)
Slovenia	Nova Ljubljanska Bk (State and KBC)	Nova Kreditna Bk **(state)**	Abanka Vipa (Local priv.)	UniCredit (UCG)	SKB (SocGen)

Source: [UniCredit Group CEE Research 2010].

Austrian banks were among the first to enter CEE, followed by Italian and later Belgian and French banks. However, investment in CEE also carried potential risks, mainly connected with macroeconomic imbalances, exchange rate volatility, and credit risk. As a result, major global players, such as Citigroup or HSBC, had a much lower level of involvement in the region than banks from neighbouring countries (see Table 4).

Table 4. CEE-17* largest players, 2008

	Assets, bn EUR	Countries of presence	CEE-17 % share of group assets
UniCredit (It)	121.6	19	12
Raiffeisen (A)	85.4	16	54
Erste (A)	79.3	7	39
KBC (Bel.)	71.6	12	20
SocGen (Fr)	65.9	16	6
Intesa SP (It)	42.5	11	7
OTP (Hun)	35.2	9	100

* CEE17: Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Lithuania, Latvia, Estonia, Romania, Bulgaria, Croatia, Bosnia-Herzegovina, Serbia, Turkey, Ukraine, Russia, and Kazakhstan.

Source: [UniCredit Group 2010].

Foreign currency borrowing constitutes a significant risk in all EE countries. At present, 15% of the private sector credit in the EE is either denominated in or indexed to foreign currencies, mainly the euro and the Swiss franc, compared with only 4% a decade ago. Before the crisis, many foreign-owned CEE banks refinanced themselves abroad and then passed on the currency risk to their clients. Macroeconomic stability and the expectation of currency appreciation after EU accession stimulated demand for such loans. However, FX exposure differs among EE countries: in 2007, unhedged foreign currency borrowing constituted more than 70% of all the private sector loans in Estonia, Latvia, and Serbia, it exceeded domestic borrowing in Bulgaria, Hungary, and Romania, but was relatively low in comparison to GDP in Poland, the Czech Republic, and Slovakia [IMF 2010]. Bank lending to unhedged borrowers exposed EE economies to systemic risk but, at the same time, it functioned as an engine for dynamic growth [Brown, De Haas 2011].

3. Building post-crisis financial architecture

Historically, banks accepted tight regulations in exchange for strong protection and as a result there were almost no OECD banking crises till the 1970s. Banks were safe but inefficient and were losing market share to non-banking firms. The period of liberalisation and deregulation since the 1980s has aimed at restoring bank profitability and facilitating expansion and, as a consequence, it has dramatically influenced the scale and complexity of banking firms. The dominant source of bank efficiency stemmed from expansion onto new markets, non-depository funding and the non-interest based sources of profits, and the adoption of new models for conducting banking activities, based on product synergies, scale and scope benefits, and global coverage [Acharya *et al*. 2011]. The increasing complexity of banks and the expansion of conglomerate structures generated synergies between banking (regulated) business and relatively unregulated investment activities offered both new sources of income and new areas of risk. The dominant tendency in banking strategies has been that of the universal bank [Fiordelisi, Molyneux 2006].

Financial supervision should ensure systemic stability, the efficient and transparent way of conducting transactions, and financial consumers' protection. To effectively carry out these functions, its organizational structure must evolve so that, like in real life, forms follows functions [Acharya *et al*. 2009]. The booming decades of deregulated global financial markets were crowned in 2004 by a new liberal regulatory regime, the so-called Basel II. In hindsight, it seems that Basel II was built on many wrong assumptions and incorrect trade-offs; namely, the assumption that regulators do not understand banking activities and that tight supervision can/should be replaced by market discipline [Allen *et al*. 2009]. Moreover, Basel II facilitated bank co-operation with and the growth of the so-called "shadow banking system" [Masera 2010]. Consequently, Basel II, which looked at isolated areas of risk and focused on partially recognized threats to financial stability, turned out to be an inadequate regulatory regime and, in the view of some people, it was responsible for the subsequent systemic failure.

The global financial crisis of 2007-2009 forced banks and regulators to rethink strategic and competitive issues in banking. The banks which for decades had been leaders in global efficiency or expansion turned out to be most affected, requiring massive public stabilization funds and, in some cases, rescue by direct government intervention. As a result, the crisis brought a new perspective and resulted in a new regulatory philosophy, posing at the same time new questions: Should we opt for global, regional, or national micro-prudential regulations? How important are macro-prudential regulations in dealing with systemic risk? How to address regulatory arbitrage from the shadow banking system?

After numerous consultations, in 2010 Basel Committee on Banking Supervision prepared a new agreement, the so-called Basel III, which was later approved by the political leaders of the G-20 meeting in Seoul in October 2010. Basel III focused on the strengthening of prudential regulations: raising the minimum level of capital to 7% (equity) and 10.5% (total) of assets in the period 2013-2019 and a more restrictive definition of capital. Macro-prudential regulation, particularly the question of how to deal with systemic risk and Systemically Important Financial Institutions (SIFIs), were left for further regulatory proposals by Financial Stability Board. Into this vacuum stepped EU and US authorities, proposing powerful and far-sighted new regulatory regimes. They were based on new macro-prudential regulatory institutions: European Systemic Risk Board (ESRB), chaired by the President of ECB, and in the US Financial Stability Oversight Council (FSOC), chaired by the Secretary of the Treasury, with the task to deal with systemic risk.

In the EU, ESRB is designed to ensure that macro-prudential and macroeconomic risks are detected and dealt with. Risks to the financial system can arise from the failure of one SIFI, but also by the common exposure of principal financial institutions to the same risk factors. The ESRB also has a duty to identify serious problems arising in a Member State, which could endanger EU financial stability. In this case, the entire European Council has to be alerted especially if the national authorities have refrained from taking the appropriate corrective measures. The main tasks of the European Systemic Risk Board are [Giovanini 2010; Beck, Brown 2010]:

– to establish adequate procedures to obtain the information about macroeconomic risks for financial stability;
– to identify macro-prudential risks in Europe;
– to decide on macro-prudential policy;
– to provide early risk warnings to EU supervisors and other relevant actors;
– to compare the observations on macro-economic and prudential developments,
– to determine how to achieve an effective follow-up to warnings/recommendations.

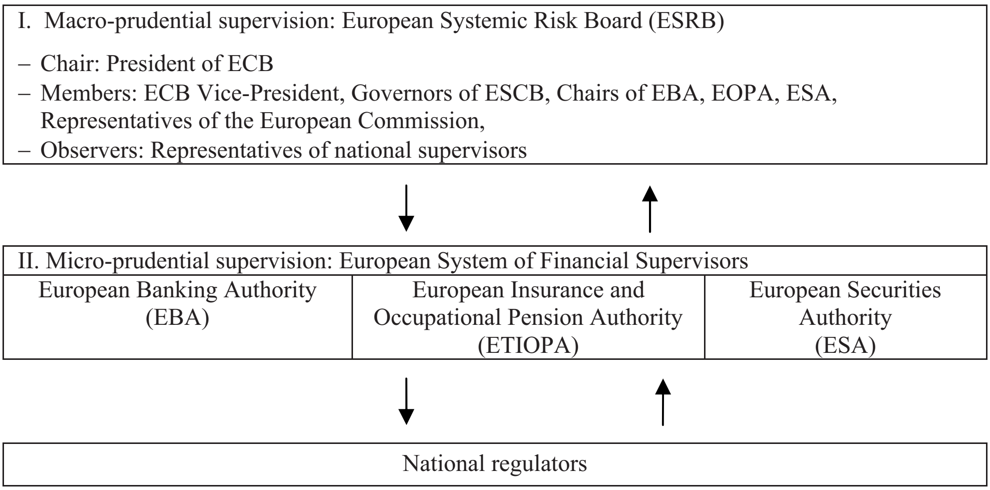

Fig. 3. New European regulatory architecture

Source: [Based on Masera 2010; Masciandaro *et al*. 2009].

4. New European financial architecture and CEE-5 banks. Conclusions

The short-term impact of the global financial crisis on CEE banks seemed to be small in terms of slowing down growth and diminishing banks' profitability and efficiency, without negatively affecting the overall stability of the banking sector. The long-term impact may in fact be much worse. The virtues of traditional banking in CEE-5 may be overstated, as a traditional bank business model may adversely affect long term innovativeness and growth, which is based on innovation and risk taking. The possible negative long term consequences may also be related to macroeconomic and market risk (currency volatility) and new business models of foreign banks (less risk, less product innovation, less competition).

Thus, a new question arises: Will new global and European regulations be beneficial to CEE, by creating more stable framework for conducting banking activities? The new EU and US institutional regulatory structures were based on the perceived need to deal with systemic risk as the major threat to financial stability. However, new post-crisis literature suggests that the 2007-2008 crisis in many cases was misdiagnosed as the liquidity problem, while the issues were the uncertainty about solvency and the wrong bank business models based on excessive leverage combined with funding longer term assets with short term liabilities [Nier 2010]. Moreover, macro-prudential regulations are needed if we do not believe that "strong banks create strong system".

There is a lively discussion about the merits of new micro-prudential regulations, whereas macro-prudential solutions are viewed as non-controversial, which may not necessarily be the case, particularly regarding CEE countries. Macro-prudential regulations and institutions entail considerable costs and regulatory burdens, particularly for countries for which systemic risk is a minor priority. Having joined the EU in 2004, CEE states are relatively new to EU decision-making processes and so tend to be rule-followers rather than rule-makers, and the new European financial architecture might just reinforce this, effecting in further marginalisation of CEE, as supervisory decision-making powers shift to European financial centres: London, Paris, Frankfurt.

To conclude, the new European financial architecture moves a series of decisions to a new, European level. European System of Financial Supervisors has far-reaching powers, potentially conflicting with national supervisory authorities. There may be some confusions as to the degree of authority and the overlapping areas of regulation. Member States are also reluctant to give up their autonomy and pass some responsibilities. The emerging complex structure based on a number of new regulatory agencies may not produce the desired, more efficient and stable European financial system.

Literature

Acharya V., Cooley T.F., Richardson M., Walter I., *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance*, Wiley, New Jersey 2011.

Acharya V., Wachtel P., Walter I., *International Alignments of Financial Sector Regulation*, [in:] *Restoring Financial Stability: How to Repair a Failed System*, ed. V. Acharya, M. Richardson, Wiley, Ney Jersey 2009.

Allen F., Babus A., Carletti E., *Financial crises: Theory and evidence*, “Annual Review of Financial Economics” 2009, No. 1.
Beck T., Brown M., *Which Households Use Banks? Evidence from the Transition Economies*, CentER Discussion Paper, www.tcd.ie, 2010.
Beck T., *Regulatory Reform after the Crisis: Opportunities and Pitfalls*, CEPR Discussion Paper, No. 7733, 2010.
Beck T., Coyle D., Dewatripont M., Freixas X., Seabright P., *Bailing out the Banks: Reconciling Stability and Competition*, CEPR Report, 2010.
Brown M., de Haas R., *Foreign Currency Lending in Emerging Europe: Bank-Level Evidence*, paper for the 54th Panel Meeting of Economic Policy, April 2011.
ECB, *EU Banking Sector Stability Reports*, 2005-2009.
EBRD, *Transition Report*: *Developing Local Currency Finance*, 2010.
Ernst &Young, *European Attractiveness Survey 2007*.
Fiordelisi F., Molyneux P., *Shareholder Value in Banking*, Palgrave Macmillan, New York 2006.
Giovannini A., *Financial System Reform Proposals from First Principles*, CEPR Policy Insight, No. 45, 2010.
IMF, *Survey Magazine: Countries & Regions*, ww.imf.org/external/pubs/ft/survey/so/ 2009/INT011409A.htm, 2010.
IMF, *Global Financial Stability Report*, Washington, DC, 2010.
Kudma Z., *The EU Financial Market Policy: Evolution, Innovation and Research Outlook*, Institute for European Integration Research, Working Paper, No. 4, 2009.
Masciandaro D., Nieto M.J., Quintyn M., *Will They Sing the Same Tune? Measuring Convergence in the New European System of Financial Supervisor*, IMF CEPR Policy Insight, No. 37, 2009.
Masera R., *Reforming Financial Systems after the Crisis: A Comparison of EU and USA*, “PSL Quarterly Review” 2010, Vol. 63, No. 255.
Nier E., *On the Governance of Macroprudential Policies*, FRB Chicago 13th International Banking Conference, September 2010.
Raiffeisen Research, *CEE Banking Sector Report*, RZB Group, June 2009.
Tonveronachi M., *Empowering Supervisors with More Principles and Discretion to Implement them Will Not Reduce the Dangers of the Prudential Approach to Financial Regulations*, “PSL Quarterly Review” 2010, Vol. 63.
UniCredit Group, *CEE Strategic Analysis*, CEE Research 2010.

SKUTKI POKRYZYSOWEJ ARCHITEKTURY REGULACYJNEJ DLA BANKÓW Z KRAJÓW EUROPY ŚRODKOWO-WSCHODNIEJ

Streszczenie: W odpowiedzi na kryzys finansowy w latach 2007-2008, w 2010 roku wprowadzono szereg nowych uchwał i powołano nowe instytucje, tworzące nową globalną architekturę regulacyjną rynku bankowego (Bazylea III, Dodd-Frank Act w USA, nowa europejska architektura nadzorcza). W artykule omówiono kształt i potencjalne skutki nowej architektury regulacyjnej, która zaczęła obowiązywać w Unii europejskiej od 2011 roku. Nowe regulacje makro- i mikroostrożnościowe są w dużej mierze wynikiem negatywnej weryfikacji dotychczasowych struktur nadzorczych w krajach wysoko rozwiniętych. Kraje EŚW nie były bezpośrednio dotknięte przez kryzys i nie miały takiej potrzeby modyfikacji struktur nadzorczych jak w krajach wysoko rozwiniętych, jednak musiały przystosować się do nowych rozwiązań. Dlatego też celem artykułu jest przyczynienie się do dyskusji na temat długookresowych, przewidywanych skutków nowych rozwiązań dla sektora bankowego w krajach EŚW.