Financial Markets in Central and Eastern Europe

Stability and efficiency perspectives

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1 Financial-sector development as a tool for EU accession

Luigi Passamonti

I am very grateful to SUERF for having invited me to deliver one of the opening addresses of this Colloquium with a reflection on the role of financial-sector development. But the organizers have also saddled me with a task that represents a big intellectual challenge for somebody that does not work in Brussels: to place my reflection in the context of EU accession. I am glad that SUERF pushed me to take this perspective. In making myself familiar with recent EU policy work, I realized how much EU solutions could help realize the full benefits of the reforms the accession countries have started with World Bank and IMF assistance thirteen years ago. I ask for your prior forgiveness if some of my observations regarding EU solutions are off mark.

The transition

Let me start with a quote drawn from a speech at a World Bank conference in 1990 by the Minister of Finance of a transition country:

> We ask ourselves how to unfold the whole process of economic transformation, how to sequence it. That is what we consider the most crucial problem. Then, when the transformation process has already started, as it has in my country, we ask ourselves how not to lose the momentum of the reform; how to build and maintain the necessary political and social consensus; how to maintain credibility of the reform policy; how not to cross the tolerance limit of the population; how to break down the old, unproductive. collectivistic social contract – how to transform it, how to rewrite it; and how to minimize the costs of restructuring in terms of growth, employment, inflation and so on.

These thoughts are indicative of the iron determination with which this Minister was looking at the multiple challenges of transition. He identified many problems. He did not have most solutions. He found them as he went along. He knew he would make mistakes. He did make mistakes.

He and others corrected these mistakes. His country will join the EU in 2004.

Seven additional countries successfully mastered the challenges of transition over the last decade. Two more, Bulgaria and Romania, are on the last mile to accession. Croatia is waiting to be admitted to the official race.

World Bank assistance

The World Bank has helped these countries cope with the transition with advice and loans in an aggregate value of about $15 billion, of which $2 billion have been used to support financial sector reforms through restructuring and privatization of state-owned banks and capacity building of supervisory authorities. EBRD, IFC and MIGA have also supported the transition with several billions of dollars of financial support to companies and financial institutions.

The World Bank's most recent activity has been to conduct thorough assessments of the financial systems of all ten accession countries together with the IMF as part of the Financial Sector Assessment Program. The results have helped the authorities fine-tune their reform strategies. They have also been used extensively by the European Commission to inform their assessment of the performance of financial sector intermediation and financial supervisory arrangements as part of their monitoring of countries' progress towards accession.

Financial sector reform: key to accession process

Without successful financial sector reform, a fundamental criteria for accession – an economy functioning on market principles – would not have been met. This has been a major accomplishment. To establish a proper legal and regulatory framework for financial intermediation activities and, within this framework, to have several hundreds of independent financial institutions mobilize and allocate the nations' savings in a profitable and sustainable way has been a very significant accomplishment – given initial conditions.

But I doubt it would be productive today to look backwards at what these countries have accomplished, even though the accomplishments are truly highly significant, especially if compared to those of other emerging countries at comparable level of GDP or of institutional development. Probably only Mexico can claim to have accomplished a similar overhaul of its financial system over a decade.

Obstacles to be removed

Much should be said, however, on obstacles that still need to be removed. The level of performance and efficiency of the financial sector is far from

EU levels. Eugenio Domingo Solans, a member of the Executive Board of the European Central Bank said recently:

> The traditional role of the financial sector in underpinning investment and realizing growth potential through its intermediation and governance functions is still very limited in most EU accession countries.

There is a long list of 'teething' problems. Private sector credit has not grown much and remains at a low level relative to GDP. SME lending accounts for less than 30 per cent of total loans, even though SMEs represent more than 60 per cent of employment and value added. Stock market capitalization and other measures of market-based finance (mutual funds, pensions, bonds outstanding) are low compared to international levels. Enforcement of laws and regulations is less predictable and less mindful of possible market impact than in the EU-15.

But I do not think either that it would be productive today to look at the further reforms needed with the transition lens – as if the race was soon going to be over. Transition is already over. EU accession is happening. I propose to change the lens of our assessment.

A post-accession perspective

Citizens of new member countries aspire to income convergence with the EU as quickly as possible. What are the pre-conditions for this process to continue? How long will this take? Do any of the strategies and approaches need to be adjusted to reap the benefits of EU membership more rapidly?

Income convergence will occur through the realization of productivity gains. They will be made possible by a range of improvements in how economic activity is organized, supported by sustained high levels of investment and organizational efficiencies gains. At the end of the day, each working citizen of the new member countries will need to produce a multiple unit of output than at present. Financial leverage will help accelerate the build-up of fixed and intangible assets that are necessary to support higher economic activity. It is estimated that less than 20 per cent of SMEs capital needs are now met by bank credit. External finance (i.e., private sector credit), whose stock today in the region amounts to approximately 40 per cent of GDP, will need to converge towards the EU level which is three-and-a-half times bigger, that is 140 per cent of GDP.

Of course, rapid credit expansion could happen in a few years. But the risk of creating a bubble through inadequate credit screening is high. The piercing of the bubble forces abrupt de-leveraging – that is, credit contraction. In this region, the memories of the rapid credit expansion in Finland and Sweden, followed by a sharp credit and output contraction, are still

vivid. In Finland the ratio of private credit to GDP moved from 55 per cent in 1985 to 95 per cent in just five years before settling back in 2000 to the level where it started 15 years before. In Sweden, after topping 140 per cent of GDP in 1993, it fell to 110 per cent in 1995 before resuming its upward trend.

Conversely, sluggish credit growth caused by extra-prudent banks sets back potential progress of society towards a higher level of personal welfare. It would be inappropriate for authorities to give the signal that credit risk underwriting standards need to be relaxed. Banks burdened with non-performing loans create many distortions in the financial system.

Even with a strong regulatory framework and supervisory practices, complemented by effective market discipline and supported by strong bank governance, sustainable credit deepening might be elusive.

Indeed there are intrinsic limits to how much capital domestic banks can effectively recycle in the local economy given the deposits they can mobilize, the returns available, the intermediation costs to be incurred, the risk profile of potential borrowers, the loan portfolio concentration risk and the equity base that shareholders are prepared to allocate to that particular business in the country.

What I am referring to is the issue of the size of the domestic financial system. In all accession countries, the individual size is very small. The biggest market is Poland: but the total assets of its 84 banks amount to US$120 billion – the size of the world's seventy-ninth largest bank which is the Commonwealth Bank of Australia. The smallest market is Estonia with US$2.6 billion. The overall size of the banking sector of the ten Central and Southern European accession countries is less than 2 per cent of the EU-15 banking sector. The size of the non-bank financial markets (insurance, pension and mutual funds) and of the equities and bond markets is even smaller relative to GDP.

The constraints of small financial systems

Small financial systems have special challenges. They are penalized by reduced network externalities in the payment and settlement infrastructure. Negative economies of scale apply to both this infrastructure and to the supervisory one. There is a higher cost per euro intermediated to support a small financial system than a larger one. And the policy capacity installed might not be sufficient to deal with emergency situations as it would in bigger markets.

Moving now from the system to individual institutions, the latter try to overcome the small size of the former by pursuing economies of scale in their individual operations. Hence, small systems have higher degrees of concentration than larger systems. But even large banks in small systems operate at sub-optimal scale as their overhead ratios are higher, compensated by higher interest margin spreads. This hampers deposit mobil-

ization. The small equity base constrains their risk appetite. Riskier borrowers are rationed out of the lending market. Loan portfolios are more risky because of a lack of sectoral diversification. Small countries use offshore deposit facilities more extensively than large countries, thus shifting liquidity abroad. Growth of non-bank finance and market-based finance is more constrained in small markets than in larger markets.

The future of market-based finance in small financial systems is questionable – other than possibly for the riskiest segment of small companies where local investors could have a role. Capital market infrastructure is already subject to international consolidation. Listings and liquidity migrate to few trading centres.

Benefits and beneficiaries of the EU single financial market

I believe EU accession offers a silver lining to the constraints of sub-scale financial systems and sub-scale financial intermediaries. The EU *acquis communautaire* is not a burden to be tolerated for the purpose of being admitted to the European club. The *acquis communautaire*, which is a fast-evolving body of financial sector legislation, could become the fulcrum on which to place the lever of a renewed financial sector development strategy for the new member countries.

The preparation for the EU single financial market, pursuant to the Financial Sector Action Plan, is moving at fast pace. And its implementation is not a matter for regulators. It has the attention of European Heads of State and Government. They are committed to complete it by 2005.

The vision of the single financial market is to create a borderless capital pool, mainly destined for wholesale operators. But the benefits of the economies of scale enjoyed by the operators could accrue to retail investors and small and medium-sized enterprises that have a limited range of choice within national boundaries.

I would like to quote a statement from Alexandre Lamfalussy when he submitted the report of his Wise Men Commission to the European Ministers of Finance:

> We urge governments and European institutions to ensure that there is an appropriate environment for the development of the supply of risk capital for the growing small and medium-sized companies. We believe that if our recommendations are followed and effectively implemented the primary beneficiaries will be those SMEs.

The benefits of a single market will be greatest to the users of those national markets that are the least integrated and the smallest. These are the new member countries.

In the new member countries, much more than in any other EU-15 country, the solution for credit and financial deepening could be found at

the level of the EU single financial market – and not within the boundaries of their small financial markets.

It is thus time to turn our sights away from the local shortfalls and start looking beyond the national boundaries at what the EU single financial market can provide. This should be the new lens of our assessment. And then we should go back and examine what each new member country needs to do in order to take advantage of the EU solutions.

We start from a good base: the new member countries have adopted a legislative and regulatory framework that is EU-compatible. And they have achieved a degree of financial sector integration with the EU-15 that is incomparably deeper than the one existing among EU-15 countries. In the Euro area, according to the EU Commission, less than 5 per cent of bank branches are owned by banks from other EU countries. In the new member countries, the percentage is of the order of 70 per cent, controlled by less than a dozen of international banks. In the Czech Republic, Hungary and Poland, the scale of cross-border financial intermediation is, in addition, already quite significant: it represents about 30 per cent of domestic private sector credit intermediation.

The benefits of the single financial market for the new member countries

What will the single financial market allow new member states to achieve? It will foster competition. And it will multiply the options for the provision of financial services. The multi-country presence of foreign investors in the region, combined with their leading position in their home markets, creates a connectivity tissue between the single financial market and the local markets for the benefit of local users – be they companies or individuals.

Local companies will have the option to borrow either from locally-licensed banks or from foreign branches or even from non-resident banks, which will be allowed to sell their services at a distance with a comparable degree of consumer protection.

But the biggest benefit for the new member countries, in my opinion, lies in the access for its residents – companies and individuals – to equity and bond investors and the associated institutional investor industry of the single financial market.

Let me give you some figures: Euro-zone investors hold un-intermediated financial assets worth about €25 trillion, of which €16 trillion are equities. As a comparison, the overall private sector credit of new member countries is €120 billion – a mere 0.5 per cent of the euro-zone asset base. A marginal reallocation of the euro-zone investors asset mix over the medium-term would provide the wherewithal for accelerated economic convergence of the new member countries. These are investors that are used to taking calculated risks as they operate in a very competitive market.

Is this just a dream? Yes, today. But it may become reality over the medium-term. With a single prospectus based on common accounting and disclosure standards and a rapidly converging securities market infrastructure, companies of new member countries will be connected to the diverse universe of investors across the single financial market that have a keener risk appetite and much stronger risk absorption capacity than domestic investors.

The credit risk underwriting considerations for a unit of credit risk in a domestic banking market, like Estonia, where three large banks control 91 per cent of the market with a combined €350 million capital base, are necessarily more restrictive than those applied, to same unit of credit risk, by a large group of investors each with total investable funds in the range of several hundreds of billion euro, even after taking into account the advantages of proximity for credit screening purposes of the domestic banks. The risk tolerance of large investors is bigger than those of small investors for a given unit of risk.

Also, securitization techniques allow the reduction of the risk profile of the unit of credit risk by creating a more diversified loan portfolio on the basis of post-credit approval performance information that the one that can be built *ex ante* on a piece-meal basis by any single bank.

Lastly, within the EU single financial market expanded to ten new member countries, intermediaries will be able to further lower the risk profile by assembling multi-country composite loan portfolios with even smaller credit risk co-variances.

Thus, it may not be far-fetched to think that the solution to SMEs' term borrowing needs in new member countries can be searched in the single financial market. I will speak later of the obstacles to be removed.

Moving now to the investing side, the mutual funds and pension directives will enable local residents, be they companies or individuals, to take advantage of the expertise, economies of scale and risk diversification offered by an industry operating at a global level. The advantage will be faster asset accumulation or lower pension contributions.

How to unlock the benefits? Considerations and obstacles

The benefits of the single financial market for new member countries could be very significant. How to unlock them? There are two background considerations. First, the pre-accession work focused on the adoption of legal and regulatory practices that are largely independent from the broad reform agenda represented by the fast-moving Financial Sector Action Plan. They reflect predominantly *stability* considerations. The main recipients are authorities. Second, the Action Plan has conversely a strong *development* orientation. It involves defining an architecture within which market forces will operate. The main beneficiaries are market participants and users.

And there are two sets of obstacles for the new member countries to reap the benefits of the single market. A first set of obstacles relates to the quality of enforcement of regulatory decisions pursuant to the *acquis* provisions. Lack of a consistent track record in enforcement will influence perceptions of market participants in this respect. Regular monitoring and continuous peer review assistance by the EU-15 will help bridge this perception and reality gap, if national authorities deepen their commitment to strengthening their capacity in this area after accession.

But, and perhaps more importantly, obstacles relate also to matters outside the scope of the core *acquis.* I refer to the effectiveness of the collateral, pledge, foreclosure and bankruptcy procedures. I also refer to the existence of local credit information and rating systems and to the reliability of the accounting and auditing professions.

Shortcomings in the functioning of these key elements of market underpinnings will prevent local borrowers from reaping the benefits of the single financial market. EU-15 investors will be reluctant to buy securities representing a portfolio of claims to small-sized borrowers of new member countries if they doubt the integrity of the prospectus data or if they fear that the servicing agent will face unreasonably protracted judiciary procedures to collect past due amounts. The most recent IMF study on financial globalization indicates that these elements, taken as a whole, enhance the absorption capacity of international capital flows by local financial systems and help recipient countries reap the benefit of financial integration.

These obstacles cannot be removed with the transposition of a new body of EU legislation, as was mainly the case on the way to accession. Their removal requires the identification of local solutions and the active involvement of a complex web of local institutions in their implementation. It is the evolution from law transplantation to institution-building. The former is much quicker than the latter.

A second set of obstacles relates to the fact that the new *acquis* under preparation per the Financial Sector Action Plan prefigures new ways of doing business at the EU scale without particular reference to the situation and the needs of new member countries. And the jury is still out as to who will be the winners and in respect of which strategy. It is, thus, a second evolution: from law transplantation to law-making in an uncertain context.

It falls on the new member countries, therefore, to assess how best to shape their local legislation so as to connect it with the new single market in a way that meets their specific national objectives in a context of strategic flux.

This calls for the formulation of new domestic financial sector development strategies. Where to start from?

A new financial sector strategy in new member countries: preliminary considerations

When launching this strategy exercise, it is important to clearly articulate the over-arching goal of financial sector policy. The main trade-off is between the welfare of the users and the preservation of the stability of the existing financial intermediaries.

Cross-border provision of financial products may benefit users, but it may also threaten local incumbents and shape new entry options in local markets in unexpected ways.

The relative shallowness of the domestic financial systems of new member countries is an opportunity to reflect on how one envisions the progressive deepening in its bank-based and market-based components. While the retail banking business has kept a local market bias, market-based products require the scale that an EU-wide market can provide.

But also on banking there are already indications, as Professor Issing of the European Central Bank has shown, that relationship banking in the euro-area, heretofore the predominant business model, might start to be eroded as a result of overcapacity and product diversification in the commercial banking sector leading to concentration and consolidation.

G-10 countries have looked hard at how the consolidation of financial services is impacting the transmission of monetary policy, the efficiency and competition of financial services delivery and, more particularly, the credit flows to small and medium-sized companies. The January 2001 report, though not conclusive in terms of strong policy recommendations, contains indications that these issues are on the watching brief of central banks.

Consolidation and concentration in small and open national financial systems with a large degree of foreign ownership pose special political challenges. One wonders if one should not pre-empt this concern and design a strategy that might have a lower likelihood of leading to further domestic concentration in small financial systems down the road.

Even in the most sophisticated EU national financial market, as arguably is the UK, there has been a protracted debate on access to financial services by SMEs. The latest Competition Commission report shows that the four largest clearing banks hold a 73 per cent combined market share of this segment. And that their average return on equity of this activity is 36 per cent p.a. – well in excess of their average cost of capital, which is 15 per cent. The annual excess profit is about €1.5 billion, equivalent to four times the capital base of Estonia's banking sector.

Therefore, it will be prudent to undertake a very forward-looking examination as to what options the new single financial market will provide for the new member states in terms of provision of cross-border financial services that will both preserve competition and enhance user's choice.

Full and open consultations

It is thus important in new member countries that the new *developmentally oriented* financial sector strategy and the ensuing new financial sector legislation, including the transposition of new EU directives, be formulated on the basis of full and open consultations – not only with local market participants and users but also with potential new entrants and alternative cross-border providers.

Only in this way will authorities have a comprehensive appreciation of the different vantage points and policy options available to better serve its citizens within the boundaries of the new single financial market.

Tommaso Padoa-Schioppa shed interesting light on the market development process. He said:

> Whoever, as I do, holds the view that freedom and responsibility should pervade the economic life, is inclined to let market forces do as much as they can to transform the structure of the market in an optimal way, not only carry on activities within a given market structure. . . . But it is crucial to be aware that market-led progress does require co-operation among economic (public and private) agents.

In the EU context, he clarified:

> Further financial integration can only result from an effective interplay between competitive market forces, co-operative efforts among market participants and the action of public authorities. Public authorities should act as both catalyst – fostering co-operation among market participants, whenever needed – and as regulators.

Participatory practices are still more the exception than the norm in most accession countries. Law and regulation making is still seen as the undivided privilege of the authorities. Market participants are rarely consulted. When they are consulted it is with little time to provide a response. And the text submitted for consultations is often in final form with an inner logic that cannot accommodate changes without a comprehensive re-drafting. Finally, market participants are not yet organized to be an effective partner of this dialogue with authorities.

In this context I am pleased to announce that EBRD and World Bank are preparing an initiative, called 'Convergence', that aims at assisting authorities in engaging with and harnessing the incentives of market participants to prepare further financial sector reforms. Although its target area of operation will be individual countries in South Eastern Europe, its know-how and experience could be shared with the new member countries.

'Convergence' will aim to replicate the principle and practices of open

and full consultations with market participants and users that has become part and parcel of the EU legislative process as recommended by the Lamfalussy Report. 'Convergence' will help prepare draft laws and regulations that meet public policy objectives with a lower likelihood of hampering or distorting market functioning.

Open discussions help establish a consensus on how public policy could best be shaped to meet the challenges of building a financial market. Prior consultations foster ownership by market participants of the solutions retained. And when this public–private collaborative method is well established, authorities could make their convening power available to help market participants find collaborative solutions that enable further market growth – in terms, for instance, of standardizing credit documentation, payment solutions and financial market practices. The European Central Bank has been very innovative in this respect.

Strengthening financial sector stability

Effective financial system integration of the new member countries with the EU requires continuous work to ensure that the financial stability infrastructure is seamless across the single market. Supervisory practices still differ. It is a big challenge to strengthen them as markets, market practices and institutions change so rapidly. This creates challenges even for the most sophisticated supervisory authorities in the EU.

Market discipline can and should complement official supervision. Transparency and disclosures are key. But there are more elements to it. As Andrew Crockett once said:

> For market discipline to be effective, four pre-requisites have to be met: First, market participants need to have sufficient information to reach informed judgments. Second, they need to have the ability to process it correctly. Third, they need to have the right incentives. Finally, they need to have the right mechanisms to exercise discipline.

Too often has market discipline been seen as a proxy for debt holders selling uninsured instruments in response to a perceived worsening financial condition of the issuer. But market discipline can and should also be equity-based. And not only in terms of acting on the price signalling, but also and more importantly on the actions taken by shareholders and boards to protect the viability of the financial institution. I am referring to the issue of 'bank governance'.

More emphasis on bank governance

Supervisory policies and practices tend to under-rate the potential contribution of effective boards to financial stability. Particularly in jurisdictions

with a less-than-consolidated pattern of relationship between supervisor and supervisee (as in the new member countries, also because of the significant number of new foreign investors), an effective board can have a vital role in strengthening the checks and balances system. By effective board I mean a board that is clearly the principal locus of accountability for the stability of the financial institution. It means that its membership has to have the capability, motivation and authority to act independently from management. In this region, too few financial institutions have the pre-requisite in place for board effectiveness: non-executive nature, in substance, of its members and a sufficient number of them being independent from majority shareholders. When one combines this situation with the fact that supervisory authorities are unclear as to how to assess the effectiveness of the parent's management oversight and the value of their financial responsibility for the local affiliate, one derives a sense of discomfort for the quantity of new risk and the pace of build-up the system can sustainably cope with.

I believe that it would be important for national supervisors to look for ways to help boards and shareholders take on more oversight responsibility for financial institutions. One could envisage being able to draw on a combination of incentives and enforcements to promote this change of practices. Supervisors could envisage sharing appropriate information with boards and shareholders on the financial condition of the bank, the adequacy of its risk management architecture and practices and an assessment of senior management actions. Similarly, they should keep the boards accountable for their oversight actions or lack thereof.

A last remark: we have observed that where bank supervisors promote bank transparency and thus induce private sector monitoring of banks, credit access conditions improve.

Conclusion

Financial-sector development in new member countries will be key to sustaining rapid convergence of income levels with old member states as much as it has been to enabling EU accession.

In its first progress report on enlargement in 1998, the EU Commission wrote: 'Taking the two criteria together, that is the existence of a market economy and the capacity to withstand competitive pressure and market forces within the Union, it can be said that none of the applicants today fully meets the Copenhagen criteria.' Three years later, one year before the 2002 Copenhagen summit, the Commission stated that the eight first-wave accession countries were functioning market economies. This attests to the vitality of the new member countries.

It is thus possible for the new member countries to become beneficiaries of the EU Financial Sector Action Plan. This would be a somewhat unexpected outcome. When the Plan was launched in June 1998, the

enlargement process was still in its infancy and spurred mainly by political considerations.

EU membership, at a time of a rapidly evolving regulatory framework, combined with a freshly re-configured financial system, characterized by significant ownership links with old EU member states, is the platform for a potential leapfrog in financial sector development.

The vision for a new financial sector development strategy in the region could consist of the following:

- to include explicit considerations of the welfare of the citizen and credit access for the SME in the definition of the guiding policy principle for the strategy;
- to develop a policy formulation tool that allows the identification of least-cost provision options from EU providers (this involves launching open EU-wide consultation processes);
- to accelerate the upgrade of domestic legal, corporate governance, accounting and auditing standards and practices so as to ensure the connectivity of local institutions and firms to the single financial market;
- to adopt measures to favour the establishment and the sustainable operations of small community banks to complement financial services provided cross-border for the benefit of the small user.

This is a major exercise. National authorities and the EU will lead it. But it requires the involvement of many players – also, and in particular, of market participants.

As an old City of London adage goes: 'Markets are not created by rules and regulations; they are created by market participants'. In the new member countries, authorities will need to tap into the experience, energy and incentives of all those that have a stake in this process and can contribute to helping define the new rules of the game.

I am sure that the richness of the deliberations of this three-day Colloquium will help to create the momentum for the launch perhaps of a New Members Financial Sector Action Plan!

Thank you very much.